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Validation Report
Banking Sector Reform Program
(Lao People's Democratic Republic)
(Loan 1946-LAO)

The attached Report is circulated at the request of the Director General, Independent Evaluation Department. The report is also being made publicly available.

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Validation Report

Reference Number: PCV: LAO 2011-29
Project Number: 33359
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October 2011

Lao People's Democratic Republic: Banking Sector Reform Program

Independent Evaluation Department

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
APB	–	Agriculture Promotion Bank
BOL	–	Bank of the Lao People’s Democratic Republic
BSRP	–	Banking Sector Reform Program
CAPE	–	country assistance program evaluation
MFI	–	microfinance institution
NPL	–	nonperforming loan
PCR	–	program completion report
PDR	–	people’s democratic republic
RRP	–	report and recommendation of the President
SOCB	–	state-owned commercial bank
TA	–	technical assistance

NOTES

- (i) In this report, “\$” refers to US dollars.
- (ii) For an explanation of rating descriptions used in Asian Development Bank evaluation reports, see Asian Development Bank. 2006. *Guidelines for Preparing Performance Evaluation Reports for Public Sector Operations*. Manila.

Key Words

asian development bank, banking sector, reforms, financial reforms, independent evaluation department, lao people’s democratic republic

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PROGRAM BASIC DATA

Project Number:	33359	PCR Circulation Date:	29 December 2010	
Loan Number:	1946	PCR Validation Date:	October 2011	
Program Name:	Banking Sector Reform Program			
Country:	Lao People's Democratic Republic		Approved	Actual
Sector:	Finance (Banking systems)	Total Program Costs (\$ million)	15.00	17.04
ADB Financing (\$ million)	ADF: 15.00	Loan (\$ million) (SDR million equivalent)	15.00	17.04
	OCR: 0.00	Borrower (\$ million)	11.34	11.34
		Beneficiaries (\$ million)	0.00	0.00
		Others (\$ million)	0.00	0.00
Cofinancier:	None	Total Cofinancing (\$ million)	0.00	0.00
Approval Date:	28 Nov 2002	Effectiveness Date:	4 May 2003	7 Mar 2003
Signing Date:	3 Feb 2003	Completion Date:	Jan 2006	31 Mar 2009
		Closing Date:	31 Dec 2006	31 Mar 2009
Project Officers:	E. Manes S. Tukuafu S. Hattori R.T. Moyer K. Bird	Location: ADB headquarters ADB headquarters ADB headquarters ADB headquarters ADB headquarters	From Dec 2002 Mar 2004 Jan 2005 May 2006 Nov 2006	To Feb 2004 Dec 2004 Apr 2006 Oct 2006 Dec 2009
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ADB = Asian Development Bank, ADF = Asian Development Fund, IED2 = Independent Evaluation Department (Division 2), IEOD = Independent Evaluation Department (Office of the Director General), OCR = ordinary capital resources, PCR = project completion report, SDR = special drawing rights.

I. PROJECT DESCRIPTION

A. Rationale

1. The poverty reduction partnership agreement in 2001 between the Government of the Lao People's Democratic Republic (PDR) and the Asian Development Bank (ADB) called for ADB assistance to develop the economy and enable the country to graduate from least-developed status by 2020. Its key pillars included sustained macroeconomic stability, increased growth through an improved commercial environment, the development of a financial system that supports private sector growth, improvement in financial outreach, and the promotion of a good credit culture. The rationale for the Banking Sector Reform Program (BSRP) was to open the banking sector to increased private participation through improved governance and incentives in banks and a strengthened environment for enforcing loan contracts.¹

B. Expected Impact

2. The BSRP was to promote sustainable growth through a viable finance sector with, in particular, strengthened macroeconomic resilience to cope with bank insolvency and a commercial environment for banking and finance sector outreach. Specific indicators included (i) improved credit analysis and asset quality, (ii) increased financial depth, (iii) a higher share of

¹ ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Lao People's Democratic Republic for the Banking Sector Reform Program*. Manila.

private sector borrowers in commercial banks' portfolios, and (iv) an increased share of private banking in total assets (footnote 1, Appendix 4).

C. Objectives or Expected Outcomes

3. The BSRP's immediate outcome was efficient financial intermediation and a sound banking system capable of supporting economic growth and extending rural outreach. This was to be achieved through (i) an improved operating environment for the banking sector under the supervision and control of a strong Bank of the Lao PDR (BOL), (ii) the immediate application of commercial principles to ensure viable state-owned commercial bank (SOCB) operations, and (iii) increased diversity in forms of rural financing. Specific targets included (i) a strengthened finance system, (ii) strengthened internal governance in SOCBs, (iii) induced a credit culture, (iv) commercial principles in the Agriculture Promotion Bank (APB) to remove distortions from the rural finance sector, and (v) greater access to credit financing for credit-worthy private borrowers.

D. Components or Outputs

4. The BSRP was to support initiatives in four areas: (i) restructuring the banking sector, including reducing the number of SOCBs, improving the commercial environment for financial institutions, and SOCB reform; (ii) improving the legal environment for loan collection and collateral enforcement; (iii) improving the secured transactions system and financial disclosure (financial reporting, accounting, and auditing); and (iv) developing a market-oriented policy and institutional environment conducive to rural finance and microfinance, including restructuring the APB.

E. Provision of Inputs

5. ADB was to disburse a \$15 million loan in three equal tranches upon the government's compliance with specified release conditions. The government was to use counterpart funds to finance the local currency costs of program implementation. ADB assistance was embedded in a broad framework of macroeconomic, fiscal, and commercial reform supported by the International Monetary Fund through its poverty reduction and growth facility (April 2001) and by the World Bank through its financial management adjustment credit (June 2002). A parallel ADB technical assistance (TA) loan of \$4 million accompanied this program loan and was to help SOCBs achieve operational and financial restructuring objectives under a governance agreement. The ADB program loan was further supported by TA projects on rural microfinance and secured transactions system.²

F. Implementation Arrangements

6. The BOL was the executing agency of the program loan, with responsibility for program implementation (footnote 1, paras. 76–78). The implementing agencies were the Ministry of Finance, Ministry of Justice, and participating SOCBs. The BOL was to establish a bank-

² ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Technical Assistance Loan to the Lao People's Democratic Republic for the Banking Sector Reform Project*. Manila (TA Loan 1931); ADB. 2004. *Grant Assistance to the Lao People's Democratic Republic for Banking Automation to Support Outreach, Efficiency, and Governance*. Manila (JFICT Grant 9050); ADB. 2002. *Technical Assistance to the Lao People's Democratic Republic for Strengthening Governance for Banking Sector Reform*. Manila (TA 4002); ADB. 2006. *Technical Assistance to the Lao People's Democratic Republic for Promoting Governance in Financial Transactions*. Manila (TA 4770).

restructuring implementation committee chaired by a deputy governor of the BOL. The committee was to oversee the implementation of both the program loan and associated TA. Program risks, though significant, were judged manageable with mitigation. The risks were (i) the macroeconomic environment; (ii) ability and will of the government to implement a broad reform program; (iii) ministries, officials, and bankers undertaking the reforms being relatively inexperienced and lacking technical knowledge, causing uneven and slow implementation; and (iv) the restructuring of SOCBs may result in redundancies which could lead to resentment and grassroots resistance.

II. EVALUATION OF PERFORMANCE AND RATINGS

A. Relevance of Design and Formulation

7. The project completion report (PCR) rated the BSRP *partly relevant*.³ While the BSRP's main focus was restructuring and recapitalizing SOCBs, its design was too complex for and incommensurate with the country's implementing capacity. Some of the program's activities had to be waived, while others required significant dedicated resources over the medium-to-long term to be effectively accomplished. Weaknesses in program formulation and design contributed to poor implementation (footnote 3, paras. 14, 64, 74, and 77).⁴

8. ADB financing for the BSRP amounted to \$19 million, or about 60% of total ADB loan and grant assistance to the finance sector in Lao PDR during 2000–2009. Consequently, the complex design of BSRP investments and their poor implementation affected the relevance of ADB's broader finance sector program. The BSRP's relevance declined during implementation, as government ownership of the reform program receded.⁵ These led to tranche release delays. To date, the financial positions of restructured SOCBs continue to be weak. In addition, the governance of SOCBs has improved less than expected. As for associated TA, it was relevant at appraisal as it sought to support program implementation by addressing the continued financial weaknesses of SOCBs (i.e., governance problems and the information technology system). Overall, this validation concurs with the PCR judgment of *partly relevant*.

B. Effectiveness in Achieving Program Outcomes

9. The PCR described mixed results. While achievements around the core objective of restoring the health of SOCBs were rated *effective*, other program elements like the development of commercial courts and related legal and judicial reforms were rated *less effective*. This was because resources for capacity development were limited. The development of commercial courts and related legal and judicial reforms required longer-term programmatic assistance (footnote 3, para. 68).

10. This validation has a less positive view of achievements toward the core objective of both the program loan and the attached TA. While there were elements that were effective in achieving desired outcomes (e.g., laying the foundation for a competitive banking system), other

³ ADB. 2010. *Completion Report: Banking Sector Reform Program in the Lao People's Democratic Republic*. Manila.

⁴ Notably, the establishment of a secured transaction registry ultimately had to be waived. The similar development of a commercial court system will require significant resources over years to come to effectively address fundamental issues and achieve a significant and sustainable process. Closer assessment of legal or judicial implications at the time of formulation could have highlighted the long-term nature of support needed.

⁵ For example, constraints on budget resources following a macroeconomic and fiscal crisis meant that Ministry of Finance priorities were not closely aligned with the goal of the BOL and the BRSP, which required a substantial placement of recapitalization bonds in two SOCBs (footnote 3, para. 73).

elements proved to be less effective. Bank financial positions were substantially restored, such as through the reduction in nonperforming loans (NPLs), but this resulted in part from an economic boom that boosted operations. As such, operational soundness has yet to be proven. Moreover, while SOCB governance has improved and banking reforms are starting to become established, particularly with various decrees on commercial bank operations and autonomy, SOCBs continue to be financially weak and more efforts are needed to activate their commercial operations.⁶ This validation rates the BSRP performance *less effective*.

C. Efficiency of Resource Use in Achieving Outputs and Outcomes

11. The PCR rated the BSRP *less efficient* because of its poor implementation. It took 6 years to complete, double the target of 3 years.⁷ As a result, it required more staff and counterpart time and TA resources than planned (footnote 3, para. 69). The program also needed support from a project funded by the Japan Fund for Information and Communication Technology and a follow-on TA grant. The longer implementation period meant considerable turnover in staff in the executing and implementing agencies and the ADB team, with no fewer than six mission leaders during implementation. Turnover caused delays to accommodate learning and adjustment in a complex and wide-ranging program. A program scope with sharper focus would have reduced the transition period for new staff (footnote 3, para. 76). The short turnaround in to third tranche release was indicative of improved efficiency. Meanwhile, the PCR appropriately pointed to a mismatch between the magnitude and scope of reforms and the loan amount, diluting incentives for timely and effective implementation (footnote 3, para. 79).⁸ This validation agrees with the PCR rating of *less efficient*.

D. Preliminary Assessment of Sustainability

12. The PCR rated sustainability *likely* in core areas while citing accompanying risks (i) to the independence and effectiveness of the BOL as prudential supervisor, (ii) from the small capital base of SOCBs and their vulnerability to external shocks, and (iii) from macroeconomic instability (footnote 3, para. 70). This validation concludes that the sustainability of the BSRP is mixed. Some elements are likely to be sustainable, including the foundation for a competitive banking system and aspects related to domestic and foreign private banks. But others seem less likely to be sustainable. These include financially weak SOCBs and their governance problems, given continuing Ministry of Finance and BOL dominance over their operations and the potential risk of the government not being able to make capital injections into SOCBs on maturing recapitalization bonds because of resource constraints. In addition, continuing problems affecting the information technology system keep it from becoming effectively and efficiently operational. On balance, this validation rates the sustainability of the BSRP outcomes *less likely*.

⁶ ADB 2010. *Country Assistance Program Evaluation: Lao People's Democratic Republic—Sustainable Growth and Integration*. Manila (para. 48).

⁷ The first tranche was disbursed on 24 March 2003, or 17 days after loan effectiveness. The second tranche was released on 2 July 2008 or 44 months after the originally scheduled release in October 2004, because of delays in meeting a number of tranche conditions. The third tranche was disbursed on 31 March 2009, more than 3 years behind the original schedule of January 2006 but only 9 months after second tranche release.

⁸ The program loan release was contingent on compliance with 42 conditions, some of which carried costs greater than the program amount (e.g., recapitalizing SOCBs) and many of which required fundamental and far-reaching institutional changes.

E. Impact

13. The PCR did not rate project impact. The country assistance program evaluation (CAPE) found that deposits, loans, and financial intermediation increased while the cost of borrowing was reduced from 2000 to 2009. Deposit increases helped savings mobilization for investment, while loan increases fuelled more private sector and small and medium-sized enterprise activity including employment creation and poverty reduction. The microfinance sector also expanded in terms of the number of microfinance institutions (MFIs) providing micro loans for livelihood development projects in rural areas that helped reduce poverty.

14. On other hand, the CAPE observed that the quality and efficiency of financial intermediation was still questionable. The large increase in loans was accompanied by a large increase in NPLs for both SOCBs and private domestic banks. In addition, SOCBs, which held about 59% of the total banking assets, were beset by weak financial positions, and their weak credit- and risk-assessment procedures put into question their ability to do efficient financial intermediation and properly evaluate the viability of the projects being financed. Low loan-to-deposit ratios attest to such inefficiency. This also applied to MFIs, whose NPLs are on the high side at 4% of loans outstanding. It is possible that the apparent financial position of SOCBs, MFIs, and private domestic banks would worsen if internationally accepted prudential regulations were applied for loan classification and provisions and for calculating capital adequacy ratios. Accordingly, the real development impacts of the large loan and financial intermediation for private sector development from 2000 to 2009 would need to discount, to a certain extent, some of these quality and efficiency factors. The CAPE concluded that ADB's finance sector reform program did not appear to have had much impact on the quality and efficiency of economic development that took place from 2000 to 2009. This validation is of the view that net program impacts were *moderate*.

III. OTHER PERFORMANCE ASSESSMENTS

A. Performance of the Borrower and Executing Agency

15. The PCR rated the performance of the executing agency *satisfactory*. Yet the BOL's performance as the executing agency proved to be mixed. The government complied with 37 of 42 policy actions, or 88%.⁹ The PCR reported that the BOL generally provided able and responsive counterpart support and adequate facilities for program implementation (footnote 3, para. 62). However, it noted that coordinating reforms outside of the BOL's jurisdiction proved to be problematic, causing delays in policy action compliance and, consequently, in tranche releases totaling about 3 years, even after several conditions were waived. The PCR noted that the BOL's lack of independence, weak supervisory capacity, and conflicts of interest arising from its dual role as owner and regulator of SOCBs undermined its prudential supervision and therefore its effectiveness as executing agency. This validation rates executing agency performance *partly satisfactory*.

⁹ All but two of the 22 tranche 1 and 3 conditions were complied with. The two relate to the financial restructuring plan, which was substantially complied with, and the secured transaction registry, which was waived. Three of the 20 tranche 2 conditions were either substantially complied with (e.g., recapitalizing SOCBs, a mitigation plan during retrenchment, and a lease financing decree) or partly complied with (e.g., compliance with governance agreements).

B. Performance of the Asian Development Bank

16. The PCR rated ADB's performance *satisfactory*. ADB sent 14 review missions from 2003 to 2009, or about 2 missions per year. To achieve effective implementation, it showed flexibility toward revising problematic governance agreements and thereby strengthening stakeholder ownership. On the other hand, staff turnover was rapid, with six mission leaders, or about one for each year. The PCR correctly noted that, given the BSRP's scope and complexity, these ADB staff changes and differences in approach and understanding with counterparts perhaps worsened delays in implementation (footnote 3, para. 63). Program implementation required twice as long as anticipated, exemplified by the 44-month delay in releasing the second tranche. Given complex program design and weak capacity in executing and implementing agencies, ADB missions could have worked more closely with government agencies toward effective implementation. This validation rates ADB's performance *partly satisfactory*.

C. Others

17. The PCR reported minimal impacts on the environment, resettlement, and indigenous people, for which it was category C (footnote 3, para. 71).

IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

A. Overall Assessment and Ratings

18. Overall, the BSRP is rated *partly successful*, as detailed in the table. Program design turned out to be complex and incommensurate with the country's absorptive capacity. Effectiveness in achieving outcomes was mixed. Some aspects were satisfactory, as the opening of the banking system to private sector participation was successful, as was laying the foundation for developing a formal rural finance and MFI sector. On the other hand, less-than-successful approaches were adopted toward reforming SOCBs.

Overall Ratings

Criteria	PCR	IED Review	Reason for Disagreement & Comments
Relevance	Partly relevant	Partly relevant	
Effectiveness in achieving outcome	Less effective to effective	Less effective	Independence problems and weaknesses continue in the BOL's supervision of SOCBs, as do financial and governance weaknesses among SOCBs, which remain as major players in the banking system.
Efficiency in achieving outcome and outputs	Less efficient	Less efficient	
Preliminary assessment of sustainability	Likely	Less likely	Financial and governance problems continue in SOCBs.
Performance of borrower and executing agency	Satisfactory	Partly satisfactory	Problems in coordinating implementing agencies delayed policy compliance and tranche releases, even after several policy actions were waived. In addition, the BOL's structural issues and weak capacity contributed to its being less effective as the executing agency.
Performance of the Asian Development	Satisfactory	Partly satisfactory	The program was hampered by rapid staff turnover and general weaknesses in the

Criteria	PCR	IED Review	Reason for Disagreement & Comments
Bank			program design and implementation.
Impact	Not rated	Moderate	The program does not appear to have had much impact on the quality and efficiency of economic development.
Overall assessment	Partly successful	Partly successful	
Quality of the PCR		Satisfactory	

BOL = Bank of the Lao People's Democratic Republic, IED = Independent Evaluation Department, PCR = program completion report, SOCB = state-owned commercial bank.

Sources: PCR and evaluation team.

B. Identification of Lessons

19. The lessons drawn from the program are quite relevant and useful to future ADB operations: (i) the importance of political support and macroeconomic stability in finance sector reform, (ii) how focused program design contributes to more effective implementation, (iii) the desirability of a flexible approach to implementation, and (iv) the need to match the magnitude and scope of reforms with how well program provides incentives for timely and effective implementation (footnote 3, paras. 73–79). Other lessons observed by this validation relate to the need for the BOL to rigorously supervise and control the banking system and acquire adequate capacity to do so in terms of staff and skills. The lack of capacity partly explains continuing weak financial positions and NPLs of SOCBs.

C. Recommendations for Follow-Up

20. This validation finds the PCR recommendations on future monitoring and follow-on assistance satisfactory and supports their going forward (footnote 3, paras. 80–83). In addition, this validation provides two practical suggestions for the future: (i) ADB continuing, together with development partners, dialogue with the government and the BOL on building the BOL's capacity to properly supervise and control the expanding and diversifying finance sector and (ii) ADB commencing discussions with the government on privatizing SOCBs as, for example, joint ventures, in line with the government's ongoing privatization program.

V. OTHER CONSIDERATIONS AND FOLLOW-UP

A. Monitoring and Evaluation Design, Implementation, and Utilization

21. The PCR confirms compliance with the assurance on program monitoring and evaluation (footnote 3, para. 31). However, evaluation seems to focus on the core objective of SOCB restructuring and on monitoring their financial performance but not on the impact of policy reforms and adjustment on poverty or their social costs.

B. Comments on Project Completion Report Quality

22. The PCR satisfactorily meets both the guidelines on PCRs (PAI 6.07) and on preparing program performance evaluation reports.¹⁰ It provides a balanced assessment of program outputs, including adequate explanation of noncompliance with targets. Some PCR ratings are somewhat optimistic, but in general there is good evidence and analysis. The PCR lessons and

¹⁰ ADB. 2009. *Project Administration Instructions*. Project Completion Report for Sovereign Operations. Manila.

recommendations are satisfactory, as the lessons drawn are thorough and relevant for future ADB operations. This validation rates the PCR *satisfactory*.

C. Data Sources for Validation

23. The main data references are (i) the ADB report and recommendation of the President and progress reports on the second and third tranche releases, (ii) ADB project completion report, and (iii) the 2010 country assistance program evaluation for the Lao PDR and an associated rapid sector assessment prepared by IED. Additional inputs were drawn from (i) the minutes of meetings of the management and staff review committee and a summary of board discussions and (ii) mission back-to-office reports.

D. Recommendation for Independent Evaluation Department Follow-Up

24. Independent review of the BSRP at the time of CAPE appears to be satisfactory. At the same time, IED may yet consider the PCR's recommendation for preparing a program performance evaluation report after 2012 based on the finance sector's continued strategic role in the country's market economy. For this reason, it is suggested that a future program performance evaluation report on the BSRP should focus on program sustainability, in particular on the progress and impact of reforms.

**REGIONAL DEPARTMENT'S RESPONSE TO THE PROGRAM COMPLETION REPORT
VALIDATION REPORT**

On 21 September 2011, Director, Independent Evaluation Division 2, Independent Evaluation Department (IED), received the following comments from the Public Management, Financial Sector, and Trade Division, Southeast Asia Department:

We have received IED's earlier draft project completion report validation report circulated to us on 17 June 2011 and its final draft that was sent to us on 7 September 2011. We have no further comments on the final draft.