

### ( 3 ) A Diagnostic Study on the Financial System in Lao PDR

Masahisa KOYAMA

The following report is aiming at analyzing the banking sector development and current condition in Lao PDR. Such issues as shortage of domestic savings, huge NPLs in dominating State-owned Commercial Banks, distorted interest rate setting mechanism, and weak capacity on the sound bank management are raised in the report which constraint the further financial depth in the country. Since those difficulties are closely related with the capital market development in Lao PDR., in order to establish a sound capital market we have to tackle with those issues.

#### **(a) Financial system development in Lao PDR**

##### i) Financial system development in transitional economies in East Asia

The financial system development patterns in such transitional economies as Viet Nam, Cambodia and Lao PDR have some common features. (The chart below shows a typical trend for financial system development towards a liberalized and market-based financial system from formerly government directed mono banking system.) Those countries successfully established so-called two tier banking systems (separation of central banking functions from commercial banking functions) from former mono banking systems in the early 1990s. However, their banking sectors are still facing the following difficulties:

- off balancing non-performing loans (NPLs) and lack of capital increase in their financial bases (preventing establishment of reliable commercial banking systems),
- existence of directed finance by government intervention
- lack of management capability and weak governance in improving banking services profitability in the economy, and
- weak implementation of monitoring and supervision activities by the central bank (preventing reliable banking systems).

Since further economic development can not be achieved in transitional economies without efficient and productive financial intermediary functions, each country should speed up its bank restructuring in a precise manner.

Figure 4-2. Financial system development in transitional economies

<b>Mono banking</b>	<b>Two-tier banking</b>	<b>Liberalization</b>
<b>State treasury (MOF)</b>	<b>State treasury (MOF)</b>	<b>State treasury (public finance)</b>
- State bank functions	<b>Central bank function</b>	<b>Independence from Treasury</b>
Treasury A/C	Treasury A/C	(State budget)
Central bank	Money supply control	
Commercial banks	Interest rate control	
- Foreign exchange	Bank supervision	
- Development finance	Inter-bank settlement	
Loans for SOEs	Commercial banks	Further liberalization (competition)
	- State-owned CBs	NPL restructuring Privatization (listing)
	- Private CBs	Business expansion expected
	- Foreign bank branches	Market expansion (alliance) expected
	Separation of policy-based banks as DFIs from SOCBs	
	Informal banking system	Institutionalization
	Money market development	
	Capital market development (Treasury Bonds, Securities)	
		Issuing market Secondary market
No clear definition on state budget and finance	Separate financial system from fiscal system	

In Viet Nam, financial system development has progressed recently in line with the stabilization of the macro economic condition. Interest rates were fully liberalized in the market, and the securities market has already started operations with an adequate legal and regulatory framework. Some of the state-owned commercial banks are still in the process of restructuring for NPLs liquidation and preparing for future listing on the stock market in Ho Chi Minh City (HCMC). Separation of the policy-based finance function from state-owned commercial banks has been accomplished, and two policy-based financial institutions have been created—namely, the Development Assistance Fund (DAF), which covers infrastructure development and strategically important industrial development projects in the country and also has an on-lending function from donor institutions like the World Bank or the Japan Bank for International Cooperation, and Viet Nam Bank for Social Policy (VBSP), which aims at promoting rural micro credit and small and medium enterprises (SME) financing for poverty eradication. Those policy-based financial institutions are operated under strong governmental direction. We have to carefully watch the soundness of their lending operations, because their autonomy in governance seems limited as yet.

Looking at Cambodia, financial reform has progressed in line with the ten-year blueprint from 2001 to 2010 instructed by an Asia Development Bank expert in

consultation with the National Bank of Cambodia. *New Law on Banking and Financial Institutions* was adopted in 1999, stipulating relicensing for existing viable commercial banks with adequate capital and asset quality. As the result of this restructuring program, 15 non-viable banks were closed and liquidated. Currently Cambodia's banking system comprises the National Bank of Cambodia (NBC) as the central bank, with 20 provincial branches, 13 commercial banks (1 state-owned, 3 foreign bank branches, and 9 locally incorporated banks), 4 specialized banks (1 state-owned, and 3 privately owned banks), and 1 representative office of a foreign bank. Specialized banks have mainly rural and micro credit functions under the NBC's supervision. Since those relicensed banks are guaranteed their viability by the NBC, deposit collection has been smoothly expanding lately. Bank supervision by the NBC seems to have been strengthened by the introduction of modern inspection and auditing methods. The problem is real enforcement of strict regulations and rules. Exploring for domestic loan opportunities seems another difficulty for Cambodian commercial banks. The loans to deposits ratio is now below 50 percent, indicating a lack of loan demand in the real business field and high macro economic risks.

A for the banking system in Lao PDR, the dominating state-owned banks are still struggling to solve heavy accumulations of NPLs caused by the steep depreciation of the local currency (kip) in US dollar denominated loans after the 1997 Asian financial crisis and the directed finance succeeded from old regime. These accumulations are the result of loans to loss making state-owned enterprises (SOEs) and provincial government's directed loans to local contractors. In order for state-owned commercial banks (SOCBs) to solve their NPL problems and achieve the necessary capital adequacy, a huge amount of budget is needed. However, another difficulty is the shortage of national budget. Recently SOCBs' loan assets have been flush with loss provisions, which has caused deterioration of equity in the balance sheet. Without restructuring of SOCBs, further financial system development can not be achieved. Recent condition of NPLs and capital ratio is as followed.

Table 4-8. Trends of Non Performing Loans (NPLs) Ratio (%, 10 billions of kip)

	1995	1997	2000	2001	2003
NPLs ratio (%)	35	60	70	56	64
Provision for NPLs (10 billion kip)	44	52.7	55.5	25	387
Capital injection by the Government	*26	-	-	-	-
Capital ratio (%)	12.2	13.6	13.7	13.1	3.7

Source: Furukawa(2004), data from BOL, ADB, and IMF

Note: \*26: 1993-1994

## ii) Review of financial system development in Lao PDR

According to the research paper “Banking and Financial Sector of Lao PDR” published July 15, 2002, the history of Lao’s financial sector development is divided into three periods since the New Economic Mechanism (NEM) was initiated in 1988, summarized as follows.

### **(1) First period (1988-1991): Transition from mono-banking toward two-tier banking system**

The mono-banking system instituted in the State Bank of Lao (SBL) since 1975, was replaced by a two-tier banking system (March 1988). The commercial banking functions of SBL were separated from its central banking functions. In 1990, the Bank of Lao PDR (BOL) was established as the central bank by the Central Bank Law (Law No.4). At this time seven SOCBs, including Bank pour le Commerce Exterieur du Lao (BCEL), Lao Mai Bank, and Lane Xang Bank, started commercial banking operations under the BOL’s management control and each was assigned a geographical area of coverage. Also, Lao’s first joint venture bank (30% BOL equity and 70% Thai investors’ equity) was established, named the Joint Development Bank.

### **(2) Second period (1992-1995): Private bank expansion and foreign bank participation**

Prime Minister Decree No. 3 of 1992, stipulating the establishment, management and operation of commercial banks, was promulgated and triggered the expansion of private-owned banks, especially encouraging foreign bank participation in Lao’s domestic financial market. Six branches of Thai banks (Siam Commercial Bank, Thai Military Bank, and Thai Farmers Bank, and others) and one branch of a Malaysian bank (Public Bank) were established. In 1993, the Agriculture Promotion Bank (APB, state-owned) was established by Prime Minister Decree to promote the rural agriculture sector development. In this period, improvement in legal and prudential framework could be seen; however, due to the weak enforcement of the regulations, NPLs for SOCBs accounted for over 35 percent of the total loan amount in 1994. In order to achieve the capital adequacy requirement, the government implemented a first round of recapitalization for the SOCBs.

### **(3) Third period (1996- ): Improvement in prudential regulation for commercial banks**

In 1996, six prudential regulations for commercial banks and APB were issued by the BOL and a new regulation on asset classification and loss provisions was promulgated. In 1997, *Decree Law on Management of Commercial Banks and Other Financial Institutions* replaced the former Decree No. 3 of 1992, identifying boards of directors as the policy making bodies of the SOCBs, and vesting in the Ministry of Finance (MOF) the power to appoint the chairman and other board members. Despite

improved bank regulations, SOCBs have continued poor performance due to weak implementation and enforcement. At the end of 2004, the banking system in Lao PDR comprised

- three state-owned banks,
- three joint-venture banks,
- six branches of foreign banks, and
- one representative office (Standard Chartered Bank).

Details are shown in Table 4-9.. The number of the formal banks decreased by one due to the retreat of one from the Lao market, and state-owned bank branch numbers have dropped by thirteen since the end of 2001 due to the restructuring of the banking system. Thirteen banks, including the dominating state-owned banks (fifty-two branches), are now operated under the BOL's supervision. The LDB and APB have wide branch networks which cover most of the provincial capitals. Foreign banks are still not allowed to establish branch offices anywhere other than Vientiane. The formal banking system and service network in Lao PDR seem still limited in terms of banking accessibility in the country and quality of services (e.g., inter-bank money transfer and settlement, and teller services at branch counters).

Table 4-9. Formal banks and market share in Lao PDR

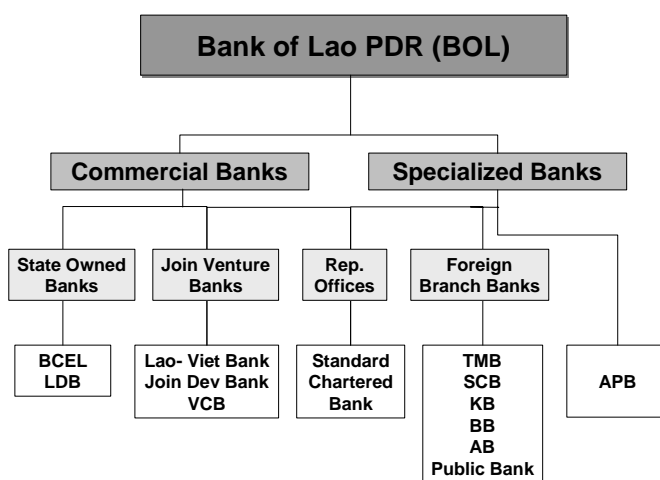
Type	Establishment	Branches (2001 2004.11)	Deposits (end of 2003)		Credit (end of 2004.07)	
<b>State-owned banks (3)</b>			<b>3,422</b>	<b>74.7%</b>	<b>1,191</b>	<b>63.1%</b>
1. BCEL	1989.11	4 7	2,028	44.2		
2. LDB (Former Lane Xane, Lao May Bank)	2003.01	21 18	1,182	25.8		
3. APB	1993.08	30 17	212	4.6		
<b>Foreign bank branch (7 6)</b>			<b>485</b>	<b>10.6%</b>	<b>377</b>	<b>20.0%</b>
4. Bangkok Bank	1994.10	1 1	90	2.0		
5. Siam Commercial Bank	1992.12	1 1	88	1.9		
6. Krungthai Bank	1994.11	1 1	47	1.0		
7. Ayudya Bank	1994.11	1 1	39	0.9		
8. Thai Military Bank	1992.02	1 1	66	1.4		
9. Thai Farmers Bank (closed in 2002)	1993.05	1 0	-	-		
10. Public Bank (Malaysia)	1995.11	1 1	107	2.3		
<b>Joint-venture banks (3)</b>			<b>677</b>	<b>14.8%</b>	<b>319</b>	<b>16.9%</b>
11. Vientiane Commercial Bank (Lao private 25%, foreign 75%)	1993.02	1 1	131	2.9		
12. Joint Development Bank (BOL 30%, Thais 70%)	1989.10	1 1	193	4.2		
13. Lao-Viet Bank (BCEL 50%, BIDV 50%)	1999.07	2 2	353	7.7		
<b>Representative offices (1)</b>						
Standard Chartered Bank	1996.02	(1) (1)				
<b>Total 13 Banks</b>		<b>65 52</b>	<b>4,584</b>	<b>100.0</b>	<b>1,887</b>	<b>100.0</b>

Sources: Furukawa (2003), *Development and International Cooperation in Lao PDR*; NERI; NGPES, *The National Growth and Poverty Eradication Strategy* (2004).

iii) Structure of the formal banking system in Lao PDR

The latest structure of the formal banking system under BOL supervision is as shown in the figure below. Besides this, informal money lender and micro credit financial services with support from non-governmental organization groups are operated and cover the rural financing at a marginal level. Those informal financial services have a reputation of charging high interest rates to borrowers. According to the SMEs promotion team's survey in this joint study, some small retail shops in the local market use short-term credit for working capital financing, and this is regularly provided by dealers or wholesalers through good connections. Paying in cash is a common type of trade in Lao PDR, which indicates limited credit expansion and financial access for business activities.

Figure 4-3. Banking system structure in Lao PDR



Source: NERI, internal paper.

iv) Recent measures taken for financial sector reform and its impact

In order to recover the creditworthiness of the commercial banks in Lao PDR and strengthen their capabilities as financial intermediaries, the Government of Lao (GOL) has introduced a series of measures since 2001. Some of the important measures for the financial sector reform are listed below (source: WB Vientiane Office, *Economic Monitor* [May 2004]).

- stipulating commercial banks to make general provision from 0.5% to 1.0% of

- performing loans (Notice No. 95/BFSD Mar. 19, 2001);
- reiterating that commercial banks set ceilings for lending (at 60% of collateral value and at 10% of the bank's capital to a single borrower), suspend accrued interest income on loans which become overdue for longer than 90 days, and prohibit new lending to defaulted borrowers (Notice No. 209/BFSD Jun. 15, 2001);
- reiterating general reserve requirement and compliance with Regulation No. 98/BOL on loan classification (Instruction No. 176/BOL Jun. 30, 2001);
- prohibiting SOCBs from providing policy-based lending (other than for infrastructure projects, promotion of exports and import substitutes, and rice plantations) and requiring them to focus on loan recovery;
- restricting SOCBs from increasing their risk portfolios if their flow NPL ratios exceed 15% and lowering their branches' approval limits (aimed at stopping further deterioration of SOCBs' loan assets) (Instruction 01/BOL Mar. 14, 2002);
- ensuring SOCBs to have full autonomy in operating their banks on a commercial bases (Notice No. 566/MOF Mar.31<sup>st</sup> 2002);
- establishing the Rural and Micro Finance Committee (RMFC) under the BOL to assess the rural and microfinance industry, formulate policy statements, and develop action plans for the implementation of reform programs (Feb. 15, 2002);
- establishing the External NPL Collection Committee (ECC) under the BOL, with the mandate to support debt restructuring on a voluntary basis by SOCBs and debtors (signed MOUs for each SOCB Mar. 31, 2001);
- merging two SOCBs, Lao Mai Bank and Lane Xane Bank, into the Lao Development Bank (LDB) (end of 2002);
- signing the Governance Agreement between the BOL, the MOF, and each SOCB (its board of directors and management) to restructure and strengthen that SOCB's management capability (Mar. 20, 2003);
- recruiting international bank advisors (by the BOL) to strengthen the soundness of SOCB management (working since Apr. 2003);
- amending former BOL regulation on loan classification, foreign currency exposure, and lending limits (being drafted);
- instructing BCEL and LDB to limit their net new lending since their NPLs exceed 15% (to force SOCBs to comply with prudential regulation and avoid further deterioration in their loan portfolios (2003);
- endorsing in principal, via the Prime Minister's Office, the rural and micro finance policy and action plan in Dec. 2003 (Notice No. 1760/PMO Dec. 17, 2003);
- Issuing MOF "triangle" bonds to SOCBs, which are designed to solve specific NPLs

caused by government arrears. In July 2003, 120 billion kip was issued with a one-year tenure and 11% semi-annual coupon. A second lot of 120 billion kip was issued in Sep. 2003 with a two-year tenure and 11% semi-annual coupon.

The above listed series of measures since 2001 has strongly impacted commercial banks' risk management systems and loan portfolios, reducing further deterioration of loan assets. We could observe some of the impact of those measures and that is depicted below in Table 4-10., which shows the recent trends of all commercial banks' deposits and credit in comparison with those of two SOCBs, BCEL and LDB. Total deposits have steadily increased in line with the stabilization of the Asian financial crisis in the middle of 1997, and the latest deposits to GDP ratio is around 17 to 18%. The domestic credit to GDP ratio has declined to 9 to 10% due to SOCBs' cautious lending behavior (under strict monitoring by international consultants and the BOL) and being NPLs written off in line with the restructuring process. Listed below are several characteristics in the structure of deposits and credit in Lao's commercial banks.

- The share of foreign currency deposits to all deposits outstanding is a dominating 70%.
- However, Kip-denominated deposits have gradually increased in line with the recent stabilized macro economic condition.
- Bank credit is mostly mobilized to the private sector (around 70%) and exposure to SOEs has decreased to around 20% lately.
- The share of foreign currency loans to total loan outstanding is about half, less than that of deposits, showing both the lack of loan opportunities in Lao and the strict risk management for foreign currency loans in the commercial banks.
- SOCBs still dominate Lao's formal banking system, with a 72% share of deposits and a 56% share of credits. However, other commercial banks have increased their market shares during the restructuring of SOCBs, causing a more competitive market condition in growing private sector businesses.

Table 4-10 Integrated balance sheet of all commercial banks in Lao PDR (2000-2004)

(billions of kip equivalent, end of period )

	2000		2001		2002		2003		2004.09	
Deposits	2,182	15.9	2,598	16.5	3,301	17.9	3,822	16.9	4,462	N.A
Kip deposits	469		569		810		1,198		1,428	.
FC deposits	1,723		1,713		2,019		2,634		3,034	
Domestic credit	1,297	9.5	1,893	12.1	1,928	10.4	2,021	8.9	2,151	N.A
To SOEs	260		533		566		451		425	.
To private	1,109		1,382		1,329		1,327		1,527	
FC credit	810		974		961		974		1,190	
SOCBs' shares of totals										
Deposits	1,712	78.5	2,009	77.3	2,480	75.0	2,822	73.8	3,217	72.0
Kip deposits	372		432		605		903		1,046	
FC deposits	1,340		1,578		1,875		1,919		2,171	
Domestic credit	815	62.8	1,281	67.6	1,222	63.3	1,152	57.0	1,213	56.4
To SOEs	217		419		449		331		280	
To private concerns	665		885		776		620		796	
FC credit	660		1,019		1,028		817		899	
Nominal GDP	13,672	100	15,705	100	18,390	100	22,536	100	N.A.	

Source: IMF (2004), Selected Issues and Statistical Appendix (Jan. 2005).

Note: Percentage in SOCBs data is relative to commercial bank totals

## b) Problems in the banking system in Lao PDR

### i) Low financial depth

Financial system modernization and liberalization has slowly progressed in transitional economies in East Asian countries such as Viet Nam, Cambodia, and Lao PDR. Those countries are still in the process of transition toward market-based economies. Their banking sectors are commonly facing difficulties in expanding banking business. A lack of domestic savings under the old planned-economy regimes, combined with unattractive interest rates (negative real interest rates for depositors and high interest rates for borrowers due to the vulnerable macro economy), inconvenient other banking services for depositors and borrowers, and a lack of trust in the banking system are factors which constrain further development of banking business. The table below indicates comparative trends of financial depth in transitional economies in South-East Asia. We can see recent improvement of financial depth in Viet Nam. It seems to be linked with the stabilization of the macro economy. Lao PDR and Cambodia seems struggling to improve the domestic financial depth due to the lack of capacity both lenders and borrowers. However, the domestic savings are gradually increasing due to the constant economic growth and the stabilized macro economic conditions.

**Table 4-11. Financial depth**

**A. Domestic deposits (% of GDP)**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	11.4	10.6	11.7	16.6	18.9	14.2	15.9	15.6	17.9	16.9
Cambodia	4.0	4.9	6.9	7.2	6.3	7.6	10.3	12.1	14.4	15.3
Viet Nam	N.A.	11.1	12.4	14.5	16.7	26.0	32.8	38.1	39.3	N.A.

Source: IMF International Financial Statistics (2003), ADB Key Indicators (2004)

**B. Domestic credits (% of GDP)**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	9.7	9.8	9.7	14.0	13.4	9.2	10.0	12.0	10.3	8.9
Cambodia	3.5	3.7	5.0	6.6	5.8	6.1	7.0	7.1	7.5	9.1
Viet Nam	N.A.	7.9	8.8	9.9	9.7	28.2	35.3	39.0	43.3	N.A..

Source: IMF International Financial Statistics (2003), ADB Key Indicators (2004)

**C. Money and quasi money (M2) (% of GDP)**

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Lao PDR	14.9	13.6	14.1	18.5	20.4	15.0	16.5	16.4	19.3	18.2
Cambodia	6.6	8.0	10.3	10.9	10.8	11.5	14.2	16.5	19.6	21.1
Viet Nam	N.A.	19.8	20.9	22.6	24.2	36.4	44.6	51.8	53.3	N.A.

Source: IMF International Financial Statistics (2004), ADB Key Indicators (2004)

**ii) Low fund mobilization (weak financial intermediary function)**

As shown above, the deposits to GDP ratio in Lao PDR is still low due to some historical reasons such as a failing experience of credit cooperatives, poverty, and unattractiveness of the banking services. The ratios are also indication of limited banking access in rural and remote areas. *The Banking and Financial Sector of Lao PDR* (2002) mentions several characteristics of the deposit structure in the Lao banking sector, and some of them are shown in Table 4-12.. Notable is the fact that SOCBs' market share and foreign currency deposits share have declined to 70 percent and less than 70 percent respectively lately when we compare the fact with latest balance sheets in Table 4-10.

**Table 4-12. Structure of Lao banking deposits (Dec. 31, 1999)**

Type of Bank	Share	Currency	Share	Type of Depositor	Share	Area	Share
SOCBs	80%	Kip	15%	Individual	48%	Urban	90%+
Other Banks	20	Foreign	85	Firms	52%	Rural	10%

Source: *The banking and financial sector of Lao PDR* (2002).

The most basic function for the commercial banks is to mobilize individual deposits to productive projects or viable enterprises efficiently. This is a sound financial intermediary function needed for maintaining viability of the bank. Efficient and

productive fund mobilization of the whole banking system will contribute to sustainable economic growth. To achieve this, a good risk management system, professional skilled workers, and a strict central bank monitoring system in line with adequate prudential norms will be needed. Looking below at the aggregated balance sheet of three state-owned commercial banks, we see a miserable static condition: the NPL ratio is over 50 percent; therefore, the losses account exceeds the total of capital and reserves, which causes negative equity. The loans to deposits ratio was 38 percent at the end of 2003, indicating low fund mobilization. And the high portion of foreign bank deposits shows a high degree of external capital flight (30-40% of foreign currency deposits), particularly through the Nostro account. There is also a lack of domestic foreign currency loan demand. With negative equity and bad quality assets, bank reliability is difficult to achieve, so they are forced to hold large sums of cash for liquidity and rely on tacit government guarantees on deposits. The deposits at BOL to deposits ratio shows a high degree, 23%.

### iii) Unsound balance sheets and loss making operations in SOCBs

#### Unsound balance sheets in SOCBs

Table 4-13. Aggregated B/Ss at the end of 2003 (billions of kip)

Assets	Jan.2003	Dec. 2003	Liabilities	Jan. 2003	Dec. 2003
Reserves	566.1	755.9	Current deposits	289.8	410.0
- Cash	39.2	60.2	- Private sector	77.5	100.6
- Deposits at BOL	526.7	695.6	- SOEs	189.0	280.4
Foreign assets	884.7	878.7	Term deposits	143.9	449.4
- Nostro A/C	708.1	568.0	- Private sector	143.2	448.3
Claims on gov.	40.6	296.0	Saving deposits	115.3	236.4
- Securities	40.6	296.0	- Private sector	111.5	230.6
Claims on SOEs	442.5	338.7	Foreign currency deposits.	1,698.1	1,934.4
- Foreign currency	442.3	331.3	Restricted deposits	18.0	19.9
Claims on private	815.3	825.8	Foreign liabilities	508.2	309.9
- Foreign currency	527.5	493.7	Gov. deposits	30.5	80.7
Inter-bank transaction	64.1	137.7	Credits from money Authorities	222.9	165.6
Other assets	308.9	229.8	Other liabilities	146.2	168.1
			Total liabilities	3,172.9	3,774.4
			Equity total	-50.4	-311.6
			- Capital	26.8	34.6
			- Reserves	32.9	33.5
			- Provisional losses	-116.0	-390.2
Total	3,122.4	3,462.7	Total	3,122.4	3,462.7

Source: Compiled B/Ss from the BOL.

Table 4-14. Aggregated B/Ss at the end of 2002

Assets	Million kip	%	Liabilities	Million kip	%
Cash	331,950	9.1	Deposits	3,488,043	95.8
Inter-bank deposits	1,085,801	29.8	Borrowings	178,544	4.9
- Foreign bank deposits	891,908	24.5	-from BOL	132,368	3.6
BOL deposits	549,550	15.1	Other liabilities	132,513	3.6
Securities investment	108,661	2.9	Liabilities total	3,799,100	104.4
Loans	1,486,043	40.8	Capital	4,800	0.1
-NPLs	791,620	21.8	Accumulated reserves	44,444	1.2
-Written off (provision)	-237,956	-6.5	Losses	-210,852	-5.7
Other credits	755	0.0	Others	205	0.0
Fixed assets	73,840	2.0			
Other assets	239,053	6.6	Equity total	-161,402	-4.4
<b>Total</b>	<b>3,637,698</b>	<b>100</b>	<b>Total</b>	<b>3,637,698</b>	<b>100</b>

Source: Compiled from all SOCBs' B/Ss.

The Lao PDR definition for NPLs: 90 days overdue.

Some Ratios for your reference:

- Loans/Deposits: 42.8%.
- Foreign bank deposits/ Deposits: 25.5% (domestic savings → foreign assets).
- NPLs: 53.2% (NPLs do not produce interest return for banks).
- Equity: Negative (credit unworthy).
- However, the liquidity seems large: cash +bank deposits + BOL deposits/deposit =56%.

One SOCB's directors' as to the causes of its NPLs are as follows.

- BCEL case: 50% caused by loans to loss-making SOEs, 20% caused by local government imposition for construction projects, 30% caused by loans to private enterprises. Local government guaranteed loans for private road contractors have defaulted, reportedly due to shortage of budget. Those NPLs were gradually replaced by government bonds with a 11% coupon rate. Clearly the heavy burden of NPLs in commercial banks constraint efficient and constructive fund mobilization in the real economy.

## Weak profit and loss structure in SOCBs

Table 4-15. Aggregated profit and loss structure of SOCBs in 2004

(millions of kip)

Revenue Items		Expenditure Items	
1. Revenue from banking business	194,838	1. Expenditure on banking business	177,267
- Interest and revenue	100,325	- Interest and expenditure	128,119
- Leasing	138	- Leasing	73
- Fees	32,686	- Fees	4,737
- Revenue from financing activities	44,553	- Expenditure on financing activities	37,347
- Other revenue	17,135	- Other expenditure	6,991
2. Current revenue	346,567	2. Current expenditure	605,953
- Non banking revenue	345,856	- General expenditure on business	47,610
- Others	711	- Depreciation on fixed assets	13,255
		- Non-banking business	34,418
		- Loss from NPLs	508,993
		- Others	1,677
Total Revenue	541,404	Total Expenditure	783,221
		Profit and Loss	- 241,816

Source: compiled from each bank's financial statement

Regarding the aggregated profit and loss statement (P/L), SOCBs produced losses in 2003 due to the large volume of NPL provision. The problem, seen in the P/L, is the net loss in interest revenue and expenditure category, which is the foundation of commercial banking business. Net banking business profit was positive but interest profit was negative, indicating a very thin interest margin. Several reasons are identified below:

- Low loan to deposit ratio (inefficient fund mobilization)
- Accumulation of overdue and NPLs,
- Thin spreads (do not cover total funding costs)

Such structural problems that are seen in both BCEL and LDB have to be solved in order for these SOCBs to compete with private commercial banks. Improvement of profitability in banking business seems crucial in order to speed up the off-balancing of NPLs.

#### iv) Issues on the interest rate structure

##### Unattractive interest rate and banking services

According to the BOL, interest rate setting is currently fully liberalized and market-based interest rates have been introduced. However, SOCBs' interest rates are said to be determined at monthly member meetings. The tables below show the interest

rate structure. We can observe some differences in interest rate setting between local banks and foreign banks, and between SOCBs and private banks. In these tables highlighted the interest rate spread between basic loans and deposits.

Table 4-16. Interest rates trend (2000-2004) (%)

	2000	2001	2002	2003	2004. 03	2004. 06	2004.11
<b>Local banks</b>							
Savings (US\$)	3.0	2.0	1.5	0.8	0.3	0.3	0.25
Savings (kip)	12.0	12.0	15.0	13.0	6.0	6.0	5.50
<b>Overdraft (OD)</b>							
kip	30.0	24.0	24.0	28.0	24.0	25.0	23.33
baht	12.0	10.0	10.0	12.0	12.0	13.5	13.50
US\$	11.0	11.0	11.0	11.0	12.0	13.5	13.50
<b>Foreign banks</b>							
Savings (US\$)	1.0	0.5	0.3	0.3	0.3	0.3	0.3
Savings (kip)	-	-	-	-	-	-	-
OD kip	23.0	23.0	21.0	22.0	24.5	24.5	24.5
OD baht	17.0	17.0	14.0	14.0	13.7	13.7	13.5
OD US\$	13.0	13.0	11.0	11.5	11.5	11.5	12.75
Spread local, kip	18.0	12.0	9.0	15.0	18.0	19.0	17.83
Spread local, US\$	8.0	9.0	9.5	10.2	11.7	13.2	13.25
Spread Foreign, US\$	12.0	12.5	10.7	11.2	11.2	11.2	12.45

Source: IMF (2004), Selected Issues and Statistical Appendix.

Table 4-17. Interest rate structure changes in 2004 (%)

		2004.02	2004.04-06	2004.07	2004.08-09	2004.10-11
Kip savings	SOCBs	8.0	6.00	6.00	5.67	5.50
	Private banks	7.0	5.75	5.75	5.75	5.75
Baht savings	SOCBs	0.3	0.28	0.28	0.28	0.28
	Private banks	0.38	0.38	0.38	0.38	0.37
US\$ savings	SOCBs	0.3	0.25	0.25	0.25	0.25
	Private banks	0.37	0.28	0.28	0.28	0.30
Kip loans 1Y	SOCBs	18.00	16.67	16.67	16.67	16.00
	Private banks	22.33	22.33	22.33	22.33	19.30
Baht loans 1Y	SOCBs	6.75	6.75	6.75	6.75	7.67
	Private banks	13.53	13.53	13.53	13.53	9.20
US\$ loans 1Y	SOCBs	6.50	6.50	6.50	6.50	7.50
	Private banks	10.30	10.30	10.30	10.77	8.40
Kip spreads	SOCBs	10.00	10.67	10.67	11.00	10.50
	Private banks	15.33	16.58	16.58	16.58	13.55
Baht spreads	SOCBs	6.45	6.47	6.47	6.47	7.39
	Private banks	13.15	13.15	13.15	13.15	8.83
US\$ spreads	SOCBs	6.20	6.25	6.25	6.25	7.25
	Private banks	9.93	10.02	10.02	10.45	8.10

Source: Compiled from BOL data

In Lao PDR, commercial banks have to manage three currencies: kip, baht, and US dollars. As for the kip, the savings deposit rate seems to be unattractive for depositors, considering the current double-digit CPI level. And for the borrowers, the

kip loans rate seems quite high. The government used to instruct SOCBs to provide preferential interest rates for agriculture and some politically important sectors (directed finance) a remnant of the mono-bank regime. This system has recently been eliminated by the BOL due to its unsoundness.

The spread between loans and deposits is a crucial factor for determining bank profit and efficiency in banking operations. Table 5-13 and 5-14 indicates that some joint venture (JV) banks and foreign branches (private banks) seem to have wider spreads than do SOCBs. This is one reason why SOCBs have had difficulty resolving NPLs and focusing on profit making management. In 2004, the kip savings interest rate dropped gradually, but SOCBs maintained spreads of 10 to 11%. It is doubtful that banks can attract depositors when their real interest rates are negative. Interest rate will be determined in the market, affected by BOL's monetary policy, supply-demand condition for the loan, credit risks of the borrowers, and maturity of the loan, etc. It is said that the interest rate setting was liberalized, however, SOCBs' interest rate for the loans still seems distorted by the government.

In our interviews with potential bank borrowers, we heard complaints about high interest rates on loans, inconvenience in rolling over loans, and difficulty in attaining bank access outside of long-established good relationships. SMEs have difficulty accessing banking facilities due to their lack of valued collateral. Commercial banks should expand viable loan assets by solving those constraints to improve their profitability in bank operations.

#### v) Weak management capacity and human resources

In order to achieve sound operations in banks, good governance, adequate risk management systems and capable bank staffs are needed. The GOL recently provided SOCBs full autonomy, eliminating so-called directed lending, one of the causes of the accumulation of NPLs in the past. Our interviews with the various types of banks indicated to us a weak capacity of SOCBs in terms of risk management systems, worker skills, and overall banking service quality. It seems that SOCBs still maintain directed lending in practice. Foreign banks and JV banks seem to succeed in minimizing NPLs and producing profit in banking operations. Some private enterprises prefer JV banks or foreign bank branches to SOCBs due to their higher quality banking services for external trade financing. And contrary to what is expected, SOCBs are still producing NPLs despite strict supervision by the BOL. The old tradition of directed finance, defined as strong government intervention in banks' loan decision making, seems to persist in SOCB management. SOCBs can not accomplish

restructuring by separating NPLs from their banks' balance sheets. They have to develop discipline in daily banking operations through autonomy from the government and learn and introduce modern risk management skills and banking services, and institutionalize them with trained capable staffs and managers.

### **(c) Observation on the financial system reform and the capital market development**

#### **i) Scope of further banking reform**

The government of Lao (GOL) has been focusing on restructuring of SOCBs' management and unsound balance sheets, aiming for them to become reliable commercial banks with advanced risk management systems and necessary capital adequacy. And now the GOL is considering the restructuring of the specialized bank Agriculture Promotion Bank (APB), separating policy lending for poor farmers from a pure commercial-based bank function. The GOL also proposes to establish a development financial institution (DFI) to support industrial and infrastructure development projects by supplying long-term loans. These and other reforms need human resource development, more strict governance structure and internal capital accumulation at banks. The SOCBs should speed up the restructuring of their balance sheets and improve the quality of their loan assets so they can become more profitable and sound. SOCBs and APB restructuring should be prioritized over creation of a new financial institution like DFI.

#### **ii) Financial system development toward the establishment of capital market**

As mentioned before, the banking system in Lao PDR faces many difficulties. Looking at the bank management failure of SOCBs' and unsound SOCBs' balance sheets, establishment of a capital market is not an easy task. However, I would like to conclude my report by indicating a rough sequence for the future establishment of a capital market in Lao PDR.

1<sup>st</sup> – Stabilization of the macro economy must be prioritized. Balancing the budget, containing inflation, and stabilizing the foreign exchange rate will contribute to mitigate market risks and provide a better business environment for SMEs. Interest rates can be determined based on the market mechanism, which gives entrepreneurs easier bank access. This also allows depositors to enjoy positive real interest on their savings at banks, which encourages domestic saving in the country. Financial deepening would be promoted in this process. Under the condition of lacking individual and institutional investors in Lao PDR, commercial banks seems to be the most

potential fund provider for future government bonds or notes issuance. Experience of bonds market development in China and Viet Nam proves this.

Under the current market condition of low domestic savings referred to above, it seems to be difficult to mobilize long-term funds in the market. If the GOL causes an absorption of scarce domestic savings by issuing bonds to mobilize for capital investment projects, it may crowd out the private financing function operated by commercial banks. Under the country's fiscal shortage constraints, a low-coupon government bond would not attract investors, commercial banks or individuals. Balancing the fiscal budget and encouraging domestic savings should be prioritized.

2<sup>nd</sup> – Strengthening of the short-term financing function should be prioritized over attention to the long-term financing function for capital investment projects, because, long-term financing faces higher risk. Maturity and coupon rate of the treasury bills or bonds must be determined in the existing market conditions affected by the macro economic fundamentals. The Detailed information disclosure and transparent accountability system will be needed to attract potential investors in the country. The modern legal and institutional frame work for promoting capital market development should be constructed. More difficult issue is enforcement of rules, because it is related to human capacity and behaviors. Dissemination efforts to train market participants will be crucial.

3<sup>rd</sup> – Monitoring achievement in the restructuring of SOCBs and considering the availability of market-based funding and human resources development for capital market will be proceeded. Once domestic savings is enlarged in line with increased credibility of the government and banking system, Lao PDR, like China and Viet Nam have done, might be able to mobilize longer-term funding by issuing treasury bonds in the market, guaranteed by the government. Since there is some risk of crowding out commercial banking activities, too much bond issue must be avoided. And TB's scope of usage should be monitored and clearly identified as being in harmony with commercial bank business, promoting private businesses.

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