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Instilling Credit Culture in State-owned Banks— Experience from Lao PDR

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Banks are essential for developing countries to transform savings into new investments, without which economic growth and poverty reduction will be retarded. However, development has frequently been set back by bank failures.

Banking is much more problematic in transitional economies as these economies move from state planning to market-based approaches for the allocation of goods and services. Because of this uncertain economic environment, banking failures have invariably led to major difficulties in terms of a build-up in nonperforming loans (NPL) and periodic crises. What can be done to create a viable and stable commercial banking system especially in transitional economies?

The key elements of standard prescriptions are competitive markets, private ownership of banks, and effective banking supervision. Transition economies have found it to be a daunting task to develop and maintain such a market-based banking system. Effective banking systems have yet to be achieved in most of the transition economies, from the People's Republic of China to Eastern Europe. Experience shows that a fully effective market-based banking system can take a generation or longer to develop, especially under the more successful but slower phasing in Asia.

However it still may be possible to have operationally effective banking even within the transition environments, provided there exists a forward-looking government and an appropriate set of governance agreements. Key to operationally effective banking is the development of a credit culture wherein banks carefully review and document repayment capabilities.

This brief describes the experience of developing a more operationally effective banking system in Lao People's Democratic Republic (Lao PDR). First, it briefly explains the nature of banking risks and highlights the role of credit culture to overcome such risks. It then presents a case study on how credit culture is introduced and developed in government-owned banks. Salient features of a design mechanism that establishes a credit culture in the absence of outright ownership change are identified. The brief concludes by noting the potential applicability of the Lao PDR case to situations where

policymakers are keen to improve the effectiveness of government-owned banking institutions for delivering financial services.

Banking Risks and Credit Culture

Banking is an extremely risky business. Banks accept demand deposits and with that funding, they provide credit for business financing, including longer-term project finance. Banking, in order to be generally successful, needs to be undertaken in a supportive market environment. What does this mean? First there must be competitive markets for banking services and bank ownership. These markets are necessary to effectively discipline the behavior of banks. Under competitive market conditions, an unsuccessful banking service will not be profitable and will cease to be offered to the public. Closing a bank is more problematic as the bank still needs to meet depositor and creditor demands in an orderly way by using capital to cover any losses. This required capital base is set and monitored by the domestic banking supervisor in line with internationally agreed standards. While market discipline tends to be much more important than supervisory oversight in disciplining banks, both are necessary to maintain an effective financial sector with a high degree of efficiency.

Successful banks have developed an internal credit culture that guides their banking operations. Loans will not be made unless there is a demonstrated capability for repayment. This can take several forms but the major reliance should be on future cash flows as opposed to security. Every credit must be subject to rigorous analytical scrutiny of the customer's repayment capability prior to approval, and on an ongoing basis following approval. There can be no exceptions.

Credit culture is often taken for granted. But its importance to successful banking cannot be overestimated. Historically, governments have been tempted to develop government-owned banks to promote savings, investment, and economic growth. Such attempts have generally not been successful. This is attributable to factors such as lack of credit culture in banking, especially in the centrally planned economies. Banks in centrally planned economies rarely conduct rigorous analysis of credit risks and of borrower's debt service capacity. In the absence of the needed credit culture, such government ownership of banks has been associated with lower growth in incomes and productivity (La Porta et al. 2000).

What should be done in a transitional economy, where the starting point is subdivision of the plan's fiscal agent into the banking system that is fully owned by the government? What is the alternative

for an economy with little prospect of effective privatization or rapid development of a market economy to provide the needed incentives to develop a credit culture, as is the situation in Lao PDR?

Banking Reform in the Transitional Economy of Lao PDR

Lao PDR is one of the least developed transition economies in Asia. Most of the country is mountainous and heavily forested with the important Mekong River forming a large part of its boundary with Thailand. With a population of almost 6 million, per capita income averaged \$375 in 2003 with about 32 percent of the population living below the poverty line. Predominately rural, almost half of GDP and 80 percent of employment is derived from agriculture.

The country's transition to a market economy began in 1986. In the five years to 2003, economic growth averaged 5.8 percent per year. However substantial imbalances are reflected in the high rate of inflation of 15.5 percent in 2003. Nevertheless, under a poverty reduction and growth program supported by the International Monetary Fund (IMF 2004) inflation fell in 2004 to under 11 percent and in 2005 is projected to decline to 6 percent.

The Asian Development Bank (ADB) is supporting a banking sector reform program initiated in March 2003.¹ The financial sector is presently dominated by two state-owned commercial banks that have been used as instruments of policy, particularly through directed loans for favored investment projects as well as for financing the losses of state-owned enterprises.² In addition there is one rural policy bank, seven branches of foreign banks, and one small private commercial bank. Total bank assets in Lao PDR only amounted to \$465 million at the end of 2003 with the two state-owned commercial banks accounting for about three quarters of this total. Reflecting the underdeveloped economy, commercial banking plays a relatively minor role as credit to the private sector still only accounts for 6.5 percent of GDP while credit to state-owned enterprises add another 2 percent of GDP.

¹ This was the third adjustment credit that ADB had extended to support banking sector reforms in Lao PDR. The previous two financial sector program loans provided important lessons that were incorporated in the conditionality of this program.

² The two surviving state-owned commercial banks are the Banque pour le Commerce Exterieur Lao, which predominantly serves large business customers; and the Lao Development Bank, which has an extensive branch network throughout the country and largely serves small and medium enterprises and individuals. The policy bank is the Agriculture Promotion Bank that serves the rural areas.

While the economy has been moving toward a market basis, major decisions remain largely determined by the government under state planning approaches, thus, investment projects are implemented and financed through the budget, state-owned enterprises, and banks. Private ownership is confined to small and medium enterprises as privatization of major enterprises and banks is not envisaged in the near future. Moreover due to the limited size of the private sector, there is no domestic market for these public assets. The central bank, the Bank of Lao, coordinates commercial banks in meeting government economic objectives and only acts as a traditional bank supervisor to a limited extent. Reflecting these approaches, there is no credit culture in the state-owned commercial banks. An initial assessment of the market economy, regulatory environment, and available incentives would lead to a very negative outlook for creating a credit culture to support commercial banking in Lao PDR.

Given this environment, state-owned commercial banks have been allowed to continue providing needed banking services while developing the credit culture needed for their success. Within a longer time perspective, it is hoped that with the increasing introduction of market forces to enhance the credit culture, combined with a performance-based recapitalization of these banks, the banks could be made increasingly attractive to both domestic and international investors. How could this be done without the needed market incentives?

Governance Program

The method chosen was a governance contract between the principal parties supported by international banking advisors (two advisors per commercial bank) to create a credit culture by transferring the necessary credit skills to these banks. The principal parties who signed the governance agreement were the Ministry of Finance (as the representative of the owners, i.e., the people of Lao PDR); Bank of Lao (the central bank that supervises banks); and the chairman and the chief executive officer (on behalf of the board and management of each commercial bank). This governance contract sets out the objectives of the reform program.³ First and foremost the contract

³ For a complete description of the program see ADB (2002). The governance approach reflects an adaptation of an approach evolved by the World Bank in Eastern Europe and was adapted to Lao PDR conditions under the mission leadership of Eric Manes who was supported by the authors of this paper, among others.

sets out the essential grants of independence for the banks in terms of the right to decide on the extension of credit and the setting of interest rates for both deposits and loans. Such freedoms provide the basis for the credit culture. As there is no internal capacity to operate a market-based bank, the international banking advisors act as mentors and coaches. The governance agreement also covers the detailed duties of each of these parties and includes reporting and performance assessment approaches, sanctions, and administration and will be revised yearly in response to changing circumstances.

To effect these changes within the Lao PDR is not easy given the lack of available incentives to influence staff behavior. Salaries throughout the banking system are based upon on a civil service structure that incorporates low salaries and few incentives relative to performance. No additional incentives are available. However recent research on public organization has indicated that it is still possible to effect change even in the absence of the traditional carrot and stick incentives. The simple ability to manage budgets and rotate work assignments can provide sufficient incentives to effect needed changes, although the time frames would be necessarily longer.⁴

In all of their deliberations, management is required to take careful consideration of the advice rendered by the advisors. For example, the advisors were required to review and comment in writing on the availability of the needed information for market-based credit decisions, and to make a recommendation on the appropriateness of the proposed credit decision. Such reviews were required on each loan proposal of over KN 200 million (\$20,000). As such there was a high degree of centralization of credit controls to eliminate the common problems found in transitional economies, i.e., that of inappropriate branch lending practices due to local political influences.⁵

Based upon the international audit for 2003 and quarterly indicators for 2004, the performance of the banks under the program has been good. The principal bank committees such as the credit and asset/liability committees, both at the board and management levels, have been meeting regularly and functioning successfully with the oversight of the international bank advisors. Perhaps the result that is most noteworthy is that the rate of NPL creation has been

⁴ For an example of this literature see Gersbach and Keil (2004).

⁵ See for example, Boureau-Debray and Wei (2004) where the segmentation of the internal capital market due to local government interference and misallocation of capital is described in People's Republic of China, another transitional economy.

sharply reduced, and the NPL collection target is largely being met. In addition some significant omissions in the governance contracts were also noted, for example the need to bring the off-balance sheet items such as letters of credit under the review of credit committees. There were also isolated instances of noncomplying loans at the branch level and these have been corrected. As the Ministry of Finance was not able to issue the recapitalization bonds in line with the program agreements due to delays in budgetary approvals, the capital shortfall of these banks was still substantial.

The major uncertainty of the governance approach in creating a credit culture is that it will require the continuous dedication and commitment of all parties under the program to ensure success. This approach requires entirely new ways of thinking and acting in terms of economic management. The risks are that the government might decide it must revert to direct economic management and use directed loans to finance desired investments. Nevertheless with historical NPLs still at a very high level relative to their loan portfolios, enlightened government officials are fully aware of the costs of the previous directed loan programs so that the prospects for continued implementation of the governance program are good.

Under this program, the final target is attracting strategic investors to support these banks beyond the program period. The program period is targeted to end in 2006, although actual program implementation will no doubt extend somewhat beyond this date.

Conclusions

The application of the governance approach for establishing a credit culture and reforming government-owned banks requires that all principals (owners, regulators, and management) must agree and actively cooperate in this transformation. There is also a need for international policy advisors to assist in the transformation toward establishing a credit culture. As such, this approach requires a substantial political and financial commitment and its applicability may be limited to situations where the banking situation has gone through a crisis and has international donor support for the needed transformation.

At the same time an important measure of the success of this approach is that the Lao PDR program is expected to be extended within the banking system to the Agriculture Promotion Bank (APB). The APB was designated as a policy bank to manage directed loans to the rural sector. However, the limitations of this approach in

developing a full range of financial products for rural areas has become clear. The APB is now to be transformed into a commercially oriented provider of savings and loan products to rural areas with an effective credit culture that yields substantial benefits in terms of economic growth and poverty reduction.

The governance approach to banking reform is transferable to many other countries where government-owned banks are being relied upon to provide banking services and where such services are not fully effective due to the lack of a credit culture. The governance agreement must substitute for the conditions found to be essential for market-based banking, namely competitive markets, private ownership, and effective banking supervision in order to support a credit culture. While it is not an easy transformation, the rewards in terms of more effective banking services can be substantial.

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