Restructuring a Credit Cooperative System: The People's Credit Funds of Vietnam

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Abbreviations and acronyms

ADB	Asian Development Bank
BMS	Banking Management System
CAR	Capital adequacy ratio
CCF	Central People's Credit Fund
CCI	Credit Cooperative Institutions Department of SBV
CIDA	Canadian International Development Agency
DGRV	Deutscher Genossenschafts- und Raiffeisenverband, German Cooperative and Raiffeisen Confederation)
DID	Développement international Desjardins
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, German Technical Assistance Agency
HCM	Ho Chi Minh City
IMF	International Monetary Fund
LPC	Local People's Committee
NBCI	Non-bank credit institutions, also NBCI Department of SBV
PCF	People's Credit Fund
RCF	Regional People's Credit Fund
ROAA	Return on average assets
ROAE	Return on average equity
SBV	State Bank of Vietnam, the central bank
SOCB	State-owned commercial bank
SOE	State-owned enterprise
SOFI	State-owned financial institution
TA	Technical assistance
VAPCF	Vietnam Association of People's Credit Funds
VBA, VBARD	Vietnam Bank for Agriculture, renamed in 1996 as Vietnam Bank for Agriculture and Rural Development

Exchange rates of VND to US$ (end of year)

Year	Rate	Year	Rate
1993	9,200	2001	15,086
1994	11,003	2002	15,395
1995	11,020	2003	15,630
1996	11,037	2004	15,776
1997	11,175	2005	15,906
1998	13,887	2006	16,056
1999	14,019	2007	16,025
2000	14,540	2008 Jul 31	16,765

Source: ADB

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I. Introduction

Vietnam is a special case among studies of the restructuring and reform of financial institutions. The primary act of reform consisted in closing the old system of rural credit cooperatives and replacing it with a new system under a new name: People's Credit Funds (PCFs). The trigger was the collapse of the old system and the realization that banks would be unable to provide inclusive financial services in rural areas. Once in place, two separate institutional reforms followed after a seven-year pilot phase: one of the PCFs, the other one of the Central People's Credit Fund (CCF). The trigger was an assessment at the end of the pilot period and the recognition of the need for restructuring and enforcement of prudential regulation. Another reform is expected in the near future: the transformation of the CCF into a commercial bank, which has been overdue since the CCF expanded its financial services to the general public in 2001 as part of its restructuring.

Inclusion of credit cooperatives, which are member-owned, in a study of the restructuring and reform of state-owned financial institutions (SOFIs) requires an explanation. There are two reasons. First, the new credit cooperative system has been created by the Government, with the State Bank of Vietnam (SBV), the central bank, in control since inception. Second, while the PCFs are member-owned, the CCF has been majority-owned by SBV, its share increased in 2008 from 73% to 96%.

Since 1976 rural credit cooperatives were part of the command economy of Vietnam. By the mid-1980s, they covered most of the communes of the country. Yet, the continual decline in the production of rice and other commodities and, finally, a period of hyperinflation led to the collapse of the economy including the credit cooperatives. In the eyes of the Government restructuring by injecting fresh capital thus ceased to be an option.

The Government responded to the crisis with a new policy, *Doi Moi* ("renovation"), aiming at the introduction of a market economy. One of the first steps of reform was the transformation of the mono-tier banking system into a new financial infrastructure, comprising a central bank and four state-owned commercial banks. In a situation of transition and turmoil, the fate of the credit cooperatives was ignored. Nobody cared to ask whether to close or reform them. As a result they simply withered away, together with the savings of their members.

No information is available on the old credit cooperative sector; this may have been due to the absence of a central monitoring institution that could have collected such data, historical neglect, or a deliberate break with the past. Whether the restructuring and reform of the old credit cooperative sector would have been feasible is now only a question for the economic historian in Vietnam. But in some other countries, where credit cooperatives are in not much better shape than they were in Vietnam in the 1980s, the question is of more than academic relevance, as closing a non-performing cooperative sector may not be politically acceptable. A few old-type credit cooperatives did survive in Vietnam and were eventually integrated into the new system of People's Credit Funds (PCFs). We visited one of them and were impressed by its performance (*Annex 1*). This might motivate policymakers and scholars to carefully examine the potential for restructuring of non-performing institutions before closing them and taking a fresh start at enormous costs.

The focus of this study is on the new system of PCFs: self-help organizations under state control, seemingly a contradiction. Credit cooperatives are supposed to be self-help organizations which are self-organized, self-financed, self-managed and free of government interference. In European and a number of other developed countries credit cooperatives have flourished on that basis; they were initially promoted, regulated and supervised by their own associations; and only at a later stage did they come under the banking law to be integrated into the formal financial sector. In contrast, in many developing countries, among them Indonesia and India, the Government has taken the cooperatives into its own hands. In

doing so it has undermined their motivation, self-reliance and health by using them as channels for the disbursement of subsidies, frequently politically motivated.

However, the case of Vietnam shows that the world of cooperatives is more complex than indicated by the simple dichotomy of successful self-help movements vs failing state-run systems. The newly established PCFs are self-managed and self-financed; yet they are part of a movement in which the central bank has been in control from inception. SBV has been in charge of designing the new system; it has prepared its regulatory framework, integrated the network into the formal financial sector, supervised its progress and enforced prudential standards. It is also a majority owner of the PCF central fund. Yet SBV has abstained from undue interference and from using, or abusing, the PCFs as credit channels or for other politically motivated purposes. Much can be learned from Vietnam and how it proceeded to build a new credit cooperative system, learning from the experience of other countries as well as from its own carefully monitored experience, and how it eventually evolved into a strong and healthy rural credit cooperative system, comprising apex organizations and a network of self-reliant PCFs, which mobilize their own resources and finance their expansion from their profits. Effective supervision and enforcement of prudential standards have played a crucial role, which have been lacking in so many other developing countries.

II. The pre-reform period

A. The making of a market economy [1]

The war between North Vietnam and the US, 1965-75, resulted in the establishment of a unified Socialist Republic of Vietnam in 1976. Searching for a productive and equitable economic and social system, the new Government first experimented with a communist-type command economy. There was no role for markets and private enterprise. State-owned enterprises (SOEs) and production cooperatives formed the backbone of the economy. Only they had access to credit, allocated according to the state plan and budget by the State Bank of Vietnam (SBV), with its affiliates, as a monopoly provider. An inverted interest rate structure, with interest rates on deposits exceeding those on loans, discouraged financial intermediation. At the bottom of the financial system were credit cooperatives, since 1976 part of the command economy. Modeled after credit cooperatives in China, their purpose was financing SOEs and production cooperatives in collective agriculture. By the mid-1980s there were close to 7200 credit cooperatives, covering almost all communes, each comprising about three to four villages.

Ten years of central planning, collectivization of land and international isolation proved disastrous and brought the country to the brink of famine. Not only had the Government failed to reconstruct the war-torn economy; with its ideological insistence on central planning following the Soviet model it had further aggravated the hardship to a catastrophic extent. Large numbers fled the country, as boat people or otherwise. In 1986, facing hyperinflation of over 700% and the collapse of the economy, the Government decided on a new experiment, the *Doi Moi* (*"renovation"*) policy of liberalization, free-market reforms, reliance on the private sector as an engine of growth, and global integration. It is this policy which ultimately led to the fall of the old, and subsequently to the rise of the new, system of credit cooperatives.

Starting in 1988, far-reaching measures were implemented, opening the economy to internal trade (previously impeded by provincial barriers), restoring the competitiveness of domestic firms and stabilizing the economy. Structural reforms were geared to dismantling the extensive system of controls; financial reforms focused on the consolidation of public finances and the reduction of inflation from hyperinflationary levels. In mid-1988 the mono-tier banking system was transformed. The commercial banking functions of SBV were divested to four government-owned commercial banks, among them the Vietnam Bank for Agriculture (VBA) as the main rural lender, while SBV focused on monetary policy.

Though the initial measures in 1988 were limited, the impact was marked. During the first half of 1988 interest rates fluctuated between 16.8% and 28.4% per month; during the second half they were brought down to between 5.3% and 9.6% per month – a reduction by two thirds. In 1989, the Government moved towards a more comprehensive approach, comprising reforms of the exchange market and the financial sector. Vietnam took the IMF's advice on monetary restraint, with a dual focus on credit supply limitations to state enterprises and interest rate increases to positive real terms.[2] Accompanying economic reforms included the further decollectivization of agriculture and a return to private household farming; a reduction of restrictions on private sector activities; trade liberalization; and the decentralization of decision-making to the managers of SOEs. Abandoning its policy of

[1] The title of this chapter is borrowed from a book by Seibel (1992). Other sources used include Cao Cu Boi (personal communication), DID (1998), The Economist (2008), EIU (2007, 2008), Hung et al. (2002), IMF (1990) and World Bank (1991, 1993).

[2] In March 1989 two packages were enacted: an anti-inflation package, raising interest rates sharply upwards to positive real levels and devaluating the official exchange rate by a factor of five to the level of the parallel market, while curtailing overall money and credit expansion; and a package of fiscal consolidation, eliminating all current budget subsidies, curtailing credit to SOEs, cutting back government employment and introducing a nominal wage freeze. (Seibel 1992: 49-50)

separation and dissociation, Vietnam opened up to the world and entered into economic relations with the convertible area.

The impact was immediate: there was a substantial flow of assets into the banking system; the growth in bank lending to enterprises fell from over 350% in 1988 to 115% in 1989; the growth in dong liquidity decelerated from 425% in 1988 to 110% in 1989; the monthly inflation rate dropped from 7.3% in the first quarter of 1989 to around zero and turned deflationary in May-July; exports to the convertible area doubled from 1988 to 1989. The two main arbiters of reform and adjustment were truly impressed. The World Bank (1991: i) found the overall impact of the reforms "very positive, particularly in terms of output growth and decline in inflation" – all the more as this was achieved under an American embargo and without significant support from the outside. The IMF (1990: 26) enthusiastically declared: "The initial success of financial policies was dramatic."

Yet the tight money policy exposed the weaknesses of the SOE sector. Their transfers to the state budget decreased from 15% during 1984-87 to 5% in 1988 and 3.5% in 1989. At the same time, commodity aid from the Soviet Union declined substantially. Fiscal reforms and the reduction of voluminous subsidies to consumers and others in 1989 and 1990 were insufficient to fill the gap. The Government thus found itself compelled to relax monetary restrictions and, in the second half of 1989, returned to excessive credit to the budget. Inflation soared to almost 70% in 1990 and 1991.

The 1989 reforms had revealed fundamental weaknesses of the financial system. The four SOCBs were but arms of the SBV; and the SBV failed to carry out its central bank functions. The Government therefore moved to new reforms, passing the Ordinance on Banks, Credit Cooperatives and Finance Companies on 23 May 1990, which became effective on 1 October 1990. This created the legal framework for a differentiated financial infrastructure, comprising SBV as the monetary policymaker and financial regulator, universal banks in government, private and partially foreign ownership, limited-service financial institutions, and credit cooperatives. This was followed by the banking decree of 15 June 1991, which accorded SBV supervision authority over the banking sector. On 15 November 1991 the SBV used its new authority to set interest rates, making adjustments for inflation and further correcting the inverted interest rate structure. In 1992 interest rates turned significantly positive in real terms, net credit to the Government fell below zero, credit to the private sector expanded rapidly. Inflation fell to 12.4% in 1992 and 5.2% in 1993. In that year Vietnam also revised its constitution to protect private property and to recognize the role of the private sector. Subsequently new company, contract, banking and foreign investment laws were enacted. In 1993 a new land law was passed, providing for land use certificates that can be sold, leased, inherited and mortgaged. (IMF 1990: 18-27, 58; Seibel 1992: 48-57; World Bank 1991, 1993)

Growth and development did not evolve unimpeded. The new opportunities that came with the market economy destroyed the old system, while the new system was still far from functioning smoothly. The new enthusiasm led to mushroom growth of private enterprises and unfettered speculation. As domestic and foreign investment surged, credit expanded rapidly, both from formal and informal sources. The economy overheated, with a bubble in 1998 and the return of inflation. At the same time, reforms stalled, and foreign investors started to rush out. As inflation surged, SBV was authorized to intervene, setting a base rate and limiting the interest rate spread. The economy slowed down, and, during 1999-2001, the inflation rate fell to levels at and below 0%.

Despite ups and downs, Vietnam has continued to grow over the past two decades in a remarkable way. Private enterprise is now the backbone of the economy in all productive sectors. Out of 12,000 SOEs, around 10,000 have been fully or partially privatized, including, as of 2007, one of the state-owned commercial banks. There seems to be hardly anyone who is not involved in one or several private businesses. Economic performance is paralleled

by social performance. Sustainable poverty alleviation has spread to a remarkable extent. Between 1990 and 2004 the percentage of the population living on $1 or less per day (at purchasing power parity) declined from over 50% to below 10%. Today 94% of households have electricity; almost all children attend primary school; nearly two-thirds stay on to upper secondary level.

Perhaps fastest and most impressive has been the impact of the change in agricultural policy, starting in the late 1980s. Private land use rights with long leases have replaced collective agriculture; and free input purchasing and produce marketing have been substituted for administrative factor allocations. Yet the freehold has remained with the central Government; this has created a system of equitable land use by farmer households and prevented abuse by local authorities, which has been so widespread in China. Harnessing the power of millions of smallholders as private entrepreneurs, the result has been an agricultural miracle, happening almost overnight. In 1989 Vietnam turned from a net importer to an exporter of rice amounting to 1.4m tons, earning over US$300m in foreign exchange. By 1993 Vietnam had become the world's third-largest and by 1996 the second-largest rice exporter; it is now also a major exporter of coffee and other farm, forest and fisheries produce.

Free enterprise, free trade and sensible state finances have been the key factors of success. Huge problems remain, among them a poor infrastructure, pervasive corruption and, as The Economist (2008: 4, 9) stated, "the glacial speed of legislative and bureaucratic processes" as well as pitiful standards of corporate governance, accounts being "largely works of fiction." Yet no one doubts that Vietnam is on the right track, that the transition from a command economy to free competition is irreversible, welcomed by all including the communist party, and that there is good reason to believe that Vietnam will continue overcoming the obstacles to continual growth and development as it did over the past two decades.

B. The fall of the old system of credit cooperatives

Rural credit cooperatives were introduced in the northern part of Vietnam in 1956. Around 1960 some 5,500 were in existence. In some parts of southern Vietnam cooperatives of the Raiffeisen type had been introduced under French colonialism. After 1975, the year of independence, they became part of the command economy under the leadership of the communist party. In the early 1980s the number of credit cooperatives further expanded. Their main functions were to collect small deposits and to provide credit to production cooperatives, farm households and small SOEs. Loans were used for agricultural and nonagricultural purposes, house construction, consumption and emergencies. At the eve of the announcement of Doi Moi, in the mid-1980s, nearly 7,200 credit cooperatives were in existence, covering almost all communes. (Boi & Hung 1992: 17-19)

Vietnam's old system of credit cooperatives collapsed at the end of the 1980s together with the old order, leaving a void in the rural areas. As production cooperatives were replaced by smallholders with private land use rights and, together with local SOEs, were unable to honor their repayment obligations, all but a few rural credit cooperatives were closed. By the end of 1990 only 160 were left operative, with an equity capital of $0.22m, savings deposits from members and non-members of $9.37m, deposits by production cooperatives and SOEs of $1.5m, and miscellaneous liabilities of $1.47m. Their total capital and liabilities amounted to $12.56m, averaging $78,500 per credit cooperative. [3] (Boi & Hung 1992: 22) If these figures are in any way representative, then the total assets of the 7,000 credit cooperatives that were closed amounted to around $550m; and close to $500m of that amount would have been raised through equity and deposits that were lost when they broke down.

[3] At an exchange rate of Dong 10,000 to the US$.

A complex set of factors led to the fall of the credit cooperatives, among them the incipient shift to private enterprise and the loss of confidence in the old state system, hyperinflation together with the erosion of capital, and the resulting liquidity crisis. In terms of governance and management, credit cooperatives were an instrument in the hands of the Local People's Committee (LPC), lacking autonomy, oversight by an independent board, and professionalism. As they were regarded as an instrument of the command economy, members did not identify with it. In operational terms, there was no insistence on good performance, neither of the credit cooperatives nor of production cooperatives and SOEs as their clients. No rigid criteria and processes of credit appraisal, risk management and internal control were applied. In terms of regulation, there was a lack of standards. Capital requirements, or rather recommendations, were minimal, amounting to $1,000-$3,000. In terms of supervision, credit cooperatives were not subject to any financial authority; there was thus no external agency or mechanism to enforce sound practices. In terms of infrastructure, credit cooperatives were isolated local units without any network and apex institutions; they had no access to sources of refinance and liquidity exchange; there was no communication between them at provincial or national levels and thus no advocacy to work out any restructuring plans.

C. Would restructuring of the old system have been feasible?

While the mono-tier banking system was converted into a two-tier system, all attention focused on the central bank and the newly separated state-owned commercial banks (SOCBs) with their new functions. These included the Vietnam Bank for Agriculture (VBA), specialized on agricultural finance. In the turmoil the credit cooperatives, which had not been part of the SBV, were left out of the reform effort. Faced with the option: *close them or reform them*, the Government opted for the former. At the end, abandoned by the policymaker[4], the credit cooperatives were unable to cope with the onslaught of the market economy. In the absence of any reporting system it might very well be – and indeed is most likely – that the true state of affairs had gone unnoticed; that many of the credit cooperatives had been inoperative and technically bankrupt long before; and that only the economic crisis had brought this out in the open.

Interestingly, a small number of rural credit cooperatives did survive; they were restructured and eventually integrated into the new credit cooperative system. We visited one restructured credit cooperative, in Duong Noi, which has performed quite well as a PCF (*Annex 1*). It appears that a good number of the management and staff of the old credit cooperatives found employment in the PCFs, which may be an indication of the potential, after due retraining, of human resources in the old cooperatives. However, as there are no systematic studies of their transformation – not even their number is known –, we cannot tell whether restructuring and reform might have been feasible on a wider scale. In the face of a near-total economic crisis, the Government took the path of closing, rather than transforming, the old system of credit cooperatives and creating a new system from scratch. What was retained, however, was the basic idea of a cooperative as a local financial institution, in competition with other financial institutions, notably the Vietnam Bank for Agriculture (renamed Vietnam Bank for Agriculture and Rural Development, VBARD, in 1996) and, since 1995, the Bank for the Poor (renamed Social Policy Bank in 2003).

The cooperative sector as a whole, particularly the non-financial cooperatives, was restructured and survived. By the early 1990s several thousand small rural and urban

[4] Salvaging VBA, but not the credit cooperatives, was a political, not an economic decision, as technical bankruptcy was a fate shared by both. As the World Bank (1993: 150) stated, "VBA's financial viability has been constrained by a negative equity base resulting from a high proportion of bad or overdue debts from state enterprises, and an interest rate spread which is insufficient to cover present operating costs and needed provisions for loan losses…. VBA has had to set aside some $53m for bad debts to state enterprises mostly inherited from the prereform era".

cooperatives, most of them non-financial, were left, though little information was available on the number still in operation. (World Bank 1993: 56) In March 1996 a new law on cooperatives was passed, followed by a law on credit institutions in December 1997. Both laws included credit cooperatives and were designed to tighten regulation and control. By 2000 a total of 8,025 cooperatives of various types had been restructured in conformity with the new cooperative law, 3,766 were newly established, and 3,353 were under preparation. (Hung 2002: 20)

III. Designing a new system of credit cooperatives

A. Examining the options

As part of a stated policy to reform and strengthen the country's financial system, the financial institutions law of 1990 provided a legal framework for the reorganization of the subsector of rural credit cooperatives. One of the options discussed were rural shareholding banks at the district level, relegating credit cooperatives to the role of local agents. In areas where shareholding banks were absent, credit cooperative could act as agents of VBA, handling small loans below the level feasible for a bank. Yet it was realized that this would not transform them into viable local institutions with responsible management; lack of autonomy would be their principal problem.

The Government thus initiated a search for a new model. During 1991 and 1992 a team from SBV and several government agencies examined the Grameen Bank in Bangladesh, cooperative banks of the Raiffeisen and Schulze-Delitzsch type in Germany with their origins dating back to 1850, and the cooperative *caisses* or credit unions in Canada initiated in 1900 by Desjardins. While the German and Canadian cooperative models are quite similar and the latter had been inspired by the former, SBV entered into a dialogue with Développement international Desjardins (DID) and decided on a pilot project for the period 1993-2000. Technical assistance by DID, funded by CIDA, started at the end of 1994. ADB became the main external supplier of liquidity after 1995 when a central fund was established. Other donors followed.

B. Deciding on a strategy

In the early 1990s a steering committee was formed for a pilot project, with the task of establishing a new network of rural credit cooperatives and guiding them throughout the duration of the pilot project. The committee comprised SBV as the lead agency, the Ministry of Finance, the Ministry of Planning & Investment, the Ministry of Cooperatives, the Ministry of Government and the Vietnam Cooperative Alliance. Its executive committee was placed in the SBV and consisted of officials of the SBV. To implement the establishment of PCFs, steering committees were formed at all levels of the administrative structure: central, provincial, district and commune. This was paralleled by a focal involvement of a newly established People’s Credit Institution Division of SBV in Hanoi and of all its branches. During the start-up phase, a wide range of technical support services were offered by DID, beginning in March 1994. In 1996 ADB approved a loan to the PCF network, comprising $14.8 million for refinancing and $1.395 for equipment and training.

To avoid any resemblance to the defunct system, which was cooperative in name but not in nature, a new name had to be found: People's Credit Funds (PCFs) – cooperative in nature but not in name.

PCFs are commune-based financial institutions which follow international practices of savings and credit cooperatives. They are jointly owned, financed and managed by their members to provide financial services. They are characterized internally by equal voting rights and self-management and externally by network linkages including intra-network support by apex organizations. In order to avoid a repetition of the mistakes of the old system and the risk of collapse, the PCFs were tightly guided and supervised by two departments of SBV, involving all its branches.

SBV provided a regulatory framework for the PCFs and training in all relevant aspects, organized on a national scale. Two units of SBV were involved in the training program: the

People's Credit Institution Department and the Center for Banking Research and Training (CBRT). They first designed the curriculum and training materials. The actual training proceeded then in two steps: (a) CBRT trained the officers of the SBV branches; and (b) the SBV branches trained the PCF board members and staff, a mandatory program still offered free of charge. This was followed by training-on-the-job and monitoring by SBV officers instructing the PCF staff in all practical affairs.

The PCF network was designed to comprise three types of institutions: (a) primary societies (PCFs); (b) a Central People's Credit Fund (CCF) together with Regional People's Credit Funds (RCFs), established in 1995 and integrated into CCF in 2000; and (c) a business organization, the Vietnam Association of PCFs (VAPCF), established in 2006.

C. Designing a model of self-reliant People's Credit Funds (PCFs)

PCFs are voluntary local organizations with at least 30 members[5]. They are based on the principles of self-help, self-reliance, self-management and democracy. In more concrete terms, they are formed and developed through the initiative of their local members; they are self-financed through shares, deposits and retained earnings; they are professionally managed by a team of qualified employees under the control of a board; and the board is democratically elected by the members, all with equal voting rights. Unlike the former credit cooperatives, they are part of a network, functioning as a nation-wide system of mutual support. It provides model bye-laws and various apex services, including access to liquidity exchange and refinancing by a central fund (including regional funds until 2000), co-owned by the PCFs. 95% of the PCFs are rural-based; given the ample supply of financial services in cities, SBV has discouraged the establishment of urban PCFs.

PCFs are formal financial institutions, established at inception under the law on banks, credit cooperatives and finance companies of 1990. They were subsequently placed under the law on cooperatives of March 1996, the law on credit institutions of 1997 and the decree on the model statute and operation of the PCF of 2001, amended in 2005.[6] The legal environment has greatly improved, with greater transparency and stronger legal enforcement. PCFs are regulated by SBV; but they are not audited. Their performance and compliance are effectively supervised by the SBV at branch level, which has the authority of licensing and, in case of non-performance, closing PCFs.

Members may be individuals, heads of households, cooperatives, local enterprises and social organizations. Lending outreach is restricted to the commune where the PCF is located; depositor outreach may extend to neighboring communes, but should not exceed 40% of total deposits. The membership fee, or qualifying share which is not dividend-earning, has been set at around D50,000 ($3). Basically profits are ploughed back into retained earnings; but members, mostly the founding members, may purchase dividend-earning shares of up to 30% of charter capital. The dividend is decided by the general assembly, but must not exceed the annual average lending rate.

The board of directors consists of three to nine persons elected by the general assembly for a five-year term. Board members are usually experienced and respected citizens who played a leading role as founding members and may hold a considerable portion of dividend-earning shares. The board decides on capital increases, interest rates within the range set by SBV, recruitment and expenditure. It also appoints the managing director, to be approved by the general assembly and confirmed by the local SBV branch. Frequently the chairman of the board also serves as managing director. The credit committee, comprising the managing

[5] Initially 12, since April 1997 30 founding members living in the same commune. They elect a temporary board of directors and steer the establishment process.
[6] Decree # 165 of 2007 on small financial institutions does not include PCFs.

director and board members, decides on loans which exceed the managing director's lending authority. Internal control is placed in the hands of supervision committee, which is elected by the general assembly.

In the early years local government, through the Local People's Committee (LPC), took considerable influence on the establishment and running of the local PCF. Establishing viable and sustainable financial institutions was a major concern of local government, aiming at the recycling of local financial resources and preventing their siphoning off to urban areas. The LPC in the respective communes first helped carrying out a feasibility study, preparing a business plan and organizing the establishment process including the application for a license from the provincial SBV branch. Subsequently it took responsibility for the performance of the PCF, in a joint effort with SBV to avoid a repetition of cooperative failure by all means. Direct influence on management and business decisions has reportedly subsided with increasing experience of management and staff and growing confidence in cooperative self-management, giving room to genuinely democratic processes, particularly since the end of the pilot period. The LPC still has a role to play when problems arise, to facilitate collection in case of defaulting, or to provide land for the premises of the PCF.

Management and staff have to be qualified and are remunerated for their work.[7] SBV has a mandatory basic training program in bookkeeping, loan appraisal, loan administration, internal control and cooperative management. Mandatory and voluntary training continue life-long, provided by SBV, CCF, VAPCF and other institutions. Standardization of staff training is under preparation.

Lending is restricted to members in good standing; but PCFs are also allowed to lend to poor non-members, restricted to 10% of their portfolio. About 30% of the borrowers are women.[8] The portfolio of PCFs is generally diversified, comprising loans for agricultural production and processing, crafts, services, trading, consumption and emergencies.[9] The emphasis is on productive loan purposes, particularly agriculture, given the location of the PCF and the main occupation of most of the members. Loans for socioeconomic organizations and small enterprises are mainly for equipment, modernization and expansion. Procedures are kept simple. The appraisal process, collateral, loan loss provisioning, record-keeping and reporting are regulated by SBV. Most loans are secured, except small loans and loans to the poor. The most common collateral is land use and house ownership certificates – mainly a formality as these are difficult to alienate.

Interest rates are determined by the board within the limits set by SBV. Repressive interest rate policies of SBV[10] have restricted the profitability and the growth of retained earnings of the PCFs. In June 2002 SBV liberalized interest rates; but a moral obligation on the part of the PCFs to keep interest rates low has continued to prevail. In an attempt to fight inflation SBV has now (2008) returned to its restrictive interest rate policy by limiting the net interest rate margin – an imposition which has not been welcomed by the PCFs and is again depressing their profits. In May 2008 SBV introduced new ceilings not exceeding 50% of the base rate, at the time being 14% + 7% = 21% as a cap on lending rates. This is just 4% above the PCF's deposit interest rate.

Deposits are mobilized from members and non-members, individuals and organizations. PCFs offer attractive conditions: proximity which entails lower depositor transaction costs;

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[7] Salaries in a PCF in Ho Chi Minh City in 1997 ranged from $22 for a guard and $30 for a cashier to $54 for the director and for the chairman of the board. (DID 1998: 17)
[8] In 1996 30% of borrowers were found to be women, accounting for 27% of loans outstanding (DID 1998: 6). In a study in 2000 by Hung et al. (2002: 60) the respective percentages were 32% and 29%.
[9] In 2000 Hung et al. (2002:60) found the following distribution by loan purpose: 58% agriculture, 27% trade and services, 12% agro-processing and crafts, 3% consumption.
[10] The central bank law of October 1998 authorizes SBV to set base interest rates and to regulate the net interest margin, thus limiting the range of savings and lending rates and profitability.

diversified products including demand, term, regular and discount deposits (with prepaid interests); higher interest rates than in banks; and term deposit insurance under the Vietnam Insurance Company (BAOVIET). As a result deposits usually account for three-quarters or more of loans outstanding: a solid basis of self-reliance. Surplus deposits are placed at the central fund; there is no direct placement of deposits or interlending between individual PCFs. Other financial services include bill payments and remittances. PCFs may also act as trust agencies for various kinds of governmental and non-governmental development programs. Both loans and deposits are mostly short-term (up to one year).

PCFs are subject to income tax up to 28%, varying by province. The first two years of a newly established PCF are tax-exempt.

Prudential standards include a minimum capital requirement of D100 million ($6,240 in 2007), a risk-weighted capital adequacy ratio of 8%, a fixed asset ratio of at most 50% of equity, reserve requirements (placed interest-free at SBV) of 1% of Dong deposits and 8% of US$ deposits, a single borrower limit of 15% (up from 10% at inception) of equity, adequate maturity matching (at most 10% of short-term deposits used for term loans) and observance of SBV's provisioning rules.

PCFs are subject to three types of oversight: daily internal control; regular random inspections by the SBV branch; and remote supervision by the supervision department of SBV. PCFs send their financial and credit reports to the SBV branches as well as the CCF branches. The SBV branches forward them to the PCF Division of the Supervision Department and the CCI of SBV. Online reporting is expanding, but not yet universal. Based on the monthly report, an SBV branch may intervene directly in case of irregularities or poor performance.

The main provider of technical assistance (TA) to the PCF network, on a continual basis since 1994, has been DID. ADB has provided TA in the framework of its financial assistance. GTZ has provided TA in 1999-2004, followed by a banking sector reform project with a PCF component since 2005; the GTZ projects have also included assistance by DGRV[11], the German cooperative auditing federation. Several donors have provided credit lines which are managed by CCF (*see below*).

[11] The ongoing support is part of a DGRV project for South East Asia, comprising Cambodia, Laos and Vietnam.

IV. The evolution of the People's Credit Funds (PCFs)

A. Institutional overview

The pilot project establishing PCFs started in July 1993. The first 179 PCFs were set up during the second half of 1993 and in 1994. They included a small number of surviving credit cooperatives that were transformed into PCFs. In 1994 SBV formally established a Credit Cooperative Institutions Department (CCI), which took charge of guidance, monitoring and supervision of PCFs. Hence, statistical information is only available as of 1994, encompassing information on PCFs established during 1993 and 1994.

Coverage and outreach: Between 1994 and 2007 the number of PCFs grew from 179 to 973; by June 2008 they reached 1005. PCFs now exist in 56 out of 64 provinces. During the 13-year period, the number of PCFs grew 5.4-fold, while the membership grew 25-fold, from an average of 257 members per PCF to 1,190. The largest annual increases in size occurred during the boom years 1996, 1997 and 1998, with annual increases in average membership above 100, reaching 662 members per PCF in 1998. Since 1999 the increase in average size has slowed down, with continual average annual increases of around 60 during 2001-03 and around 50 during 2004-06. In 2007 average PCF size increased by only 19 members. To a smaller extent this is due to the establishment of a larger number of new PCFs, with a small initial membership; to a larger extent it indicates that well-established PCFs, still limited in outreach to a single commune each, have reached a saturation point. This will change once PCFs start expanding into neighboring communes, for which SBV would first have to give the green light. There is a considerable demand for expansion. Eg, the CCF branch in Hatay which we visited reports that among the 320 communes in its area of operation an additional 100 PCFs could be established; 40 applications are presently being processed. *Depositor outreach:* SBV does not report on the number of depositors, which includes members as well as non-members, the latter also from neighboring communes. Judging from anecdotal evidence [12] total outreach of the PCFs as of December 2007 may be around 3m, comprising 1.2m members and 1.8m non-members.

Borrower outreach: Since 1997 SBV also reports on the number of borrowers. Until 1999 the number of reported loans exceeded the number of members. This changed in 2000. In 2007 the number of loans was 785,638, the number of members 1,157,416.

Total assets grew 112-fold from $7.6m in 1994 to $850.7m in 2007; in terms of Dong, the growth was 163-fold. During the same period, mean total assets per PCF grew almost 21-fold, from $42,500 in 1994 to $874,000 in 2007. During 1995 and 1996, the period of rapid expansion of the number of PCFs, mean total assets per PCF almost doubled every year. They stagnated during the following two years of the slow-down of expansion, 1997 and 1998. During the consolidation period, 1999-2002, they gradually increased. With the resumption of expansion of the network in 2003, average total asset per PCF increased substantially, by $77,000 and $72,000 in 2003 and 2004, by $90,000 in 2005, by $124,000 in 2006 and by a remarkable $250,000 in 2007.

Loans outstanding increased 111-fold, from $6.6m in 1994 to $731.1m in 2007, practically at the same rate as total assets; in terms of Dong they increased 162-fold. As loans constitute around 86%-87% of total assets, the pattern of their growth is very similar to that of total assets. During that period the average portfolio per PCF increased from $37,000 to $751,000. The average loan outstanding per borrower increased from $169 in 1997 (the first year for which SBV reports the number of borrowers) to $931 in 2007.

[12] PCF Duong Noi reported 800 members and 1000 non-member depositors in July 2008. DID (1998: 25) reported 291 members and 776 non-member depositors of PCF Cong Hoa in 1996.

Disbursements: As most loans are short-term, ie, below one year, the volume of disbursements exceeds that of loans outstanding. During 1996-98, the first years for which data are available, disbursements exceeded loans outstanding by around 100%. Since then, average loan terms have increased somewhat, with the percentage of the amount disbursed above loans outstanding falling to 56% in 2001 and roughly staying at that level until 2007. An exception is 2006 when it fell to an unusual 11%.

Deposits of clients increased 116-fold since 1994, from $5.0m to $582.5m, in terms of Dong 169-fold. During that period the average deposit balance per PCF increased from $28,000 to $600,000. the average balance per member from $109 to $503, indicating a substantial increase in financial assets of the members. Throughout this period, the loan portfolio of the PCFs has been self-financed to a considerable extent. With the exception of a single year, the deposit-to-loan ratio was above 70%. Overall it has slightly increased, reaching 80% in 2007.

Borrowings from the CCF, the refinancing apex of the network, started in 1997, a year after it had become operational. During the ten-year period, borrowings (in terms of amounts outstanding at the end of FY) grew from $18.4m in 1997 to $153m in 2007. In percent of loans outstanding, they grew from 16% to 21%, but on the whole have remained a modest percentage, indicating the strength of local self-financing of the PCFs.

Equity has increased 39-fold from $0.98m in 1994 to $38.55m, in terms of Dong 57-fold. Average equity per PCF grew from $5,000 in 1994 to $13,000 in 1997 and remained at or below that level until 2001. Strenghtening the equity base was apparently not part of the consolidation effort, which started in 1999. Since 2002 it gradually increased to $30,000 in 2006 and surged to $40,000 in 2007, with a further jump to $72,000 as of June 2008. SBV does not provide information on capital adequacy. As a percentage of loans outstanding (not risk-weighted), total equity declined from 14.9% in 1994 to 5.3% in 2007, but increased to 9.4% as of June 2008.

Balance sheet trends: Figure 2 shows how closely loans outstanding have been related to total assets, and client deposits to loans outstanding, throughout the history of the PCFs; and how total assets, loans outstanding and deposits have surged, virtually in unison, from 1994 to 2007, with a flattening of the parallel curves after 1996 and a turn-around to an increasingly steep incline in 2002. Borrowings have stagnated at a very low level until 2000, after which they increased modestly until 2004. In the last three years they grew somewhat faster; but the rate of growth as indicated by the incline remained far behind that of total assets, loans and deposits. Equity has remained at a low level. Its growth has remained far behind that of the other curves, indicating an inherent source of weakness of the PCFs which might make it difficult for them to cope with major external shocks.

Repayment performance: The PCFs have been performing well in terms of repayment. Payments are considered overdue if late by one day or more; in actual fact, borrowers are reportedly given a grace period of up 10 ten days before a payment is rated as overdue – still rather strict for a cooperative financial institution or any other type of MFI. In 1994 and 1995 overdue ratios were well below 1% - a meaningful figure, given the short-term nature of loans. In 1996 they climbed to 1.2% and went up to 3.5% in 1997, at a time when the expansion of the PCF network began to slow down. Until the middle of the consolidation period, 2000, they roughly stayed at that level. In 2001 and 2002, the latter part of the consolidation period, they fell to respectively 2.2% and 1.4%. Since 2003, as expansion resumed, they consistently stayed below 1%, and since 2005 at 0.5%, a level previously attained only in 1995.

Financial performance: SBV has provided information on return on average assets and equity since 2000. ROA was 1.2% in 2000. Between 2001 and 2006 it fluctuated around 1.3%-1.4%. In 2007 it fell to 0.87 and continued falling to 0.72% as of June 2008. The drop in

profitability in 2007 and 2008 is not due to an intrinsic weakness of the PCFs, but is a result of restrictions imposed by SBV on the interest margin to fight soaring inflation. Similarly, ROE started at 15% in 2000, climbed to rates between 18% and 21% and subsequently fell to 14% and 9%, respectively.

Overall performance assessment: On the whole the PCFs have performed extraordinarily well, both in quantitative terms – number of PCFs and members, amounts of loans outstanding and deposits –, and in qualitative terms – repayment rate and profitability, the latter reduced however by the recent restrictive interest rate policy of SBV designed to regain and maintain macroeconomic stability.

Performance of SBV as supervisor: The assessment of excellent performance also pertains to SBV as the supervisor, who has closed almost 100 PCFs to maintain the health of the credit cooperative sector. This is all the more impressive as this is written at a time (September 2008) when major financial institutions in the Western World collapse or suffer large losses, indicating at the same time a gigantic failure in performance of their respective regulators and supervisors.

Table 1: The development of PCFs, 1994-2007 (in million US$)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
No of PCFs	179	567	847	936	977	964	959	906	888	896	905	917	938	973
Growth in number p.a.		*388*	*280*	*89*	*41*	*-13*	*-5*	*-53*	*-18*	*8*	*9*	*12*	*21*	*35*
No. closed by SBV	0	0	0	0	0	0	5	53	24	3	3	4	4	2
No of members	46,045	153,901	378,978	522,080	646,701	727,098	797,069	807,546	850,781	911,926	966,540	1,029,987	1,098,754	1,157,416
Av. no of members/PCF	*257*	*271*	*447*	*558*	*662*	*754*	*831*	*891*	*958*	*1,018*	*1,068*	*1,123*	*1,171*	*1,190*
No of borrowers				677,717	734,796	746,481	711,769	661,443	660,361	663,757	661,663	670,933	732,774	785,638
Balance sheet														
Total assets	7.6	40.67	120.81	128.91	133.74	163.39	184.2	196.15	232.14	303.11	371.01	458.74	585.98	850.71
Av. total assets/PCF	*0.042*	*0.072*	*0.143*	*0.138*	*0.137*	*0.169*	*0.192*	*0.216*	*0.261*	*0.338*	*0.41*	*0.5*	*0.625*	*0.874*
Loans - gross	6.59	34.9	91.16	114.61	116.17	140.46	161.9	169.64	200.66	259.09	322.5	404.44	511.3	731.11
Growth p.a. in percent		*430*	*161*	*26*	*1*	*21*	*15*	*5*	*18*	*29*	*24*	*25*	*26*	*43*
Disbursements	n.a	n.a	193.47	230.69	227.33	258.02	274.83	264.19	318.3	395.85	496.42	603.63	569.49	1,131.37
Deposits	5.01	24.69	60.26	80.86	85.63	107.39	117.85	129.41	153.97	205.23	250.05	299.75	389.65	582.47
Growth in percent		*392*	*144*	*34*	*6*	*25*	*10*	*10*	*19*	*33*	*22*	*20*	*30*	*49*
Borrowings				18.39	19.62	20.44	22.34	35.92	39.77	51.88	63.36	85.96	106.7	152.98
Equity	0.98	4.32	9.05	12.01	11.03	11.28	11.96	11.8	13	15.64	19.53	24.44	28.52	38.55
Av. equity/PCF	0.005	0.008	0.011	0.013	0.011	0.012	0.012	0.013	0.015	0.017	0.022	0.027	0.03	0.04
Net profit after tax*	0.26	1.15	3.13	3.52	2.76	3.55	3.18	3.96	4.89	5.8	7.19	8.79	10.54	10.24
Financial ratios (in %)														
CAR (not risk-weighted)	14.9	12.4	9.9	10.5	9.5	8	7.4	7	6.5	6	6.1	6	5.6	5.3
Overdues (≥1 days)	0.74	0.51	1.24	3.53	3.84	3.72	3.42	2.17	1.36	0.84	0.66	0.53	0.53	0.5
ROAA*							1.17	1.37	1.43	1.38	1.4	1.38	1.3	0.87
ROAE*							15	18	20	20	21	18	19	14
Loans-to-deposits	131	141	151	142	136	131	137	131	130	126	129	135	131	126
Deposits-to-loans	76	71	66	71	74	76	73	76	77	79	78	74	76	80
US$ exchange rate	11,003	11,020	11,037	11,175	13,887	14,019	14,540	15,086	15,395	15,630	15,776	15,906	16,056	16,025

Source: Based on data from SBV

B. The reform of the PCFs

The network has evolved in three phases, which are not sharply marked, as the number of PCFs, their membership and the volume of financial transactions did not evolve at exactly the same pace; reforming the network has been an intervention by SBV over a 2-3 year period during the second phase:

(1) a period of rapid growth in the number of PCFs and members as well as in the amount of loans and deposits,1993-1996, resulting in 847 PCFs with 378,978 members;
(2) a slow-down and consolidation phase, 1997-2002, during which growth in the number of PCFs first leveled off over a two-year period, followed by a consolidation phase, based on an evaluation of the pilot project, after which SBV closed nearly 100 non-performing PCFs; by the end of 2002 the number of PCFs had fallen from a peak of 977 (in 1998) to 888, while growth in the number of members was only slightly affected, reaching 850,781 in 2002; loans and deposits (measured in US$) continued to grow at a low rate;
(3) the current phase since 2003, is characterized by three trends: cautious growth in the number of PCFs, with SBV closing about 3 PCFs per year; continual growth in membership; and rapid growth in loans and deposits, indicating the members' trust in their cooperatives. By the end of 2007, the network covered 973 PCFs with 1.16m members, total assets of $851m, loans outstanding of $731m and total deposits of $582m. By June 2008 the network had expanded to 1005 PCFs with 1.2m members and total assets of $888 million.

Highlights of the evolution of the PCF network are summarized in Table 2 below.

Table 2: Highlights of the evolution of the network of PCFs

July 1993	Start of the pilot project establishing People's Credit Funds; first 179 PCFs established during 1993-94
1995	Central People's Credit Fund (CCF) established, together with a growing number of Regional People's Credit Funds (RCFs)
1997	Slow-down of expansion
1999	Assessment and subsequent consolidation of the network; nearly 100 PCFs closed in 1999-2002
2000	Official conclusion of pilot phase in March 2000; network reorganized into two tiers, PCFs and CCF; RCFs converted into CCF branches
2002	Growth of loans and deposits resumed at increasing rates
2003	Cautious expansion of the network resumed
2006	Vietnam Association of PCFs (VAPCF) established
2009/10	CCF expected to be converted into a commercial bank
2020	1700 PCFs expected to cover about 6,000 communes

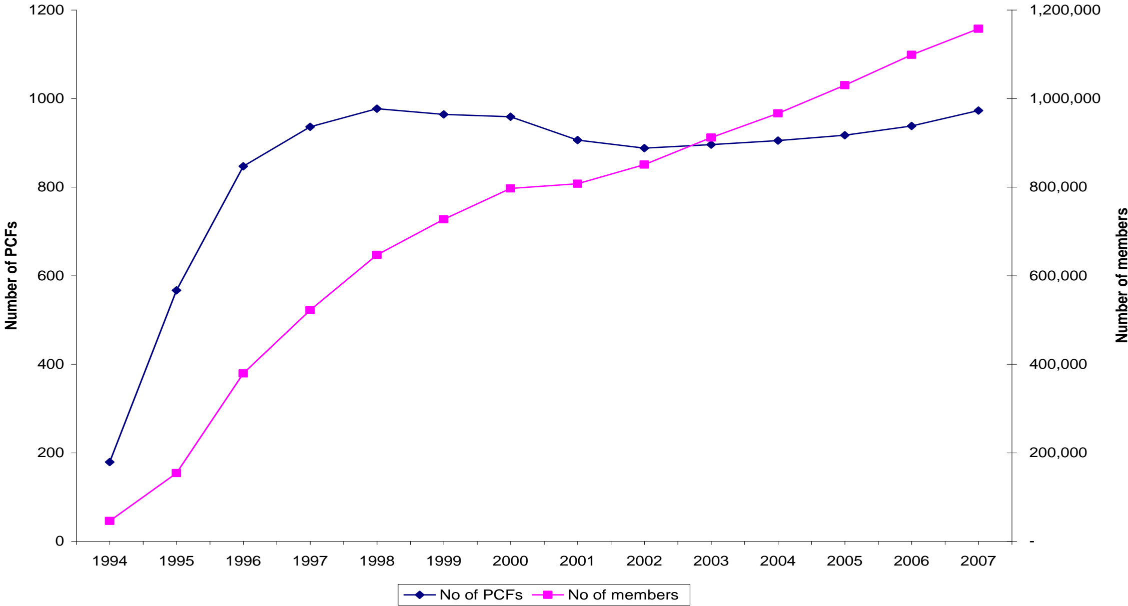
The overall evolution of the network of PCFs is graphically represented in two figures below. Figure 1 shows the rapid growth in the number of PCFs during the initial years, a subsequent leveling off and decrease, and slow growth since 2003. This contrasts with the continual growth in membership, only slightly affected in 2001 by the consolidation. Figure 2 shows the rapid increase in total assets, loans outstanding and deposits during the initial years, followed by low growth rates during 1997-2001, and stellar growth after 2002. Equity has been insignificant throughout; borrowings have picked up since 2001, but remained far behind the value of deposits.

It is expected by SBV that the present phase of cautious growth in the number of the PCFs will be followed by a 10-year phase of rapid expansion, at the end of which most communes will be covered; and that within a year or two CCF will be converted into a commercial bank, with a rapidly expanding portfolio. VAPCF is expected to assume a wide spectrum of non-

financial functions as a network apex, including training, consulting and auditing in auxiliary organizations.

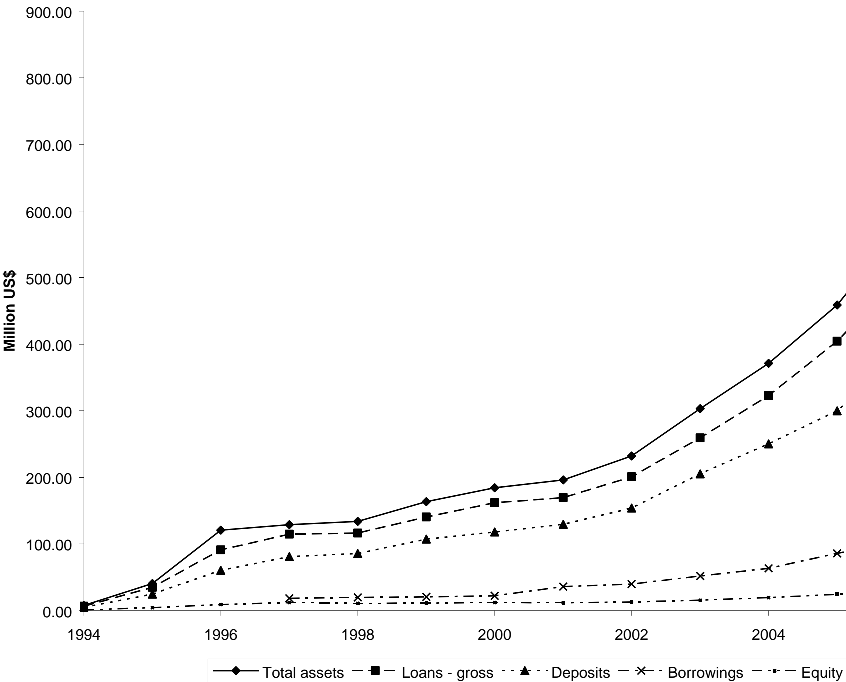
Reform of the network has been an intervention prepared by SBV through an assessment at the end of the pilot project. It was implemented by tightening supervision while closing a large number of PCFs during 2000-2002. Enforcement of prudential regulation was the decisive act which prepared the ground for the cautious growth in the number of PCFs and the spectacular growth in financial intermediation since 2003. One major challenge is left for SBV: full interest rate deregulation for PCFs as a prerequisite of financial deepening, growth and inclusive financial services reaching large numbers of low-income groups in rural areas.

Figure 1: Number of PCFs and members, 1994-2007



Source: Table 5, based on data from SBV

Figure 2: PCFs: total assets, loans outstanding, deposits, borrowings & equity, 1994-2007



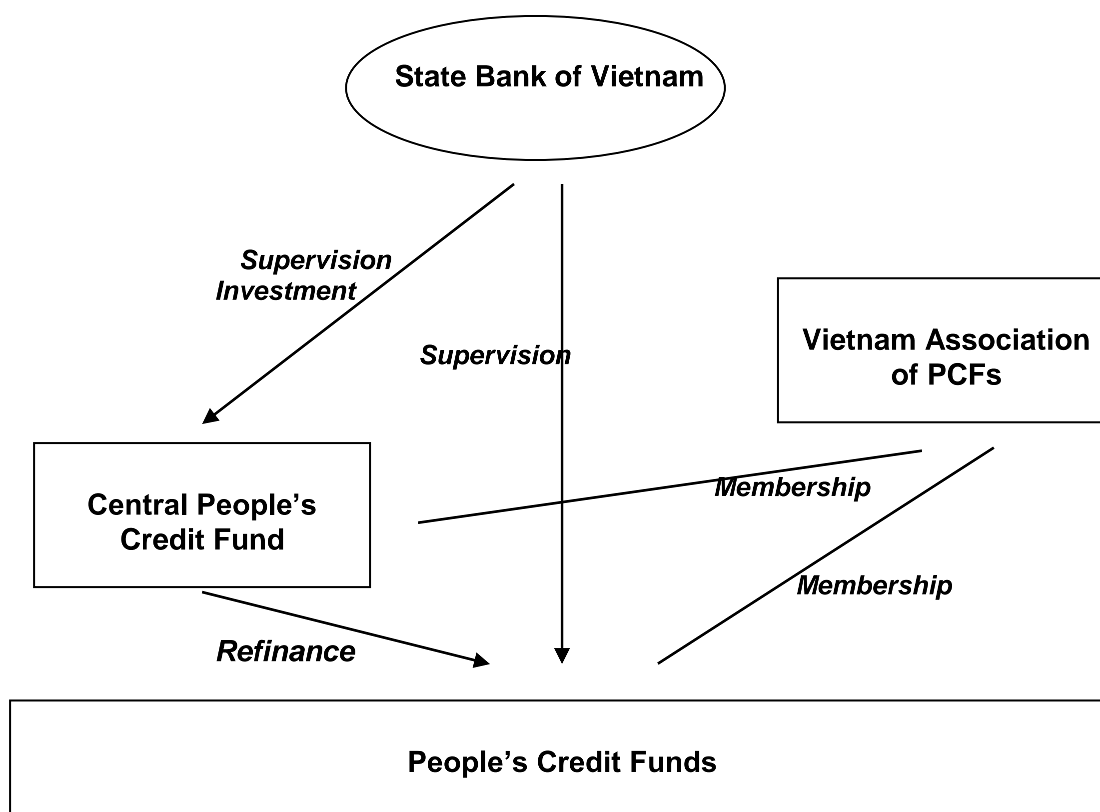
Source: Table 5, based on data from SBV

V. Building an apex structure

A. Overview

The apex structure of the PCF network comprises the Central People's Credit Fund (CCF), established in 1995, as a refinancing agency for the PCFs, acting until recently also as a representative body; and the Vietnam Association of PCFs (VAPCF), established in 2006, as a representative body in which the CCF and the PCFs are members. The State Bank of Vietnam (SBV) is the supervisor of the PCFs and the CCF, the majority shareholder of the CCF, and a guidance and training agency for the PCFs. Figure 3 gives an overview.

Figure 3: Apex structure of the People's Credit Fund network



Key financial data of the PCFs and the CCF are given in Table 3, indicating that the PCFs in terms of most key balance sheet data are more than twice the size of the CCF. They are also more efficient than the CCF, with less than half the overdue ratio and twice the ratio of return on assets.

Table 3: Key financial data, PCFs and CCF, 2007 (in million US$)

	PCFs	CCF
Total assets	850.7	378.0
Loans outstanding	731.1	293.5
Deposits	582.5	280.8
Borrowings	153.0	71.0
Total equity	38.6	14.9
Net profit after tax	10.2	1.4
Overdue ratio (≥1 days)	0.5%	1.3%
ROAA	0.87%	0.43%

B. The Central People's Credit Fund (CCF)

1. Institutional overview

Establishment, legal form and mandate: CCF was licensed by SBV in 1995 as the apex cooperative financial institution of the PCF network and started its lending operations during the same year. There was no equivalent in the old credit cooperative system. The CCF is a joint stock credit institution under the law of cooperatives, the law of credit institutions and the decree (of 2001) on PCF including CCF; it is supervised by SBV. It is expected to be transformed into a commercial bank. CCF provides financial services to PCFs and the general public, including SMEs, farmers and CCF staff. In addition it provides technical assistance to PCFs and has been acting as focal point for the network in its relations with SBV, domestic and international organizations. Its annual report comes out in two languages, Vietnamese and English, and reports on CCF, the PCFs and VAPCF. It is audited by Deloitte.

Regional People's Credit Funds (RCFs): From 1995 to 2000 the refinancing function of the CCF was paralleled by a number of RCFs, a dual but overlapping structure. The RCFs operated independently from the CCF; but in the two largest cities, Hanoi and HCM, the CCF acted as an RCF, lending directly to the PCFs. In all other provinces where an RCF existed the CCF refinanced the RCFs for onlending to the PCFs. In provinces without an RCF, the SBV branch took the role of an apex, refinancing the PCFs. Various inconsistencies emerged, pointing to a need for restructuring. On the one hand, during 1998-2000, total assets, loans outstanding and mobilized deposits of the RCFs grew faster than those of CCF, exceeding those of the CCF throughout the three-year period. The discrepancy was widest in terms of deposits, which in 2000 amounted to $0.15 million in CCF and $10.8 million in the RCFs. On the other hand, in terms of capital strength and efficiency, CCF did far better than the RCFs. Equity of the RCFs, at $1.6 million in 2000, was but a fraction of that of CCF at $14.9 million; and their capital adequacy ratio was less than half. Furthermore, while overdue ratios of the RCFs were low, they still were a multiple of those of CCF. The net profit of CCF exceeded that of the RCFs by more than 50%; and its return on assets was almost 50% higher (*see Annex 1* and Table 7). The RCFs thus exceeded the performance of CCF in quantitative terms, while CCF outperformed the RCFs in qualitative terms. The Government, with its concern for quality, thus decided to merge the two types of central funds in 2001, transforming the 21 RCFs into branches of CCF.

Ownership and capitalization: CCF is owned by the PCFs, the four state banks and the Government as a special member represented by SBV. SBV owns a controlling share. The legal capital as of 31 December 2007 amounted to $7.0 million. The PCFs contribute D10 million each, amounting to 9.0% of the legal capital; the state banks contribute D5 billion each, amounting to 17.8%; SBV holds the remaining 73.2%. In early 2008 SBV injected D600 billion, bringing the total up to D712 billion ($42.5 million by the exchange rate of July 2008), and its share to 95.8%. The Government plans to increase its legal capital up to D2.0 trillion in 2009.[13]

Governance: The general assembly of CCF comprises SBV, the four state banks and the PCFs on a representative basis, with one-fifth of the PCFs attending the annual meetings on a rotating basis. SBV has a strong influence on CCF not only as an owner but also on its governance, in two respects. First, the policy and legal framework in which CCF operates has been determined by SBV. Second, the chairman of the board of management, in a full-time position who also serves as chairman of the board of VAPCF, is a former director of the CCI at SBV and has been delegated to CCF by SBV; his predecessor came also from SBV. The general director of CCF since 1997 is the former secretary to the Governor of SBV.

[13] Minimum capital requirements for commercial banks have been raised to D1.0 trillion in 2008. They are expected to be increased to D2.0 trillion in 2009 and D3.0 trillion in 2010. SBV has stopped licensing new domestic banks and focuses on strengthening the existing ones.

There is agreement that the overwhelming influence of SBV on CCF as well as on the PCFs has been for the benefit of the system.

Management and supervisory boards: The board of management, with a term of five years, has 11 members: the chairman of the board and the general director from SBV; four board members from the four state commercial banks; and five representatives of the PCFs. All board members thus have a strong financial institutions background, the majority intimately familiar with the PCF system. The supervisory board, which permanently works in CCF, has three members, comprising a full-time chairperson and two PCF directors. The management, or executive committee, is comprised of the chairman of the board, the general director and four deputy general directors.

Organizational structure and employment: CCF is comprised of a head office in Hanoi which also serves as a city branch plus 24 regional branches, 21 of them former RCFs. It has 1,110 employees. The head office has 12 functional departments and five external units, one with deposit and credit services and four for deposit collection. The branches, with a staff of 11-25, have four functional departments and may also have external units, mostly for deposit collection. Branches have annual business plans and operate as profit centers. CCF has its own salary structure and is free to hire its personnel on the market, with the exception of deputy general directors who are nominated by CCF and approved by SBV. Like SOEs, CCF is not part of the civil service. The Ministry of Finance approves recruitment plans as part of the annual business plan, but is not involved in individual appointments. Performance incentives take into account branch and individual performance. They are based on monthly performance appraisals and quarterly salary reviews, plus an annual bonus. Performance incentives may effectively double one's salary. CCF has no training institute of its own. Training is done on the job and by external institutions including the banking academy.

Lending authority of branch managers for loans to PCFs is 50% of net loans outstanding of the respective PCF, D2.0 billion for productive loans to individuals and D50 million for consumer loans. For SOEs with equity up to D10 billion it is D1.5 billion and for SOEs with equity above D10 billion it is D5.0 billion. For joint stock companies and cooperatives it is D4.0 billion. Applications for larger loans have to be submitted to the credit committee at the head office.

Risk management in CCF pertains to four major risks: credit risk, which is jointly managed by the credit department and internal control; liquidity and solvency risk in the hands of the prudential standards department, which may issue early warnings to the credit and planning departments; market risk under the credit and planning departments; and interest rate risk under the planning and accounting departments. An internal auditing department, made mandatory for commercial banks and CCF in 2007, is being built up with technical assistance from GTZ.

Provisioning differs by borrower category. No provisions are being made for loans to PCFs; hence gross and net loans were identical for the period 1995-2000. With the beginning of lending to the general public in 2001, provisions were made for that segment of the portfolio, accounting in 2007 for 2.5% of that segment and 1.2% of the total portfolio. (Table 7)

The accounting system is largely in line with international accounting standards. Reporting is based on a format issued by SBV. The accounting department prepares a daily balance sheet, which is sent to all departments. The branches submit their data daily, with automatic overnight inclusion in a consolidated report.

Deposit products: CCF accepts deposits from corporate and individual clients. Deposit-taking from PCFs started in 1998 and from the general public in 2001. As of 31 December 2007 total deposits amounted to $280.7 million, comprising 14.9% from PCFs, 39.9% from banks and 45.1% from other clients, the latter mainly in the form of term deposits. Of $126.7 million deposited by other clients, 96.9% were term deposits, 2.7% current accounts and 0.4% special deposits.

Loan products: CCF has been lending to PCFs since 1995, either directly as in Hanoi and HCM or indirectly by wholesaling through RCFs in other parts of Vietnam. Lending to SOEs started in 1998, in an effort to contribute to their viability. In 2001 CCF introduced consumer lending to individual clients. As of 31 December 2007 CCF's loan portfolio stood at $293.5 million. It is overwhelmingly short-term and financed from own funds. 52% of the portfolio is extended to PCFs, 7% to SMEs and 41% to individuals. 73% of the loans were short-term, 25% medium-term and 3% long-term. 84% of the portfolio is financed from own resources, 16% from project funds. At a rate of 85% CCF uses its own funds predominantly for short-term loans. In contrast, at a rate of 92%, project funds are predominantly used for term finance. Loans to SOEs, amounting to $1.2 million from own funds only, accounted for 0.4% of the portfolio and 6% of SME lending; two-thirds were short-term and one-third medium-term. CCF does not offer any loan protection insurance; the feasibility of a life insurance product for loan protection is under study.

Table 4: Loan products by term and source of funds, 31 December 2007 (loans outstanding in million US$)

Borrower & source of funds	***Short-term***	***Medium-term***	***Long-term***	***Total***
PCF:	115.0	30.3	7.6	**152.9**
Own funds	*110.9*	*0.0*	*0.0*	***110.9***
Project funds	*4.1*	*30.3*	*7.6*	***42.0***
SMEs	15.5	4.6	0.2	**20.3**
Own funds	*15.5*	*4.6*	*0.2*	***20.3***
Project funds	*0.0*	*0.0*	*0.0*	***0.0***
Individual clients:	82.6	37.6	0.0	**120.2**
Own funds	*82.5*	*31.8*	*0.0*	***114.2***
Project funds	*0.1*	*5.9*	*0.0*	***6.0***
Total	**213.1**	**72.5**	**7.8**	**293.4**
Total own funds	*208.9*	*36.3*	*0.2*	***245.4***
Total project funds	*4.2*	*36.2*	*7.6*	***48.0***

Source: CCF

Interest rates on current accounts in August 2008 were 4.8% p.a. and on fixed deposits from three to 24 months between 19.24% (3-6 months) and 17.52% (24 months). Lending rates varied from 13.2% to 19.8% on loans from project funds and from 16.8% to 21.0% on loans from own funds. The net interest rate margin was 2.95%, reflecting a partially inverted interest rate structure. Long-term loans were more expensive than short-term loans. This differential is due to interest rate uncertainty; it is not an indication of greater risk of longer term loans, which actually have a lower overdue ratio (0.9%) than short-term loans (1.5%). PCFs paid the lowest, individuals the highest interest rates on their loans.

Table 5: Annual interest rates by borrower, source of funds and term, August 2008 (in %)

Borrower & source	Short-term	Medium-term	Long-term
PCFs: Own funds	16.8	17.4	18
PCFs: Project funds	13.2	14.4	14.4
SMEs: Own funds	19.8	21	21
SMEs: Project funds	13.2	13.2-19.8	13.2-19.8
Individuals: Own funds	21	21	21
Individuals: Project funds		19.8	19.8

Source: CCF

Donor relations: CCF as a financial apex handles donor credit lines to the PCF system. ADB has been the main donor since 1996. This has included two credit lines directly to CCF, $15 million in 1996-2002 for its rural credit operations and $2 million in 2005-2008 for urban low-cost housing. Its credit lines to PCFs have included $33 million in 2001-2007 for MSMEs and $3 million for tea and fruit plantations. The World Bank has provided D100 billion as part of a rural finance project in 2004-2008; a follow-up project is under preparation. The Spanish

Government has provided €15 million to PCFs to finance SMEs in 2006-2009. The Japanese government Government has provided a credit line of D60 billion for SME finance, starting in 2008. A credit line of €30 million for SME finance by the Agence Française de Développement (AFD) and a grant of €100,000 for women's micro and small enterprises by the Agence Internationale de la Francophonie (AIF) are under preparation.

Membership in international organizations: Since 2004 CCF is an active member of the Asian Confederation of Credit Unions (ACCU), which is part of the World Council of Credit Unions (WOCCU).

2. The reform of the CCF

There are *two distinct phases* in the evolution of CCF, the turn-around marked by the transformation of the CCF into a retailer-cum-wholesaler after the end of the pilot project:

- 1995. the year of establishment, to 2000, the end of the pilot project, a period of slow growth during which CCF operated as an organization separate from the RCFs and lent only to PCFs in Hanoi and HCM, to RCFs for onlending to PCFs in other parts of the country, and since 1998 to SOEs;
- a period of rapid growth since 2001, initiated by the merger of the RCFs with the CCF and the provision of retail financial services to the general public; this has laid the institutional foundation for the transformation of CCF into a commercial bank which is under discussion at the time of writing.

The merger and transformation into a retailer led to a substantial increase in financial depth as shown in Table 6. Total assets during the five-year period, 1995-2000, grew from $11.0m to 33.0m and during the following seven-year period to $ 378m, at an average annual growth rates of 40% and 149%, respectively. Similarly, total loans outstanding grew from $5.8m in 1995 to $25.8m in 2000 and $293.5m in 2007, at annual growth rates of 69% and 148%, respectively. Deposits, which started near zero in 2000, reached $280.8m in 2007, nearly matching the amount of loans outstanding. With the spectacular increase in deposits the relative weight of borrowings declined. In absolute terms borrowings grew from $0.6m in 1995 to $10.1m in 2000 and $71.0m in 2007; but average annual growth rates of borrowings declined by 9/10th, from 513% to 54%.

Table 6: Increases of core balance sheet parameters, 1995-2000 and 2000-2007, amounts in million US$ and average annual growth rates in percent

	Balance sheet data (in million US$)			Annual growth rates (in %)	
	1995	2000	2007	1995-2000.	2000-2007
Total assets	11.00	32.99	378.04	40	149
Total loans gross	5.78	25.79	293.51	69	148
Total deposits	0.00	0.15	280.83		26,904
Total borrowings	0.56	14.91	70.98	513	54
Total equity	9.98	10.11	14.89	0.3	7

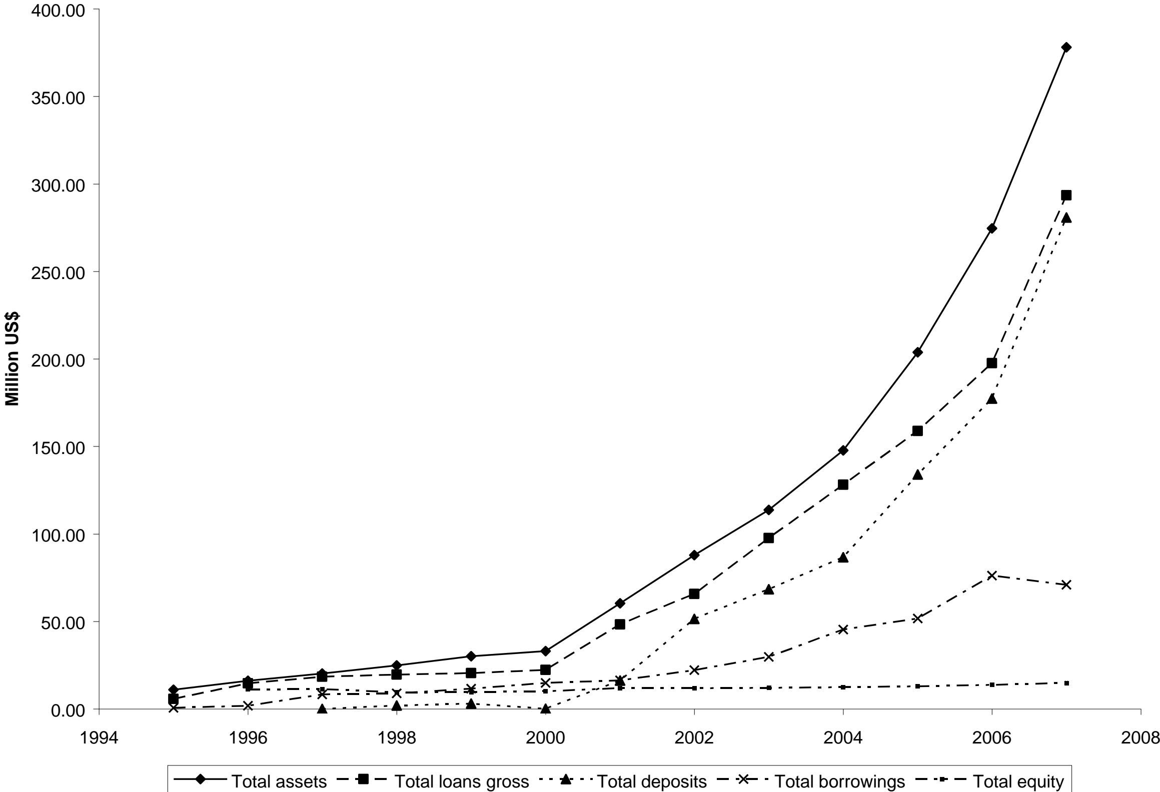
Source: CCF, abstracted from Table 7.

The turn-around of CCF led to a fundamental change in the structure of the balance sheet. Comparing percentages in terms of total passiva in 2000 and 2007, deposits surged from 0.5% to 74%, borrowings fell from 45% to 19%, and total equity dropped from 31% to 4%. This is paralleled by a decrease in the percentage of loans outstanding to PCFs in terms of total activa from 68% to 40%; and a corresponding increase of loans to other clients from zero to 37%. The overall result of the transformation has been a savings-driven institution

with a diversified portfolio. Self-reliance through deposit mobilization has been the most outstanding result of the transformation.

Graphically the turn-around is shown in **Fehler! Ungültiger Eigenverweis auf Textmarke.** (*based on data in Table 7*), All curves are nearly flat up to 2000, at very low growth rates. In contrast, during 2001-2007, there has been a surge in total assets and loans outstanding by more than 1000% (measured in US$); deposits grew from 7% of loans outstanding to almost 100%. Only the curve of total equity remained flat, with a growth of less than 50% over the seven-year period until 2007 (but over 400% by 2008 after a capital injection by SBV).

Figure 4: CCF: total assets, loans outstanding, deposits, borrowings & equity, 1995-2007



Source: Based on CCF data

The spectacular transformation of CCF in terms of expansion, reliance on savings as a source of loanable funds and portfolio diversification has not been matched by a similarly impressive improvement in financial performance, quite to the contrary. Any hopes that restructuring might lead to a lower overall overdue ratio did not materialize. Due to the adoption of lending to the general public in 2001, the overdue ratio (≥1 day) of CCF increased from 0.25% in 2000 to 2.05% in 2001 and oscillated subsequently between a low of 1.02% and a high of 2.9%. From 2000 to 2007 net interest income grew by more than 900%; but efficiency went down as costs surged, as indicated by the increase in the ratio of operational expenditure over operational income from 57% in 2000 to peak of 91% in 2002 and 68% in 2007. Net profit after tax only doubled; and return on average assets declined from 2.2% to 0.4%. (Table 7) However, note should be taken that this before-and-after comparison does not reflect on an assessment of the overall performance of CCF after twelve years of operation (*see below*).

The overall development of CCF is shown in greater detail in Table 7. From 1995 to 2007, total assets grew 34-fold, from $11.0 million to $ 378.0 million. Gross loans outstanding grew 51-fold, from $5.8 million to $293.5 million, accounting for 78% of total assets.

Deposit-taking from PCFs started only in 1997, with a modest amount of $15,000. In 1998 deposits by PCFs amounted to $1.9 million. From there they grew 22-fold, reaching $42.0

million in 2007. In 2001 CCF began accepting deposits from other clients, which immediately outpaced PCF deposits by a wide margin, accounting for 71% of total deposits during that year. In the following years they fluctuated between a low of 80% in 2003 and 89% in 2005. Overall deposits grew 21-fold during 2001-07, from $11.5 to $138.9 million. The deposit-to-loan ratio has grown from 10% in 1998 and 34% in 2001 to 96% in 2007, now the major source of loanable funds, virtually matching the amount of loans outstanding. In 2007 deposits mobilized from PCFs accounted for 27% of loans to PCFs; deposits mobilized from the general public accounted for 170% of loans to that market segment, thus serving as a major source of funds for loans to PCFs.

Borrowings started at $0.56 million in 1995. When the first donor credit line became operational in 1997, total borrowings surged to $8.3 million, with donor funds accounting for 78%. Since then donor funds fluctuated between 100% of borrowings (in 1998) and 65% (in 2006). In 2007, total borrowings stood at $71.0 million, with donor funds accounting for 78% of that amount.

Between 1998, the first year of meaningful financial intermediation, and 2007 the composition of the passive side of the balance sheet changed fundamentally: deposits surged from 8% to 74%; borrowings fell from 36% to 19%; equity fell from 38% to 4%. Risk-weighted capital adequacy (CAR) has been reported by SBV since 1998. Until 2003 the ratio has been above 30%, which is exceptionally high and reflects the very low risk exposure as measured by SBV. Since then CAR has fallen rapidly and now (2007) stands at 10%, which is still adequate by Basel standards.[14]

Throughout its history CCF always had a positive net interest income. With some fluctuations it rose from $0.5 million in 1995 to $10.8 million in 2007. During the first three years CCF was tax free; its tax rate today is 28%. During 1995-2007 net profit before tax rose 5.4-fold, from $0.36 million to $1.94 million; net profit after tax rose 3.9-fold, from $0.36 million to $1.40 million – rather modest rises due to the restrictive interest rate policy imposed by SBV. The total amount of taxes paid by CCF since 1998 amounts to $2.8 million.

In terms of profitability CCF has been performing well. Overdue ratios have been moderate: they were near zero during the first three years for which data exist, 1998-2000, when CCF only lent to PCFs and RCFs; since then they fluctuated between a low of 1.0% (in 2004) and a high of 2.9% (in 2005) and stood at 1.3% in 2007. The best-performing years (in relative terms) were 1996 and 1997, in a liberal era: the net interest margin was above 8%; the ratio of operational expenses over operational income was very low at around 40%; and return on average assets was above 7%, which is exceptionally high. Since then the net interest margin, restricted by SBV policy, has been a modest 3% to 4% and stood at 2.95% in 2007, the lowest ever. Operational expenditure over operational income has gone up substantially, fluctuating between a low of 57% in 2000 and a high of 91% in 2002; in 2007 it stood at 68%, which is satisfactory, but leaves room for greater efficiency. Return on average assets has come down substantially. In 1998-2000 it roughly oscillated around 2%; it fell to 1.2% in 2001 and since then has remained substantially below 1%. For the past three years it stagnated at 0.4%, due to the repressive interest rate policy of SBV. This ratio is far too low for an otherwise well-performing institution, particularly in light of its expectation to be transformed into a commercial bank. In the present inflationary environment, during 2008, SBV does well to impose a tight money policy and raise interest rates. But a cap on interest rates – in an effort to keep inflation low – and restricting the interest rate margin are definitely the wrong instruments. There is great risk that this will damage the expansion and the health of the otherwise sound credit cooperative sector.

[14] Risk-weighted assets in 2007 amounted to D2.21 trillion, out of total assets of D6.06 trillion. Of loans to PCFs only 20% are counted to risk-weighted assets.

Table 7: CCF, 1995-2007 (in million US$)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance sheet													
Total assets	11.00	16.04	20.24	24.84	30.14	32.99	60.39	87.83	113.69	147.67	203.80	274.59	378.04
Loans to PCFs and RCFs	5.78	14.63	18.39	19.62	20.44	22.34	35.92	39.77	51.88	63.36	85.96	106.70	152.98
Loans to other clients gr	0	0	0	0	0	0	12.37	25.93	45.75	64.77	72.86	90.83	140.54
Loans to other clients net	0	0	0	0	0	0	12.26	25.75	45.50	64.14	71.07	88.31	137.01
Total loans gross	5.78	14.63	18.39	19.62	20.44	22.34	48.29	65.70	97.63	128.14	158.82	197.53	293.51
Total loans net	5.78	14.63	18.39	19.62	20.44	22.34	48.18	65.52	97.38	127.50	157.03	195.01	289.99
Gross other/total loans in %				*0*	*0*	*0*	*26*	*40*	*47*	*51*	*46*	*47*	*48*
Deposits of PCFs	0	0	0.015	1.89	3.07	0.15	4.74	6.25	13.90	15.10	15.35	22.07	41.96
Deposits of other clients	0	0	0.00	0	0	0	11.50	45.20	54.45	71.61	118.56	155.21	238.86
Total deposits	0	0	0.02	1.89	3.07	0.15	16.24	51.46	68.35	86.71	133.91	177.28	280.83
Other/total deposits in %			*0*	*0*	*0*	*0*	*71*	*88*	*80*	*83*	*89*	*88*	*85*
Domestic borrowings	0.56	1.87	1.79	0.01	0.71	2.41	0.59	3.63	1.59	3.30	0.22	20.62	9.30
Donor credit lines	0	0	6.52	8.95	10.86	12.50	14.65	18.51	28.15	35.86	45.33	49.47	55.57
Total borrowings	0.56	1.87	8.31	8.96	11.57	14.91	16.38	22.18	29.74	45.38	51.62	76.19	70.98
Total equity*	9.98	11.25	11.31	9.46	9.65	10.11	11.91	11.77	12.13	12.44	12.97	13.71	14.89
Profit/Loss													
Net interest income	0.48	1.39	1.66	1.01	1.09	1.17	2.02	2.49	3.12	4.27	7.01	8.37	10.79
Net profit before tax	0.36	1.06	1.36	0.72	0.76	0.84	0.81	0.75	0.75	0.92	1.06	1.42	1.94
Net profit after tax	0.36	1.06	1.36	0.39	0.64	0.71	0.55	0.51	0.52	0.66	0.76	1.02	1.40
Financial ratios (in %)													
CAR, risk-weighted	n.a.	n.a.	n.a	35	37	32	36	35	34	25	17	13	10.1
Overdues, ≥1 day	n.a.	n.a.	n.a	0.06	0.09	0.25	2.05	2.06	1.24	1.02	2.9	2.3	1.3
Return on average assets**		7.81	7.49	1.75	2.33	2.23	1.18	0.69	0.51	0.51	0.43	0.43	0.43
Return on average equity**			12.05	3.79	6.69	7.14	4.99	4.29	4.33	5.40	5.99	7.64	9.79
Net interest margin	4.35	8.67	8.18	4.08	3.61	3.73	3.46	2.97	2.88	2.99	3.55	3.15	2.95
Op.exp./op.income	24.34	38.97	41.61	61.19	70.08	56.65	84.86	91.16	74.16	74.68	58.56	66.32	68.17
Deposits-to-loans	0	0	0	10	15	1	34	78	70	68	84	90	96
US$ exchange rate	11,020	11,037	11,175	13,887	14,019	14,540	15,086	15,395	15,630	15,776	15,906	16,056	16,025

* Equity for 1995 is estimated.
** After taxes, calculated over the average of beginning and end of year.

C. The Vietnam Association of People's Credit Funds (VAPCF)

In many countries the driving force behind the expansion of a cooperative movement has been an association of cooperatives, frequently an instrument in the hands of a promoter like Raiffeisen in Germany and Desjardins in Canada. In Vietnam this initiative has been taken by SBV, from inception the promoter as well as training institution in addition to its function as regulator and supervisor. Since 1995 CCF has increasingly assumed functions of an association as focal point of the movement, in addition to that as a financial apex. In particular, CCF has acted as a central contact organization in relation to Government and international organizations and has played a key role in advocacy, and actually continues doing so. VAPCF has been a latecomer to the PCF network and is now struggling to find its place. CCF continues to assume a central reporting function; eg, in its annual report for 2007 it also includes a section on the VAPCF, in Vietnamese and English.

VAPCF was established in 2006. During the start-up phase CCF assigned some staff and provided budgetary assistance. VAPCF is the umbrella organization for the PCFs in charge of the wider non-financial interests of the network. Its main functions include promoting the expansion of the network, supporting its growth and quality including product and IT development, training and study tours, consulting and other technical assistance, legal assistance, relations with domestic and international organizations, advocacy, and communication with SBV and other agencies. In July 2007 responsibility for IT development and training and for the introduction of a banking software (Banking Management System, BMS) was transferred from SBV and CCF to the association. Among the issues under discussion are income tax exemption for PCFs and social insurance for their employees backdating to 1996. An important future function will be auditing services; at present the PCFs are supervised but not audited. As an incentive, VAPCF has instituted an award, the *Golden Rice Flower*; in 2006 and 2007, 79 PCFs, 15 managers and CCF obtained a prize for excellence, and five PCFs for "overcoming difficulties". Its website (www.vapcf.org.vn) serves as a communication and information dissemination instrument. Donor support has been received from DID and GTZ. Assistance for IT development by the Bill & Melinda Gates Foundation and for technical assistance by the Ford Foundation is under preparation.

VAPCF is owned by the network institutions, the PCFs and CCF. For the time being the chairman of the board of CCF serves at the same time as a chairman of the board of VAPCF. The association runs its services out of a head office in Hanoi and three representative offices. It has a total staff of 30, including 12 in the representative offices (*mid-2008*). The head office comprises six departments: consulting services, training, information & international relations, IT, accounting, and administration. Sources of income include member dues, fees for services and donor support.

VAPCF plans to establish three subsidiaries, transferring its training and consulting services to two auxiliaries and establishing an auditing firm as a third. Setting up these services on a self-sustained cost-covering basis faces some difficulties, as SBV has been providing its services for free. In the future, training courses by SBV will be fee-based; but in contrast to those by VAPCF, the basic and follow-up training courses by SBV are compulsory.

D. Establishing a stabilization fund

CCF as a financial apex provides liquidity exchange and refinancing services to PCFs in good health. It has no instrument, and no mandate, of financial support to PCFs in difficulty. After having closed nearly a hundred PCFs in recent years, SBV is now considering to set up a stabilization fund to restructure loss-making PCFs, enabling them to recover their losses and regain their profitability. The stabilization fund would be funded through contributions from PCFs as a tax-deductible cost item, plus 50% of the dividends of the Government's investment in CCF. SBV considers placing the stabilization fund under VAPCF management,

expanding its hitherto non-financial role. The wisdom of placing such a fund under such a young association is questionable. It may take decades of experience until such a move could be reasonably considered. CCF as a financial institution would be more qualified. However, whether this might constitute a conflict of interests would need to be discussed.

E. Direct or delegated supervision?

Direct or delegated supervision: The PCFs report monthly to SBV and are supervised by the SBV branches. On the whole this supervision has been very effective, but places a burden on SBV, both in manpower and financial terms. In a determined effort to build a healthy network, SBV has been providing its supervisory services free of charge. VAPCF is now planning to establish an auditing arm. This will only be effective if auditing is made compulsory by SBV; the costs of auditing would have to be borne by the PCFs. Once auditing by VAPCF is effective, which might take a number of years, SBV considers transferring supervision to VAPCF. This would convert the current practice of direct supervision by SBV to a system of delegated supervision, akin to the German system where the supervisory authorities (Bundesbank and Bafin) have delegated supervision to eleven so-called auditing federations under the roof of a national cooperative auditing confederation, DGRV. However, the German system of delegated supervision has evolved over a century. It might be premature and risky for SBV to transfer its supervisory function in the foreseeable future to a cooperative association, which at the same time serves as an auditor. It requires a very mature system to provide consulting, auditing and supervisory services out of one hand. Effective supervision would have to be equipped with the power to enforce regulation and, if need be, to close non-performing PCFs. Even in the most mature cooperative systems, the wisdom of placing these three functions, with their potential conflicts of interest, into one hand is questionable. Effective supervision of a thousand PCFs, and in the future perhaps a total of 1,700, will be costly in any case. The capacity to supervise can be built up in SBV or in the VAPCF; in either case, a major portion of the costs would have to be borne by the PCFs. It will require diligent observation and policy dialogue to determine the feasibility of the two models of supervision, or a hybrid. DGRV, which has been providing technical assistance to the network through SBV, might serve as an advisor. For the near future, auditing by VAPCF and supervision by SBV seems to be by far the most effective way of organizing oversight and enforcing standards.

VI. Decisive factors of reform

One factor has been crucial behind the success of the PCF system: the political will of the Government to create a viable and sustainable system of credit cooperatives, avoiding the mistakes of the previous system. The trigger was two-fold: the collapse of the old system, which had been unsustainable, and the political will to create a new system with sustainable outreach to the rural population.

From inception the highest financial authority of the country was put into control: SBV, the central bank. SBV provided three essential inputs: leadership, regulation and effective supervision, the latter including the authority and will to enforce its regulation and, if necessary, close non-performing institutions.

The Government installed a high-level team headed by SBV traveling to several countries, examining the options and selecting an institutional model. It provided an appropriate legal framework, found an experienced technical assistance agency and a provider of financial assistance, followed by other technical and financial assistance projects. It then proceeded, in 1993, building the network. At the basis are member-owned and self-managed credit cooperatives, which are savings-based and self-financed, one in each commune of three to four villages.

The ownership structure of the central fund, CCF, creates a bond between the Government and the PCFs. The CCF is owned by Government through SBV as the majority shareholder, four SOCBs and all PCFs. For reasons of commercial viability, the CCF functions not only as a financial apex for the PCFs, but has diversified into a broad range of commercial banking activities for the general public. In the absence of a business association of the PCFs, it has also served as a focal point for the network in all its domestic and international relations. Some of its non-financial functions are now being transferred to the recently established VAPCF, which is building up a range of professional services for the PCFs, among them training, consulting and auditing.

Technical assistance has continually played an important role since inception. While several donors have been involved, two have played lead roles and provided consistency of inputs: DID in technical and ADB in financial assistance.

Building a new system took seven years, until 2000. Toward the end of the pilot period the Government submitted the pilot project to a critical evaluation; the results were decisive in preparing the reform of the PCFs. Rapid growth in the number of PCFs and members had not always been accompanied by adherence to the required standards, leading to poor performance in a number of PCFs. The Government stopped further expansion for several years. It consolidated the PCF network, closing almost 100 PCFs, strengthened the role of CCF, intensified staff and management training and tightened supervision, insisting on good performance. The result has been an overall healthy sector. Closing nonperforming institutions is one of the most decisive factors in the restructuring and reform of local financial institutions. Enforcement of prudential standards sends a strong signal to the sector.

Reform of the PCFs was accompanied by the restructuring of the CCF in 2001 after the end of the pilot project. This has led to a spectacular expansion of the Fund's financial activities (measured in terms of both national and hard currency). There are three decisive factors introduced in 2001 which marked the transformation: the merger of the RCFs with the CCF, creating a single central fund; financial intermediation with the general public, adding retail to wholesale banking; and self-reliance through savings mobilization from the private sector. This has laid the foundation for the Fund's transformation into a commercial bank, which is at present (2008) under consideration.

SBV has opened the debate on a reform of the structure of supervision of PCFs. Supervision in the hands of the SBV has been very effective. In the foreseeable future, supervision should remain the responsibility of SBV and its branches, however stretched these may be; there is no institutional capacity yet for a system of delegated supervision. PCFs should pay for the service, which will enable SBV to strengthen its supervisory structure and make it sustainable. An online IT system and an effective auditing service, both under preparation, will greatly facilitate supervision by the central bank.

Effective supervision must be based on the political will to enforce prudential regulation. Closing non-forming institutions has been an important instrument for the policymaker and supervisor, signaling that good performance based on prudential standards is a must.

There is yet another reform measure under discussion. The experience of SBV when closing non-performing PCFs has indicated the need for another instrument, complementing the CCF which only lends to PCFs as long as they are well-performing: a consolidation fund, with the objective of rescuing PCFs in difficulty. The options of where to place such a fund need to be carefully examined: in CCF as the network's financial apex and soon commercial bank, in VAPCF as its non-financial apex, or in a new entity. Placing the consolidation fund into the hands of VAPCF would create conflicts of interest which would undermine its reputation and effectiveness.

After fifteen years of successful reform and restructuring, monitoring and consolidating the PCF network is now on the right track. The credit cooperative system is now ready for further expansion, further contributing to the growth of the economy. It is expected that by 2020 most of rural Vietnam will be covered by PCFs as self-reliant local financial intermediaries – similar to the Raiffeisen cooperatives and People's Banks (*Volksbanken*) in Germany and similar institutions in the Netherlands, Canada, South Korea and many other countries. As the history of any of these countries has shown, crisis is inevitable, in an expanding as well as in a mature system. There will be mergers, reforms and innovations as well as necessary adaptations to changes in the economic and policy environment. We may thus expect a continual need for international communication and assistance.

The experience in Vietnam of creating, consolidating and expanding one of the most successful credit cooperative systems in the developing world may be shared with other countries in need of cooperative reform. SBV, VAPCF and CCF may consider institutionalizing international consulting services, including training and exposure visits – of course as commercially self-financing as CCF and the PCFs.

VII. Conclusions and lessons learned

Ten years of central planning, collectivization of land and international isolation led to the collapse of Vietnam's command economy in the mid-1980s. Reform efforts focused on the introduction of a market economy. A first strategy was the transformation of the mono-tier banking system into a central bank and four SOCBs in 1988. In the turmoil, the fate of credit cooperatives, which covered all communes but were not part of the state-owned banking system, was ignored. As a result most of the 7200 credit cooperatives simply withered away. A few survived, and were integrated into the new system. For policymakers in other countries facing the options of closing or reforming their credit cooperatives, this raises the question of whether restructuring on a broad scale would have been feasible; there is some, albeit limited, evidence that it might. In building a new credit cooperative system Vietnam applied a number of principles which would also be crucial in the restructuring of an existing system.

Innovation vs replication

In many developing countries the government has used financial institutions including credit cooperatives as an instrument for its own purposes. But government interference has frequently undermined their health and perverted the intended results. In contrast, credit cooperatives are supposed to be self-help organizations which are member-driven, self-financed, self-managed and free of government interference; there are numerous positive examples, particularly among developed countries. Yet every country faces the challenge of finding its own way in a given economic, cultural and political environment. In Vietnam, the Government examined the options, benefited from the experience of other countries, but replicated none. Instead it came up with its own innovation: People's Credit Funds (PCFs), self-help organizations under state control, seemingly a contradiction. The case of Vietnam shows that the world of cooperatives is more complex than indicated by the simple dichotomy of successful self-help movements vs failing state-supported systems. The newly established PCFs are self-managed and self-financed; yet they are part of a movement in which SBV, the central bank, has been in control from the beginning. SBV has been in charge of designing the new system; it prepared its regulatory framework, integrated the network into the formal financial sector, supervised its progress and enforced prudential standards. Yet SBV has abstained from undue interference and from using, or abusing, the PCFs as credit channels or for other politically motivated purposes.

Policy environment

Facing hyperinflation and the collapse of the economy in 1986, the Government decided on an experiment: a policy of liberalization and free-market reforms. It is this policy which provided the framework for a series of legal provisions preparatory to the rise of a new system of credit cooperatives. Initial financial sector reforms were accompanied by a return to private household farming, a reduction of restrictions on private sector activities, and trade liberalization. The reforms revealed fundamental weaknesses of the financial system: the SOCBs were but arms of the SBV; and SBV failed to carry out its central banking functions. In response a financial institutions law was passed in 1990, which included a legal framework for the establishment of credit cooperatives as part of the formal financial sector. This was followed by a banking decree in 1991, which accorded SBV supervision authority over the banking sector including credit cooperatives. In 1993 a new land law was passed, providing for land use certificates that can be sold, leased, inherited and mortgaged – a prerequisite for collateralized lending particularly in rural areas.

Examining the options as a participatory process

Examining the options and deciding on a strategy for establishing a new system of rural credit cooperatives was a complex participatory process. A team from SBV and several government agencies examined shareholding banks with credit cooperatives as local agents,

the Grameen Bank in Bangladesh, cooperative banks of the Raiffeisen and Schulze-Delitzsch type in Germany, and credit unions in Canada. SBV decided on a pilot project of People's Credit Funds (PCFs), following the Canadian model which is originated from the German model, but adapting it to the emerging situation in Vietnam. For the pilot project a steering committee was formed, comprising SBV, the Vietnam Cooperative Alliance and several ministries. Its executive committee, consisting of SBV officials, was placed in the SBV. To implement the establishment of PCFs, steering committees were formed at all levels of the administrative structure: central, provincial, district and commune. This guaranteed the effective coordination of all relevant agencies.

Building a network

The old credit cooperatives were isolated entities lacking a cohesive network and apex bodies – a structural weakness, considered a major factor in their downfall. In contrast, the PCFs were designed to be part of a network comprising primary societies (PCFs), a central fund (CCF), initially together with regional funds (RCFs), and a business organization (VAPCF). PCFs are voluntary local organizations based on the principles of self-help, self-reliance, self-management and democracy. While SBV has functioned as the lead agency in the development of the system at national and provincial level, the local PCFs are formed and developed through the initiative of their local members; they are self-financed through shares, deposits and retained earnings; they are professionally managed by a team of qualified employees under the control of a board; and the board is democratically elected by the members, all with equal voting rights. Unlike the former credit cooperatives, they are part of a network, functioning as a nation-wide system of mutual support. The network provides model bye-laws and various apex services. Liquidity exchange and refinancing together with various other services are provided by a central fund (CCF). In 2001 the regional funds were integrated into the central fund as branches. VAPCF, has only recently come into existence.

Legal framework

An appropriate legal framework inspires local initiative and provides a basis for the mobilization of deposits from members and the general public. The PCFs and their central fund, CCF, are formal financial institutions which are largely self-financed, with deposits and retained earnings as engines of growth and the main source of loanable funds.

Prudential regulation and effective supervision

The PCFs and the CCF have performed exceedingly well, both in quantitative and qualitative terms. Appropriate regulation and effective supervision have played a key role. PCFs are subject to prudential regulation and supervision by SBV as a financial authority, which has also provided guidance and training. PCFs are subject to three types of oversight: daily internal control; regular random inspections by the respective SBV branch; and remote supervision by the supervision department of SBV. Effective supervision, which includes the political will and ability to enforce prudential standards, has also been a learning experience for SBV. Upon the conclusion of the pilot project, SBV tightened its supervision and closed around 100 PCFs. This has substantially contributed to the health of the credit cooperative sector, with the result that in 2007 only two PCFs, out of almost 1,000, had to be closed. This is all the more impressive at a time of global financial crisis, attributed to a gigantic failure of regulators and supervisors in some advanced countries. Effective supervision is a continual challenge; and SBV, which has performed well as a supervisor, would be ill-advised to prematurely delegate supervision to VAPCF, which is under discussion.

Interest rate deregulation: a continual policy issue

Interest rates are determined by the board of each PCF, but only within the limits set by SBV. Interest rate controls of SBV have restricted the profitability and the growth of retained

earnings of the PCFs. In June 2002 SBV deregulated interest rates; but a moral obligation on the part of the PCFs to keep interest rates low continued to prevail. In an attempt to fight a new surge of inflation SBV has now (2008) returned to its restrictive interest rate policy by limiting the net interest rate margin – an imposition which has not been welcomed by the PCFs and is again depressing their profits. In May 2008 SBV introduced new ceilings; interest rates are not to exceed 50% of the base rate, at present 14% + 7% = 21%. This is just 4% above the PCF's deposit interest rate and not sufficient to bolster them against external shocks.

Annex 1: PCF Duong Noi, a reformed credit cooperative

PCF Duong Noi operates in three villages which constitute Duong Commune in the former Hatay province, which is now being integrated into Hanoi, Originally established in the 1960s, it is one of a small number of credit cooperatives which survived the breakdown of the old system and was transformed in 1994 into a PCF under the statute of 1992. The present director has been with the credit cooperative since 1979. In 1994 he was transferred to the PCF together with three others out of a total staff of nine; three of them are still with the PCF. He has been promoted to the position of director in 2006. The first director, appointed in 1994, was one of the four staff members transferred from the old credit cooperative. He recruited local people with a good reputation and with banking experience, starting in 1994 with one new staff member and increasing the number of staff with the growth of the PCF. Total employment is now 14, including three loan officers.

The director attributes the breakdown of the old system of cooperatives to their isolation and their lack of linkages, which made it impossible for them to cope with the run on deposits in 1989 as inflation soared to three-digit figures. The credit cooperatives tried to retain their members by substantially increasing the interest rate on deposits. However, they ultimately failed when SBV, in an attempt to control inflation, put a cap on interest rates at 180% p.a. This turned out to be the main cause of the collapse of the system according to the director. Many of the funds that were withdrawn were invested in an age-old informal financial institution, *hui*, which is ubiquitous in Vietnam and even today still a strong competitor to the PCF.[15] The main characteristic of the new system as opposed to the old system is seen by the manager in two factors: regulation and tight supervision by SBV; and linkages within the PCF network. In addition SBV has established a comprehensive staff and management training program.

As of 31 July 2008 the PCF had a membership of 1578, which is 50% of total households in the commune; the maximum achievable would be 70%. 800 members hold deposit accounts and 420 have loans outstanding; in addition there are about 1000 non-member depositors. Total outreach is thus about 2600. Total assets amounted to D58 billion ($3.5 million), loans outstanding to D52 billion ($3.1 million) and deposits to D50 billion ($3.0 million). The overdue ratio (1 day or more) is 0%. The PCF has an efficient reporting system; financial data could have been provided "as of yesterday".

Interest rates are set by the board of directors of the PCF, but within a band set by SBV. They were adequate until 2007, but have declined substantially in 2008 due to the intervention of SBV. Average interest rates on deposits were 8.4% p.a. in 2007 and interest rates on loans 14.4%. In the present inflationary climate, rising deposit and lending rates of competing commercial banks forced the PCF to also increase its interest rates: to 17% on deposits and 21% on loans, resulting in a decrease of the net interest margin from 6% to 4%. The PCF is now stepping up its marketing and communication with members, calling upon their loyalty.

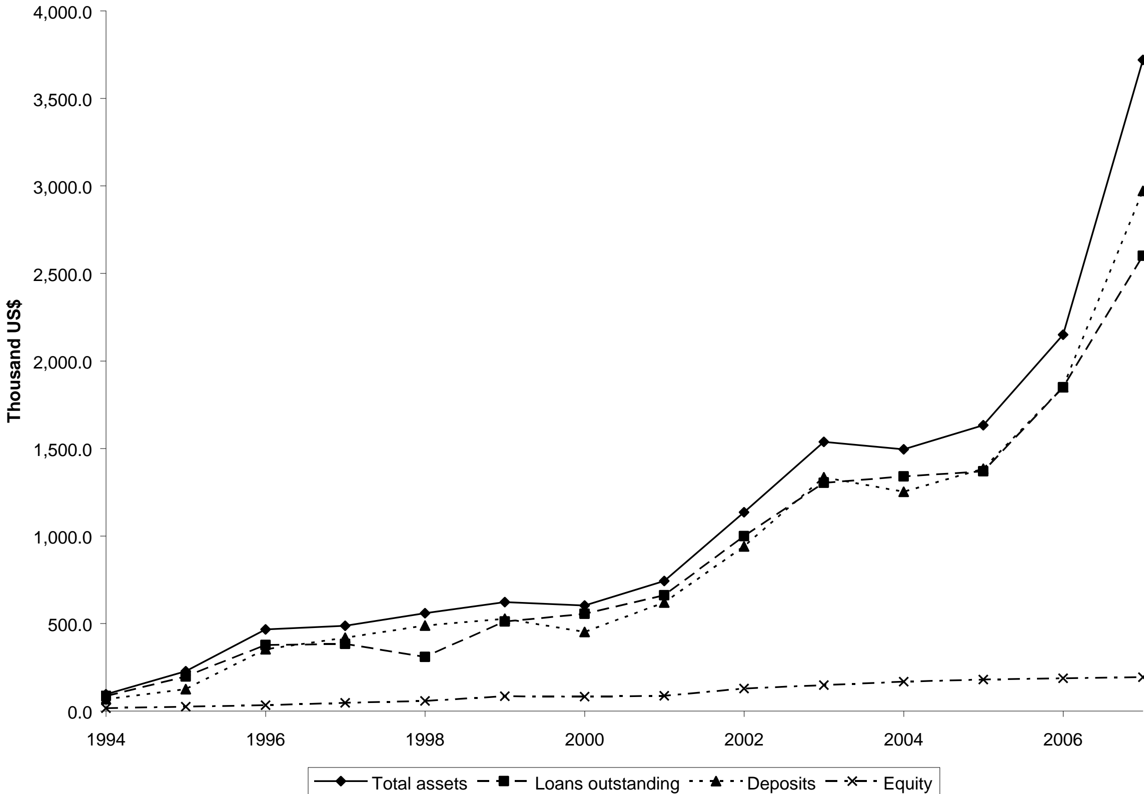
CCF has applied to SBV to increase the cap for cooperatives and is now waiting for a reply. The PCF also complains about the high tax rate on profits, which at 28% is one of the highest among the provinces. Its chief competitor is the government-owned Agribank (VBARB), which can write off loans and have its capital replenished by the Government; no such mechanism exists for the PCF. The Social Policy Bank is not considered a competitor, as it lends to the very poor who are not members of the PCF.

[15] A *hui* is rotating savings and credit association which allocates the fund collected in equal amounts from the members at regular intervals (daily, weekly, monthly…) to the lowest bidder on the basis of an auction, until every member has received the pot once. It is widespread in southern China and in Vietnam.

The PCF receives from CCF intermediation of funds, liquidity, training, technical assistance and advocacy services, negotiating with SBV on the interest rate cap and with provincial government on the tax rate. Relations with newly established VAPCF are more recent and not yet well established. Its role is not very clear yet, says its director. The PCF is not interested in the training offered by VAPCF, because it is fee-based and was previously offered by SBV for free. The training by SBV is now also fee-based; but it is compulsory, while training by VAPCF is voluntary. Plans for the future include improvements in its quite impressive premises and in its IT equipment. It also plans for new products, including domestic remittances and later perhaps international remittances. Further training in management, working skills and IT would be useful.

PCF Duong Noi has shown an impressive growth since 1994. Membership during the 13-year period until 2007 grew 4.3-fold. In US dollar terms total assets, loans outstanding and deposits have grown in parallel and very closely together, with the curves for loans and deposits intersecting several times as shown in Figure 2.

Figure 5: PCF Duong Noi: total assets, loans outstanding, deposits & equity, 1994-2007



From 1994 to 2007 total assets grew 39-fold, from $95,400 to $3.72 million. Loans outstanding grew 30-fold, from $85,700 to $ 2.60 million. Deposits grew 44.5-fold, from $66,700 to $2.97 million. Equity grew 12-fold, from $16,200 to $192,500. Profit after tax grew 12-fold, from $3,800 to $46,800. During the first two years the PCF was tax free. During the following eleven years it has contributed a total of $84,100 to the Government's tax coffers. Return on average assets was 6.2% in 1995. As taxes were due the following year ROA dropped to 3.4% and fluctuated until 2006 between a low of 2.3% and a high of 3.8%. In 2007, when SBV imposed its cap on interest rates, it dropped to 1.6%. The PCF is largely self-financed, but to a varying degree over 1994 to 2007. Its deposit-to-loan ratio fluctuated between a low of 65% in 1995 and a high of 159% in 1998. It fell to 81% in 2000 and gradually climbed to 114% in 2007. (Table 2) The continually healthy growth of PCF Duong Noi since 1994 is proof of the success of its restructuring – perhaps an indication that restructuring the old-type credit cooperatives might have been feasible on a broader scale.

Table 8: PCF Duong Noi, 1994-2007 (in thousand US$)

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
No of members	362	650	818	933	1,073	1,144	1,225	1,286	1,389	1,430
Growth in number p.a.		*288*	*168*	*115*	*140*	*71*	*81*	*61*	*103*	*41*
Total assets	95.4	226.2	466.2	486.9	558.3	621.4	602.3	742.9	1,134.8	1,537.0
Average total assets		*160.8*	*346.1*	*473.7*	*475.0*	*587.2*	*600.7*	*661.7*	*931.4*	*1,327.4*
Loans outstanding	85.7	195.7	376.6	382.4	307.8	510.8	555.2	660.6	998.6	1,302.9
Growth p.a. in %		*128*	*92*	*2*	*-19*	*66*	*9*	*19*	*51*	*30*
Deposits	66.7	124.7	352.2	418.6	488.1	526.1	451.2	619.7	939.8	1,335.5
Growth p.a. in %		*87*	*182*	*19*	*17*	*8*	*-14*	*37*	*52*	*42*
Borrowings	2.7	59.0	0.0	0.0	0.0	0.0	34.4	0.0	13.0	0.0
Equity	16.2	24.4	33.0	46.1	57.0	84.0	81.1	86.7	128.4	147.7
Share capital	15.5	14.6	12.0	12.3	10.6	40.6	32.7	29.4	60.7	72.6
Profit before tax	3.8	10.0	12.7	17.1	14.4	16.8	29.8	27.3	35.9	42.2
Profit after tax	3.8	10.0	11.8	14.8	12.4	14.5	22.8	23.5	27.2	32.0
Tax paid	0.0	0.0	0.9	2.3	2.0	2.3	7.0	3.8	8.7	10.2
ROAA*		6.2	3.4	3.1	2.6	2.5	3.8	3.6	2.9	2.4
US$ exchange rate	*11,003*	*11,020*	*11,037*	*11,175*	*13,887*	*14,019*	*14,540*	*15,086*	*15,395*	*15,630*

* Profit after tax over average total assets (calculated over the average of total assets at the beginning and the end of the year), in %

Source: PCF Duong Noi

Annex 2: Regional credit funds (RCFs), 1997-2000 (in million US$)

	1997	1998	1999	2000
Number of RCFs	11	19	21	21
Total assets	18.50	25.41	34.79	37.66
Loans outstanding	16.48	19.89	25.94	31.98
Deposits	9.71	7.42	10.92	10.82
Borrowings from CCF	6.50	11.03	14.88	16.08
Transfer pricing & misc.	1.51	5.66	7.45	9.17
Equity	0.78	1.31	1.54	1.58
Net profit	0.34	0.29	0.40	0.43
% of loans overdue	0	1.2	0.8	1.2
ROA		1.4	1.3	1.2
Deposit-to-loan ratio	59	37	42	34
Exchange rate	11,175	13,887	14,019	14,540

Source: CCF

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