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Programmed Lending for Social Policies
-Challenges for the Vietnam Bank for Social Policies-

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* Recent information regarding the VBSP has been obtained by the author through the JBIC-financed research conducted in February and July 2003. The distribution of this report has been given permission by the JBIC.

Contents

AFC	Agriculture, Forestry and Fishery Financial Corporation in Japan
BAAC	Bank for Agriculture and Agricultural Cooperatives
BIDV	Bank for Investment and Development of Vietnam
CSG	Credit and Savings Group
DAF	Development Assistance Fund
GTZ	Duetsche Gesellschaft für Technische Zusammernarbeit
ICB	Industrial and Commercial Bank of Vietnam
IMF	International Monetary Fund
JBIC	Japan Bank for International Cooperation
JERI	Japan Economic Research Institute
MARD	Ministry of Agriculture and Rural Development
MOF	Ministry of Finance
MOLISA	Ministry of Labor, War Invalids and Social Affairs
MPI	Ministry of Planning and Investment
NFLC	National Life Financial Corporation
NPL	Non-Performing Loan
ODA	Overseas Development Assistance
OPEC	Organization of the Petroleum Exporting Countries
PCF	People's Credit Fund
SBV	State Bank of Vietnam
SME	Small and Medium-sized Enterprise
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise
VBARD	Vietnam Bank for Agriculture and Rural Development
VBP	Vietnam Bank for the Poor
VBSP	Vietnam Bank for Social Policies
VND	Viet Nam Dong
VPSC	Vietnam Postal Savings Company
WB	World Bank

1. Introduction

The intention of this report is to describe and analyze the features of the lending system of the Vietnam Bank for Social Policies (VBSP), established recently. A number of problems with said system are discussed. In addition, through the analysis of the VBSP lending system, suggestions for improvements are offered.

The basic mission of the VBSP is to provide low interest and accessible financial services to the residents and rural communities that have been left behind during the steady growth of the Vietnamese economy in recent years, in an attempt to narrow the gap that has emerged and to alleviate poverty. Whilst these objectives are essentially appropriate, the financial services provided by the bank all represent so called “subsidized credit”, which inevitably gives rise to doubts concerning the sustainability of its system. In addition, the compounding of industrial policy objectives, the integration of risk alleviating measures within the lending program, and the involvement of the politics, arouse another problems. Inevitably, the characteristics of financial services provided by the VBSP are complex by nature. This report aims to clarify the issues involved and to seek specific measures that may contribute to improving the *modus operandi* of the VBSP.

Generally speaking, there are not so many examples of financial institutions dedicated to delivering social policy credits in low-income countries, thus an analysis of the characteristics of the lending systems involved is also considered to be of profound interest from an academic perspective.

The materials used in compiling this report were predominantly sourced from information acquired during JBIC surveys on Vietnam’s financial sector conducted in February and July 2003. The February survey was designed to explore rural finance in Vietnam in the context of the provision of ODA. The survey concentrated on reviewing the performance of the various rural financial institutions in Vietnam, with a specific focus on the newly established VBSP. However, since the VBSP had only been operating for a short period at the time, the decisions on the content of the various lending programs and the transition from the old into the new system were as yet far from completion. Accordingly, a supplementary survey was undertaken six months later in July.

Prior to the July survey, a list of questions was sent to the VBSP headquarter in Hanoi with a request for answers to the questions to be furnished in English. The survey comprised interviews based on the answers provided together with additional inquiries. The questions sent to the VBSP concerned the details of the lending programs offered, the sources of the bank's funds, its plans for annual loan disbursement as well as outstanding loans, the profit and loss statement, and the costs for establishment of the system including branch offices network.

The survey team also visited related organizations (the World Bank 4 times, IMF, GTZ, and VBARD), which provided the opportunity for exchanges of opinions with experts on rural finance in Vietnam and on the banking sector in general. An interview was also undertaken at the Tran Yen district branch of VBSP located in Yen Bai Province. Through these studies and the discussions with ODA experts, it was possible to gain an understanding of the basic aspects of the VBSP's operations.

Notwithstanding, the information obtained during the surveys remains incomplete. In the preliminary stages of the survey, the aim was to obtain figures for the costs of setting up the systems as those needed for annual ordinary operation, and to analyze the quantitative relationship between costs and benefits.[1] However, it was not possible to obtain the necessary figures to perform this analysis. Besides, changes to the content of some of the bank's lending programs are slated for future discussion (the Job Generation Program and the Lending Program for Policy Beneficiaries in Difficult Areas), thus several information is not on firm ground.[2]

The reason for the shaky data obtained is, in the first instance, that there has been insufficient liaison among the ministries and institutions involved in the different lending programs to date. Although the establishment of the VBSP was made official by a decision of the Prime Minister in October 2002 and the bank opened its doors to customers in January 2003, integrating the lending programs operated by a number of separate institutions within a single bank is no mean accomplishment.[3] Consequently, a mere six months down the line,

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[1] In this instance, the measurement of the Subsidy Dependency Index (SDI), a tool developed by Shreiner and Yaron (2001), was forefront. Although it is hard to apply to cross-country or intertemporal comparisons of financial institutions, the index is premised on accurate, figures-based management as well as ensured transparency and disclosure of accounts information. It is suggested that information disclosure by the VBSP and figures-based management control were both insufficient and that this prevented us from obtaining the information necessary to calculate the SDI.

[2] Of the lending programs offered by the VBSP, it was not possible to obtain sufficient information on loan disbursement, the details of the loan procedures, etc., on the predecessors to Program 5 (Loan Program for Policy Beneficiaries in Difficult Areas) and Program 6 (Housing Loans to residents of the Mekong River Delta and Tay Nguyen). It is hoped that further studies of these programs will be undertaken in the future.

[3] "Policies also need implementing regulations but those regulations often lag behind the issuance of the Government's resolutions and decrees, leaving the practitioners in the field at a loss about the implementation."

there are specific aspects of VBSP's operating system that have yet to be consolidated. The blueprint for the bank's lending portfolio and loan recovery plans remains vague giving rise to the possibility of some wavering in the figures per.[4]

In the second instance, the out-dated modus operandi of the VBSP is considered to be problematic. There were some misgivings regarding the reliability and transparency of the figures included in data received from the Bank. It is thus believed that the defects in the accounting practices used by VBSP's predecessor, the Vietnam Bank for the Poor (VBP), have yet to be eliminated. If the VBSP is to remain viable as a bank, every effort must be made to improve its competence as a financial institution. Efforts must include the improvement and disclosure of its accounting system.[5]

In any event, it should be kept in mind that for the reasons cited above the information obtained by the survey mission is by no means complete, and that the contents of this report may be subject to partial revision (although any changes are unlikely to be substantial); the report may also contain some erroneous and/or altered figures.

2. Background of the establishment of the VBSP

2.1 Increasing necessity of social policies

It is widely known that the *doi moi* (renovation) policies have stimulated rapid growth in the Vietnamese economy. The percentage of the population below the poverty line has dropped and living standards have widely improved (WB [1999]). The problem lies in the widening economic gaps, both in relative and absolute terms, between urban and rural areas, between lowlands and mountainous regions, and between the majority Kinh and other ethnic groups (WB [1999], Izumida and Shindo [2001], WB [2002b]).

It is believed that either the government or the people of Vietnam cannot ignore these gaps. The following two reasons may be offered in this connection.

(JBIC [2003a], p. 93). The same mechanism is in action in the case of the VBSP.

[4] A number of Japanese research bodies conducted interviews at the VBSP either in parallel to or as a follow-up on the JBIC survey of February. The details of the interviews are included in a number of published reports (JBIC [2003a], JBIC[2003b], NFLC [2003], JERI [2003]) with slight discrepancies in the explanations and figures provided by each of the organizations.

[5] This is in concurrence with the following comment. "But these institutions (the Social Policy Bank and the Development Assistance Fund [DAF]) need a transparent legal framework to function in a prudent manner." (Mid-year Consultative Group Meeting [2003], p. 30)

Firstly, Vietnam is a country of socialism, where equality is most fundamental. When all the people were equally poor, there were no special concerns for social policies. However, the economic growth that accompanied the introduction of a market economy saw the collapse of the equality principle upheld by the nation, and the socialist government was unable to overlook the widening economic gaps that began to emerge.

Secondly, social policies generally increase after one nation's surpassing certain level of economic development. After reaching a certain level of GDP per capita, policy-makers and people recognize that social issues, such as poverty and unemployment, first start to emerge, are too serious to be ignored. It is also a given that securing the funds required to implement social policies requires a certain level of economic activity. In Japan's case, social policies did not achieve critical mass until the 1930s and no special compensatory policies were adopted during the initial stages of economic development.

In addition to the two reasons cited above, it is also necessary to heed the fact that the transition to a market economy has increased economic and social risk in Vietnam. In a market economy competition serves to separate the strong from the weak. It weeds out the losers, whilst corporate restructuring makes unemployment an everyday occurrence. Furthermore, the risks involved in economic activity are magnified as the national economy becomes more integrated with the global economy. In the agricultural sector, increasing participation in international markets leaves farmers open to greater risk from competition and price fluctuations, and creates many difficulties for farmers. Moreover, Vietnam is hampered by the absence of comprehensive social security system. The people have been convulsed by the increased risks and the government is being pressed to come up with countermeasures.

However, there are slight discrepancies between the financial policies and the risk countermeasures employed as social policies and the two cannot be taken as analogous. Some of the lending programs offered by the VBSP would seem to represent a combination of the two, in principle, the provision of credit and countermeasures for risk need to be debated as separate issues.

2.2 Separation between policy and commercial lending

The establishment of the VBSP must be considered in the light of the long-run financial reforms that have been undertaken in Vietnam (Tran Van Son [2001], WB [2002A], SBV [2002]). Due attention must be paid to this point.

Post *doi moi* reforms to the banking sector in Vietnam are understood to have commenced with the transition from the mono bank system of a planned economy to a financial system in line with market economic principles. With this transition came increasing liberalization of the banking sector, the abolition of interest controls and attempts to minimize government involvement in the operations of the State-Owned Commercial Banks (SOCBs). In a planned economy a state control approach is taken to investments made by the State-Owned Enterprises (SOEs) that lead the nation's economic activities and the procurement of the funds necessary to achieve this. It follows, therefore, that the operations of the SOCBs, which were established under the guise of the post *doi moi* financial reforms, also included numerous aspects of the planned economy system. Public investment financing for infrastructure development, lending to SOEs, and policy financing are representative aspects. The Bank for Investment and Development of Vietnam (BIDV), for example, was responsible for administering public investment financing. Similarly, the lending services provided by SOCBs like the Vietnam Bank for Agriculture and Rural Development (VBARD) incorporated both state directed lending and commercial loans qualifying for state planning programs (VBARD [2001]). To give an additional example, the VBSP's main predecessor, the Vietnam Bank for the Poor (VBP) established in 1995, was, to all intents and purposes, controlled by VBARD (SBV [2002]).

Providing policy lending via the SOCBs was convenient for the state. One merit, for example, was that providing credit to poor households via VBARD was inexpensive. There were various problems, however. Since the commercial banks employed no full-time staff to handle policy lending it was not possible for responsible activities to be undertaken, nor was there any division between the policy lending activities and the commercial bank's own lending activities, which forced the commercial banks to shoulder an excessive work load (SVB [2002]). Again, it appears that the commercial banks were keen to graduate away from the "slipshod accounting practices" employed in the provision of both policy and commercial lending. It is generally conceived that the state directed lending to the SOEs was a key factor behind the non-performing loans (NPL) portfolio of the SOCBs.

Under these circumstances, the government mapped out a policy to separate policy lending from commercial lending, establishing the Development Assistance Fund (DAF) as the financial institution dedicated to public investment (for details of DAF see Mori [1998], Koyama [2001], and JERI [2003]), and the VBSP as the financial institution with specific responsibility for social policy lending.

The separation of policy and commercial lending was a desirable development in Vietnam's banking sector and deserves detailed investigation since the principles involved do not necessarily coincide with what happens in practice. In this respect, the author would like to comment on two matters.

In the first instance, the establishment of a policy bank with its own branch network is not necessarily essential to the separation of commercial banking and policy lending. It is possible to guide funds into a specific sector in the form of interest subsidizing through existing banks (naturally funded by the private sector). In fact, private sector funding is used to provide funds for Agricultural Modernization Program and Disaster Relief Program in Japan, with interest subsidizing for promoting agricultural mechanization and policy responses to natural disasters. In such cases, government involvement is, in principle, limited to the provision of interest subsidies and the financial institutions extending the loans are required to bear the risk of any delinquency that occurs. In addition, it is possible to keep the organization of policy banks to a minimum by consigning lending operations to commercial banks. As is covered in more detail later, given that the VBSP utilizes both direct and indirect lending through commission, the building a network comprising more than 600 branches cannot be fully justified.

Secondly, although progress has been made with the separation of policy and commercial lending in Vietnam, much of the policy lending undertaken continues to be provided via the SOCBs. According to SBV [2002], the VBARD is responsible for the Sugarcane Program and the On-stilt Housing Program, whilst the BIDV supervises the ships for oil transportation program and the offshore fishery and sea products processing program. Other policy lending schemes include the five million hectare reforestation program and the aquaculture program, which are directly funded by credit from the state. These are outstanding policy lending programs.[6]

There are other forms of lending with the aim of supporting policy objectives that are not covered by SBV [2002]. For example, when coffee prices crashed, between 2000 and 2001 the Ministry of Agriculture and Rural Development (MARD) started the emergency program for purchasing coffee to forestall a sharp fall in the coffee price (Idei [2003]). The MARD requested SOCBs to be in charge of providing loans for coffee purchasing to SOEs. This emergency coffee buying program was a resounding failure as it only served to push the price of coffee even lower and the SOEs involved lost vast sums of money.[7] The government set out a fiscal support policy for the SOEs (July 2002) under which many forms of assistance

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[6] Of the social policies funded by state credit, Program 135 and the Job Generating Program have been transferred to the VBSP. See section 3.3.

[7] These short term hoarding loans of rice, coffee, and other agricultural products have been replaced, at least partially, by the short term export promotion credits under the DAF scheme established in 2002 (JBIC[2003b]).

such as debt moratorium or “debt freezing”, were provided (Idei [2003]).

Inevitably, the impression given is that the Vietnamese government tends to resort to policy programs involving this type of funding with remarkable ease. As the country moves towards the separation of policy and commercial lending, a key issue for the future will be to find an appropriate way to remove the policy programs mediated by the SOCBs.

3. Establishment of the VBSP

3.1 Basic mission

The VBSP was established against this background on October 4, 2002 by a decision of the Prime Minister (131/2002/QD-TTg). It commenced operations in January 2003.

The VBSP is a non-profit organization charged with programmed lending, and as cited above, its main predecessor was the VBP. The VBSP’s services have been diversified and are being extended via new mechanisms. The specific lending programs are elucidated in section 3.3, however, as the bank’s name suggests, its primary objective is to contribute to specific policies (predominantly social policies) through the provision of credit.

The bank’s Board of Directors (BOD) comprises twelve members and is chaired by the Governor of the State Bank of Vietnam (SBV). Board members include vice-ministerial level officials from relevant government offices including the Ministry of Finance (MOF), the Ministry of Planning and Investment (MPI), the MARD, and the Ministry of Labor, War Invalids and Social Affairs (MOLISA), as well as the vice presidents of the Vietnamese Women’s Union and the Farmers’ Association, and the Governor of the VBSP; the BOD is responsible for supervising the operations of VBSP. Similar boards have been set up to support VBSP operations at the provincial and district level.

The VBSP is granted numerous privileges by the government. It is not required to have any reserve funds or to take out deposit insurance (national), and it is exempt from taxation. According to the interview with SBV, the notable characteristic of VBSP credits is that borrowers are required to offer a fund use plan and are able to borrow 100 percent of the sum required.

Not only does the bank extend credit, it also accepts deposits, issues government guaranteed bonds, receives domestic and foreign assistance, and offers account settlement services. It can also commission financial institutions and mass organizations to undertake these operations.

The bank receives its funding from a variety of sources, including the state budget, borrowings from the SBV and other institutions, and deposit quota from SOCBs. The bank's charter capital comes from the state budget and funds of the Hunger Eradication and Poverty Reduction Program are utilized. It was written that public finance surpluses at all levels could be mobilized. Besides, ODA funds (with prospective awards) are also specifically listed.

The bank's deposits comprise accounts mobilized by the VBSP itself plus a quota from other financial institutions.[8] The quota is two percent of the domestic deposit portfolio as of the end of December in the preceding year. The Prime Minister has the right to change the two percent figure. Banks bound by the quota are paid their annual average interest rate plus a reasonable deposit commission. The VBSP is also permitted to accept interest-free deposits from volunteers.

The bank has borrowed funds from the SBV and domestic financial institutions. It should be noted that its borrowings also include loans from postal savings and from the Vietnam Social Insurance Fund. At the time of its establishment, the VBSP had a charter capital of VND 5,000 billion (Prime Ministerial Decision 131).

The VBSP extends credit directly and indirectly via agent banks. It has established branches in all the provinces and at the district level (although not all districts are served by their own branch) and its direct lending activities now account for a specific share of the loan portfolio. The bank pays commission to agent banks. For example, the rate of interest on loans to poor households is 0.5 percent a month; however, of this sum 0.35 percent is paid to the agent bank and 0.1 percent is handed over to the local Credit and Savings Group (CSG). However, the risk is not shared between the trustee (VBSP) and the agent. In short, should a borrower be unable to service their debt, the agent bank is under no obligation to repay the outstanding sum to the VBSP .[9]

The purposes of loans are centered upon production, but those for daily consumption are permitted. Naturally, loans to students can be used to cover school fees and other related expenses. Maturity periods are determined on the basis of how the loan is to be used, and in

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[8] Apparently the quota measure was based on studies of foreign cases. It is believed that policy makers were aware of the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand.

[9] In the case of Japan's Agriculture, Forestry and Fishery Financial Corporation (AFC), the agent bank is required to shoulder some of the risk, although this depends on the credit program involved. For example, on loans for basic agricultural infrastructure the agent bank must guarantee to pay a sum equivalent to 20 percent of the unpaid principle and interest. However, in case of program loans aiming at protecting owner farmers (Program Loans for Supporting Owner Farmers, that is heavily redolent of farm household protection), agent banks are not required to share any of the risk on such loans. See Izumida [1995].

some instances the capacity of the borrower to make repayments is also considered. A penalty interest rate of 30 percent higher is applied to borrowers who are unable to repay their loans within the maturity period.

Problems lie in the handling of cases in which repayments become impossible due to "objective causes".[10] "Objective causes" include natural disasters, fires, contagious disease, and changes in state policy, as well as fluctuations in market prices. When the economic damage sustained as the result of an "objective risk" is widespread, the Prime Minister determines measures to deal with the issue. When the damage is sustained at the individual level or in a specific region the losses are absorbed by VBSP's risk reserve fund (0.02 percent of its average loan balance). In other words, when a borrower falls into insolvency due to an "objective cause" their debt will be frozen or "rescheduled". The problems with these measures are discussed later.

3.2 Network

The VBSP's network was also an ambitious undertaking for a newly formed social policy bank. The bank has 61 provincial level branches and 548 of a lower level. These latter were referred to as transaction offices in the responses to our questionnaire, however, they probably also include some district level branches. The VBSP does not have any mobile bank at this time. As of the end of June 2003, the bank had a payroll of 2,628 employees, of which some 100 are assigned to the head office. Clearly, the VBSP has employed a considerable number of dedicated staff. Apparently, at least 1,048 staff were taken on from the VBP, however, this figure may not be reliable. It is not clear how many (what percentage of) staff were transferred from the VBARD, but the number is believed to be quite considerable.

It was not possible to obtain data on the costs involved in establishing the VBSP. System set-up costs, including the costs of construction of branch offices, are believed to have been substantial, but the figures had not been made public at the time of our survey.

3.3 Lending programs

As of July 2003, the VBSP offered six lending programs as follows: (1) Loans to poor households, (2) Loans to disadvantaged students, (3) Loans for promoting job generation (Resolution No. 120/HDBT, dated April 11, 1992), (4) Loans to foreign migrant workers, (5)

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[10] Individual delinquency or that due to managerial incompetence is referred to as being the result of "subjective causes".

Loans to policy beneficiaries in difficult areas (in Regions II and III and communes covered by Program 135), and (6) Measures for policy beneficiaries who borrowed loans for house construction / renovation in the Mekong River Delta and Tay Nguyen (central highlands).

The conditions for each of the programs, including target groups, maximum loan sizes, and interest rates are given in Table 1. However, the author would like to provide some detailed explanations making reference to this table.

(1) Loans to poor households

In this instance, the maximum loan size is VND 7 million and maturity periods are between 1-3 years. A proposal has been made to increase this loan size to VND 10 million in the near future. Interest is generally charged at a rate of 0.5 percent per month. However, a monthly rate of 0.45 percent is applied to borrowers in Region II (mountainous terrain, remote islands) and Region III (which is even more inaccessible than Region II). Poor households are not required to place the collateral of their loans, but eligibility to borrow is based on selection of the communal Credit and Saving Group (CSG) and on the list of poor households compiled by the communal level People's Committee.

It should be noted that the poor households targeted by this lending program do not necessarily belong to the poorest quintile. In the commune located in Quang Xuong District, Thanh Hoa Province visited by the author in October 2002, there were poor people living in extreme conditions due to disease, disability or lack of workforce. These people are not classified as poor but in a lower rank ("extremely poor" or "hungry") and have not been reached by VBP credit services. They carry certificates showing that they belong to the poorest quintile (people classified as "poor" also carry these poverty certificates) and are eligible to receive a number of special treatments such as discharge of medical expenses and child education, and exemption of tax payments.

According to the responses provided by the VBSP to our questionnaire the lending procedure for this loan program is as follows.

At the initial stage, the poor household must prepare a loan application and submit it to the leader of the CSG. After the CSG receives a loan application from a member it then determines that member's eligibility to receive VBSP credit. In addition, it submits the list of poor households and the application form to the communal People's Committee. The People's Committee then confirms that the entries on the submitted list comply with the commune's stipulated definition of poor households. After the People's Committee checks, the documents are sent to the prospective lender via the CSG. The prospective lender collects the loan application and the list, checks loan eligibility and legal compliance and sends the documents to the bank's Administrative Division. This process should be completed within five days. Inadequate loan applications are returned and guidance on compliance is provided. The communal People's Committee is notified of the final decision to grant credit, at which point it advises the borrower and the CSG accordingly.

Table 1: VBSP Loan Conditions

Target Groups	Maximum loan size	Interest rate	Collateral, guarantee
1. Poor households	VND 7 m (at present). Proposal to increase the loan size to VND 10 million	0.45% per month (Region II, III) 0.5% per month	No collateral, but borrowers must be in the list of poor households, selected by CSG and certified by the communal level People's Committee
2. Disadvantaged students	VND 200,000 per month	0.45% per month	Disadvantaged students must have a guarantor
3. Job creation under Resolution No. 120 / HDBT, dated April 11, 1992	VND 200 m	Normal: 0.5% / month Special: 0.35% / month Applied to businesses that employ disabled people	- If the loan exceeds VND 15 m, collateral is required, and the borrower must guarantee the loan by their creditworthiness (reputation). The maximum loan shall not exceed 70% of the value of assets used as collateral. - If the loan is below VND 15 m, the borrower must guarantee the loan by their creditworthiness (reputation)
4. Lending to policy migrant workers	The maximum loan shall be 80% of total expenses, stated in the Labor Contract.	As for poor households	The borrower and their family shall have repayment commitment.
5. Policy beneficiaries in mountainous regions II or III and exceptionally inaccessible areas.	No limit but the loan amount shall depend on the request of the borrower, capital and the value of assets used as collateral for their loan lending (if any) and the VBSP's sources	15% to 30% lower than the lending rate of other commercial bank in the area	The economic entities have to comply with VBSP collateral regulations
6. Policy beneficiaries who borrow on deferred payment for housing construction / renovation in the Mekong River Delta and Tay Nguyen	VND 7 m	3% pa, including the first 5 years of the grace period	No collateral requirement provided the borrower is included in the list approved by the provincial level People's Committee or the offices / agency authorized by said People's Committee.

Source: Questionnaire responses provided by VBSP. Quoted verbatim with the exception of obvious errors.

Although not stated in the VBSP's response, the CSGs have joint liability function on loans to poor households. In short, if one member of a CSG is unable to make repayments, the responsibility to service the debt is transferred to the group. Due to the small number of such cases however, it is not clear to what extent the joint liability measure is actually functioning (Izumida and Pham Bao Duong [2001]). Notwithstanding, it is believed that CSG mediated monitoring effectively pressurizes borrowers to make their repayments. This undoubtedly has an effect on the efficiency of loan recovery.

As evidenced in the lending procedure abovementioned, the CSGs (with mass organization involvement) and the People's Committees have clearly taken on considerable roles in the VBSP's lending program for poor households. Neither the VBSP nor the agent banks have a mechanism for evaluating whether the fund use and investment plans of poor borrowers are bankable, but such is probably unnecessary. The peer monitoring mechanism of the CSGs is functioning effectively, thus any independent assessment of small loans is, in this case, believed to be unnecessary.

In the past, loans to poor households were only to be used for production or business purposes. However, it should be pointed out the establishment of the VBSP provided a window of opportunity for the introduction of major changes into the scope of loan uses. In fact, aside from production and business applications, it is now possible to divert a portion of the loans to a wide range of purposes, including housing construction / renovation, securing clean water, electricity link-ups and for funding education (school fees and related expenses). These expansions should be evaluated as being a meaningful improvement in view of the diversity of demand for credit among households. Limiting loan purposes is practically difficult due to so-called credit fungibility.

(2) Loans to disadvantaged students

The maximum loan size is VND 200 thousand per month. The program targets students of universities, colleges and vocational colleges, but excludes post-graduate students. Students enrolled on 4-year university courses may take out a loan at any time during their second to fourth year of study, with most taking out 3-year loans. Disadvantaged students can receive loans for a maximum of six years depending upon the duration of their course of study. The maximum maturity period is 7.5 years, but most students are required to repay their loans within three to four years after graduation. Interest is set at a monthly rate of 0.45 percent, and as might be expected, students are under no obligation to repay any of the principle or interest during their term of study. Disadvantaged students are defined as the children of poor households, the children of policy families (war heroes or those who are officially recognized to have contributed to the revolution), and students who were born in Region II or Region III. The VBSP requires applicants to submit a certificate of obligation from a guarantor (a parent, step-father, step-mother, or legal guardian), and the guarantor must present a permanent address certificate.

To understand this lending program it is necessary to touch on the Education Fund lending program provided by the Industrial and Commercial Bank of Vietnam (ICB), one of VBSP's predecessors. This program was piloted between 1995 and 1998 and went into full-scale operation in 1999. The Education Fund was officially established in 1999 and targeted the children of poor households who had achieved a certain level of academic results, with funding being provided to cover the necessary expenses to permit such children to go up to university or to continue their studies. The program was administered by the ICB, and the maximum loan size was VND 200 thousand per month for a maximum term of one year, with the student's parents acting as guarantors. By the end of 2001, the Education Fund had reached VND 65.5 billion, a breakdown of which shows VND 30 billion from the state budget, VND 30 billion on borrowings from the SVB, and VND 5 billion contributed by the ICB. By February 2002, the ICB had provided loans worth VND 62 billion, and some 35 thousand students had benefited from the program (SBV [2002]).

As pointed out in the report of NFLC [2003], the biggest problem with this lending program was the high risk of delinquency. The ICB only had branches in urban centers and its tracking system was insufficient to monitor the movements of student borrowers who dropped out of school, moved to other institutions or graduated. Moreover, the guarantors were classified as the parents of poor households and as such had only limited ability to make the repayments.[11]

The Education Fund lending program for disadvantaged students was transferred to the VBSP and has been improved via the introduction of conditions such as limiting loan duration to a maximum of five years for students on six-year programs of study, for example. However, there do not appear to have been any major alterations in the measures against NPL since the program was transferred from the ICB.

In this connection, VBSP officials were questioned as to the introduction of credit

[11] According to SBV [2002], the poor recovery rate for this program was not only due to the ICB's inadequate tracking system, but also the large numbers of students unable to find work upon graduating. Besides, it should be pointed out that many students believed there was no obligation to repay subsidized credits from the government.

protection measures by the author. Apparently, no new measures have been introduced to date, however, the bank is hoping to adopt a system under which the loans will be disbursed to the parents and not to the students themselves.

(3) Loans for promoting job generation

This type of policy funding is provided in line with Resolution 120/HDBT of 1992. Its predecessor was a lending program administered by MOLISA.[12] The maximum loan size is quite substantial at VND 200 million. The maximum repayment period is five years with the program targeting farmers, urban households and small and medium-size enterprises (SME). Groups of producers and agricultural cooperatives are also eligible to receive capital via this program. As the program name suggests, funds are to be used to generate employment (employment expansion with family members is permitted). Beneficiaries are eligible to receive VND 15 million in funding for each job created. However, the bank requires applicants for loans exceeding this sum to place the collateral for the loan and to have a recommendation from a mass organization (the Women's Union, Farmers' Association). The bank will lend up to 70 percent of the value of assets used as collateral. Borrowers are not required to place a collateral for loans of less than VND 15 million, but their eligibility is assessed in terms of their reputation (according to the VBSP, this takes the form a recommendation from a mass organization).

Loans to promote job creation fall into two categories – those to expand regular employment and those to create jobs for the disabled. In the latter instance, a monthly interest rate of 0.35 percent is applied.

At the initial stage in the lending procedure, a regional branch of the Ministry of Labor (MOLISA) maps out a fund use plan designed to support employment at the provincial and/or district level. Based on this plan, the branch office then advertises for prospective borrowers. The investment plans of prospective applicants are checked for appropriateness and borrowers

[12] The former program is believed to have been a lending program that provided state credit. The following is quoted from the explanation provided in the NFLC report. "This program is administered by the MOLISA, it targets small-size enterprises and joint corporations, etc. Program funding is to be used for business expansion or the creation of new job opportunities for the poor. Under the basic program scheme, business plans approved by the MOLISA are assessed by the executing SOCB and related organizations. Funds are actually disbursed by SOCBs such as VBARD or directly from the National Treasury." (NFLC [2003], p.8) From this quotation, the central role of the MOLISA in the former system becomes clear. It also has influence to the lending procedure used after the program was transferred to the VBSP.

are screened by the local MOLISA office in conjunction with various related institutions (the VBSP, People's Committee). It is important to note the core position of local MOLISA offices in the administration of this lending program. When the investment plans are administered by a mass organization, the provincial level mass organization will be involved in the decision to approve funding. In the event of a conflict of opinion between the VBSP and the local MOLISA office, the matter is to be taken to a high-ranking decision-making level for adjudication.

The involvement of so many organizations (MOLISA, the People's Committee, mass organizations, and the VBSP) in the procedural flow for this lending program is troublesome. The mechanism is such that it is virtually impossible to know where responsibility for determining the appropriateness of the funding and of the investment plan actually lies.

The VBSP acknowledges that there is a large number of organizations involved in the decision-making process and that accountability is opaque (in interviews), and is aware of the need to improve these aspects of the lending program. Moreover, it is also difficult to ascertain at what point in the process a lending project is assessed in terms of its creditworthiness. With the pre-VBSP program, applications were assessed in terms of job creation effect, fund usage and the appropriateness of the business plan, not in terms of their content merely as prerequisites for funding (NFLC [2003], p.9). With the employment generation program, large sums of money are involved and there appear to be no reciprocal monitoring systems like those seen with the loans to poor households. It may be necessary to develop a system for assessing the appropriateness of funding projects from a financial perspective.

(4) Loans to foreign migrant workers

As with the loans to poor households, interest is charged at a rate of 0.5 percent per month on loans extended under this program. The bank will lend up to 80 percent of the costs indicated on the labor contract (air fares, training, etc.). Borrowers are those who are authorized to work overseas under contract with their employer. Foreign migrant workers from all policy families (as mentioned above) are also considered.

(5) Loans for policy beneficiaries in difficult areas

The predecessor to this lending program was Program 135 (Prime Ministerial Decision

135, dated July 1998), which targeted ethnic minorities living in disadvantaged areas.[13] Under Program 135, government funding was used for infrastructure development (community centers, roads, electricity, potable water, etc.), and investment was increased by using state credit, with the objective of improving economic conditions in disadvantaged areas (Regions II and III, as stated above). The credit part of Program 135 has been transferred to the VBSP.

A list comprising 414 disadvantaged communes in Region II and 586 especially disadvantaged communes in Region III was presented when this lending program was finalized. This lending program does not target poor people living in the two regions. Such individuals are targeted by Program 1 (loans to poor households).

Interest rates are between 15 to 30 percent lower than those offered by the commercial banks. There is no upper limit on loan amount. Loan amounts are determined on the basis of the amount of capital required by the borrower, the value of assets used as collateral and the financial status of the lender. Prospective borrowers are required to place a collateral for their loans in compliance with VBSP's collateral regulations.

(6) Measures for policy beneficiaries who borrowed loans for house construction / retrieval in the Mekong River Delta and Tay Nguyen (central highlands).

The maximum loan size is VND 7 million with a repayment period of 5-10 years. Interest is 3 percent per annum, also payable during the first five years of the grace period. No collateral is necessary if the name of a prospective borrower is on the list provided by the provincial level People's Committee (or is an organization approved by the People's Committee). The program is believed to target families who lost their homes due to flooding in the Mekong River Delta or to natural disasters in the central highlands.

4. Lending plan, funding sources and annual operating expenses

4.1 Lending plan

Table 2 shows VBSP's plan for annual loan disbursement as of July 2003, and its outstanding loans for the end of 2003 and the end of 2004. All figures are rough forecasts moreover, the transfer of Loan Program 5 (Loans to policy beneficiaries in difficult areas) is

[13] There is another region category embraced in Regions II and Region III. The exceptionally difficult area in Regions II and III without any means of transport is defined as this category. The government provides subsidies of VND 500 million to communes in the category.

incomplete and annual plans have yet to be finalized. Notwithstanding, the figures listed give a sense of the size of the sums involved in each of the programs.

With the exclusion of Loan Program 5, the VBSP will extend a total VND 3,306 billion in loans (forecast) in 2003. There is a strong emphasis on loans to poor households with such accounting for approximately two thirds (VND 2,078 billion) of VBSP's loan portfolio. Understandably, considerable sums are lent to promote job generation, with loans under this program amounting to VND 840 billion. Loans to disadvantaged students and to foreign migrant workers are small.

As of the end of 2003, outstanding loans will total VND 9,750 billion, however, this figure is not particularly helpful, as Loan Program 5 remains an unknown quantity. The balance as of the end of 2004 shows that loans to poor households would account for 51 percent, and loans for employment generation for 12 percent. The ratio of loans to disadvantaged students and to foreign migrant workers is nearly one percent each. By contrast, at the end of 2004, the plan that a large proportion (29 percent) of total preferential loans would be extended to policy beneficiaries in difficult areas is noteworthy. At any rate, the balance forecasts reveal the VBSP to emphasize on three programs, namely, loans to poor households, loans to policy beneficiaries in difficult areas, and loans for employment generation.

Table 2: VBSP Loan Portfolio Plans Unit: Billion VND

The groups	Disbursement	Balance	
	2003	End of 2003	End of 2004
1. Poor households	2,078	7,500	8,650
2. Disadvantaged pupils, students	38	100	150
3. Job creation projects under Resolution 120	840	1,800	2,000
4. Social policy beneficiaries as migrant workers going abroad on limited terms	50	50	150
5. Area II, area III, and exceptionally difficult areas	NA	The handover is incomplete	5,000
6. Housing loan on deferred payment term in Mekong River Delta and Tay Nguyen	300	300	1,000
Total	3,306	*9,750*	*16,950*

Source: Questionnaire responses provided by VBSP.

4.2 Funding sources

As stated in section 3.1 VBSP loans are financed by (1) its own capital, (2) borrowings from the central bank (SBV), (3) the SOCB deposit quota (2% of the deposit portfolio as of the end of the previous year), (4) other borrowings, (5) savings mobilized by the VBSP, (6) the issue of government guaranteed bonds, (7) government budget, (8) overseas assistance, including ODA, (9) trust funds from local governments and mass organizations, and (10) others. This breakdown includes some element of wishful thinking; the reality would be quite different.

The questionnaire sent to the VBSP ahead of the survey included questions on funding sources; the bank's responses have been put together in Table 3. As indicated by the explanatory notes appended to the table, some of the figures are at variance with the figures contained in the reports of other organizations. Again, although the figures for the end of 2003 and for the end of 2004 are forecasts, the differences are substantial. At any rate, the figures listed in the table should be regarded as very rough ones.

An analysis of major fund sources yielded the following results. Firstly, as of the end of 2003 the shares of statutory capital would be 15 percent, loans from the central bank 15 percent, and loans from commercial banks (including VBSP mobilized capital and the deposit quota of 29 percent) 41 percent, respectively. Of note, is the appearance of a new category in the form of funds from the state budget, which moreover, have a fixed share (20%). However, as is indicated in the table, the use of these government funds is limited.

Table 3: Breakdown of VBSP Funding Sources Unit: Billion VND

Funding Sources	End of 2003	End of 2004
(1) Statutory capital	1,516	2,516
(2) Borrowings from the SBV	1,531	1,531
(3) Borrowings from commercial banks, and mobilization from the market	1,238	6,298
(4) Government funds for housing finance on deferred payment terms	200	600
(5) Government funds for job creation	2,000	2,200
(6) Capital from the Credit and Training Fund	160	200
(7) On-lending from foreign countries (OPEC)	155	155
(8) SOCB deposits (2% quota)	3,000	3,500
(9) Capital from the Investment Trust Fund	500	700
Total	10,300	17,700

Source: Interviews conducted at the VBSP in July 2002.

Notes: [1] The VBSP has a charter capital of VND 5 trillion.

[2] The VBSP has yet to issue any government guaranteed bonds.

[3] The VBSP has yet to borrow any funds from the Vietnam Postal Savings Company.

[4] Item (3) includes commercial bank borrowings and funds received from mass organizations. Item (8) represents quota of two percent of the previous year's deposit portfolio with SOCBs.

At the end of 2004, the statutory capital would account for 14 percent, borrowing from central bank borrowings 9 percent, loans from the commercial banks 55 percent (including VBSP mobilized capital and the deposit quota of 20 percent), and treasury funds 16 percent, of total funds, respectively.

These percentages reveal the heavy dependence on external funds. As might be expected, since it is not known how much deposits VBSP expects to be able to mobilize it is not possible to make any categorical statements in this respect; however, assuming that, like VBP, for the time being deposits mobilization will amount to one percent of total funds raised, then the VBSP will be almost totally dependent on external funds. In other words, in counting the total of borrowings from the commercial banks (assuming no deposit mobilization) and borrowings from the SBV as external funds, the ratio of external funds would be 56 percent in 2003 and 64 percent in 2004, respectively, the extremely high ratio. In 2002, the external fund share of the VBP stood at 75 percent, and despite drops in the percentages for 2003 and 2004 they remain high. The decreases in the rates for 2003 and 2004 are attributed to the appearance of government funds.

If government funds are added to external funds, the VBSP's dependency on outside funding becomes even more pronounced (76% in 2003, 80% in 2004). The remainder comprises statutory capital, trust funds and so forth, but since capital and trust funds are also budget appropriations, this effectively means that very little funds are being procured as the result of internal efforts.

Of course, loan capital procured from government funds formally becomes VBSP internal capital, and respecting this formality the internal capital weighting for 2004, calculated accordingly, becomes 30 percent.

Furthermore, if capital essentially procured at market rates (the borrowings, including quota, from the commercial banks and the portion mobilized by the VBSP) is separated from low-interest or interest-free funds, as of the end of 2003, the former accounts for 41 percent and the latter for 59 percent of total funds. At the end of 2004 these figures stand at 59 percent and 41 percent, respectively. As long as ODA funding is not introduced then the proportion of funds procured at market rates is expected to increase with time.

Looking at the trends, total funds stood at VND 6,887 billion as of the end of 2002 (this figure is for VBP), VND 10.3 trillion for the VBSP as of the end of 2003 and VND 17.7 trillion as of the end of 2004; evidence of a huge expansion, with the 2004 end figure representing an increase of some 2.6 fold compared with that of the 2002 end figure (for VBP).

The VBSP has no plans to issue bonds at this time. It receives virtually no ODA funding.

4.3 Annual operating expenses

Rough estimates of annual operating expenses are given in Table 4. The figures are estimated on the basis of payments forecasts, and opportunity costs are not included. The figures are extremely rough, however, they are able to explain a number of key issues.

Firstly, the VBSP borrows from the SBV at a low rate of interest, but in principle pays market rates for funds borrowed from the commercial banks. The interest rate for procuring funds from the commercial banks (interest rate + procurement costs) is 8.6 percent, which is the same as the rate applied to the quota. No doubt the VBSP is anticipating that the rate for internally mobilized capital will be the same (including the interest payable on deposits). Interest payments amount to less than 4.1 percent of outstanding loans. Given that funds procured at nominal rates accounted for 41 percent of total funds at the end of 2003, this 4.1 percent figure is acceptable. Naturally, this is calculated in using statutory capital, government funds, which are exempted from interest payments, and low-interest borrowings from the SBV.

Table 4: Breakdown of Annual Operating Expenses (forecasts) Unit: Million VND

Item	Expenses for 2003	Remarks
Interest payments to;		
SBV	34,752	2.3% of outstanding borrowings
VBARD	42,382	8.6% of outstanding borrowings
Other banks	64,528	
Quota	259,200	8.6% of the quota
Others	428	
Total interest payments	400,862	4.1% of outstanding loans
Commission fees	290,200	4.27% of outstanding brokered loans
Other expenses	150,290	5.1% of outstanding direct loans
Loan loss provision	43,360	
Total expenses	948,610	9.7% of outstanding loans
Earnings from interest	450,960	4.5% of outstanding loans
Other income	6,600	
Total income	457,560	4.7% of outstanding loans
Estimated subsidies	491,050	5.0% of outstanding loans

Source: Interviews conducted in July 2003.

The second issue is commission fees, which represent approximately 4.27 percent (monthly rate of 0.36%) of the bank’s loan balance. Broadly speaking, these can be interpreted as lending costs. As stated in section 3.1, these fees are payable to agent banks and to the CSGs. The VBARD is currently the only agent bank actually bearing the responsibility of extending funds for the VBSP's lending programs, and whilst the VBARD is planning to extend VND 6,800 billion of its outstanding portfolio in loans to poor households, direct loans extended by the VBSP amount to no more than VND 700 billion. Understandably, there are currently no plans to use other financial institutions as the broker of the funds for employment generation, student loans, loans to foreign migrant workers, and so forth.

The third point is that total earnings are approximately half total expenses, which means that the bank is receiving huge subsidies. Given that earnings from interest account for 4.5 percent of outstanding loans in highly simplified terms, an outlay of 9.7 percent yields earnings of 4.7 percent, with the deficit of 5.0 percent being covered by subsidies. In monetary terms, total deficit would be VND 491,050 million.[14]

However, the costs cited above are not the bank's only expenses; if opportunity costs and implicit costs – privileges such as tax exemptions – are included, the figure will increase exponentially. Disregarding implicit costs, if market rates are applied to funding costs (8.6%) and a 4.27% commission fee to lending costs, then the annual rate of interest on loans will be 12.9 percent, assuming a zero profit margin. If risk is also factored into the equation (i.e. 0.45% of the loan loss provision balance shown in Table 4) then the lending interest rate will be even higher. This implies that it is impossible even to apply the market lending rate, which is said to be one percent in a month.

5. Features of lending system

5.1 High costs and subsidy dependence

The most critical problem for the VBSP is that its system requires vast costs to establish and maintain it, thus it is, by necessity, dependent on government subsidies. Without these subsidies, the VBSP's operations would be unsustainable. Moreover, given the plans to increase the number of lending programs, there is an inherent possibility of progressive

[14] According to the sector survey report (JBIC [2003b]), since annual subsidies to the VBP, for example, amounted to VND 170,500 million in 2002, assuming the VND 491,050 million figure to be accurate, this represents a 2.8 fold increase in subsidies. This figure is not as incongruous as it may seem. In view of "VBSP is expanding its branch network at the district level and taking on staff, and that VBSP will be 2.5 times larger than VBP, there is a possibility that the required subsidy for VBSP will be much larger than for VBP" (p.80), then the range of error in the calculation is not particularly large.

increases in government subsidies.

In the first instance, given the need to construct a new network of branches and to recruit staff, the cost of establishing the bank must have been prodigious (however, as noted in section 3.2, it has not been possible to obtain definite figures). Furthermore, merely establishing a branch network and securing the necessary personnel does not mean that a bank is ready to do business. Efforts must also be made to train staff, to help them acquire knowledge of good credit practices, and so forth. Again, loans to disadvantaged students, loans to policy beneficiaries (including ethnic minorities) in difficult areas and foreign migrant workers, and loans for employment generation, are all essentially new services, thus the knowledge of VBP personnel is presumed to be insufficient. There are many areas of the banks operations where personnel will have had to start from scratch.

In addition, there is no way of circumventing the huge costs involved in running its lending operations. Lending interest rates are lower than cost, which will obviously generate losses. Commissions to agent banks and the costs generated by measures such as "rescheduling" applied to NPLs are also believed to be enormous.[15] Besides hidden subsidies such as interest-free government funds, exemptions from deposit insurance and reserve funds, etc., that are not directly involved in the bank's actual expenditure are also considerable. There is even the possibility that excessive use of debt "rescheduling" could cause a system meltdown.

The VBSP was created because there was a need to make a rigid distinction between the policy lending and the commercial lending functions of the SOCBs, and there is no argument on the judiciousness of this move. However, as to whether this, perforce, requires the establishment of a policy bank with its own independent network is, as mentioned earlier, open to dispute. Policy lending in the form of interest subsidizing on commercial bank lending is one option that was apparently not considered. At any rate, the Vietnamese government needs to review policy lending in terms of minimizing policy costs.[16]

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[15] It has not been possible to confirm how below calculation has been performed, but the Department of Finance at MPI mentioned that budget spending on VBSP lending programs was in the range of 0.2 percent of the total budget and that it imposed little burden on government. However, the social cost of VBSP lending is believed to be quite substantial if all implicit costs are included.

[16] Social policy reforms are under discussion as part of the structural reforms being undertaken in Japan recently, and Vietnam's social policy bank may also find it beneficial to discuss the disclosure of policy costs and their minimization (Izumida [2002]).

5.2 "Distortion" of lending interest rates

The second problem lies in the setting of lending interest rates. The VBSP's rate is lower than the market rate of interest. Accordingly, it "distorts" the financial market. However, the "distortion" caused by lower interest rates has a number of degrees. The greatest "distortion" is judged to occur when the relationship between (1) lending interest rates in the market, (2) deposit interest rates, and (3) policy lending rates is (3) < (2) < (1). In this instance, individuals receiving cheap policy loans can, in principle, make a profit by depositing the funds received (this scenario ignores the transaction costs involved). Researchers who give priority to market functions, on the other hand, assert that the relationship should be (2) < (1) = (3) or (2) < (1) < (3) .[17]

An intermediate scenario – (2) < (3) < (1) – is also possible. In this case a policy loan cannot be turned into a profit, even if the funds are deposited. Interest rate settings should, at the very least, not create such incentives to borrowers. In political terms, even if, for other reasons, the lending rates of policy banks have to be below market levels, they should desirably be set so as to at least satisfy the formula of (2) < (3) < (1) relationship. The SBV research group (SBV [2002]) asserts that the policy lending rate should be somewhere between the deposit rate and the market rate. As mentioned earlier, as long as the lending interest rate of credit program is higher than the deposit interest rate, borrowers are precluded from profiting directly from policy loans even if they deposit the money.

So then, at what level have the VBSP lending interest rates to be set? As stated in an earlier section, the VBSP lends to poor households at a monthly rate of 0.5 percent.[18] The interest rates applied to its other lending programs are close to 0.5 percent, or even lower. Even this 0.5 percent rate is demonstrably lower than the rates offered by VBARD and the People's Credit Fund (PCF) on their main savings product, the six-month time deposits (0.62-0.65%). Accordingly, the lending interest rates of the VBSP do not satisfy the assertion made by the SBV research group and it is thus difficult to refute the criticism that they "distort the market".

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[17] The latter case factors in the size of the cost and risk of providing credit to poor households or small farmers. Assuming that policy lending is primarily targeted at people who are unable to access to the formalized financial market, then if the focus is on securing access to credit this formula for interest rate settings is appropriate.

[18] According to the interview with experts of the SBV the 0.5 percent rate will not be changed for three years. The bank provided no clear-cut reasons for setting the interest rate at this level, but presumably consideration was given to continuity with VBP rates.

5.3 Dependence on external funds

The issue of heavy dependence on external funds has already been explained in numerical terms in section 4.2. Assuming only government investment to be internal funds, then 70 to 80 percent of the bank's total funds are external. Of course, this heavy reliance on external funds is dependent on what level of funds VBSP is able to procure through savings mobilization and the issue of bonds in the future.

A policy bank that is excessively dependent on external funds and has lending rates that are below-market levels is considered to be a classic example of old-fashioned directed credit labeled by the school that attaches importance to market functions (Adams [2000], Meyer and Nagarajan [2000]). This is the worst type of policy bank and may lead to a failure.

In order to lessen the heavy dependence on external funds, the VBSP should promote savings mobilization by absorbing more deposits through their own network or by issuing the debentures. Besides, the policymakers should recognize that savings are a multi-dimensional concept. Firstly, savings mobilization serves to enhance the independence of a financial institution. Secondly, it also acts as a barometer of the credibility of banks in the public eye. Thirdly, information on the level and change of deposit amount also has the merit of enabling the banks to ascertain the economic status of their customers. Fourth, for the depositor, the existence of low-cost, reliable deposit facilities provides a cushion against risk. To provide accessible and reliable deposit facilities can be one of the most important social policies.

Thus, given the multiple functions of the savings, the VBSP probably need to make more efforts on absorbing deposits. For that case, deposits absorption should be linked effectively with credit delivery.[19]

5.4 Targeting issues

Finding the measures to specify social policy beneficiaries is another important issue. Policy loans are extended at low rates of interest and bring benefits to the borrower, which means that there is strong demand for the bank's services. If targeting is inappropriate, demand will constantly exceed supply and applicant screening will become more difficult. In extreme cases, people with political influence or those with connections to authorities can conceivably use this clout to obtain cheap funds.

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[19] Since the policy bank is established to complement private financial institutions, then it might be unnecessary for the bank to offer the full-fledged services to all customers, including deposits absorption, credit delivery and others. The point is how to determine the degree and scope of the services, and those should be determined by examining the whole benefits and costs of the services.

The loans to poor households are not considered to be particularly problematic since communal level People's Committees and the CSGs assess the eligibility of prospective borrowers, the process is seemingly transparent and the reciprocal monitoring function is working. There do, however, appear to be problems with the employment generation program, problems of a critical nature in terms of funds targeting.

The problems lie in the "job creation" requirement since it is satisfied by almost all business entities that execute economic activities and it is thus virtually impossible to use as a screening criteria for loan customers. Put another way, given that the majority of businesses are able to present an investment plan that includes "job creation", it follows that the screening of investment plans and applicants using this criterion alone will be problematic. This is an instance of poor targeting and could allow arbitrariness into the process of deciding which applicants are eligible to receive low-interest credit. Even assuming that "job creation" was deemed to be a justifiable policy objective, it cannot, in isolation, eliminate all the ambiguities of applicant screening and means that the process of narrowing down targets is constantly fraught with difficulty and lacking in transparency.

In this connection, it should be pointed out that the "job creation" requirement may contain elements that are not necessarily direct social policies. The direct beneficiaries of this lending program are employers who invest funds procured on preferential terms to create jobs; they stand on the job increasing side and are not generally socially disadvantaged. According to our interview with credit officer of VBSP in Yen Bai Province, livestock farmers that are registered as so-called "farms" (large-scale farmers with employees), apply for this credit program as a group. In terms of income levels, "farms" are not poor households and should not be the targets of social policy. There is clearly something incongruous about large businesses like "farms" benefiting from low-interest credit as employment generating businesses. If financial support is provided to "farms" in the form of industrial policy, there is surely another means of achieving this end.[20]

5.5 Subordination to policy and politics

The fifth problem lies in VBSP's subservience to the government and policy. There may be some who counter that VBSP's subordination to policy is only natural given that it was established with the express purpose of achieving policy objectives. However, policy lending

[20] Undeniably this will generate effects by indirectly increasing employment. It is also significant in terms of increasing employment opportunities for the disabled.

is still lending and funds that do not circulate are not sustainable. The circulation of capital requires strict rules on lending, and at the same time, banks must establish independent lending discipline and shoulder the responsibility for judging the creditworthiness of funds. From the debate surrounding the VBSP in Vietnam it would appear that the policy makers have not sufficiently grasped this point. Of particular concern is the excessive extension of the socialist principle of equality, which is causing relief measures to be used. As stated in section 3.1, rules on measures such as "rescheduling" are included in government ordinance. There is a risk that rural finance per se will come off the rails if the "hoop" of financial rules and regulations breaks.

5.6 Institutional capability

As suggested on a number of occasions, the VBSP has insufficient institutional capability. In the first instance, the bank must enforce operation and management using the figures. It needs to develop its accounting practices and undergo regular audits administered by a foreign, third-party organization. As stated in section 5.5, if the VBSP is to break free from its excessive subordination to policy and government it must first enhance its overall capability as a financial institution. It may find it beneficial to attempt frequent staff training and simultaneously to open positions to exceptional candidates from outside the organization. Further, loan appraisals are not currently being undertaken in any substantive way. It is crucial that efforts be made to improve their specialist skills such as credit analysis and risk management.

6. Conclusion

6.1 Necessity of programmed lending for social policies versus financial principle

Generally speaking, there is no denying that Vietnam has many people in need of social policy assistance. There are people suffering from poverty and those living in the highlands and/or in remote areas who are not even able to access formal credit. Despite the clamoring over the importance of rural industries, insufficient funds are reaching handicraft producers, even in lowland areas. There are also people who have lost their land, and the loss of homes due to flooding and typhoons is an annual occurrence. However, existing financial institutions are often unwilling to open their doors to such people, and there are many who require the financial support offered by government policy.

Of course, providing low-interest credit to the socially disadvantaged or to people who have no access to funds is not necessarily the only answer; it may be more important to ensure that this section of society has access to financial services. Nevertheless, the provision of credit at below-market rates is one way for the government to demonstrate its support of the people who need policy lending.

The author admits the role of policy lending for social policies. There is clearly a demand for this type of lending, and in certain instances it may be meaningful to offer such credit at low rates of interest. Nevertheless, the role of credit in policy lending needs to be considered to be limited.

In the first instance, given that policy lending is still lending, the financial principles need to be able to work. In a financial transaction, money that is lent out is repaid at a later date with interest, which marks the end of the transaction. Sinking capital into the production process enables the creation of new values, generating funds for repayment so that they are returned to the lender. Funds that are recovered provide the source for subsequent lending. It is necessary to keep this simple financial principle firmly in mind.

Naturally, financial measures can also be applied to policies aimed at alleviating social problems. But, as stated above, there are cases when the financial principle does not work. As stated in section 3.3, the financial principle does not work in poor households whose members are unable to hold down jobs, and it is necessary to devise alternative policies like direct subsidies.

Secondly, since policy lending is policy oriented one, it is necessary to specify the targets of the lending programs to those that are not reached by private-sector banks. In essence this means focusing policy lending on targets that will be lost without it and excluding the segments of the population that can be served by the private sector. To give an example, the business entities targeted by the employment generation program could, in many instances, be served by private sector banks. This issue needs to be reconsidered.

The author would like to reiterate that he is not critical of the *a priori* assumptions about policy lending. The funds provided by international donors such as the World Bank also induce artificially changed money flow, and can be regarded as one type of policy lending. Moreover, they are generally extended at low rates of interest and are actually “subsidized policy credits”. Of course in this case, the beneficiaries of low interest loans are not private banks that disburse or the final borrowers, but the governments or central banks as their counterparts. However, in the case of international donors policy lending is rarely criticized. One wonders why.

The problem lies in whether the changes generated by credit allocation under the policy oriented intervention serve to strengthen rural finance or to guide it towards destruction. In case of loan disbursement of international donors, the counterparts (mostly government institutions such as ministry of finance or central bank) are carefully checked and monitored, and only institutions with high capability are selected. Loan programs are designed in order that involved institutions or individuals do not get any "institutional rent".[21] The "policy lending" operated by international donors is undertaken in full cognizance of the need to strengthen rural finance and cannot be criticized in this respect.

The future of the VBSP is not assured. The financial discipline in the socialist society of Vietnam is not infallible. The financial culture there is not particularly strong as compared with other developing countries. Many people consider policy lending to be a gift from the government, one that they are not required to repay.[22] There is a very real possibility that expanding accessible policy credit could create a mountain of bad debt.

6.2 Directions for improvements

At the very least, it is first necessary to change the lowest lending interest rate so as to establish a relationship of (2) deposit rate < (3) policy lending rate < (1) market lending rate. This measure will serve to minimize the "distortion". Again, there is a need to reconsider eliminating the "rescheduling clause". Of course, there are cases in which "rescheduling" is justified by shortages of funds over the medium to long-term and its use can serve to prevent a crisis situation from arising in the borrower households. Accordingly, a careful and critical examination of this issue needs to be undertaken with a view to limiting the use of "rescheduling" as a means of averting risk. The application of the "rescheduling" measure would best be avoided in the case of business difficulties resulting from price fluctuations.

The employment generation program, with the exception of jobs for the disabled, is believed to be in need of radical review. There seems little sense in providing low-interest credit to the current target population.

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[21] In case of World Bank Rural Finance Project in Vietnam, the MOF received the low interest rate (0.7%) and long-term loans from the WB. Interest rates applied to retail banks (private financial institutions) were market interest rate (around 6.5% dependent on market situation) and the lending conditions to end users were determined by retails banks. Thus, private financial institutions involved in the project as well as customers are not allowed to enjoy the "institutional rent" as far as cheapness of credits is concerned.

[22] The report issued by SBV's social policy research group (SBV [2002]) also points out that one of the causes of the poor recovery rate for the On-Stilt Housing Program is that "with the concessional credit, the borrowers bear in mind that this is a subsidy loan, thus they do not have to repay the bank" (p.30). The report also indicates

The VBSP needs to look at ways of reducing its reliance on external funds and to this end, serious efforts must be made to mobilize capital.

Consigned lending will continue to be important; however, as agent banks become more diverse, commission levels must be utilized effectively so as to provide an incentive to financial institutions and mass organizations to participate in the system. It may also be beneficial to consider the introduction of a system to share the risk between the agent institution and the VBSP.

As mentioned in an earlier section, efforts must be made to improve the bank's capabilities of credit analysis. To this end, there is a need to introduce elements that will enable projects to be assessed in terms of their creditworthiness (or the bankability of the application). It goes without saying that the VBSP needs to be audited by an external organization and that it needs to improve on its operating information disclosure. The VBSP is also urged to specify the costs involved in policy lending and to provide the documentation for judging the necessity of policy funding.

With time, the need to provide technical and managerial guidance when extending policy loans to poor households and peasant farmers is likely to emerge. Thus the VBSP will need to arrange tie-ups with "improvement penetration organizations" and at the same time, organize and staff an internal department to handle technical and managerial issues.

6.3 Remaining research issues

This report has examined the characteristics of and problems with the credit system of the VBSP, however, the matter has been addressed in terms of financial systems and from the perspective of the financial organization, and contains little analysis of how the system affects the households and businesses located in rural areas. These aspects need to be further incorporated into field studies.

In addition, whether the inauguration of the VBSP is truly an effective means of implementing social policy is a matter that will need to be examined when the bank's operations have got off the ground. The study should focus on the impact of the credit, i.e. whether it is actually achieving policy goals. Another key research issue will be to examine what effect, if any, the establishment of the VBSP has had on the rural finance market. It will also be necessary to touch on its effects on VBARD and the PCF as well as on the microfinance provided by NGOs.

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a similar cause underpinning the poor repayment rate for student loans.

The author intends, with additional surveys, to pursue his analysis of the areas that could not be sufficiently covered in this report. The trends of the Development Assistance Fund (DAF), another policy lending institution, and the financial activities of the agricultural cooperatives are also issues to be explored.

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