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# Major Steps Towards Improving the Legal Infrastructure of the Financial Sector in Lao PDR

The development of the financial sector requires a sound legal framework, which enhances the ability of financial institutions to operate and provide needed services. In Lao PDR, the legal framework of the financial sector remains weak evidenced by the fact that bank lending in Lao PDR decreased from 3,265 billion Kip ($307 million) in 2005 to 3,011 billion Kip ($299 million) in 2006. Moreover, total loans in the banking sector represent only 8.7% of GDP, compared to over 75% in Thailand, and the loan deposit ratio is only 39.4% and has declined from 2005. These figures show that much more could be done to improve the depth and outreach of the financial sector. The lack of a strong financial sector infrastructure is one of the main problems.



**Table 1: Financial depth and outreach in Lao PDR**

| | 2004 | 2005 | 2006 |
|---|---|---|---|
| Total loans in billion Kip | 2,528 | 3,265 | 3,011 |
| Loan growth rate (%) | 18 | 29 | (8) |
| Loans as % of GDP | 10 | 11 | 9 |
| Total deposits in billion Kip | 5,387 | 6,186 | 7,649 |
| Deposit growth rate (%) | 19 | 15 | 24 |
| Deposits as % of GDP | 20 | 20 | 22 |
| Loans as % of deposits | 47 | 53 | 39 |
| Number of Financial Institutions per 1,000 people | 0.2 | 0.2 | 0.2 |
| Number of bank branches per 1,000 people | 0.8 | 0.8 | 0.8 |

Source: Compiled by IFC-MPDF based on data from BoL, World Bank and ADB

## Overview of the Legal and Regulatory Environment for Commercial Banking

With the clear objective of strengthening the legal and regulatory framework for commercial banking, the government of Lao PDR has recently taken several important steps. The most recent development in the financial sector is the promulgation of the Law on Commercial Banks in early 2007,[1] which supports sound financial sector and banking practices including creating an environment where all commercial banks - private, foreign and state-owned - operate on a level playing field. The increased competition in the banking sector brought about by the promulgation of this law will result in improving the service level of the financial sector and ultimately increasing access to finance for Lao businesses. Specific improvements provided through the new law include:

- Equal conditions for locally-owned, state-owned and foreign-owned banks regarding the minimum capital requirement and branch network establishment;
- Prompt corrective action for seriously undercapitalized banks;
- A clear and comprehensive two-stage licensing process;
- Modern techniques for bank governance that supplement the Enterprise Law;
- Comprehensive provisions to prevent conflicts of interest;
- A broad range of enforcement actions; and
- Provisions for resolving bank insolvency.

In addition to the Law on Commercial Banks, the Bank of the Lao PDR (BOL) has also revised the Presidential Decree on the Management of Foreign Exchange and Precious Metals.[2] The purpose of the amendments to this decree is to remove provisions that discriminate against commercial banks that are not state-owned, focusing on the following:

- Whereby the current decree requires foreign exchange bureaus to sell foreign exchange only to state-owned commercial banks or to BOL, these bureaus will be allowed to sell foreign exchange to

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The "Business Issues Bulletin" provides those interested in business issues with a short summary and analysis of a particular topic affecting the business environment in Lao PDR, and exposure to different opinions held by various stakeholders on the topic.

The statements and opinions presented here are only meant to provide additional reference material and do not reflect official opinion of the Lao National Chamber of Commerce and Industry (LNCCI) or IFC-MPDF.



[1] The law was prepared with assistance from the International Finance Corporation's Mekong Private Sector Development Facility (IFC-MPDF).

[2] These amendments are expected to be approved by the government in the coming months.

any bank;

- Whereby the current decree requires foreign investors in mining and other business activities involving the exploitation of natural resources to maintain accounts at state-owned commercial banks, these mining and natural resources businesses will be allowed to use the services of any banks, including private commercial banks;
- Whereby the current decree allows foreign investors to borrow from local banks only for working capital purposes, banks will be allowed to provide more loan products for foreign clients on a long-term basis giving them access to a wider range of financing from local banks.

The new commercial banking legislation and the amendments to the decree have leveled the playing field for all types of banks in Lao PDR. As a result, Australia and New Zealand Bank (ANZ) entered into a joint-venture agreement in March 2007 with Vientiane Commercial Bank (VCB), a locally established bank. These reforms in commercial banking have also encouraged the International Finance Corporation to invest in VCB by taking a 10% stake in the bank.

Having promulgated the Law on Commercial Banks, the challenge ahead is to ensure effective implementation through additional decrees and regulations, including an implementing decree, strengthened prudential regulations in the area of loan classification and provisioning, and guidelines and instructions for bank supervisors and inspectors.[3]

**Mr. Sengdeuane Pannhasith, Director General, Bank and Financial Institutions Supervision Department, Bank of Lao PDR**

*The promulgation of the Law on Commercial Banks is an important step in the development of the banking sector in our country. By creating a level playing field for domestic and foreign banks, and private and state-owned banks, the Law on Commercial Banks will encourage stronger competition, which is a prerequisite for developing a strong commercial banking sector. It is expected that increased competition will result in strengthening the service level of the financial sector and improving access to bank financing for businesses in the country. At the same time, this law also provides an effective regulatory and supervisory tool consistent with international practices to ensure healthy growth of the financial sector and protect the interest of depositors.*

*To support the implementation of the Law, a more detailed implementing decree will be developed with the technical assistance from IFC-MPDF. The decree will focus on details of the licensing process, bank governance and structure, banking operations/activities, supervision and inspection, rehabilitation and insolvency. Along with the development of the implementing regulations, we will also strengthen our supervisory capacity through reviewing and revising existing prudential regulations, and training our staff.*

**Mr. Paul Freer, Managing Director, Phongsavanh Bank**

*The Law on Commercial Banks is an important legislative framework that suggests the government is serious about developing the banking sector in Lao PDR. However, the devil will be in the detail – the timely roll out of implementing decrees and regulations (in particular the implementation of the Secured Transaction Law) and the enforcement of such will be key to seeing the banking sector develop and grow. Deposits will not be fully leveraged in terms of lending until banks can rely on a transparent and enforceable legal framework. Uncertainty in any environment acts as a deterrent to investment. The Law on Commercial Banks is a bold step and one that has already proved itself in attracting international players to the market and the opening of wholly Lao owned commercial banks such as ours. This can only be good for business and the government and the sponsors of this newly promulgated law are to be applauded. When transparent and enforceable implementing decrees are rolled out, expect to see a raft of innovative products and services launched by Phongsavanh Bank!*

## Need for Effective Secured Transactions Legal Framework

A recent diagnostic of the financial sector carried out by IFC-MPDF revealed that only 20-30% of households and private enterprises have access to finance. The diagnostic also identified the following barriers limiting access to finance:

- Lending decisions are based almost entirely on collateral; and
- Banks generally do not accept movable and intangible assets such as motor vehicles, machinery, equipment, accounts receivable and inventory as collateral, but instead require immovable assets (property or user rights to land) as security for a loan.

Consequently, the majority of businesses in Lao PDR, of which more than 90% are small and medium enterprises (SMEs), are unable to access finance for business expansion. This has a negative impact on the ability of the private sector to create more jobs, increase the tax base and contribute to national prosperity.

If banks were able to feel more comfortable to lend on movable and intangible assets, SME access to bank financing would be greatly enhanced. For this to occur, the legal infrastructure for secured transactions needs to be strengthened. Although the Secured Transactions Law promulgated in May 2005 allows banks to accept movable assets and intangible property as collateral, it has not yet been implemented. In order to further

[3] IFC-MPDF will be providing further support to the BOL to draft these necessary implementing regulations.

facilitate the ability of banks to lend based on movable and intangible assets, the following measures will need to be taken:

- Improve the existing legal and regulatory framework by issuing the necessary implementing decree for the Secured Transactions Law;
- Improve the supporting infrastructure for secured lending by establishing a pledge registration system, which will enable lenders to quickly register their financial interest in an asset and search for existing claims in a database;
- Banks will need to strengthen their credit risk management capacity by developing expertise in loan portfolio management, enhancing their understanding of the risks and technical aspects of particular industries and improving monitoring and client relationship management; and
- SMEs will need to develop and maintain proper accounting records, which provide sufficient financial information for banks to carry out loan assessments.

To support the government's effort in promoting lending based on movable and intangible collateral, the Asian Development Bank has been working with the Ministry of Justice and other relevant agencies to develop the implementing regulations for the Secured Transaction Law. It is envisaged that these regulations will provide guidelines for the establishment and operation of an effective pledge registration system as well as rules and procedures for the repossession of movable and intangible property.

**Mr. Sengdeuane Pannhasith, Director General, Bank and Financial Institutions Supervision Department, the Bank of Lao PDR**

*We are currently working with the Ministry of Justice and other relevant ministries to develop the implementing decree for the Secured Transactions Law, which will enable businesses to use both their movable and immovable assets as collateral for bank credit. This decree, together with the plan to establish a pledge registration system, is expected to facilitate the country's lending market.*

**Mr. Allan Marlin, ANZ Shareholder Representative Lao PDR, ANZ Banking Group Ltd.**

*The Secured Transactions Law is one of the most important pieces of legislation in respect to providing an understanding of what type of assets are available to be taken by lenders as security for finance lines extended. The law distinguishes the different forms of security available to lenders and authorizes the use of moveable property as a legal form of security. The effect of this is that those who do not have access to immovable property and title are able to offer other forms of assets to lenders.*

*The promulgation of this law is good for Lao PDR as it allows more businesses, particularly SMEs, access to financing provided that all other factors are aligned. However this law has been in existence since May 2005, and we await the promulgation of an implementing decree to instruct lenders and borrowers on how the law is to work.*

*We all understand how problematic it is for lenders to realize on security held when a debtor defaults and a loan becomes bad. This needs to be rectified in the implementing decree so that lenders are given the right to obtain loan repayments through the sale of security property.*

*In this regard the implementing decree requires some form of self help for lenders, particularly in the case of moveable property, whereby a lender can seize and secure its ownership of the goods promptly in the case of a defaulting debtor. A national registration system, preferably computerized, is also needed which would allow lenders to record the security they hold and which others can easily access to check whether security is held over a particular item. This will ensure that a moveable item is not used as security for a loan more than once. This registration process needs to be simple, fast and by notice only.*

*As lenders we look forward to the promulgation of the implementing decree, which will provide more clarity around the intent of the law. Of course lenders should not look to security as the only way to lend money but also require access to proper financial information and repayment capacity in support of any loan proposal. Borrowers themselves will need to maintain proper financial records. However, this is another subject in its own right.*

**Dr. Aksone BOUPHAKONEKHAM, Chairman, Banque pour le Commerce Exterieur Lao**

*In addition to having an effective legal framework in the form of laws and implementing regulations, supporting infrastructure such as a pledge registration system, which will enable lenders to quickly register their financial interest in an asset and search for existing claims, is a necessary condition to encourage more lending, especially to SMEs, who generally lack land and property. I anticipate that the implementing regulation for the Secured Transactions Law currently under development will provide us with a broad scope of assets that may be used as security, clear rules on priority for the secured creditor, and effective enforcement upon default.*

## Non-bank Financial Institutions-Leasing

Businesses in Lao PDR consider their limited access to finance as a major constraint to doing business. Since the reliance on collateral-based lending is the principal hindrance for many businesses from accessing bank loans, in particular for SMEs, finance leasing is an alternative financial product, which could be utilized to mitigate collateral requirements. Although lease

financing can be complicated, it helps businesses to structure financing based very much upon the individual situation of the user of the equipment (the lessee). Some businesses lease because of cash flow or tax considerations, some for country risk reasons and others for convenience or budgetary reasons.

The Decree on Finance Leasing was issued in 1999 and is largely consistent with international best practices. To date, however, not a single finance leasing company has been established in Lao PDR. One of the main reasons for the absence of finance leasing is the lack of regulations concerning the requirements and licensing procedures for establishing finance leasing companies. Implementing guidelines for the Decree on Finance Leasing are needed which would:

- Provide guidelines and procedures for licensing finance leasing companies;
- Clarify repossession rights of lessors; and
- Define the tax treatment of finance leasing so that it is not disadvantaged vis-a-vis bank lending. In this way leasing will be a competitive financial product.

**Mr. Sengdeuane Pannhasith, Director General, Bank and Financial Institutions Supervision Department, Bank of Lao PDR**

*Leasing is a widely used financial product in many countries. However, to make leasing a viable product in Lao PDR, we will need to further improve the existing legal framework by clearly defining the rights and responsibilities of both lessors and lessees and making it easier for lessors to repossess leased property in the event of default on the part of lessees.*

**Mr. Allan Marlin, ANZ Shareholder Representative Lao PDR, ANZ Banking Group Ltd.**

*While it is true that there has been a Decree on Finance Leasing in existence for some time it is likely that no one has acted under this legal framework because of the absence of any implementing guidelines and clarity around the ability of a lessor to regain possession of the goods that are owned by the lessor if the lessee decides not to maintain the lease payments. Additionally, the accounting and tax regimes need to be favorable for leasing to be competitive with traditional forms of finance.*

*There is far greater awareness nowadays that most businesses make money by using equipment and not owning it. There are numerous benefits available from using lease financing as follows:*

- *It allows businesses to retain cash reserves for a company's core business activities;*
- *Fixed payments usually at fixed interest rates allow for more accurate forecasting of cash flow and budgeting;*
- *100% financing is available;*
- *Payments can be structured to more closely align with a company's seasonal business activities and income;*
- *Operating budgets may permit lease finance when a capital budget does not allow the purchase of an asset;*
- *Benefits to balance sheet structuring;*
- *It allows better utilization of tax benefits by both lessor and lessee;*
- *It provides a hedge against technological obsolescence; and*
- *It may offer non financial services such as equipment service and maintenance (operating leases).*

*What is required to ensure leasing is practicable are decent implementing guidelines that provide a framework of the intent of the Law but allow the lessor and lessee to agree on specific details in terms of the lease agreements between the two parties. There needs to be a formal registry where the interests of the lessors in moveable assets can be registered. Finally, repossession rights which allow the lessor to regain possession of goods they rightfully and legally own.*

*In terms of tax treatment, there should be no turnover or value added tax associated with finance lease transactions and no withholding tax payments applicable. Tax rules should also ensure that matters such as depreciation and deductibility of lease payments do not disadvantage finance leasing.*

## Conclusion

Improving access to finance in Lao PDR depends greatly on the development of the country's financial sector infrastructure. With the passage of key legislation concerning the leveling of the playing field for private, state-owned and foreign commercial banks, a major step forward has been taken to extend the outreach and availability of financial services to the business community. However, to enhance the ability of commercial banks to lend, a clearer regulatory framework with regard to the pledging, registration and repossession of collateral is needed. The issuance of implementing regulations to the Secured Transactions Law and the development of a pledge registration system will enhance the ability of commercial banks to use movable and intangible property as collateral. Improving the enabling legal framework for leasing is also necessary to diversify the financial products available in the market. With the development of this legal infrastructure, financial institutions will be better able to provide the financing needed to support businesses to expand, add jobs and create wealth for the country.


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