

PROGRAM COMPLETION REPORT

ON THE

SECOND FINANCIAL SECTOR PROGRAM
(Loan 1458-LAO [SF])

TO THE

LAO PEOPLE'S DEMOCRATIC REPUBLIC

December 2001

CURRENCY EQUIVALENTS

(as of 1 December 2001)

Currency Unit – Kip (KN)

		At Appraisal	At Program Completion
		1 July 1996	30 April 2001
KN1000	=	\$1.049	\$1.179
\$1.00	=	KN9,530	KN8,482.5

ABBREVIATIONS

ADB	–	Asian Development Bank
APB	–	Agricultural Promotion Bank
BCEL	–	Banque pour le Commerce Exterieur Lao
BOL	–	Bank of Lao PDR
CIB	–	Credit Information Bureau
ECU	–	European Currency Unit
ESAF	–	Enhanced Structural Adjustment Facility
FSPLI	–	First Financial Sector Program loan
FSPLII	–	Second Financial Sector Program loan
GDP	–	gross domestic product
IMF	–	International Monetary Fund
Lao PDR	–	Lao People's Democratic Republic
LMB	–	Lao May Bank Ltd.
LXB	–	Lane Xang Bank Ltd.
MOF	–	Ministry of Finance
NPL	–	nonperforming loan
PRGF	–	Poverty Reduction and Growth Facility
SACIII	–	Third Structural Adjustment Credit
SCB	–	State owned commercial bank
SDR	–	special drawing rights
SED	–	Supervision and Examination Department
SOE	–	state-owned enterprises
TA	–	technical assistance
T-bills	–	treasury bills
US	–	United States
WB	–	World Bank

NOTES

- (i) The fiscal year (FY) of the Government and its agencies ends on 30 September. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2000 ends on 30 September 2000. The central bank and commercial banks use the calendar year (CY).
- (ii) In this report, "\$" refers to US dollars.

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BASIC DATA

A. Loan Identification

1.	Country	Lao PDR
2.	Loan Number	1458- LAO (SF)
3.	Program Title	Second Financial Sector Program
4.	Borrower	Lao PDR
5.	Executing Agency	Bank of Lao ODR
6.	Amount of Loan	SDR17,151,000
7.	Project Completion Report Number	PCR LAO-1458

B. Loan Data

1.	Appraisal	
	– Date Started	21 May 1996
	– Date Completed	5 June 1996
2.	Loan Negotiations	
	– Date Started	14 August 1996
	– Date Completed	15 August 1996
3.	Date of Board Approval	12 September 1996
4.	Date of Loan Agreement	15 August 1996
5.	Date of Loan Effectiveness	
	– In Loan Agreement	13 November 1996
	– Actual	6 December 1996
	– Number of Extensions	1
6.	Closing Date	
	– In Loan Agreement	31 October 1999
	– Actual	30 April 2001
	– Number of Extensions	4
7.	Terms of Loan	
	– Interest Rate	0
	– Service Charge	1
	– Maturity (number of years)	40
	– Grace Period (number of years)	10
8.	Disbursements	
a.	Dates	

Initial Disbursement	Final Disbursement	Time Interval
16 December 1996	4 August 2000	3 years, 7.5 months
Effective Date	Original Closing Date	Time Interval
6 December 1996	31 October 1999	2 years, 10.5 months

b. Amounts

First Tranche	Second Tranche	Total
SDR8,575,000	SDR8,575,000	SDR17,151,000
US\$12,369,987.24	US\$11,262,632.93	US\$23,632,620.17

C. Project Performance Report (PPR) Ratings

Implementation Period		Ratings		
From	To	Development Objectives	Implementation Progress	Project Classification
January 1997	Dec. 1997	--	--	A
January 1998	Dec. 1998	Satisfactory	Satisfactory	--
January 1999	March 1999	Satisfactory	Partly Satisfactory	--
April 1999	Dec. 1999	Satisfactory	Partial Satisfactory	--
January 2000	Dec. 2000	Satisfactory	Unsatisfactory	--
January 2001	April 2001	Partly Satisfactory	Partial Satisfactory	--

D. Data on Asian Development Bank Missions

Name of Mission	Date	No. of Persons	No. of Person-Days	Specialization of Members
Pre-Fact Finding ^a	7-15 Dec 1995	6	46	Senior Financial Analyst Senior Programs Officer Project Economist Young Professional Economist Counsel
Fact Finding	23 Jan – 5 Feb 1996	4	56	Senior Financial Analyst Senior Counsel Project Economist Young Professional
Appraisal ^b	21 May – 4 June 1996	5	75	Senior Financial Analyst Senior Programs Officer Project Economist Counsel Young Professional
Review Mission 1	12-21 Nov 1996	2	10	Senior Financial Analyst Young Professional

Name of Mission	Date	No. of Persons	No. of Person-Days	Specialization of Members
Review Mission 2	28 April – 9 May 1997	2	24	Senior Financial Analyst Project Economist
Review Mission 3	16 Feb – 4 March 1998	2	17	Project Economist Investment Officer
Review Mission 4	22 June – 2 July 1998	1	12	Trade Economist
Review Mission 5	19 – 23 Oct 1998	2	10	Trade Economist Senior Programs Officer
Review Mission 6	15 – 19 Feb 1999	1	5	Senior Financial Economist
Review Mission 7 ^c	11-26 March 1999	2	21	Senior Financial Economist Financial/Capital Market Specialist
Review Mission 8 ^c	13-21 May 1999	1	3	Senior Financial Economist
Review Mission 9 ^c	16-26 Aug 1999	1	2	Senior Financial Economist
Review Mission 10 ^c	21-29 November 1999	3	18	Senior Financial Economist Financial/Capital Market Specialist Associate Project Analyst
Review Mission 11 ^c	6-14 December 1999	2	4	Senior Financial Economist Financial/Capital Market Specialist
Review Mission 12 ^c	21 Feb – 6 March 2000	2	10	Senior Financial Economist Financial/Capital Market Specialist
Review Mission 13 ^c	31 March – 5 Apr 2000	1	2	Senior Financial Economist
Review Mission 14 ^c	3-11 July 2000	4	8	Senior Financial Economist Financial Economist Economist Associate Project Analyst
Project Completion Review ^c	19 – 31 August 2001	2	16	Senior Financial Economist Associate Project Analyst

Note:

^a Director Infrastructure, Energy and Financial Sectors Department (West) and Manager, Financial Sectors and Industry Division (West) assisted the Mission.

^b Manager, Financial Sectors and Industry Division (West) assisted the Mission.

^c Multi-purpose Mission; person-days are pro-rated.

I. PROGRAM DESCRIPTION

1. Loan 1458-Lao (SF): Second Financial Sector Program (FSPLII) was approved on 12 September 1996 to develop an environment favorable to nurturing a market-driven financial sector. The Program comprised (i) a policy loan of SDR17,151,000 (\$25 million equivalent) to be disbursed in two equal tranches of SDR8,575,500 and (ii) two technical assistance (TA) grants to (a) support the restructuring and consolidation of state-owned commercial banks (SCBs),¹ and (b) develop an interbank market.² The program period was originally up to 31 October 1999. The first tranche was disbursed shortly after the loan became effective on 6 December 1996. The second tranche was planned to be disbursed at the end of October 1998.

2. The objective of FSPLII was stated as: (i) “to mobilize a greater amount of domestic savings, particularly long-term savings, and allocate them efficiently to promote private sector development; and (ii) to strengthen macroeconomic management through the development of a sound and more market-responsive banking system.” A program framework, prepared on an ex post facto basis to assist in the program evaluation, is attached as Appendix 1.

3. The components of the Program were (i) restructuring and consolidating the seven SCBs for their long-term viability; (ii) strengthening the autonomy and commercial orientation of the SCBs; (iii) strengthening the supervisory function of the Bank of Lao PDR (BOL) to implement and enforce prudential regulations; (iv) building a market infrastructure to support the banking system; and (v) developing human resources and building capacity in the SCBs.

II. EVALUATION OF DESIGN AND IMPLEMENTATION

A. Relevance of Design and Formulation

4. Following the introduction of the “New Economic Mechanism”, the Government initiated financial sector policy reforms in 1988 to separate central banking from commercial banking functions in a two-tier banking system and to remove structural distortions and constraints to resource mobilization through commercial banks.

5. Since 1988, ADB has played a lead role in the development of the financial sector of the Lao People’s Democratic Republic (Lao PDR) through TA grants and program loans. In December 1990, ADB approved Loan 1061-Lao (SF): Financial Sector Program (FSPLI), for SDR17,424,000 (approximately \$25 million), aimed at developing an efficient financial system that was responsive to the needs of a nascent private sector in a transition economy. FSPLI supported a broad program of policy reforms aimed at strengthening the overall financial sector policy environment, enhancing the institutional base of the financial sector, and promoting private sector enterprise development and privatization. While commendable progress has been made by the Government of the Lao PDR in liberalizing the financial sector supported by FSPLI, there still remained major impediments in the sector.

6. ADB’s strategy was to establish a sound, efficient, and market-responsive banking system in line with the economic transformation of the country. The financial sector reforms under FSPLII were expected to improve efficiency in mobilization and allocation of resources and to provide the foundation for private sector development and sustainable economic growth.

¹ TA 2642-LAO: *Restructuring and Consolidation of the State-Owned Commercial Banks*, for \$954,000, approved on 12 September 1996

² TA 2643-LAO: *Development of an Interbank Market*, for \$130,000, approved on 12 September 1996.

FSPLII continued the unfinished agenda of FSPLI on the policy environment and market structure and added the establishment of deposit insurance and credit information services to the reform agenda. These policy actions aimed at helping bring about more effective macroeconomic management through interest rate liberalization and open market operations as well as creating a conducive legal and regulatory environment for banking. Deposit insurance and a nationwide deposit mobilization campaign had the goal of mobilizing savings through the banking system. More generally, savings mobilization was an objective to be achieved by instilling greater public confidence in the banking system. FSPLII built on progress achieved under FSPLI in creating an institutional base for the financial sector. FSPLII included institutional reforms comprising the consolidation and corporatization of state-owned banks, their commercialization through operational and financial restructuring and governance improvements, and greater autonomy in the structure, management, and operation of these banks.

7. Although the ultimate goal of FSPLII was private sector development and sustainable economic growth, FSPLII did not continue the enterprise sector reform started under FSPLI. The stated objective of mobilizing savings for intermediation and productive use of the private sector gave prominence to the promotion of private sector development. As the economy was dominated by state-owned and state-connected enterprises, the role of the private sector was limited. As such, without reforms aimed at strengthening the private sector and downscaling the state-owned enterprise sector, coupled with policies to eliminate or reduce directed lending, the flow of financial resources to the private sector through bank intermediation would be limited.

8. Since the New Economic Mechanism was initiated in 1988, the formal financial sector grew at about 24 percent per year to reach an asset size of about \$656 million in 1995. Despite this rapid growth, the financial sector was small, as its total assets amounted to only 43 percent of gross domestic product (GDP) in 1995. The assets were almost all concentrated in the banking sector, with over 70 percent in the SCBs. The financial sector comprised the central bank, seven SCBs, two joint-venture banks, seven branches of foreign banks, the state-owned Agricultural Promotion Bank (APB), 32 foreign exchange bureaus and a joint-venture insurance company. The private banks were concentrated in Vientiane. The SCBs had branches outside Vientiane in accordance with their assigned geographic responsibilities. Borrowers were concentrated in the urban areas and banking services were limited. Most lending was for working capital and trade finance. There were very few financial instruments, mainly treasury bills (T-bills) for which there was no secondary market activity. The legal, regulatory, and supervisory framework was inadequate to cope with the transformation of the financial system. BOL was not independent of the Ministry of Finance (MOF) since by law, all the key monetary policies and action plans of BOL had to be approved by the Government. Although the banking system was no longer monolithic, in reality the SCBs were extensions of BOL, being under the control of the central bank. About 10 months after the SCBs were recapitalized in December 1994 (using a cash injection of KN4 billion from FSPLI proceeds and KN14 billion of treasury bonds), their capital structure had weakened as almost 15 percent of their loan portfolio was reported to comprise bad and doubtful debts. An audit of 1997 accounts of the SCBs showed that nonperforming loans (NPLs) ranged from 25 to 70 percent of total outstanding loans as at the end of December 1997 and estimated provisions for NPLs was 70 percent of their loan portfolios. While anticipating that there may be a need for a second round of recapitalization, having provided for this in the cost of the Program, FSPLII specified no policy condition for preparing a financial restructuring plan.

9. The financial development of the Lao PDR was the lowest among Southeast Asian countries. In 1990, the financial depth of the Lao PDR, as measured by the ratio of broad money

to GDP, was merely 7.5 percent. Financial depth improved to 18 percent in 1998, compared to 24 percent for Viet Nam and 90 percent for Thailand. It is comparable with the financial development of the Central Asian republics, which are also market transition economies.

10. FSPLII was designed in 1996, without a project preparatory TA. Of the six advisory TAs approved between loan closing of FSPLI and fact-finding for FSPLII, three were directly related to the FSPLII policy actions, namely auctioning of T-bills,³ the leasing decree⁴ (both carryovers conditions from FSPLI), the SCB operations manual, and secured transactions regulations.⁵ The Government and ADB did not give enough time and effort to building ownership and strengthening commitment prior to FSPLII implementation.

11. At appraisal of FSPLII, the policy framework paper for 1996-1998 agreed with the International Monetary Fund (IMF)-defined macroeconomic objectives, including a 7 percent average annual output growth rate, a reduced inflation rate of 7.5 percent in 1996 and 4.5 percent in 1997 and 1998, a current account deficit (excluding official transfers) of 12 percent of GDP in 1998, and increased gross official reserves equivalent to three months of imports. This was an optimistic scenario. External shocks and policy-induced hyperinflation and economic instabilities sidetracked the Program.

12. The Program was coordinated with the reform and assistance programs of IMF through an enhanced structural adjustment facility (ESAF) for 1996-1998 and the World Bank (WB) through its \$40 million Third Structural Adjustment Credit (SACIII). The Program addressed weaknesses of the commercial banking system while IMF addressed weaknesses of BOL in macroeconomic management and WB structural issues in BOL's supervisory function. However, in 1998 IMF's ESAF was discontinued and WB's SACIII was cancelled as a result of the Government's inability to comply with policy conditions; ADB continued with its policy interventions.

B. Program Outputs

13. The Government satisfactorily fulfilled 19 of 23 of the policy actions, did not comply with one, complied partially with two, and substantially fulfilled the terms of the remaining one (Appendix 2). Thirteen of the 23 are conditions for second tranche release, of which 12 have been fully complied with. The Government continued to progress in moving forward several reforms under the Program, engaging ADB as well as WB and IMF in policy dialogue for preparation of the next reform program of assistance.

1. Restructuring and Consolidation of the State-Owned Commercial Banks

14. Through the determined efforts by the Government, BOL, and the SCBs themselves, six of the former government banks were consolidated into two, namely Lao May Bank Ltd. (LMB) and Lane Xang Bank Ltd. (LXB). Together with Banque pour le Commerce Extérieur Lao (BCEL), which essentially remained intact, LMB and LXB were corporatized and acquired a shareholding structure, with the Government as the sole owner. The consolidation of the SCBs fell short of restructuring operations, rightsizing its organization, and rationalizing its branch network. Consolidation was not coupled with a program for retrenchment of redundant personnel or a social safety net. While there were measures to strengthen the commercial

³ TA 1843-LAO: *Mechanisms for Tendering Government Paper*, for \$85,000, approved on 15 December 1992.

⁴ TA 1844-LAO: *Pension Fund and Leasing Legislation*, for \$100,000, approved on 25 January 1993. TA assisted in the drafting of the leasing legislation. The pension fund component was cancelled.

⁵ TA 2160-LAO: *Human Resource Development in Banks*, for \$350,000, approved on 21 September 1994.

orientation of the SCBs, including an operations manual, business plan, audit, and policy-making board, these were not integrated into an operational restructuring plan. In fact, no restructuring plan was considered at appraisal. Neither did the attached TA 2642 prepare one. The need for it was recognized in the plan for enforcement of prudential regulations (paras. 43-44) and in the strategic framework for banking reform and SCB restructuring programs (para. 70) prepared with assistance provided under the subsequent TA 3466.⁶

2. Strengthening the Autonomy and Commercial Orientation of the State-Owned Commercial Banks

a. Corporatization and Autonomy of the State-Owned Commercial Banks

15. Amendments were made to the Decree Law on Commercial Banks and to the Law on the Bank of Lao PDR to incorporate provisions that the board of directors of the SCBs would be the policy-making body of each SCB, that the chairperson and other members of the board would be appointed by MOF, and that the role of appointing the managing director and other senior management of the SCB would be removed from BOL. Accordingly, MOF officials were appointed to be chairperson and board members of the SCBs. Some retired government officials were also appointed to the boards. However, BOL still has a residual influence in the transfer and appointment of key personnel of the SCBs and has exercised control over SCB financial management.

16. As part of the Program, BOL was to increase the SCBs' autonomy. The options included joint-venture arrangements with well-established international banks, changing the SCB board structure to reduce government control, management contracts, and reduction of government ownership in the SCBs through sale of government-owned shares to the public and employee stock ownership programs. As anticipated, full autonomy of the SCBs was not achievable during the period of the Program. Political reluctance to increased autonomy remains strong. Before foreign investors can be attracted to seriously look at the SCBs, the banks have to undergo deep operational and financial restructuring, which the authorities have to approve.

b. Commercial Orientation and Management Improvement

17. Initial steps have been taken to commercialize the SCBs. The banks have adopted business planning processes, put in place deposit mobilization plans, and established procedures for credit and other operations. However, the banks have deficient policies, inadequate systems and procedures, incomplete formal operational guidelines, and hardly any guidelines for accounting, audit and control, risk management, and human resources management. Recent and ongoing ADB TAs have been designed to address these shortcomings. Under TA 3146,⁷ operational guides and work aids for credit management were prepared to supplement the operations manuals and a credit risk asset management system was introduced to enhance credit procedures. Under TA 3466, a code on roles, duties, and responsibilities of bank directors, a code of conduct and ethics, a code on levels of authority, and corporate planning documents were drafted. These were translated to Lao and discussed in a number of workshops. With the assistance of ADB consultants, a general framework was prepared for measurable improvements in corporate governance focusing on financial

⁶ TA 3466-LAO: *Strengthening Corporate Governance and Management of the State-Owned Commercial Banks*, for \$900,000, approved on 7 July 2000.

⁷ TA 3146-LAO: *Commercial Banking Capacity and Efficiency Enhancement*, for \$550,000, approved on 24 December 1998

soundness, efficiency, profitability, and other key results areas. However, the SCB boards and management have a long way to go in absorbing a meaningful dosage of these management concepts and tools and applying them at work. The process has been gradual and in segments, due to SCBs' resource constraints and low skill at all levels.

18. The SCBs have adopted and used the chart of accounts prescribed by BOL. However the financial accounts of the SCBs do not strictly comply with guidelines under International Accounting Standard 30 and their financial statements are unreliable. Reports on independent audits of accounts in 1996 and 1997 have several qualifications, seriously limiting the value of the audited financial statements. Deficiencies in the accounting system impeded the smooth and timely completion of audits according to international audit standards.⁸

3. Strengthening the Supervisory Function of the Bank of Lao PDR

19. The establishment of a separate Supervision and Examination Department (SED) in BOL provided the focal point for BOL to carry out its supervisory function. SED has tried to discharge its responsibilities with its limited human resources and training. But SED has not strictly enforced the prudential regulations of the SCBs. BOL has given special consideration to the SCBs because of their seriously impaired financial condition, agreeing to regulatory forbearance to allow the SCBs time to restructure. Although APB was under BOL supervision, the prudential regulations were not applied to APB's commercial lending. Supervision of APB was constrained by the absence of separate accounting and reporting for commercial activities vis-à-vis development activities. BOL has been stricter with private banks, conducting regular on-site inspection, issuing warning, and occasionally imposing penalties.

20. SED, which was reorganized in March 2001 and renamed the Banking and Financial Institutions Supervision Department, has a total of 24 personnel. The 19 staff below division chief level are recent recruits, with no prior work experience. The relatively young and inexperienced supervision staff members lacked the authority to deal with the older and more senior SCB management and were helpless in the face of severe capital deficiencies of the SCBs. Staff members who underwent initial training in bank supervision have been reassigned or left BOL. Staff need hands-on training in both off-site analysis and on-site examination.

4. Building a Market Support Infrastructure for Banking

a. Legal Framework

21. The Government has issued various laws and regulations, most of which were drafted with technical assistance from ADB. Uncompleted work on laws and regulations started under the FSPLI was continued under FSPLII. Corresponding conditions for tranche release were carried over to FSPLII. Consultation and approval processes were extremely long and arduous. Laws that did not have a clearly identified originating ministry or that concerned several ministries encountered excessive delays.

22. The decree on bills of exchange and promissory notes was issued in December 1998. Use by companies of checks for monetary transactions is limited, but increasing. BOL has a

⁸ The Australian Government has recently funded the international audit of the balance sheets of BCEL for 1998 and 1999, the balance sheets of LXB and LMB for 1999 (from April 1999 when the consolidated banks were incorporated), and the annual financial statements (income statement, balance sheet, notes to the accounts) of all three banks for 2000. The audit reports are due to be completed before the end of December 2001.

rudimentary net settlement system under which banks' representatives meet at BOL once a day to settle their net debit or credit positions through BOL clearing accounts.

23. The Government issued the decree to implement the Law on Secured Transactions in September 1999. This specifies the priority of security and the provisions for enforcement of security. The implementing decree for the Law on Bankruptcy was issued in June 2000. Along with the Decree on the Settlement of Economic Disputes (issued in July 1994), this set of laws forms the legal framework for protection of the rights of creditors and debt recovery. However, weaknesses in the judicial system have impeded the recovery of assets from debtors. Debt recovery through the courts normally entails protracted delays and the outcomes are uncertain. There are reported impediments to the full application of the law and difficulties in execution of judgments made. The Ministry of Justice is considering a proposal for the establishment of a judicial police force. Furthermore, many judges do not have an adequate background and training to properly adjudicate loan recovery cases. As a joint undertaking by the Ministry of Justice and ADB, a training program is planned for law students and legal professionals on the bankruptcy and secured transactions laws and their implementing decrees. A component of TA 3737 would investigate issues and impediments in the legal framework concerning loan collection, claims on security, asset assignment, creditors' rights, and bankruptcy implementation.⁹

b. Market Infrastructure

24. BOL has issued the regulations for interbank borrowings. However, the interbank market is not operating. There are no reported transactions between banks for short-term funds. A major reason is unfamiliarity of the SCBs with interbank mechanics. Because SCBs do not have treasury or fund management units, the SCBs are unable to manage their liquidity and do not actively look for opportunities to borrow or lend and participate in the interbank market.

25. The SCBs lack management autonomy and flexibility in pricing assets and liabilities. Although restrictions on interest rates have been removed, BOL still exercises moral suasion over the SCBs. In the past, the SCBs were provided guiding rates by BOL. Although the SCBs are supposed to be free to set their own interest rates, the deposit and lending rates they offer are almost uniform. This is reportedly because the management and officers of the SCBs, who know each other, compare and agree on the rates.

26. BOL has also issued regulations covering supervision of the interbank foreign exchange market. But there continues to be no interbank foreign exchange trading. Foreign exchange in the banking system is scarce. Bank customers are reluctant to surrender foreign exchange to the banking system. Presently, SCBs have a combined negative foreign exchange position of \$77 million. Reluctance to trade has limited the development of the foreign exchange market. SCBs do not have skills in foreign exchange trading. SCBs are dependent on BOL for information on exchange rate movements in the international markets, as they do not have their own research staff.

27. From April 1998 to May 2001, no T-bills were issued through BOL and occasionally limited amounts were sold directly to the public. Apparently, the authorities were concerned with the budgetary impact of servicing obligations on T-bills. In recent T-bill issues, the SCBs purchased only small amounts despite substantial excess reserves. SCBs do not have a global view of their reserve position and lack skills in funds management. MOF and BOL are

⁹ TA 3737-LAO: *Financial Sector Development*, for \$400,000, approved on 10 October 2001.

contemplating more regular floats of T-bills in the context of resolving MOF's debt obligations to contractors. The reintroduction of T-bills is crucial to the development of the interbank markets.

c. Deposit Protection

28. To comply with FSPLII conditionality, BOL issued regulations for a deposit protection scheme in August 1999 and the Government established, in January 2000, the Deposit Protection Fund Inc., a government-owned corporate entity (with KN100 million in capital). The company, which receives budget support from BOL, is tasked with the management of a fund for protection of depositors in member banks (SCBs, APB, two joint-venture banks, and one private bank). Insurance coverage is limited to kip deposits up to a maximum of KN15 million (about \$1,700) per depositor. Current contributions to the fund by participating banks are small relative to the contingent liability from the insurance coverage. It will take many years to fully fund the scheme. In due course, it is expected that the scheme will cap the implicit government guarantee of the banking system.

29. The need for a deposit protection scheme is questionable. The general view is that the Government will not allow the SCBs and APB, which together account for about 70 percent of banking assets, to fail. As such, the deposit protection scheme does not really operate as an insurance scheme. Its establishment is untimely because it imposes a financial burden on the participating banks, most of whom are in poor health.

d. Credit Information Bureau

30. FSPLII supported the establishment of a Credit Information Bureau (CIB) to identify delinquent borrowers. BOL issued the implementing regulation for CIB in November 1997. CIB operated on trial basis, using spreadsheets to capture loan data from April 1998 to January 1999. By February 1999, all banks had registered to participate in CIB. However, CIB could not immediately become fully operational, as it had limitations with its computer software and was understaffed. CIB became operational in November 2001 using a semi-automated system. CIB plans to have an upgraded information management system and computer network in 2002.

e. Nonbank Financial Institutions

31. The decree on leasing was issued in February 1999. The decree has not been disseminated. Few persons understand financial leases. Lending on future cash flows of a rented asset, rather than on past performance and collateral, is a novel idea. To date, no one has applied for a financial leasing license.

32. The implementing decree on social security funded by the United Nations Development Programme covering, on a compulsory basis, state-owned enterprises and private companies with 10 or more employees was signed in December 1999. The system will be self-financing with an equal sharing of contributions from the employer and the employee. The Social Security Organization, an autonomous body under the Ministry of Labor and Social Welfare, will administer the system.

5. Development of Human Resources and Capacity Building

33. The recently completed TA 3146 was provided to enhance the capacity and efficiency of the SCBs, with the major focus on credit risk management, primarily through coaching and

hands-on training. The main focus of the follow-up TA 3466 was on strengthening corporate governance, overall risk management, and restructuring the SCBs.

34. BOL has a Bank Training Center in Dong Dok, Vientiane, which was established in 1979. It has a full-time director who teaches credit and finance and a full-time deputy director who handles courses in economics and computer training. To date, 33 training courses and workshops have been offered and the total number of participants is about 1,220. Most of the courses are basic. Curriculum and faculty development is needed.

35. Formal training on banking and related subjects and assistance to BOL to set up a management information system for bank supervision was to be provided under an ECU3.5 million bank training project of the European Union. Implementation of the project has been delayed by over two years.

C. Program Costs

36. ADB supported the Program with a loan for SDR17,151,000 (\$25 million equivalent). The loan was disbursed in two equal installments of SDR8,575,500 each. The cost associated with the implementation of the Program was estimated at between \$28 million and \$38 million.

D. Disbursements

37. The proceeds of the loan were withdrawn in accordance with ADB's standard disbursement procedures and utilized for financing the full foreign exchange costs of items produced in and procured from ADB's member countries. The disbursements were carried out during the implementation of the Program in an acceptable manner. The major share of imported goods originated from Singapore (38 percent), Thailand (48 percent), and Viet Nam (14 percent). The distribution of imports is attached as Appendix 3.

E. Program Schedule

38. FSPLII was approved on 12 September 1996 and became effective on 6 December 1996, on which date the first tranche was released. The second tranche was released in August 2000, almost two years after the original scheduled date because of delays in implementing the required conditions of the loan. The loan was officially closed in April 2001 and the program completion report mission was fielded in August 2001.

F. Implementation Arrangements

39. BOL acted as the Executing Agency for the Program, responsible for the overall implementation of the Program, initiated the withdrawals under the loan, and closely coordinated with MOF and other authorities concerned in implementing the Program.

G. Conditions and Covenants

40. The July 2000 progress report to the ADB Board of Directors on FSPLII reported that 12 of the 13 conditions for the release of the second tranche were fully complied with and one was partially complied with, and sought a waiver for full compliance of this partially complied condition, namely that BOL should demonstrate to ADB's satisfaction that the prudential regulations were enforced, and that penalties were imposed for noncompliance. As discussed in

paras. 13-35, while the conditions were fulfilled with the adoption of specific reform measures and policies, implementation needed to achieve the intent underlying the reforms was lacking.

41. The Government has issued various laws and regulations, most of which were drafted with ADB TA resources. Consultation and approval processes were extremely long and arduous. Laws that did not have a clearly identified originating ministry or that concerned several ministries encountered excessive delays. The time elapsed from drafting a law or regulation to its approval, signing, or passage varied from five months to four years, as summarized in Appendix 4. Legislation that took several years to be approved did not have an originating or sponsoring ministry responsible for preparing the first draft. This was the case for the legislation on negotiable instruments (bills of exchange and promissory notes) and the leasing decree. Because of inadequate guidance on what kind of legislation was required for debt recovery, three drafts were prepared by three different legal experts. It was only sometime in early 1999 that the Ministry of Justice advised that an implementing decree to be issued by the Prime Minister, rather than a regulation, was required to achieve the objective of the tranche condition on secured transactions.

42. The Government has fully complied with the tranche conditions on undertaking a nationwide deposit mobilization campaign and the establishment of a deposit protection scheme. However, there were ambiguities regarding the extent to which the underlying reforms could be pursued, indicating design flaws. The condition on deposit mobilization had no quantitative targets and did not require success, only "undertaking a campaign." The setting-up of a deposit protection scheme was not timely and the need for deposit insurance questionable because the Government would bail out the SCBs anyway. Deposit insurance would be an explicit government guarantee, but the level of protection was low, and it would take many years before it would cap the implicit government guarantee. Besides, deposit insurance could represent a moral hazard if, under a lax and lenient supervisory regime, it encouraged banks not to follow prudential regulations.

43. The SCBs have not complied with the prudential regulations on (i) minimum capital adequacy; (ii) limits on large exposure; (iii) limits on uncovered foreign exchange positions, net open position for a single currency, and net open position for aggregate amount of foreign currencies; and (iv) limits on insider and connected lending. While loans have been classified and general provisions made on NPLs, the regulations on specific provisions and nonaccrual of interest on NPLs have not been followed. Only in recent months have these been complied with, for new loans approved after 31 December 1999. Provisioning for pre-2000 NPLs has been held in abeyance in accordance with a plan submitted to ADB in April 2000. According to the plan for enforcement of prudential regulations, the stock of NPLs as of 31 December 1999 would be set aside for resolution through debt recovery efforts under regulatory forbearance. The SCBs could then focus on the flow of new loans and loans from the old portfolio that become nonperforming beginning 1 January 2000. The SCBs would be required to pass provisions for new NPLs. This would give the SCBs an opportunity to put into actual application the credit risk management framework, enhance governance, and improve performance.

44. The enforcement plan envisaged that over the medium term, all areas of credit management would be brought in line with international best practice, a strong credit culture would be adopted, and internal audit and control, asset and liability management, and risk management would be introduced. The way forward would be to achieve profitability so that the SCBs would be in a position to consider longer-term actions, including foreign technical partnership, divestment of the Government's shareholding in the SCBs, and eventual privatization. While the enforcement plan had some elements of bank restructuring, it was not

comprehensive. As such, TA resources of TA 3466 were deployed to design a comprehensive bank restructuring program and SCB-specific restructuring plans.

45. ADB pointed out that, to guard against bad lending practices, corporate governance of the SCBs should be strengthened and a strong credit culture adopted. Several ADB and WB-ADB joint missions have emphasized that bank restructuring embodies more than recapitalization and that recapitalization of the SCBs should only be carried out after corporate governance is improved and the banks are ready to operate independently.

46. The enforcement plan's reporting requirements for compliance with the prudential regulations have been incorporated in the interim measures for SCBs that the Government has agreed to adopt as a condition for IMF's Poverty Reduction and Growth Facility (PRGF). The interim measures serve as necessary elements in restraining the further deterioration of the SCBs, developing a reporting and compliance culture within SCB management, and instilling financial discipline. The interim measures are important guidelines that will govern SCBs, pending the formulation and formalization of the SCB-specific restructuring plans.

H. Related Technical Assistance

1. TA 2642: Restructuring and Consolidation of the State-Owned Commercial Banks

47. TA 2642 was intended to assist the Government in carrying out key components of the FSPLII reform program; consolidating the SCBs; making them efficient and financially sound; corporatizing and evaluating assets of SCBs to pave the way for future joint-venture partnerships; identifying joint venture partners, management contracts, and ways to reduce government ownership of SCBs; setting up a depositor protection scheme; establishing a credit information bureau; and devising an effective campaign for mobilizing deposits.

48. TA 2642 was carried out over a two-year period utilizing approximately 30 person-months provided by a consulting firm and an additional eight person-months of individual consulting inputs for credit portfolio review and supplementary work in drafting legislation. The TA was extended a number of times and additional consulting time allocated to cater to particular additional requirements, including business planning, training needs assessment, advice on corporatization, credit review, and assistance with monitoring the implementation of FSPLII.

49. The consulting firm failed to prepare an action plan for restructuring the SCBs. It presented various options for increasing autonomy of the SCBs. However, the consulting firm could not identify any suitable bank interested in a joint venture or management contract arrangement. Legislative drafting had to be repeated, using an individual consultant, as the first output was not acceptable to the Government or ADB.

50. While many of the TA components were achieved, including the corporatization and consolidation of the SCBs, little progress was made in restructuring the SCBs. The TA was less than successful.

2. TA 2643: Development of an Interbank Market

51. The main objective of TA 2643 was to assist the monetary authorities to promote the development of an interbank market. The intended scope of the TA included the establishment of the institutional framework, systems, and procedures, and regulations for an operational interbank market, transfer of technical know-how, and training for bankers.

52. Two person-months of an interbank market adviser and one person-month of a legal and regulatory adviser were recruited to implement the TA within two months. The scope and timeframe were ambitious. The interbank market adviser prepared a strategy outlining recommended policy and institutional actions, drafted regulations including a proposed clearinghouse agreement and code of conduct, prepared a manual for interbank trading, and conducted a one-day seminar.

53. BOL still had to enact appropriate policies to create the right environment for market development and take steps to overcome constraints, such as the segmented nature of the banking sector and banks' associated reluctance to interact and their general lack of awareness of opportunities afforded by interbank markets for improving asset-liability management. BOL needed time to implement the consultant's recommendations. In fact, it took BOL almost 1.5 years to issue the interbank market regulations. The TA was less than successful.

I. Performance of the Borrower and the Executing Agency

54. The Government supported the FSPLII policy reforms. However, it showed no proactive involvement to achieve things in an expeditious manner. Apparently, the flow of information to high-level policy makers concerning issues that arose during program implementation was slow and irregular. Some issues required interministerial consultations, but these were not brought up early and were allowed to drag on, resulting in inordinate delays. The mechanism for consultation and coordination was deficient.

55. The Government's commitment to the reform program was inadequate. Before endorsement by the Government of the reform program for ADB financial support, the implications of reform measures were not well thought out and discussed. The steps required for compliance with stipulated conditions, and the potential impediments along the way, were not carefully considered. Consequently, when issues and constraints were encountered during program implementation, the reaction and response time was unduly long.

56. BOL's efforts and persistency in executing the reform program supported by FSPLII merit high marks. Despite its shortcomings, BOL managed to move the reforms forward, in a step-by-step manner.

57. BOL lacked the capacity to implement the reforms under FSPLII. The knowledge and experience gained by BOL from being the lead agency that executed FSPLI were useful. However, although FSPLII had a more modest agenda compared to FSPLI, BOL still faltered. The Governor and Deputy Governor, who were involved in the design of the reform program and were considered by ADB and other international financial institutions as leading proponents of reform, were assigned to other posts. During the four-year period of implementation of FSPLII, the central bank had three heads. This lack of continuity pervades the organization, as

well as other government agencies. On the positive side, counterpart staff at deputy director level assigned to liaise with ADB and to coordinate the Program remained at BOL during the entire implementation period.

J. Performance of the Asian Development Bank

58. Learning from the experience of FSPLI, as documented in the program completion report dated 20 December 1994, ADB staff made a conscious effort to keep the number of policy actions of FSPLII required for second tranche release to a minimum, focusing the reform measures on strengthening the SCBs and on the institutional support needed to improve their operations. However, six of the second tranche conditions were formulated from FSPLI policy actions that were not fully complied with, and of these six conditions, four required the passing of laws, which all took several years to complete.

59. At the time of the design of FSPLII, ADB staff knew that one year from the date of loan effectiveness of FSPLI was too soon to meet the conditions for second tranche release. And so, in FSPLII the target date of second tranche release was two years after the date of loan effectiveness, and this was considered achievable because there were fewer conditions to be met (13 compared to 38 in FSPLI). However, this was still too early, as the actual date of disbursement was three years and nine months after loan effectiveness. ADB failed to adequately assess how prepared the Government and the Executing Agency were to own the reforms. ADB was too optimistic in its evaluation of the implementation capacity of BOL and did not seriously take into account the bureaucratic and cumbersome legislative process.

60. The optimism of ADB, as well as of BOL and the Government, was evident during the Program's appraisal and at the beginning stage of its implementation, when measures to increase the autonomy of the SCBs such as joint ventures, management contracts, and divestment of government ownership and control, were being discussed. These reform measures were premature. During the program period, the political and economic climate and the prevailing institutional weaknesses were not conducive to such bold reforms.

61. As regards consolidation of the SCBs, for the first 18 months since loan inception in November 1996 discussions were held on how many consolidated banks there would be, which banks would be grouped, and what was required for corporatization of the consolidated banks. The Lao PDR government officials had limited understanding of the corporatization process. To bridge the knowledge gap, the TA 2642 consultant organized a workshop. Official authority to proceed with the consolidation of the SCBs was issued only in May 1998.

62. The design of FSPLII did not anticipate that some of the bank-specific requirements would more appropriately apply to the consolidated banks, instead of the original seven banks. More specifically, the program required the appointment of a board of directors for each bank, adoption and use of an operations manual, and preparation and implementation of a business plan for 1997. Notwithstanding partial compliance with these conditions by some of the seven SCBs, the policy actions had to be undertaken again for the consolidated banks, beginning in 1999.

63. ADB staff who designed the Program were not involved in its administration, while staff supervising the Program were changed midway through implementation. ADB closely supervised the program after the original target date of tranche release when only two conditions were met. Nine of the 14 review missions were fielded after that date. Thereafter, ADB review missions actively engaged in dialogue with BOL counterpart staff, managers of the

SCBs, and government officials, and closely supervised and coordinated the work of the ADB consultants.

III. EVALUATION OF PERFORMANCE

A. Relevance

64. The Program design, which focused on establishing the essential market infrastructure and institutional reforms, was relevant for building a sound, efficient, and market-responsive banking system in a transition economy and retained its relevance throughout program implementation.

65. The Program's design elements that gained greater significance than others during implementation were the improvement in autonomy and governance of the SCBs and the implementation of prudential regulations. The political economy was not conducive to introducing autonomy in the SCBs, strengthening their boards, or implementing accountability measures. Lack of autonomy of the SCBs was evident in their policy lending and lending to state-owned enterprises and strategic defaulters. This was the basic cause of NPLs and capital deficiency of the banks, hampering enforcement of prudential regulations. Institutional reform was largely limited to consolidation, corporatization, and restricted operational and organizational improvements. Further assistance had to be provided to prepare operational and financial restructuring plans.

B. Efficacy in Achievement of Purpose

66. Implementation of financial sector reforms under the Program was expected to have a positive impact over a wide section of the economy. However, as most of the commercial banks are located in urban centers, in the short to medium term, the Program's impact was anticipated to be mainly in these urban areas. Implementation of the Program would improve public confidence in the banking system in the near term. Improved access to credit and better banking services would benefit the small and medium enterprise sector to the extent that it is not crowded out by state-owned enterprises. In the longer term, the increased efficiency and competition in the banking sector would improve allocation of resources in the agriculture sector and rural areas and help bring credit to the rural poor. A deepened financial system would facilitate macroeconomic management.

67. The short-term positive impact of the Program was limited, as the reforms were delayed because of persistent market and institutional constraints, a severe lack of banking skills, and weak commitment by the Government to implement reform measures. The Program was derailed by the Asian financial crisis in 1997 and the hyperinflation coupled with the kip's depreciation during 1998-1999. Because of substantially negative real interest rates, there was no incentive to save, as reflected in the decline of the gross national savings rate in 1997-1998.

C. Preliminary Assessment of Sustainability

68. A preliminary assessment of the sustainability of the legal, regulatory, and institutional framework for a market-based financial system created under the Program is good. The market infrastructure was built, but several measures adopted have not been implemented. The structure is incomplete and the pace of reform is slow. Nonetheless, the reform measures have laid a solid foundation for the further development of the financial system.

69. To achieve sustainability of institutional reforms, the Government should be more decisive and persevering. The Government would have to restructure and turn around the bankrupt SCBs, which have been incurring heavy losses (Appendix 5). But the Government does not have the capacity to turn around the SCBs, and it has become obvious that TA alone will be insufficient to do this. External management assistance is essential.

70. FSPLII opened the door for dialogue with the Government to develop a future program of structural reforms in the financial sector. ADB and WB, in collaboration with BOL, have undertaken a diagnostic review of the financial sector. A series of workshops and seminars organized and led by the Government with support from TA 3146 and TA 3466 have been held in the past two years to foster government ownership of reforms. As a result, the Government has adopted a comprehensive strategic framework for banking reform, incorporating the vision, strategic policy, and implementation details of bank restructuring. Using this framework, the SCBs have outlined their respective proposed restructuring programs, which are part of PRGF. The process of designing the next phase of financial sector development, drawing on the lessons of FSPLI and FSPLII, was initiated under TA 3146 and TA 3466 and continued under TA 3737.

D. Environmental Impact

71. FSPLII was classified as Environment Category C, i.e., unlikely to have adverse environmental impact. The Program has no direct environmental impact.

IV. OVERALL ASSESSMENT AND RECOMMENDATIONS

A. Overall Assessment

72. Overall, FSPLII contributed significantly to developing an environment favorable to nurturing a market-driven financial sector. The Program has moved step by step down the long road toward a sound and stable financial system. The introduction of institutional, regulatory, and legal reforms demonstrates encouraging progress. These sector reforms must be sustained. Significant inroads have been made in enhancing the capacity of the SCBs. But much more remains to be done. With the achievements under the Program, a foundation has been laid for further reforms in the financial sector. Considering the deficiency in program design and weaknesses in program implementation and sustainability, and limited contribution in meeting its broad objectives of deposit mobilization and improved macroeconomic management, the Program is rated as partly successful.

B. Lessons Learned

73. FSPLII underestimated the scope of work involved in changing the fundamental behavior of an established system. In hindsight, the design of the program agenda was optimistic and the implementation period originally envisaged for the Program was unrealistic.

74. Waivers of tranche conditions should be given only sparingly, and only for strong valid reasons. Waivers were given in FSPLI to policy actions with little or no progress because of delay in implementation of TAs supporting the tranche conditions and technicalities difficult for the Government to understand and resolve. Because of this precedent, the Government did not press on with some FSPLII reform measures in the face of delays and complexities.

75. The SCBs should not be recapitalized unless they have a high degree of independence to operate commercially. Recapitalization should be based on improvement in performance as measured by performance indicators. This should be documented in a restructuring plan.

76. The Government did not give much thought to the steps to be taken and the coordination efforts required by the Program before it sought ADB financial support. Neither the Government nor ADB devoted enough time or effort to building government ownership of the reforms.

77. ADB did not adequately assess the preparedness of the Government and the Executing Agency to own the reforms. ADB's evaluation of the implementation capacity of BOL was too optimistic. ADB underestimated the bureaucratic and cumbersome legislative process. Continuity and perseverance by ADB in monitoring and supporting program implementation are essential.

78. The appraisal and design of TA 2642, which was done during loan appraisal, were deficient. The TA assumed a banking system and SCB sector more developed than was in fact the case. The operations of the SCBs have been directed from BOL, including setting of lending and deposit targets and interest rates. The SCBs had little understanding of risk management, as the conditions under which they operated did not require them to systematically deal with risks.

79. FSPLII recognized at appraisal, but did not support by tranche release conditionalities, the need for measures to increase the autonomy of the SCBs, i.e., joint ventures, management contracts, and privatization. TA 2642 was tasked to explore and arrange joint-venture partnerships and management contracts. Considering the political economy and economic climate at that time, such arrangements were premature. Even now there is political reluctance to increase the autonomy of the SCBs. This will have to be addressed in the bank restructuring plans of the SCBs and future financial sector development program of the Government.

C. Recommendations

1. Program Related

80. The BOL needs to be strengthened in the area of bank supervision. BOL does not have enough staff, equipment, or know-how to carry out supervision required for enforcement of prudential regulations. Priority should be given to establishing a regime of compliance and reporting for the prudential regulations. This process needs to be carried through as part of monitoring the implementation of restructuring plans for the SCBs.

81. The recapitalization of the SCBs will involve not only restructuring their balance sheets but also upgrading their banking operations to best banking practices and adopting good governance measures. The Government has to make strategic decisions on the nature of management support needed by the SCBs to achieve the goal of sustainable and profitable operations. Given the magnitude and complexity of the SCBs' problems, external management is essential to turn them around.

82. A critical area of reform concerns governance in public sector financial management and policy lending, which forms a major part of NPLs of the SCBs. The large volume of policy loans, including directed and connected lending, has been a heavy burden on the SCBs. Such lending should not continue and the Government should fund government projects from the budget.

83. The new decrees and regulations have to be understood by legal professionals, regulators, banks, and all parties concerned. For debt recovery, clear procedures should be established for land entitlement and for enforcing land-user rights. The commercial court system has to be strengthened. The legal framework for secured lending should encourage banks and other lenders to accept assets such as equipment, vehicles, inventories, and receivables as security.

84. The preparation of the program performance audit report for FSPLII should be undertaken after implementation of the SCB restructuring plans (about end-2005). By then, the regulatory forbearance for the SCBs could be terminated and prudential regulations fully enforced.

2. General

85. Future reforms should be directed at the unfinished agenda of restructuring the SCBs to make them autonomous, commercially viable, and sustainable. The Government and BOL should put in place strong corporate governance, financial discipline, and internal incentives in the SCBs. The Government should carefully weigh options on provision of external management support to the SCBs.

86. Properly designed and sequenced economic and sector work and capacity building and advisory TAs should precede the processing of program loans and should be used to build ownership of the policy reforms. TAs attached to the loan would also be needed to support program implementation and further strengthen government commitment.

APPENDIXES

Number	Title	Page	Cited on (page, para.)
1	Program Framework	18	1, 2
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5	Financial Performance of State Owned Commercial Banks	31	14, 69

PROGRAM FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goal:</p> <p>Create a more efficient, sound and market-responsive banking system</p>	<p>Develop an environment favorable to nurturing a market-driven financial sector</p> <p>Increase domestic savings to more than 15 percent of GDP (1996 level)</p> <p>Facilitate better macroeconomic management</p> <p>Respond efficiently to the needs of the private sector</p>	<p>Increased confidence in the banking system</p> <p>Growth in bank deposits</p> <p>More diversity in financial services</p> <p>Macroeconomic stability</p> <p>More competitive business environment</p> <p>Enhanced profitability of private investments</p>	<p>Lack of Government commitment to implement the reform program within the required time frame</p> <p>Lack of staff expertise and institutional capability to implement the reform measures</p> <p>Overexpansion of credit due to possible recapitalization of the state owned commercial banks (SCBs)</p>
<p>Purpose :</p> <p>Implement a program of policy reforms and institutional strengthening in the financial sector, in accordance with the Government's financial sector development program.</p>	<p>First and second tranches of ADB Program loan.</p> <p>Release of first tranche</p> <p>Release of second tranche</p>	<p>Compliance with the tranche conditions</p> <p>Policies adopted and actions taken continue in effect for the duration of the Program</p>	<p>Close coordination with programs of the International Monetary Fund (IMF) and the World Bank (WB)</p> <p>Progress in privatization and other reforms that complement the reforms in the financial sector</p>
<p>Outputs:</p> <p>Financial Sector Policy Reforms</p>	<p>Policy measures as per Development Policy Matrix and Loan Agreement</p>	<p>Asian Development Bank (ADB) review missions</p> <p>ADB consultants' reports</p> <p>Reports of Bank of the Lao PDR (BOL) to ADB on implementation of policy reforms</p> <p>Translated copies of Government policy statements, BOL directives and instructions, and BOL regulations</p> <p>Copies of legislation</p>	<p>Political will of the Government to adopt the program reform measures within the required time frame</p> <p>ADB technical assistance (TA) to assist the Government in the implementation of the Program measures</p>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
		Copies of SCB board papers and SCB financial statements	
A. Strengthen SCB's Autonomy and Commercial Orientation	<p>1. SCB board of directors to approve the operations manual and show evidence of implementation¹</p> <p>2. SCB board of directors to approve business plans and show evidence of effective implementation¹</p> <p>3. To amend Decree No. 3 of 1992 on the Management of Commercial Banks and Other Financial Institutions to be consistent with the Business Law and the Law on the Bank of the Lao PDR, including a provision that the board of directors will be the policy-making body of each SCB, and the chairperson and other members of the board will be appointed by Ministry of Finance (MOF).¹</p> <p>4. SCBs to undertake a nationwide public campaign to increase deposit mobilization with priority on attracting longer term deposits and savings from rural areas¹</p> <p>5. Each SCB to prepare a 1997 annual report to include audited financial statements prepared in accordance with International Accounting Standard 30, and a summary of the business plan. Such annual report will be approved by the SCB's board of directors and publicly disclosed.¹</p> <p>6. BOL to increase SCB's autonomy through joint ventures, management contracts, reduced government ownership and control, or other arrangements acceptable to ADB</p> <p>7. BOL to establish policy review of subsidized lending and the impact of compulsory sector lending of 10 percent bank deposits to agriculture</p>	<p>Observed change in structure and composition of the board of each SCB</p> <p>Observed changes in SCB lending operations</p> <p>Copies of manuals, plans, and documents</p> <p>Copies of decrees</p> <p>Audit reports and audited financial statements</p>	Strong commitment the board and management of the SCBs
B. Strengthen BOL's Supervisory Function	<p>8. BOL to divide Control Department into two separate departments for banking supervision and internal audit functions</p> <p>9. BOL to require adoption and implementation of chart of accounts by all banks</p> <p>10. BOL to require 1996 independent audits of commercial bank accounts</p>	<p>BOL regulations, directives, and instructions</p> <p>Monitoring and inspection reports of the Supervision and Examination Department (SED) of BOL</p>	Prudential regulations in place

¹ second tranche conditions

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
	11. BOL to show evidence of enforcement of prudential regulations in all banks including Agricultural Promotion Bank (APB) and imposition of penalties for noncompliance ¹		
C. Restructure and Consolidate SCBs	12. SCBs to be consolidated and their number reduced from seven to no more than four ¹	Policy pronouncements by MOF and BOL	Creation of credit and liquidity in the economy, giving rise to inflationary pressures and instability of the local currency
D. Build Market Infrastructure	<p>13. BOL to circulate higher denomination 2000 and 5000 kip notes in the market</p> <p>14. BOL to facilitate T-bill auction operations through auctions and to increase the range of maturities</p> <p>15. BOL to establish a Credit Information Bureau (CIB), acceptable to ADB, which will maintain a database on the performance of the loan accounts of the banks and other financial institutions to enable these institutions to identify delinquent borrowers¹</p> <p>16. BOL to issue regulation and formulate procedures for the development of an interbank market, acceptable to ADB¹</p> <p>17. The Government to establish a depositor protection scheme, acceptable to ADB, including a separate and independent insurance fund targeted to protect small investors¹</p> <p>18. The Borrower to issue implementing regulations for debt recovery and enforcement of security in connection with the Law on Bankruptcy and the Law on Secured Transactions¹</p> <p>19. The Borrower to issue a decree establishing the legal basis and regime governing bills of exchange and promissory notes¹</p> <p>20. The Borrower to issue a decree on leasing¹</p> <p>21. The Borrower to issue a decree on pension funds by the end of the program period (31 October 1999)</p>	<p>BOL directives and instructions</p> <p>MOF policy statements</p> <p>Budget for institutions created</p> <p>Draft of regulations and legislation</p> <p>Copies of laws, decrees, regulations, and procedure manuals</p>	

¹ second tranche conditions

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
E. Upgrade Staff Commercial Banking Skills	22. BOL and SCBs to establish a system of commercial bank training 23. BOL and SCBs to complete the training program for implementing and enforcing commercial bank prudential regulations	Feedback reports on training programs	Available funds for bank training Effective training programs
Activities/ Inputs ADB Program Loan	Loan of SDR17,151,000 TA 2642: Restructuring and Consolidation of SCBs, for \$954,000 TA2643: Development of an Interbank Market, for \$130,000	Three year program period up to 31 October 1999 TA implementation schedule Tranche release schedule: First tranche: 6 December 1996 Second tranche: 31 October 1998	Ownership is accepted by SCB executives Availability of local currency counterpart funds and counterpart staff from the Government

DEVELOPMENT POLICY MATRIX

POLICY ACTION	STATUS OF IMPLEMENTATION
<p>A. Strengthen SCB's autonomy and commercial orientation</p> <p>1. State-owned commercial bank (SCB) board of directors to approve the operations manual (credit operations manual prepared under TA 2160) and show evidence of implementation¹</p> <p>2. SCB board of directors to approve of business plans and show evidence of effective implementation¹</p> <p>3. To amend Decree No. 3 of 1992 on the Management of Commercial Banks and Other Financial Institutions to be consistent with the Business Law and the Law on the Bank of the Lao PDR, including a provision that the board of directors will be the policy-making body of each SCB, and the chairperson and other members of the board will be appointed by MOF.¹</p> <p>4. SCBs to undertake a nationwide public campaign to increase deposit mobilization with priority on attracting longer-term deposits and savings from rural areas¹</p>	<p>Complied with. The seven original SCBs to varying extent have used the operations manuals developed in 1995 under TA 2160. The credit manuals have been modified over the years. The board of directors of Banque pour le Commerce Extérieur Lao (BCEL) formally adopted the operations manual that it had already been using. Lane Xang Bank Ltd. (LMB) and Lao May Bank Ltd. (LXB) have each drafted a uniform manual drawn from manuals previously used before the consolidation. The revised manuals were adopted by the boards of LMB and LXB on 11 June 1999 and 22 June 1999, respectively. These manuals were recently supplemented by operational guides and work aids prepared under TA 3146. With assistance from Asian Development Bank (ADB) consultants, credit procedures have been enhanced through the introduction of Credit Risk Asset Management.</p> <p>Complied with. The Business Planning Workshop in August 1998 under TA 2642 assisted senior SCB staff prepare business plans for the newly consolidated SCBs. The plans have been updated by the new management of the SCBs. BCEL's board adopted its business plan in December 1998. The boards of LMB and LXB adopted their respective business plans in June 1999. Under TA 3146, improvements in business planning processes were introduced.</p> <p>Complied with. Decree Law No. 1 of 1997 amending and replacing Decree Law No. 3 of 1992 was adopted by the National Assembly in March 1997. While it provided that an SCB be governed by a board of directors as a policy-making body, whose chairperson and members will be appointed by the Ministry of Finance (MOF), Decree Law No. 1 of 1997 fell short of giving the desired greater autonomy to the SCBs. Further amendment to Decree Law No. 1 of 1997 was necessary to remove provisions stating that the Bank of the Lao PDR (BOL) will appoint the managing director and other senior management of SCB down to branch officer level and the internal auditor (Articles 58, 59, 62, and 64). The President signed on 22 March 2000 the amendment to Decree Law No. 1 on Commercial Banks after the National Assembly passed a similar amendment to the Law on the Bank of the Lao PDR of 1995 on 20 October 1999.</p> <p>Complied with. The business plans of the SCBs, which the respective boards have adopted, included a savings mobilization and marketing plan to attract deposits of longer maturity. In line with the marketing strategy outlined in the business plan, each bank has undertaken deposit mobilization activities. New branches and subunits (many in the public markets) were opened to reach depositors. In the rural areas, some SCBs adopted mobile banking targeted at specific depositor groups. These efforts have had limited success. Because of the high inflation rate, people have preferred nonfinancial savings; the few who put their money in the banks prefer to keep them in US dollar or baht accounts, rather than in kip deposit accounts. The SCBs have joined efforts in publicizing and selling the Savings Bonds for Development (par value KN10,000 each, 5 percent interest rate per annum, five-year maturity) issued by the Government through BOL in May 1998. Savings bonds worth KN5.225 billion were sold. To induce more people to buy the bonds, the Government added a lottery feature, with cash prizes paid every quarter. The cost to the Government of the bond issue was effectively</p>

¹ second tranche conditions

POLICY ACTION	STATUS OF IMPLEMENTATION
<p>5. Each SCB to prepare a 1997 annual report to include audited financial statements prepared in accordance with International Accounting Standard 30, and a summary of the business plan. Such annual report will be approved by the SCB's board of directors and publicly disclosed.¹</p> <p>6. BOL to increase SCB's autonomy through joint ventures, management contracts, reduced government ownership and control or other arrangements acceptable to ADB</p> <p>7. BOL to establish policy review of subsidized lending and the impact of compulsory sector lending of 10 percent of bank deposits to agriculture</p>	<p>12 percent. The proceeds of the sales of the savings bonds were lent to the SCBs and Agricultural Promotion Bank (APB) at 13 percent with maturities of one to five years. The SCBs and APB in turn have lent the funds for food (rice, coffee, etc.) and livestock production at 18 percent, or for ancillary services for food production at 20 percent. Sale of the savings bonds is now solely entrusted to APB.</p> <p>Complied with. The external audit of seven SCBs' 1997 accounts was completed on 18 December 1998. The management of the former SCBs, including BCEL, signed the audited financial statements. Consolidated financial statements for LMB and LXB were signed by the respective managing directors at the board meeting in June 1999. The international audit shows substantial deficiency in equity after making provisions for bad and doubtful loans. Annual reports of the seven SCBs, with the 1997 audited accounts, have been printed by the Government of the Lao PDR (GOL). Availability of the reports at BOL to interested parties was announced in the Vientiane May and Pasasone Lao newspapers on 6 April 2000 and in the Vientiane Times on 7 April 2000.</p> <p>Not complied with. This remains the medium- to long-term objective. However, operational restructuring, including organizational re-engineering, improved corporate governance, enhanced credit risk management, and streamlined policies, systems, and procedures, as well as financial restructuring to strengthen the balance sheets of the SCBs, have to be implemented in the near to medium term. The vital issue of recapitalization of the SCBs also needs to be addressed. At the macro level, the economic climate in the Lao PDR banking sector has not been conducive to foreign investment with interest rates not reflecting a real rate of return, substantial weakness in the business sector leading to a high incidence of nonperforming loans, and a restricted marketplace that may already be "over- banked."</p> <p>Partially complied with. Compulsory sector lending by the SCBs for agriculture has been removed. However, the SCBs still charge a lower interest rate for agricultural lending, without consideration of risk versus reward factors. APB continues to be a policy bank, lending at subsidized rates for Government agriculture programs, providing subsidized credit to private farmers, and importing and providing fertilizer, hand tractors, and equipment to borrowers.</p>
<p>B. Strengthen BOL's supervisory function</p> <p>8. BOL to divide Control Department into two separate departments for banking supervision and internal audit functions</p> <p>9. BOL to require (i) adoption and implementation of chart of accounts by all banks, and</p>	<p>Complied with. SED and Internal Audit Department were established effective 15 May 1998.</p> <p>Complied with. The chart of accounts has been adopted; implementation is under review. Based on feedback, two issues were brought to the attention of BOL: the need to simplify the chart of accounts through reduction in the number of accounts and having fewer levels of disaggregation; and the extent to which deviation from the standard chart of accounts will be allowed, considering that branches of foreign banks have perfectly adequate systems developed by their parent bank specifically for their needs.</p>

¹ second tranche conditions

POLICY ACTION	STATUS OF IMPLEMENTATION
<p>(ii) BOL to require 1996 independent audits of commercial bank accounts</p> <p>10. BOL to show evidence of enforcement of prudential regulations in all banks including APB and imposition of penalties for noncompliance¹</p> <p><u>Note:</u> The prudential regulations relate to</p> <ul style="list-style-type: none"> • minimum capital adequacy of 8 percent • classification of assets and loan loss provisions • limits on large exposure <ul style="list-style-type: none"> - to non-collateral borrowers, 10 percent of capital, - to collateral borrowers, 25 percent of capital • limits on uncovered foreign exchange positions, <ul style="list-style-type: none"> - net open position limited to 15 percent of capital for a single currency - net open position limited to 20 percent of capital for aggregate amount of foreign currencies • limits on Insider and connected lending • handling and treatment of failed banks 	<p>Complied with. The reports of the 1996 audits of the seven SCBs, funded by the World Bank, were signed on 22 May 1998. The results highlighted the need for substantial provisions for nonperforming loans, which resulted in all SCBs having a negative net worth. The subsequent audit of the 1997 accounts, funded by the Australian Government, confirmed that position. The Australian Government again funded the audit of the 1998 (for BCEL), 1999, and 2000 accounts of the consolidated SCBs, which is expected to be completed before end of December 2001.</p> <p>Partially complied with. All seven branches of foreign banks and one private bank, Vientiane Commercial Bank, have satisfied the minimum capital adequacy requirement. However, the original seven SCBs, APB, and Joint Development Bank, which is partly owned by the Government, did not comply with this. Based on the 1996 and 1997 external audits, the financial accounts of SCBs, which were recapitalized in 1995 with support from FSPLI, have shown negative equity capital, resulting from accumulated losses after provisions for nonperforming loans. Since its establishment in 1993, the initial capital of APB has not been augmented.</p> <p>All seven former SCBs started loan classification for the period ending 30 June 1998. However, actual provisioning made by some of the SCBs was for general provisions only (no specific provisions). APB was instructed to make specific provisions in 2001.</p> <p>SED carried out on-site and off-site inspection of the private and joint-venture banks and branches of foreign banks. As of end-1999, the Vientiane Commercial Bank and five of the seven foreign branches had complied with the loan classification and loss provisioning regulation. Joint Development Bank and two foreign branches—Krung Thai Bank and Thai Military Bank—failed to meet this regulation. SED asked them to propose solutions on how they would comply with the regulation.</p> <p>After SCBs consolidation into three banks, provisions for loan losses as of December 1998, as of June 1999, and quarterly thereafter, have been computed based on the loan classification specified in the prudential regulations. The Government acknowledged the need for loss provisions. The Government wanted to pass the provisions on the accounts when it is opportune for recapitalization of the SCBs to restructure the balance sheet of the SCBs and meet the risk-weighted 8 percent capital adequacy requirement. Part of the plan for enforcement of prudential regulations is a study of the form, timing, and amount of recapitalization of the SCBs.</p> <p>SED has not found violations of the regulation on limits on insider and connected lending. As no banks have failed yet, the procedures for handling and treatment of failed banks are not yet operational.</p> <p>In April 2000, SED issued an instruction to the SCBs that effective 1 January 2001, the general provision should be increased from 0.5 percent to 1 percent. This was followed up by another notice by SED in March 2001 (Notice No. 90 dated 19 March 2001) and a BOL instruction in June 2001 (Instruction No. 176/BOL dated 30 June 2001). According to SED, the increased general provisions were actually passed by the SCBs in July 2001.</p> <p>In accordance with the regulatory forbearance regime stated in the enforcement plan, BOL issued in July 2000 an instruction (Instruction No. 206/BOL dated 7 July 2000) giving exceptions to the SCBs for passing loan loss provisions for accounts as of 31 December 1999 (pre-2000 stock of NPLs) and required provisions to be made for accounts that become nonperforming beginning 1 January 2000 (i.e. credit flows). SED issued separate warning notices to BCEL, LXB and LMB in March 2001 to comply with prudential regulations on loan loss provisioning. BOL sent follow-up instructions and notices (Instruction No. 195/BOL dated 6 July 2001 and Notice No. 263 dated 6 August 2001) asking the SCBs to pass specific</p>

POLICY ACTION	STATUS OF IMPLEMENTATION
	<p>provisions for new credit flows in accordance with BOL98. In July 2001, in a meeting with the Acting Governor, it was agreed that the SCBs' estimates of the required specific provisions would be submitted to BOL on 16 August 2001 and decision would be made on passing the provisions. However, to date, the SCBs have not passed specific provisions for new credit flows.</p> <p>In several notices of SED (including Notice No. 209 dated 15 June 2001, Notice No. 263 dated 6 August 2001), SED told the SCBs to reverse interest accrued on NPLs and stop accrual of interest on loans overdue by over 90 days. ADB consultants have explained to the SCBs the procedure for reversal of interest accruals. Amount of interest accrued and unpaid on NPLs have been computed and reported in Excel spreadsheets prepared by the SCBs and reviewed by the ADB consultants. The three SCBs submitted the spreadsheets as of 30 June 2001 in July 2001. To date, however, the reversal of interest accrued on NPLs has not been actually carried out.</p> <p>As regards the prudential regulation on limits on large exposures, as of end of December 1999, all SCBs, APB, Joint Development Bank, and five of the seven foreign branches (all except Ayouthaya Bank and Public Bank) had exceeded the limits on large exposures based on the unimpaired capital and reserves of the banks. All except the foreign branches, were undercapitalized. All had large exposures to state-owned enterprises (SOEs) because of loans to Government projects. In particular, the Bangkok Bank branch exceeded its lending limit because of a loan to Phou Doi Development Company. SED has officially notified these banks of the violation of the lending limits and advised them to reduce their large exposures. All banks had violated the foreign currency exposure limits. Adjustments to reduce their exposures were difficult because of the sharp depreciation of the kip. The absence of an interbank foreign exchange trading arrangement constrained the options of the banks in managing their foreign exchange positions.</p> <p>SED has been stricter in enforcing the other regulations of BOL, such as the 12 percent reserve requirement on total deposits by currency (kip, US dollar, Thai baht) and the loan-to-funding (deposits plus borrowing) ratio. In 1995, one SCB (Phak Tai Bank), two private banks, and two branches of foreign banks were fined a total of KN92 million for exceeding the loan-to-funding ratio. SED has been closely monitoring compliance with the prudential financial ratios specified in Regulation No. 14 dated 18 January 1998 (not part of the prudential regulations specified in the tranche condition).</p>
<p>C. Restructure and Consolidate SCBs</p> <p>11. SCBs to be consolidated and their number reduced from seven to no more than four¹</p>	<p>Complied with. The Governor of the BOL and the MOF signed the policy statement on 15 May 1998 confirming the consolidation plan for the SCBs. Plan implementation started in December 1998. MOF agreed to keep BCEL, the largest of the seven SCBs, essentially intact and establish two new banks from the six other SCBs. The two new banks were LXB (formed from the former Lane Xang Bank, Aroun May Bank, and Settathirath Bank) and LMB (formed from the former Lao May Bank, Phak Tai Bank, and Nakhouneluang Bank). LXB, LMB, and BCEL each acquired a corporate structure, with the Government as sole shareholder. MOF appointed the members of the BCEL board on 10 August 1998 and the nominees of BOL to the seven-person boards of LXB and LMB on 13 January 1999. On all three boards, the chairperson was the representative of MOF and the vice-chairperson was the managing director of the SCB. One of the seven board members of LXB and LMB was from the private sector and one was is a representative of the bank employees. On the other hand, all seven members of the BCEL board were government representatives, including three who were provincial officials. LXB was incorporated on 7 April 1999, LMB on 13 April 1999, and BCEL on 20 April 1999.</p>

¹ second tranche conditions

POLICY ACTION	STATUS OF IMPLEMENTATION
	The consolidation fell short of restructuring. There was no restructuring and governance plan, although operational improvements were undertaken, including use of operation and credit manuals and preparation of business plans.
<p>D. Build Market infrastructure</p> <p>12. BOL to circulate higher denomination 2000 and 5000 kip notes in the market</p> <p>13. BOL to facilitate T-bill auction operations through auctions and to increase the range of maturities</p> <p>14. BOL to establish a credit information bureau (CIB), acceptable to ADB, which will maintain a database on the performance of the loan accounts of the banks and other financial institutions to enable these institutions to identify delinquent borrowers¹</p> <p>15. BOL to issue regulation and formulate procedures for the development of an interbank market, acceptable to ADB¹</p> <p>16. The Government to establish a depositor protection scheme,</p>	<p>Complied with. The new notes were announced to the public on 22 May 1998 and introduced on 8 June 1998. The benefits of the new notes have been offset to a large extent by the substantial devaluation of the kip and high inflation over the past 3 years.</p> <p>Substantially complied with. BOL has been issuing T-bills for the Government at a discount in certificates in units of KN10 million. Since 1994, T-bills had been auctioned twice a month. The auction had been used to determine market interest rates. From October 1997, yields on T-bills were capped at 20 percent per annum, until April 1998 when the auctions were stopped for lack of bids from the commercial banks. From April 1998 to May 2001, limited amounts of T-bills were occasionally sold by MOF directly to the public. From April to end of 1998, T-bills were sold through commercial banks at a fixed rate of 24 percent. In January 1999, the rate on T-bills issued (KN55 billion lot) was increased to 30 percent. More than half of this lot remained unsold. In April 1999, T-bills at 60 percent were issued and the entire lot of KN12.5 billion was sold after eight days. In May 2001, BOL resumed auction of T-bills and banks were allowed to bid. However, the amount purchased by the SCBs was small although the SCBs had substantial excess reserves.</p> <p>The maturity of T-bills was increased from 6 months to 12 months in December 1997. In 1996, BOL started issuing BOL bills as indirect instruments of monetary control. The bills were sold through the commercial banks. BOL also issued its own bills directly to the public. BOL bills were issued at face value; they could be rediscounted by the commercial banks at BOL.</p> <p>Complied with. BOL issued the implementing regulation for CIB on 10 November 1997. Actual work started in April 1998. With funding and assistance under TA 2642, a computer program was developed and a database on large borrowers of the SCBs and APB was created. The CIB operated on trial basis from April 1998 to January 1999. It formally commenced on 1 February 1999 under the Credit Department of BOL, with a staff of two officials and two assistants. In mid-1999, it was placed under the responsibility of SED. Membership in CIB was extended to private joint venture banks, private banks, and foreign branches. However, CIB encountered capacity limitations both in its computer programs and the structure of its database. Furthermore, CIB was understaffed. All this hampered its ability to provide credit information services. CIB was transferred to the Accounting Department of BOL in 2001. CIB became fully operational in November 2001 using a semi-automated system. CIB plans to have an upgraded information management system and computer network in 2002.</p> <p>Complied with. Interbank market regulations, a code of conduct, a clearinghouse agreement, and a procedures manual were drafted in 1998 under TA 2643. A BOL ad hoc committee was formed to review the papers. The regulations were finalized after consultations with the SCBs and interdepartmental review. The BOL Governor approved the clearinghouse rules on 30 August 1999 and signed the regulations on interbank market and the code of conduct, along with regulations for auctioning of T-bills, on 29 November 1999. The Governor also issued the regulation on supervision of the interbank foreign exchange market on 30 November 1999.</p> <p>Complied with. The Governor of BOL announced in 1998 the establishment of a DPS. Rules and regulations for the DPS and the charter for the deposit protection company were drafted in 1998 under TA 2642. The Governor approved the</p>

¹ second tranche conditions

POLICY ACTION	STATUS OF IMPLEMENTATION
<p>acceptable ADB, including a separate and independent insurance fund targeted to protect small investors¹</p>	<p>regulations for the depositor protection scheme on 30 August 1999. On 20 January 2000, the deposit protection company with the official name "Deposit Protection Fund" was established under the Business Law as a corporate entity fully owned by the Government. Registered capital of KN100 million (10,000 shares at KN10,000 par value per share) was contributed by MOF and operating expenses were shouldered by BOL. Membership is limited to the three SCBs, APB, two joint venture banks and one private bank. Insurance coverage is limited to kip deposits up to a maximum of KN15 million (about \$1,700) per depositor. The premium rate charged is 0.1 percent of average kip deposits. Current contributions to the fund by participating banks are small relative to the contingent liability from the insurance coverage. At an appropriate time, it is planned to make participation of all banks mandatory, including branches of foreign banks. Deposit insurance cannot be fully implemented as most of the banks are in poor financial condition. As the SCBs and APB together account for about 70 percent of banking assets, it is widely believed that the Government will not allow them to fail. Thus, the Government implicitly guarantees deposits of the SCBs and APB. In due course, it is expected that the deposit protection scheme, which is an explicit Government guarantee, would cap the implicit Government guarantee of the banking system.</p>
<p>17. The Borrower to issue implementing regulations for debt recovery and enforcement of security in connection with the Law on Bankruptcy and the Law on Secured Transactions¹</p>	<p>Complied with. The Ministry of Justice advised that implementing decrees, not implementing regulations, would be preferable for both laws in order to achieve the objective of this condition. However, this was procedurally more complex, requiring more time for full implementation. ADB's project counsel found previous draft regulations and decree to implement the Law on Secured Transactions prepared by ADB consultants to be deficient. A new legal expert recruited in May 1999 under TA 2642 redrafted an implementing decree. The Prime Minister signed the decree to implement the Law on Secured Transactions on 21 September 1999. The implementing decree for the Law on Bankruptcy was drafted under TA 3154 and cleared by ADB's project counsel in December 1999. An interagency working group was organized by Ministry of Justice to review and revise the draft. After considerable delay, Ministry of Justice endorsed issuance of an implementing decree to the Prime Minister's Office in early June 2000. The Prime Minister signed the decree to implement the Law on Bankruptcy on 20 June 2000.</p>
<p>18. The Borrower to issue a decree establishing the legal basis and regime governing bills of exchange and promissory notes¹</p>	<p>Complied with. Issuance of a decree governing bills of exchange and promissory notes was a carryover condition from FSPLI. The Prime Minister signed the decree on 12 December 1998.</p>
<p>19. The Borrower to issue a decree on leasing¹</p>	<p>Complied with. Issuance of a leasing decree was a carryover from FSPLI. A leasing decree was drafted in 1997 under TA 1844. The Prime Minister signed the Leasing Decree on 18 February 1999.</p>
<p>20. The Borrower to issue a decree on pension funds by the end of the program period (31 October 1999)</p>	<p>Complied with. Issuance of a decree on pension funds was a carryover from FSPLI. This was undertaken through the social sector project of the United Nations Development Programme under the purview of the Ministry of Labor and Social Welfare. The implementing decree for a social security system for all workers in state-owned enterprises and private sector companies with 10 or more workers was signed by the President on 23 December 1999. The social security system will be compulsory in mid- 2000, initially in Vientiane Municipality and later gradually covering the rest of the country. The system will provide health care benefits for the insured worker and his immediate family (spouse and children), disability benefits in case of work-related accidents and occupational disease, lifelong pensions on retirement at 60 or, in cases of invalidity or death of the breadwinner in the family, survivor's benefits, as well as sickness, maternity, birth and death benefits. The system will be self-financing. Contributions, to be shared almost equally by the employer and employee, will be 9 percent of total earnings of the worker. The Social Security Organization, an autonomous body under the Ministry of Labor and Social</p>

¹ second tranche conditions

POLICY ACTION	STATUS OF IMPLEMENTATION
	<p>Welfare, will administer the system. The Social Security Organization will manage four separate funds, one for each type of benefit: health care fund, pension fund, injury and disability fund, and fund for short-term benefits.</p> <p>This social security system for state-owned enterprises and the private sector complements the social welfare system established in 1990 for government employees comprising civil servants, members of the armed forces and policemen. Government employees contribute 6 percent of their salaries. The Government provides annual budgetary support to supplement the employees' contributions, as needed to meet expenditures. The benefits include pension, health care, and other benefits such as allowance for dependent children. The unfunded "pay-as-you-go" pension scheme pays retirement benefits. The welfare system covers old people who retired from public service before 1990 and soldiers who are war invalids. Reforms to rationalize the public sector scheme and merge it with the private sector scheme are under discussion within Government.</p>
<p>E. Upgrade Staff Commercial Banking Skills</p> <p>21. BOL and SCBs to establish a system of commercial bank training</p> <p>22. BOL and SCBs to complete the training program for implementing and enforcing commercial bank prudential regulations</p>	<p>Complied with. Under TA 2642, training needs were assessed to identify the requirements of BOL and the SCBs. ADB used the results in designing TA 3146 for enhancing the capacity and efficiency of the SCBs. The focus of TA 3146 was the adoption of a credit risk asset management system, which provides the framework for introducing reforms in the SCBs, including corporate governance, improvements in processes and procedures, enforcement of prudential guidelines, capacity building for transfer and development of skills, monitoring and reporting. The capacity building approach was primarily hands-on, with on-the-job application. The modalities were training the trainers, coaching and mentoring executives, small group discussions, and workshops. BOL staff participated in the training. TA 3466 supported the implementation of the credit risk asset system to improve the efficiency of SCBs' operations and provided advice to strengthen corporate governance and management of the SCBs.</p> <p>The bank training project of the European Union for Lao PDR was formulated in 1998. The two-year project was to be financed by a grant of ECU3.47 million (about \$3.93 million equivalent in 1998). The project was intended to help BOL set up a management information system for bank supervision; provide training for staff of BOL and the SCBs, primarily at BOL's Bank Training Centre at Dong Dok; and promote banking products and services to the local communities to raise their awareness of banking. Originally scheduled to start in 1999, the training project has been delayed by more than 2 years.</p> <p>Complied with. The World Bank consultants assisted in drafting the prudential regulations and conducted training. The bank supervision consultant completed his tasks in December 1998. Under TA 2642, TA 3146, and TA 3466, the SCBs received further advice and assistance on loan classification and provisioning for loan losses and interpretation and implementation of the BOL prudential guidelines.</p>

DISTRIBUTION OF IMPORTS BY ORIGIN

Country	Code	Amount (US\$ Million)	Percentage
Singapore	25	8,881,703	38
Thailand	27	11,236,959	48
Viet Nam	30	3,513,958	14
Total		23,632,620	100

Note: Data may not add up to 100 due to rounding

DELAYS IN PREPARATION OF LEGISLATION

Legislation/ Regulation	Date of First Draft	Date of Approval/ Signing	Elapsed Time to Date Approved/ Signed
Decree on Bills of Exchange and Promissory Notes	Little progress under FSPLI Draft Decree on Negotiable Instruments –1995		4 years
	Draft Decree on Bills of Exchange and Promissory Notes – June 1998	12 Dec 98	6 months
Decree on Leasing	Little progress under FSPLI – 1997 (TA 1844)	18 Feb 99	2 years
Implementing Decree on Law on Secured Transactions	Legislation on debt recovery – little progress under FSPLI Draft Regulations – May 1997 (TA 2160)		2 years and 3 months
	Draft Regulations – December 1998 (TA 2642)		9 months
	Draft Implementing Decree – April 1999 (TA 2642)	21 Aug 99	5 months
Implementing Decree on Bankruptcy Law	Legislation on bankruptcy – little progress under FSPLI December 1999 (TA 3154)	20 June 2000	6 months
Interbank Market Regulations	July 1998 (TA 2643)	29 Nov 99	1 year and 5 months

FSPLI = first Financial Sector Program Loan, TA = technical assistance.

FINANCIAL PERFORMANCE OF STATE-OWNED COMMERCIAL BANKS

Combined Profit and Loss Statements, 1998-2000 (KN Million)

	1998	1999	2000
Interest Income			
Deposits with Other Banks	11,443	18,860	29,712
Net Loans and Related Assets	26,829	48,812	52,953
Total Interest Income	38,272	67,672	82,665
Interest and Related Expenses	35,643	66,072	68,802
Net Interest Income	2,629	1,600	13,863
Gain (Loss) on Foreign Exchange Operations	0	0	0
Income on Foreign Exchange Transactions	27,379	77,732	29,371
Loss on Foreign Exchange Transactions	15,573	48,052	2,747
Loss from Revaluation of Loans & Off Balance Sheet Items	6,601	23,788	21,840
Net Gain (Loss) on Foreign Exchange Operations	5,205	5,892	4,784
Commissions and Service Fees	7,770	25,384	28,981
Other Operating Income	1,187	1,630	2,742
Net Operating Income	16,791	34,506	50,370
Less:	0	0	0
General and Administrative Expenses	6,958	18,697	28,056
Non-Banking Expenses	1,911	-1,017	10
Provision for Loan Losses	4,009	235,585	97,038
Net Taxable Income (Loss)	3,913	-218,759	-74,734
Less: Income Tax	2,755	0	0
Net Income (Loss) After Tax	1,158	-218,759	-74,734
 PERFORMANCE INDICATORS			
Ratio of Non-Interest Expense to Interest Income & Fees (%)	17.6	27.0	32.8
Gen. & Adm. Expenses + Recurring Non-Banking Expenses/Beg. Assets (%)	N/A	2.1	1.7
Return on Assets (%)	0.1	-12.9	-3.4

Source: ADB consultants' estimates.

FINANCIAL PERFORMANCE OF STATE-OWNED COMMERCIAL BANKS

Combined Balance Sheets, 1998-2000 (KN Million)

	1998	1999	2000
ASSETS			
Cash, Deposits & Interbank Accounts	547,392	1,182,803	1,286,877
Net Loans (After Provisions)	220,890	235,892	486,769
Other Receivables	56,525	180,885	301,832
Investments (At Cost)	12,620	48,541	48,116
Net Fixed Assets	16,637	34,348	45,544
Other Assets	7,700	10,303	13,057
TOTAL ASSETS	861,764	1,692,772	2,182,195
LIABILITIES AND CAPITAL			
Deposits	845,511	1,804,651	2,343,054
Borrowings and Interbank Accounts	36,083	78,267	85,612
Other Liabilities	37,348	86,805	106,960
Capital	0	0	0
Paid-Up Capital	4,000	4,000	4,000
Premium & Other Accounts	7,630	9,733	15,286
Accumulated			
Deficit	-68,808	-290,684	-372,717
Total Capital	-57,178	-276,951	-353,431
TOTAL LIABILITIES & CAPITAL	861,764	1,692,772	2,182,195
PERFORMANCE INDICATORS			
NPL Ratio [Before Provisions] (%)	39	64	52
Ratio of Liquid Assets to Deposits (%)	65	66	55
Ratio of Loans to Deposits (%)	26	13	21

Source: ADB consultants' estimates.