DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

FOR AGENDA

SM/02/223
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

August 23, 2002

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Lao People's Democratic Republic—Selected Issues**

The attached correction to SM/02/223 (7/15/02) has been provided by the staff:

Page 4, footnote 5, line 4: for "elements. International...." read "elements. They differ from those reported in Box 5 of the Staff Report because the estimates were compiled at different times during which loan classifications were revised."

Questions may be referred to Mr. Winglee (ext. 35693) and Mr. Q. Hussain (ext. 37334) in APD.

Att: (1)

Other Distribution:
Department Heads

I. The Reform of State-Owned Banks and Enterprises[1]

A. Introduction

1. **Persistent inefficiencies in the operations of state-owned commercial banks (SCBs) and enterprises (SOEs) have constrained the growth potential of the economy.** Recurring high levels of nonperforming loans (NPLs) of SCBs have been caused by internal factors, including continued weak credit risk management, lack of skilled and experienced credit personnel, and poor credit culture; and external ones, including the absence of financial discipline among both state and private borrowers, outside interference in lending decisions, and an inadequate regulatory, legal, and judicial framework. Enduring reform of SCBs and SOEs will require that these problems are corrected, and that SCBs and SOEs are put on a commercial footing, including through increased private sector participation. Only with such reforms will effective financial intermediation promote the growth of an efficient enterprise sector.

B. The Endemic Problem

State-owned commercial banks

2. **The Lao financial system is dominated by the three SCBs, which together account for almost three quarters of total gross assets of the banking system.**[2] BCEL alone accounts for about half of total deposits and 40 percent of total loans. There are branches of several foreign banks which are permitted to operate only in Vientiane. The weak banking environment has so far limited foreign bank activities to mainly trade finance, and thus they are not well integrated into the local economy. There is also a joint venture bank (Lao-Viet Bank), with two branches outside the capital, and a small domestically-owned private bank.

3. **For over a decade and a half, the SCBs have failed to fundamentally improve their performance, despite recapitalization in 1994.** Following the break-up of the monobank system in 1988, the commercial banking system grew from 2 to 17 in the decade to mid-1998, including 7 SCBs, accounting for two-thirds of total assets. In the early-1990s, under the weight of "inherited" bad loans from the monobank system and continued state interference in the commercial banking system, all the SCBs became deeply insolvent. In 1994, the government recapitalized all SCBs through a cash injection of KN 4 billion and the issuance of KN 14 billion in treasury bonds (amounting to about 35 percent of all outstanding

---

[1] Prepared by Eric Sidgwick.

[2] Banque pour le Commerce Extérieur du Laos (BCEL), Lane Xang Bank (LXB), and Lao May Bank (LMB). The Agricultural Promotion Bank (APB), which accepts deposits but acts more as a development bank and is used for policy lending to the agricultural and rural sectors, accounts for only about 5 percent of total assets. APB is not covered by the Commercial Banking Law, and is not required to comply with BOL prudential regulations.

loans), eliminating NPLs originating from the monobank period, and in principle bringing the banks to a capital adequacy ratio (CAR) of 8 percent.[3] At that time, SOEs accounted for about 80 percent of the total NPL portfolio, while cooperatives and the private sector accounted for the remaining 4 percent and 16 percent, respectively.[4]

4. **The recapitalization was not accompanied by operational restructuring or a reduction in outside interference**. As could have been anticipated, without operational restructuring, the up-front recapitalization of the SCBs in 1994 improved balance sheets only temporarily. As a result of a political shift in 1996 to more interventionist polices, bad loans grew rapidly, especially to SOEs such as Phoudoi and DAFI, and others under the influence of provincial governments. In 1998, the 7 SCBs were merged into the current three, but operational restructuring proved impossible in the face of the massive exchange rate depreciation of the kip stemming from the Asia crisis and inappropriate domestic policies. As a result, balance sheets worsened further (especially for BCEL, which accounted for the bulk of foreign exchange transactions).

5. **The accumulation of bad loans has continued, even after the economic crisis**. BOL estimates indicate that by end-1999, less than 5 years after an initial round of recapitalization, the total amount of NPLs for all the 3 SCBs had risen to about 3 percent of GDP. State-related NPLs accounted for over 70 percent of total NPLs, of which 55 percent from SOEs and a further 11 percent from other policy loans. In the two years to end-2001, the ratio of newly approved or flow NPLs of the SCBs ranged from 23 percent for BCEL, 30 percent for LXB, and around 70 percent for LMB. Notwithstanding such poor lending, until recently all three SCBs paid taxes and declared dividends, resulting in further capital erosion.[5] [6]

6. **The vast majority of NPLs was concentrated in the construction and manufacturing sectors**. In addition to loans to large SOEs, another major source of NPLs is contractors for government projects who borrowed funds (often with the support of

---

[3] The Treasury bonds exchanged for the bad loans were long-term securities, ranging from 1 to 10 years, issued by the government at an average interest rate of 15-18 percent. The bonds are redeemable up to 2004. The bonds plus the cash injection amounted to 1.6 percent of GDP.

[4] The Bank of the Lao P.D.R., Asian Development Bank, and World Bank, "The Banking and Financial Sector of Lao PDR: Financial Sector Note" (May 2002).

[5] Until early 2002, the SCBs were not appropriately implementing the Bank of Lao P.D.R. Prudential Regulations (BOL Regulation 98), for loan classification and provisioning. The above NPL rates are based on those standards, and while not up to international best practice, they capture the essential elements. They differ from those reported in Box 5 of the Staff Report because the estimates were compiled at different times during which loan classifications were revised. International standard external audits of the SCBs' 2001 accounts are expected to be completed by end-2002.

[6] In addition to the losses from high levels of NPLs and large negative foreign exchange positions, indications are that off-balance sheet liabilities, though not yet fully identified, are likely to be significant.