



Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 14-Mar-2019 | Report No: PIDC26436



BASIC INFORMATION

A. Basic Project Data

Country Lao People's Democratic Republic	Project ID P169194	Parent Project ID (if any)	Project Name Lao PDR Financial Sector Safety Net Strengthening (P169194)
Region EAST ASIA AND PACIFIC	Estimated Appraisal Date Aug 23, 2019	Estimated Board Date Oct 31, 2019	Practice Area (Lead) Finance, Competitiveness and Innovation
Financing Instrument Investment Project Financing	Borrower(s) Lao People's Democratic Republic	Implementing Agency Deposit Protection Office	

Proposed Development Objective(s)

to strengthen the financial and institutional capacity of the Deposit Insurance Office to enable it to fulfill its deposit insurance mandate.

PROJECT FINANCING DATA (US\$, Millions)

SUMMARY

Total Project Cost	20.00
Total Financing	20.00
of which IBRD/IDA	20.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Development Association (IDA)	20.00
IDA Credit	20.00

Environmental and Social Risk Classification

Concept Review Decision



Low

Track II-The review did authorize the preparation to continue

Other Decision (as needed)

B. Introduction and Context

Country Context

- 1. Lao PDR has been one of the fastest growing economies in the world, with Gross domestic product (GDP) growth averaging 7.8 percent per year from 2007-2016.** However, in recent years growth has moderated and risks have emerged that threaten to reverse the country's recent development gains. Private sector credit growth has fallen to single-digits and legacy of bad loans during the credit boom have increased vulnerabilities in the sector. Public debt has increased and the country faces high level of debt distress. Human development indicators have slowly improved, but poverty reduction has been slower than peers. Malnutrition has been persistently high and minority ethnic groups have persistently lagged behind.

Sectoral and Institutional Context

i. Banking Sector Structure and Performance

- 2. The Laotian financial sector is bank-dominated with significant state ownership.** The number of banks has grown from 12 in 2006 to 42 in 2018, driven by the partial liberalization of the sector beginning in 2007. Three state-owned banks (SOBs) Banque pour le Commerce Exterieur Lao (BCEL), Lao Development Bank (LDB), and Agricultural Promotion Bank account for about approximately 43 percent of total assets, foreign owned banks (28 percent), domestic private banks (19 percent), and joint-venture banks (10 percent) account for the remainder.
- 3. Private sector credit growth has fallen significantly after a sustained period of high growth.** Private sector credit growth averaged more than 35% for a decade (through 2014) amid a booming economy and strong growth in domestic deposits before slowing to 21 percent in 2016, 11 percent in 2017. During 2018, credit growth continued on a downward trend due to economic slowdown and fiscal tightening, as private lending to the private sector declined from 12 percent in October 2017 to 6.4 percent in October 2018.
- 4. Overall, capital levels might be overstated, and state-owned banks and some smaller banks face capital shortages.** Regulatory capital to risk-weighted assets increased to 18 percent in September 2018 from 16 percent at the end of 2017, well above the minimum requirement of 8 percent although asset quality might not be accurately reflected in those numbers due to weak accounting standards and a regulatory cap on non-performing loans. 3 commercial banks with publicly available data, six experienced negative return on assets (ROA) in 2017, and only 5 recorded ROA above 2 percent. Though the level of non-performing loans is reportedly low, market participants believe they are understated and rising. The level of non-performing



loans is reported at 3.08 percent at end-September 2018. The Central Bank (Bank of Lao-BOL) sets a 3 percent maximum threshold for the ratio of NPLs to total loans, which has led to the practice of rolling over delinquent loans.

5. **Lao PDR also has low levels of financial inclusion.** According to FINDEX 2017, only 29.1 percent of adults 15+ have a bank account, compared to 70.6 and 57.8% for EAP and lower middle-income countries, respectively. Disaggregated by gender, women have a slightly higher access at 31.9 percent. Only 8.6 percent age 15+ borrowed from a financial institution or used a credit card in the past year, which is well below EAP average of 21.5 percent and slightly below average for lower middle-income countries.
6. **The banking sector's rapid growth from a low base has raised concerns over financial stability.** The rapid increase in the number of banks and credit growth has placed a significant burden on the banking supervision department, which relies on a compliance-based framework, while working towards a more risk-based approach. BOL does not have an early warning system in place, relying on regular off-site monitoring (mostly based on manual process and analysis), in addition to on-site inspections. There is no framework for prompt corrective or early supervisory action in place, nor is there an institutional arrangement for bank resolution—such as dedicated resolution unit or a crisis management framework. The reported financial soundness indicators are presented on an aggregate basis¹, which masks vulnerabilities in state-owned and some smaller banks. Around 50% of loans and deposits in the banking sector are denominated in foreign currency, exposing the sector to significant exchange rate risk. The legal framework for the financial sector has improved significantly with passage of commercial banking law (see below), Bank of Lao Law and Deposit Insurance decree, however secondary regulations for the must be drafted and implemented. Mechanisms to deal with bank failures and exercise of lender of last resort functions are lacking or inadequate. The Deposit Protection system contains several areas of non-conformity with international best practice (International Association of Deposit Insurers - IADI Core Principles), creating risk of contagion in the event of bank closure with DPO not ready to promptly execute payouts.
7. **The legal framework supporting deposit insurance has been strengthened with the adoption of a Deposit insurance decree in October 2017.** The Deposit Protection Office, with World Bank support, conducted a self-assessment against IADI Core Principles for Effective Deposit Protection² in 2017, which identified several areas of non-conformity with international best practice (International Association of Deposit Insurers - IADI Core Principles), creating risk of contagion in the event of bank closure with DPO not ready to promptly execute payouts. The proposed project will help DPO implement the plan to address the gaps to IADI compliance.

¹ Publication of financial soundness indicators disaggregated by types of banks is an indicative trigger for Green Growth DPO 3.

² IADI Core Principles for Effective Deposit Insurance Systems (2014).



8. The proposed investment project is part of a wider World Bank engagement, coordinated with IMF, to support the government’s coordinated efforts to strengthen the financial sector safety net³ comprising also policy based lending and programmatic technical assistance (Financial Sector Development Project, P160715). Authorities recognize that strengthening financial sector stability will require a sustained effort with strong support from development partners.

Relationship to CPF

9. The project is fully aligned with the Country Partnership Framework for the Lao People’s Democratic Republic, 2017-2021, and the Systematic Country Diagnostic. The SCD identifies strengthening financial sector stability as a top priority, which is necessary to achieve inclusive and sustainable growth. Strengthening the legal and regulatory framework in the financial sector is a key imperative under the CPFs overarching priority to enhance institutional quality and creating a rules-based environment. In addition, the project directly contributes to CPF Objective 1.1, “supporting financial sector stability”.

C. Proposed Development Objective(s)

Note to Task Teams: The PDO has been pre-populated from the datasheet for the first time for your convenience. Please keep it up to date whenever it is changed in the datasheet. *Please delete this note when finalizing the document.*

to strengthen the financial and institutional capacity of the Deposit Insurance Fund to enable it to fulfill its deposit insurance mandate.

Key Results (From PCN)

The project is expected to lead to improvements in the financial and institutional capacity of DPO, with results expected in two areas:

- Ensuring adequate financial inflows into the DPO during the course of the project, in order to achieve a funding ratio⁴ of at least XX%;
- Improving the institutional capacity of the DPO to perform its legally-mandated function (deposit payout), as evidenced by progress towards compliance with IADI Core Principles .

³ The “financial system safety net” is defined to include the functions of prudential regulation and supervision, resolution authority, a lender of last resort and deposit insurance.

⁴ Funding ratio is the standard measurement of financial capacity of a deposit insurance scheme, and is defined as the ratio of total insured deposits to total reserves of deposit insurance fund.



D. Concept Description

10. The proposed US\$ 20 million operation is in response to the Government's August 2018 request for financing to increase DPO's capitalization and strengthen its institutional capacity. The project is part of a broader strategy to strengthen the overall financial safety net, through strengthening the supervision and resolution of deposit-making financial institutions, as well as the mechanism for timely payouts of depositors in the case of bank failures. As efforts described above to strengthen banking supervision and resolution framework progress, and in light of the existing vulnerabilities in the banking sector, during the project period it is possible that DPO may face its first payout event. Hence, it is imperative to bolster its financial and institutional capacity with World Bank support. As demonstrated by the lessons from the Global Financial Crisis, the establishment of a credible Deposit Insurance System is critical for financial sector stability, including maintaining public confidence, and protecting less sophisticated and small depositors.

11. **The proposed instrument is IPF with disbursement linked indicators (DLIs), drawing on experience from recent successful WB projects supporting deposit insurance schemes.** In particular, the recent WB projects in Bulgaria (P154219), Serbia (P146248), and Mozambique (P166107) financed the bolstering of reserves of respective deposit insurance funds, with disbursements linked to the tangible measures aimed at strengthening the institutional and financial capacity. The World Bank team and Authorities also agreed that Lao PDR would require substantial technical assistance, given the large capacity building agenda demonstrated in the recent IADI self-assessment.

12. The project will comprise two components:

Component 1: Capitalization of Deposit Protection Reserve Fund

13. **The first component will capitalize DPO's deposit protection fund.** It will utilize disbursement linked indicators, whereby the WB funds are disbursed in tranches based upon verification of achievement of the pre-agreed DLIs. The DLIs, in turn, will be formulated based on the World Bank's assessment of critical actions necessary for DPO to move toward compliance with IADI core principles.

14. **The WB financing is needed to support the DPO in achieving a more prudent funding ratio,** reflective of the current risks in the banking system. According to the International Association of Deposit Insurers "should be sufficient for serious difficulties in the banking sector but not for systemic crisis". DPO reserves can be increased through equity, premiums collected from member banks, investment income and resolution proceeds from failed banks. Premium collection will constitute a major contribution to the Fund over the long term, but given low bank profitability, it is not considered a viable strategy to rely solely on increasing premium levels for achieving a more prudent fund ratio in the near to medium term. The PAD will include details on the methodology of the assessment of fund adequacy based on standard IADI methodology.



Component 2: Institutional capacity building for DPO

15. In addition to capitalizing the Fund, the project aims to strengthen DPO’s institutional capacity, and in particular address key shortcomings identified in the IADI self-assessment. World Bank has been providing technical assistance (financed by Bank-executed trust funds) since 2016. Substantial technical assistance is needed to support DPOs institutional development.

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

The screening of social risks and impacts of project activities is based on discussions with the task team and desk research on previous experience of projects of this nature. The project has the potential for positive impact specifically for those insured depositors who will not lose their savings, and will get a timely payout, in the case of a bank failure. Surveys are planned for understanding of awareness on deposit insurance and further information needed for inclusivity will be incorporated into the survey design. Prior to appraisal an Environmental and Social Commitment Plan (ESCP), and a Stakeholder Engagement Plan (SEP) will be developed. As the project preparation moves forward engagement will be undertaken with the implementing agency to understand better their strategy for promoting awareness and literacy about the deposit insurance and their feedback and complaints mechanism. The SEP will be updated periodically in line with implementation of the strategy and survey results findings. The environmental screening was carried out by discussing the nature of project activities with the Task Team and Deposit Protection Office, it is confirmed that the Bank's deposit will only be investing on a Government Bond or Stock Market, which will not pose any physical footprint. The project will not finance any infrastructure and/or technical assistance that could conceivably result in any adverse environmental impacts.

Note To view the Environmental and Social Risks and Impacts, please refer to the Concept Stage ESRS Document.

CONTACT POINT

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APPROVAL

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