MANAGEMENT RESPONSE TO THE PROGRAM PERFORMANCE EVALUATION REPORT FOR THE SECOND FINANCIAL SECTOR PROGRAM LOAN IN THE LAO PEOPLE'S DEMOCRATIC REPUBLIC (Loan 1458-LAO)

On 29 March 2006, the Director General, Operations Evaluation Department, received the following response from the Managing Director General on behalf of Management:

A. Overall Assessment

1. Management finds OED's Program Performance Evaluation Report (PPER) well prepared. The PPER's analysis and conclusions are substantially in agreement with the program completion report (PCR), which was prepared in January 2002. The PCR found the Second Financial Sector Program Loan (FSPL II) to be deficient in design, implementation, and effectiveness. These findings are underscored by the PPER, and we therefore concur with the latter's overall findings and assessment.

2. Like other transition economies, Lao PDR, at the time it initiated the transition to a market-based financial system, faced the twin challenges of building up governance institutions and resolving the insolvency of the state banks. Significant progress was made in the first round of reforms in the 1980s through the establishment of a two-tiered banking system and the containment of bank losses to a relatively small proportion of GDP. The Government's reform agenda in the 1990s was more ambitious. Effective bad debt resolutions, a sound and safe banking system with increased lending to the private sector, and strong supervisory capabilities were the outcomes that the government sought, with the support of ADB and other development partners. However, these envisaged outcomes were not achieved. The attempt to strengthen governance by building up institutions that are insulated from political influence did not prove feasible. The incentives supported by the FSPL II did not change the behavior of banks. Nor did it contribute to adequate strengthening of supervisory and oversight capacities. In particular, neither banks nor regulators engaged in sufficient investments to improve their capacities.

B. Lessons Learned

3. The PPER's findings help to clarify the weaknesses of the program design and implementation that explain the limited outcomes emerging from FSPL II. The PPER's analysis of current issues is an exemplary guide towards the principles for reengagement with Lao PDR on further reform of the financial sector. We note, in particular, the importance of the PPER's findings on the need for sequenced and synchronized reforms. This has two major implications for the program design. First, to link progress in the banking sector to improved fiscal management, attainment of macroeconomic stability, and the strengthening of the legal framework including the capacity of the court system. Second, the need to address the problems of banks and enterprises together, rather than in isolation.

4. As noted in the PPER, macroeconomic instability arising from the Asian economic crisis of 1997 adversely affected the policy climate and made it more difficult for Lao PDR to pursue reforms under FSPL II. However, by 2000, with the return of macroeconomic stability a basis emerged for renewed attention to reforms. At about this time, Lao PDR began to develop a comprehensive framework for macro economic stability, poverty reduction, financial and fiscal reforms, and judicial strengthening in conjunction with policy dialogue and support from the ADB, International Monetary Fund, and the World Bank.

5. Reflecting the importance ADB attached to the issues of political commitment raised in the PPER, a sustained process of consultations with high-level officials was initiated and this laid the basis for the policy reform agenda that was subsequently developed. This was underpinned by a very difficult—and necessary—joint exercise in which the staff of the state- owned commercial banks (SCBs), the Bank of Lao PDR, and ADB carried out a detailed examination of the balance sheets and portfolio of the SCBs. The high level policy dialogue, in combination with the portfolio examination, led to a reformulation of the reform agenda stressing upfront reforms, conditional recapitalization, stricter lending criteria, and greater transparency and disclosure to aid monitoring.

6. Thus, the key lessons emerging from the PCR, and those which could be said to have been anticipated in the PPER, helped shape the international community's support of further banking and financial sector reforms in Lao PDR during 2000–2003. In particular, they helped shape the design of the ongoing Loan 1946-LAO (SF): Banking Sector Reform Program and in structuring the Rural Finance Sector Development Program in the pipeline for 2006.

7. The overall context for reform remains difficult however, in part because of weak capacities in terms of human resources and institutions, and in part because of the political economy context in which reforms are required to be understood, supported, and reconfirmed with a range of domestic actors and agencies. Two specific aspects of ongoing difficulties are noteworthy. First, to resolve of bad debts the Banking Sector Reform Program makes the recapitalization conditional on the progress made in the resolution of non-performing loans (NPLs). We see encouraging progress in the reduction of NPL ratios of flow loans. However, the ultimate test of progress made will lie in the attainment of hard budget constraints on the state enterprise sector. There is not yet conclusive evidence that budgets have hardened, although the issuance of debt clearance bonds—admittedly at below market interest rates—is a step in this direction.

8. Second, the need for stricter lending requirements and market-based credit risk management in the SCBs. This is highlighted by the PPER as a key issue and was anticipated in the design of the Banking Sector Reform Program. In addition to other measures, this objective was addressed by the introduction of resident advisors who were to certify that SCB's were meeting the new criteria. The initial results are encouraging with a sharp reduction in SCB credit growth in 2003-2004 in line with the recommendations of the advisors. However, since then SCB credit growth has grown substantially. It will be important to determine the basis of some recent credit decisions and whether they conformed to the new

lending criteria. The issue here is not only the independence of credit decisions made by the management of the SCBs; it is whether a definitive shift has taken place from the centralized bank decision-making culture.

C. Conclusion

9. In conclusion, Management appreciates the PPER's comprehensive analysis of FSPL II and its implementation. In implementing the Banking Sector Reform Program and preparing the Rural Finance Sector Development Program, ADB will be proactive in taking actions proposed in the PPER to enhance program effectiveness.