

Lao People's Democratic Republic:  
Technical Assistance  
Report-Risk-Based Banking  
Supervision



# LAO PEOPLE'S DEMOCRATIC REPUBLIC

## TECHNICAL ASSISTANCE REPORT— RISK-BASED BANKING SUPERVISION

June 2020

This Technical Assistance report on Lao People's Democratic Republic was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on January 2020.

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# **INTERNATIONAL MONETARY FUND**

Monetary and Capital Markets Department



## **LAO PEOPLE'S DEMOCRATIC REPUBLIC**

### **RISK-BASED BANKING SUPERVISION**

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**January 2020**

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**GLOSSARY**

BoL	Bank of the Lao P.D.R.
BSD	Bank Supervision Department
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
FBB	Foreign Bank Branch
FIRST	Financial Reform and Strengthening Initiative
FSI	Financial Soundness Indicator
FX	Foreign exchange
FX NOP	Foreign Exchange Net Open Position
IP	Institution Profile
LAK	Lao kip
MCM	IMF Monetary and Capital Markets Department
MOU	Memoranda of Understanding
NOP	Net Open Position
NPL	Nonperforming Loan
RAS	Risk Assessment Summary
RBS	Risk-Based Supervision
ROX	Report of Onsite Examination
TA	Technical Assistance

## PREFACE

The IMF's Monetary and Capital Markets Department (MCM) technical assistance (TA) mission visited Vientiane, Lao People's Democratic Republic (P.D.R.) during September 16-27, 2019 to assist the Bank of Lao P.D.R. (BoL) in implementing risk-based supervision (RBS). The mission comprised Ms. Hee Kyong Chon (mission chief), Mr. Joel Hefty, Mr. and Richard Nun (external experts).<sup>1</sup> The mission was conducted within the framework of a TA program being provided to the BoL to adopt RBS and strengthen the capacity of Banking Supervision Department (BSD) staff. The mission was financed by the Financial Reform and Strengthening Initiative (FIRST).<sup>2</sup>

The mission team held discussions with the Deputy Governor and senior officials of the BoL, and provided training to staff of BSD. The mission is grateful to the BoL's management and staff for their excellent cooperation and productive discussions.

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<sup>1</sup> Ms. Chon (mission chief) participated in the mission during September 26–27 to conclude the project and to meet the Deputy Governor.

<sup>2</sup> A TA project was approved in December 2015 with funding from FIRST. For the tasks of the project, periodic TA missions assisted the BoL in developing a RBS framework during the period from 2016–2017. To maintain the commitment of BoL in enhancing RBS framework, a new TA project was approved in December 2017 with the FIRST funding as a Phase II project.

## EXECUTIVE SUMMARY

**The Banking Supervision Department (BSD) of the BoL is implementing risk-based supervision (RBS) methods.** BoL staff are showing favorable results in understanding and applying RBS, recognizing that they are still in the early stages of capacity development.

**A new commercial banking law became effective in June 2019.** The law incorporates expectations that financial institutions establish appropriate risk management systems and maintain adequate capital and liquidity. The law also gives the BoL purview over the adequacy of risk management in banks.

**The RBS Manual has been formally approved and is being applied.** BSD staff informed the mission that the manual is considered as an internal document, although parts of it may be shared with the banking industry in the future. The mission encourages the BoL to inform bankers as soon as possible about RBS methods and the BoL's supervisory expectations to reinforce that bankers need to manage risks prudently.

**Institutional Profiles (IP) and Risk Assessment Summary (RAS) documents have been prepared for all banks and foreign bank branches (FBBs).** BSD staff suggested and the mission agreed with minor changes to IP and RAS documents. Changes will improve efficiency and strengthen the focus on risk in the RAS. In particular, the mission identified the need to strengthen measures for liquidity and clarify the calculation of the foreign exchange net open position (FX NOP).

**The mission team recommended streamlining treatment of branches of the same bank.** For FBBs and branches of domestic banks, all branches of the same entity are best analyzed using a single IP, RAS, and report of onsite examination (ROX).<sup>3</sup>

**The BoL has improved its systemic report using key risk indicators and identifying trends over time according to types of institution.** The mission welcomed efforts for the draft systemic report and encouraged finalization and submission to senior management. The mission team recommends that a systemic report be prepared and provided to senior management on a quarterly basis.

**Planning and conducting onsite examinations has significantly improved.** The mission team favorably noted that the number of banks which had not been examined for long intervals has been reduced, and it is anticipated that further gains will be achieved in 2020. It was also noted that planning and timelines for inspection have incorporated prior recommendations although there is still room for improvement in identification of areas of focus.

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<sup>3</sup> Onsite examinations may be conducted separately but should use the same financial statement date.

**Table 1. Main Recommendations**

<b>Recommendations</b>	<b>Priority</b>	<b>Timeframe<sup>1</sup></b>
<b>Implementation of RBS</b>		
1. Streamline supervision of multiple branches of the same bank: use a single IP and RAS for each bank. Use a single ROX for each foreign bank (internally); continue using a separate ROX for each FBB (to notify the bank).	High	LT
2. Enhance cooperation and communication among offsite and onsite for planning inspections; prepare planning memo jointly.	High	ST
3. Establish Memoranda of Understanding (MOUs) with regulators of all countries with banks operating in Lao P.D.R.	High	LT
4. Give priority to conducting bankers' information seminar to explain RBS, Capital, CAMELS rating system, and roles and responsibilities of bank boards of directors and senior managers.	Medium	LT
5. As new regulations are issued pursuant to the new banking law, align and update RBS Manual to new requirements.	Medium	LT
<b>Offsite and Systemic Analysis</b>		
6. Use revised IP and RAS formats for all banks starting 2019:3Q. <ul style="list-style-type: none"> <li>Emphasize bank business models (primary risk-taking and earning sources) in IP.</li> <li>Identify summarized sources of significant risks in RAS.</li> </ul>	High	ST
7. Expand the scope of data collection and enhance liquidity analysis in RAS and systemic report. <ul style="list-style-type: none"> <li>Collect remaining maturity information so that short-term assets and liabilities may be presented.</li> <li>Present other measures of liquidity until short-term assets and short-term liability indicators are available.</li> </ul>	High	MT
8. Align calculation of total foreign exchange net open position (FX NOP) relative to capital to the Financial Soundness Indicator (FSI); continue to monitor each NOP FX to capital.	Medium	ST
9. Rely mainly on onsite examiners to rate "M" – management, as explained during the mission.	Medium	LT
<b>Onsite Examinations</b>		
10. Begin analysis with "big picture" view of performance, governance, and risk management; then look for anomalies and identify causes and possible risks. Focus first on asset quality and provisions, and then earnings, liquidity, and capital strength.	High	ST
11. Continue to focus the examination schedule on the largest and riskiest banks, and those with longest interval since last inspection; use targeted/limited scope inspections for smaller and low-risk banks.	High	ST
<sup>1</sup> ST means short-term (3–6 months), MT medium-term (6 months to one year), and LT long-term (more than one year).		

## I. BACKGROUND

### A. Introduction

1. **The primary focus of this mission was hands-on training of staff using actual bank data.** Activities during this mission concentrated on review, open discussion, feedback, and training for offsite activities and products (IP, RAS, and systemic report), and onsite inspections (examination planning, writing examination reports, and annual inspection schedule). The mission team supported onsite examiners by reviewing their work and providing advice to improve pre-examination planning, scoping, information requests, and conducting onsite examinations of banks.

2. **The Lao PDR financial system is largely concentrated in commercial banks.** Gross assets of the banking sector are LAK 144,318 billion (95 percent of estimated GDP).<sup>4</sup> The banking sector consists of 36 commercial banks and 1 specialized bank.<sup>5</sup> As of end-2019:Q2, the 3 state-owned commercial banks held 38 percent of banking assets; 20 foreign bank branches held 30 percent; 8 private banks, 14 percent; 8 foreign bank subsidiaries, 7 percent; 3 joint-venture banks, 8 percent; and 1 specialized bank, 2 percent.<sup>6</sup>

### B. Progress Since the Previous TA Mission

3. **The BSD has demonstrated favorable efforts applying RBS concepts (Table 2).** BSD staff have prepared IP and RAS reports for all banks and branches, and an improved systemic report has been drafted for submission to senior management. The BSD has conducted 18 onsite examinations to date in 2019. The number of onsite examinations completed and use of ROX format reflect increasing attention to risk and use of RBS methods; however, much of the narrative in RAS and ROX reports still emphasizes data volumes and changes rather than analysis of risk levels and trends. This is understandable for initial efforts, and BSD staff welcomed feedback and recommendations for improving analysis.

4. **The offsite team is now reviewing a broader set of financial indicators to update Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS) ratings and identify risk sources and levels.** This is a significant

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<sup>4</sup> Year-end 2018 estimated GDP, Article IV Consultation mission (August 2019)

<sup>5</sup> Previous mission reports showed 42 banks operating in Lao P.D.R. However, it was clarified during this mission that 4 of the 14 foreign banks operate a total of 10 branches in Lao, and the BoL licenses and treats each foreign branch as a separate “bank.” In reality, there are only 14 foreign banks operating branches in the Lao P.D.R.; 1 has 4 branches, and 3 have 2 branches each.

<sup>6</sup> Source: Bank of the Lao P.D.R.

improvement over previous practice. The consideration of peer performance for domestic banks and for foreign branches strengthens perspective on financial indicators.

**Table 2. Status of Recommendations Last TA Mission (March 2019)**

Recommendations	Priority	Status
<b>Implementation of RBS Tools</b>		
1. Officially approve RBS Manual; update as needed.	High	Done.
2. Complete IP and RAS for all banks.	High	Done.
3. Amend IP to focus on static profile data, RAS on dynamic risk data.	Medium	Done.
4. Use ROX format as recommended; focus on risk assessment, support of supervisory response action/s.	High	Done.
5. Prepare draft for bankers' seminar.	Low	Not done.
<b>Supervisory Ratings Framework</b>		
6. Provide better definitions for CAMELS ratings in RBS Manual.	High	Done.
7. Strengthen qualitative assessments for CAMELS ratings: <ul style="list-style-type: none"> <li>• Offsite: consider level, trend, and inter-relationships of components and financial ratios.</li> <li>• Onsite: discuss preliminary ratings with bankers at wrap-up meeting; disclose final rating in ROX.</li> </ul>	High	Being done; progress noted.
8. Develop qualitative criteria for FBB ratings.	High	In progress.
<b>Banking Sector Analysis</b>		
9. Strengthen banking system reporting; show system averages for key FSIs; add peer group averages	High	Report drafted.
10. Support system report with most recent RAS for largest banks and all problem banks.	Medium	In progress.
<b>Onsite Examinations</b>		
11. Conduct targeted or limited scope inspections for banks not examined for long time and systemically important banks	High	Substantially done.
12. Adopt internal BSD policy for onsite examination scheduling and timeline.	Medium	Criteria are included in Annex of the Manual.
<b>Supervisory Response</b>		
13. Adopt policy for supervisory response, corrective measures.	High	Awaiting regulations being drafted.

5. **The RBS Manual has been approved for internal use by the BoL senior management during this mission.** Minor adjustments to the RBS Manual were made to clarify concepts and intentions. BSD staff are applying RBS methods in practice.

6. **RBS methods are being applied progressively for analyses and examinations.** However, additional analytical skills development is needed. The mission reviewed and

coached BSD staff to help improve their analyses and narrative content of reports. Examples are:

- A holistic approach is needed for both banks and foreign branches—to understand the strategy, main products, performance, and financial standing (including branch standing within its parent entity).
- Greater emphasis should be placed on understanding root causes of identified risks—to make risk conclusions and supervisory response recommendations clearer.
- More attention should be paid to the interrelationships of financial indicators—to improve perspective on key ratios (e.g., a loan portfolio growing at 150 percent per year may not be problematic if it comprises only 5 percent of total assets).

## II. IMPLEMENTATION OF RBS

### A. Banking Law and Prudential Regulations

7. **The BoL is updating its legal framework.** A new commercial banking law became effective in June 2019. The new banking law is explicit that banks develop comprehensive systems for corporate governance, risk management, and internal audit. The law gives the BoL broad authority to ensure the safe and sound operations of banks, adequate capital and liquidity, risk management, disclosures, and consumer protection. The law also defines criteria and sets forth measures that may be taken for early intervention and resolution of banks in crisis. Practical application of many of the provisions in the new law requires promulgation of detailed regulations, and the BoL has established several task groups to work on drafting the new or revised regulations. The BoL has requested TA from the World Bank in this regard.

8. **Prudential regulations are being updated.** The BoL is revising and updating its regulatory framework to align with the new law. Sixteen regulations are in process of drafting or revision.<sup>7</sup> It is anticipated by BSD staff that the regulations will be completed by mid-2021. The BoL should ensure that the RBS Manual is updated to coincide with any significant changes to regulations.

### B. RBS Manual

9. **The Lao language version of the RBS Manual is final and has been approved by BoL senior management.** The RBS Manual has been finalized as an internal working document for BSD to conduct risk-based supervision. Going forward, it would be appropriate

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<sup>7</sup> Drafting of regulations is being supported by TA provided from the World Bank

for the BoL to prepare a summary document that can be shared publicly to help inform bankers of RBS methods and the BoL's supervisory expectations.

***Recommendation:***

- *As new regulations are issued pursuant to the new banking law, align and update the RBS Manual to new requirements.*

**C. Training all BSD Staff and Banker Information Seminar**

10. **Continued training of all BSD staff in RBS methods is needed.** Now that the RBS manual and tools are final, hands-on training is needed for all BSD staff. The mission conducted an introductory training session on RBS for many staff at the prior mission, and BSD managers have requested more training for future TA. In this regard, optimal results can be achieved working with actual data and building capacity through learning-by-doing. Strengthening the holistic understanding of each institution is essential in the short term. Specific expertise by risk topic should be developed as capacity strengthens.

11. **RBS methods and expectations must be explained to bankers.** Past missions have recommended, and BSD agrees, that a seminar to explain RBS objectives and methods to bankers is needed. Although the seminar has not yet been formalized, it remains very important to strengthen the BoL's risk-based approach and to hold bankers accountable for sound risk management. BSD managers said that a condensed version of the manual may be shared with bankers in the future. If desired, the preparation for a banker seminar on risk-based supervision may be supported through a technical assistance request.

***Recommendation:***

- *BSD staff should prepare and conduct an informational seminar for bankers to share supervisory priorities and expectations as soon as possible.*

**D. Criteria for Supervision of Foreign Branches**

12. **Analysis of foreign bank branches (FBB) is somewhat different than for domestic banks.** At present, examination activities and analysis, used by BSD for FBBs, are similar to that for domestic and separately capitalized subsidiary banks. While this is understandable, and generally acceptable given the limited experience and expertise of BSD staff, analysis of FBBs requires a slightly different approach.

13. **The mission provided training for analysis of FBBs.** As a first step, staff must assess the business model of an FBB to determine its intended purposes and activities in the Lao P.D.R. The IP should briefly summarize the parent bank strength, parent bank's support and oversight, and influence on the branch in the Lao P.D.R. Using available information, the supervisors should attempt to assess the overall bank; if available, a rating by an international

rating firm can help. Since FBBs do not have “capital” in the normal sense,<sup>8</sup> examiners should focus on the access to sources of capital including the extent of parent support, the quality of risk management oversight by the parent/home office, the level of head office funding support, the level of profits for head office repatriation, and any other factors that may affect safety and soundness of the Lao branch. Examiners should also consider onsite examinations provided by the home country regulator. In this case, the BoL should request their participation in onsite examinations, discuss the findings and remedial actions, and share the report.

**14. Memoranda of Understanding (MOUs) provide a basis for information sharing between supervisory authorities.** Fourteen foreign banks operate 20 branches in the Lao P.D.R., but so far, an information sharing agreement has only been agreed with the Bank of Thailand. Informal communication and cooperation are occurring through various channels, but more formalized MOUs are a requisite to effective cross-border supervision of multinational banking organizations.

***Recommendations:***

- *Establish MOUs with home country regulators for all banks operating in Lao P.D.R.*
- *Consider applying qualitative criteria for FBBs mentioned above in assessing the “M” component of the CAMEL rating.*

**E. Supervisory Response**

**15. The BoL is revising regulations that relate to supervisory responses.** The mission team was informed that the BoL/BSD is in the process of drafting/updating several regulations and has requested TA from World Bank for this. Two regulations, “Early Intervention” No. 811, and “Bank Resolution,” are expected to address supervisory responses. BSD managers indicated that, once these regulations are adopted, an internal policy for applying supervisory responses can be considered. The mission team cautioned that the BSD should not delay implementation of much-needed corrective actions. Depending on the final outcome of the regulations, a policy for supervisory responses may still be appropriate. The mission team suggests that the BoL begin developing a more defined range of supervisory responses that will be used based on identified risk levels, trends, compliance, and managerial capacities and cooperation. An example is provided for BoL’s consideration in Appendix I.

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<sup>8</sup> FBBs must hold “investment capital (quasi-capital),” which provides some protection and liquidity to Lao customers.

**Recommendation:**

- *When developing internal policy for applying response and corrective measures, refer to Appendix I.*

**III. OFFSITE SUPERVISION****A. IP and RAS**

16. **Since the transition to RBS began, the offsite team has completed IP RAS documents for all banks in the Lao P.D.R.** The mission reviewed IP and RAS documents for one commercial bank and one foreign branch. The sample documents provided a view of the current capacity of offsite staff in transitioning to RBS. Progress is noted; however, some streamlining is needed along with additional practice and coaching.

17. **The mission reiterated the need to make the IP more static and the RAS more dynamic.** The IP should reflect a bank's size and significance in the Lao PDR along with its ownership, leadership, business model, products offered, and specific markets served. The RAS should discuss a bank's performance in the most recent period, and it should identify the types and sources of net risk that should be monitored and examined.

18. **The mission provided sample IP and RAS documents with minor changes from the existing format.** The revised formats aim to emphasize a holistic view of each institution, streamline workflow, and improve risk focus. BoL management supports the slight rearrangement of information to streamline workflow and improve the focus on risk.

19. **Multiple branches, whether for domestic or foreign banks, should be viewed and evaluated together.** Several banks operating in Lao P.D.R. have multiple branches. For foreign banks, these are separately chartered branches. To date, the BoL has supervised these entities separately. The mission emphasized a holistic view, since branches are parts of one bank; therefore, it recommended that branches of the same bank be supervised as a group with a single IP and RAS. The mission also recommended that all branches of the same bank be examined using the same financial statement date and a single ROX be prepared.

**Recommendations:**

- *Implement revised RAS and IP format for all banks starting from 2019:3Q..*
- *Evaluate and supervise multiple branches of the same bank as a group preparing one IP, one RAS, and one ROX.*

## B. Data Quality and Performance Ranges

20. **Use of real bank examples identified two data issues.** Additional attention should be given to liquidity measures, and calculation and monitoring of the total net open position in foreign currencies should be clarified.

21. **Additional indicators of liquidity are needed.** In the examples reviewed, only a narrow measure of liquidity was referenced. Previous missions recommended more than one measure of liquidity, and two financial soundness indicators were agreed. The BoL had stated its plans to collect data to calculate liquid assets and short-term liabilities in 2018; this has not yet been completed. The BoL reiterated that it would begin collecting data to calculate liquid assets and short-term liabilities.<sup>9</sup> Until requisite data is available, the BoL should use other liquidity indicators<sup>10</sup> in RAS reports.

22. **Calculation of Total NOP should be reviewed.** The BoL closely monitors net open positions in individual banks but has not been calculating the overall NOP correctly. The total NOP calculation is recommended to be reviewed to ensure that it is harmonized with the FSI.<sup>11</sup> If the BoL regulations reference a different method, both the BoL method and the FSI method should be presented and monitored.

### *Recommendation:*

- *Enhance liquidity indicators presented in RAS; clarify calculation of total net open position in FX to capital ratio.*

## C. Systemic Report

23. **Offsite supervisors have drafted a report on the banking system for use by senior management of the BoL.** The mission welcomed discussions about the report and appreciated the opportunity to see graphic illustrations of some of the data provided in it. Prudential and risk ratios are clearer by institution type and time period. Some data can be presented better in table format rather than in narrative text. Other data may require a secondary scale for graphs to be meaningful. In particular, additional important indicators of institutional and systemic liquidity that the BoL calculates and monitors should also be included in the report (see paragraphs 21 and 22 for the examples of additional indicators).

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<sup>9</sup> Both liquid assets and short-term liabilities require remaining maturity information.

<sup>10</sup> E.g., (Cash + Due From Correspondents) / Customer Deposits; Gross Loans / (Deposits + Borrowings).

<sup>11</sup> Paragraph 7.83, the IMF 2019 Financial Soundness Indicators Compilation Guide.

**Recommendation:**

- *Add additional indicators of liquidity to the systemic report.*

**D. Training, Coaching, and Collaboration**

24. **Completed IP and RAS documents for two banks were used for training.** Using two actual banks with identifying information redacted, the mission was able to review data, analysis, and underlying issues with BSD staff. This enabled very effective hands-on training for offsite analysts and helped identify areas for additional work and analysis.

25. **A more holistic view of risk is needed; also, root causes of risk should be more clearly identified.** Shifting from a compliance focus to a risk-based focus requires practice, expertise, coaching, and validation. A broader understanding of each bank's business model<sup>12</sup> will strengthen IPs and better identification of root causes of risks will make RAS reports more effective. Initially, better analysis and use of data already supplied by banks will help to identify causes. As skills strengthen, targeted communication with bankers to understand data and deepen the analysis will enhance the transition from RAS to onsite planning.

26. **The mission noted that the "M" rating for bank management is best assigned during an onsite inspection.** Offsite examiners have a view of managerial effectiveness based on financial results; however, this approach is not forward looking and is less accurate. Onsite examiners have better insight to the adequacy of bankers' risk management policies and procedures, their responsiveness to problems, and their business strategy. For these reasons, the "M" rating in the CAMELS rating is best assigned by onsite examiners.

27. **Collaboration between offsite and onsite teams is essential.** The mission appreciated that communication and collaboration between offsite and onsite staff has improved significantly over the past two years. Continued cooperation will enhance the understanding of banks, improve risk identification, strengthen the focus of examination activities, and ensure more effective supervision.

**Recommendations:**

- *Emphasize bank business models (primary risk-taking and earnings sources) in IPs.*
- *Identify and summarize root causes of risk areas in RAS reports.*

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<sup>12</sup> Reference documents include bank or parent bank's annual report, strategy, profit goals, and areas of emphasis in the current and next time period. Bank rating agencies can profit insight for larger institutions while smaller banks may be tracked locally or through consultation with home country supervisors. As skills strengthen, analysts can communicate directly with bankers to understand planning processes, profit goals, and risk management oversight. Results should be summarized in the RAS.

- *Rely primarily on onsite examiners to assign “M” rating for management.*

#### IV. ONSITE SUPERVISION

##### A. Planning and Conducting Onsite Examinations

28. **Planning onsite examinations can be further improved.** The process used by the BSD to plan onsite examination is generally good, but emphasis remains on compliance rather than risk. At present, pre-planning is a joint effort of offsite and onsite staff reviewing information contained in the most recent IP and RAS reports plus information from the previous inspection and offsite monitoring. A memo to the division manager detailing issues to be investigated at the current inspection is prepared by onsite staff.

29. **The mission reviewed the IP, RAS, and planning memo for a sample bank.** The planning memo for a bank being examined during this mission showed that emphasis was on compliance issues rather than risks. The memo had two sections: a short paragraph, stating whether compliance issues identified at the last examination had been corrected; and a list of issues to be reviewed at this inspection. Seven of the eight items listed for review pertained to compliance to the BoL rules while only one dealt with risk. This was discussed in detail with BSD staff, pointing out that the main purpose of most onsite inspections should be safety and soundness. Further review of data showed negative trends for key ratios such as nonperforming loans (NPL) and capital, a high level of large credit exposures, and especially one large exposure that was more than one-third of capital and in excess of the single borrower limit. In order to improve the planning process, the mission team provided an improved format for the planning memo.

30. **Real bank data allowed the mission to assist staff in conducting more effective analysis and planning techniques.** Similar to the approach used for offsite training, actual data from the sample bank was used for an effective learning exercise on how to properly analyze information and plan an examination. As a result, examination activities were immediately revised to concentrate on asset quality, the impact on capital, and actions that the BoL may need to take to mitigate further risk.

31. **The mission reviewed BSD’s timetable for onsite inspections and examination reports.** The mission favorably noted that the timeline used by the BSD is similar to the sample provided at the previous mission, just a bit shorter, reflecting the smaller number of staff and the less complex nature of most banks operating in the Lao P.D.R.

32. **For most banks operating in the Lao, lending and deposit-taking are the main activities and loans are the bulk of assets.** Review of asset quality is usually the most important examination task followed by analyzing adequacy of loan loss provisions, the impact on earnings and liquidity, and adequacy of capital. If FX trading is a significant

activity or if a bank has a substantial volume of loans and investments in FX funded by FX deposits or borrowings, then analysis of the FX NOP becomes important.

**33. Credit analysis should focus on repayment capacity and collateral support.**

When analyzing loans or equity investments (e.g., debentures), it is important to determine repayment capacity from normal operations. If repayment capacity is in doubt, collateral as a secondary source of repayment must be evaluated, i.e., the realistic value on a recovery basis. Examiners must assess whether valuations are reasonably supported by reliable information such as comparable sales data, income data, replacement data, etc.

**34. Compliance is important, but risk management and governance should receive greater emphasis.** Checking compliance to lending limits is necessary, but the quality of assets is usually more important in understanding the effectiveness of risk management and the adequacy of governance. If loans to a single customer exceed the single borrower limit, examiners should determine why the over-limit debt occurred. The following questions should be addressed:

- Were loan officers not paying attention to total debt? Was bank management and/or board of directors not concerned about prudential limits? Review the loan committee and board minutes to determine how the loan/s were approved.
- If a loan exceeds limits, whether regulatory limits or board-approved internal limits, ask how and why the over-limit loans were granted, and what and when the banker intends to bring line into compliance.

**35. The mission reviewed with BSD staff progress on the 2019 onsite examination schedule.** The 2019 schedule originally contemplated 17 inspections but was revised to 19. As of 2019:Q3, 18 inspections have been completed, 1 is being done during this mission, and it is possible that 2 or 3 more could be done by year's end.

**36. Table 5, in Appendix II, shows progress made by the BSD conducting onsite inspections for banks where the interval since previous exam was more than two years.** The mission team is favorably impressed that the interval exceeds 18 months for only a few banks and the size and risk levels for those banks is much lower than noted at previous missions.

**37. Schedule for onsite examination for the year 2020.** A schedule has not yet been prepared for 2020, but it is anticipated that 20–23 inspections can be made. Using available data, the mission helped BSD staff identify six banks that should be top priority for inspection in 2020. The primary criteria for selecting these banks included the relative asset size, interval since last examination, RAS risk ratings, systemic importance, and other factors such as ownership, supervision by home country regulator, and restructuring plans. The mission team also recommended that targeted or limited scope inspections requiring only one week could be conducted for many smaller banks where the interval since last examination is

18 months or more. This will allow a quick check to determine whether more intensive review or supervision is needed.

***Recommendations:***

- *Identify areas of focus through closer cooperation between onsite and offsite teams to plan onsite inspections. Exam memo outlining areas of focus should be prepared jointly by onsite and offsite.*
- *Analysis should start with a “big picture” view of bank performance, governance, and risk management; then look for anomalies and outliers to identify probable reasons and possible risks. For most banks, focus first on asset quality, then probable impact on provisions, earnings, liquidity, and capital strength, etc.*
- *Continue to focus examination schedules and activities on the largest and riskiest banks and those with longest interval since previous exam.*

**B. ROX**

38. **A sample ROX was provided for review and comment.** The BSD staff provided a first draft of an examination report for the mission to review and give feedback. The report was for the same bank as the IP and RAS used by offsite. The mission team noted that, while some data elements and analytical narrative in the ROX may be completed in advance, conclusions should not be drafted until they are supported by analysis of facts gathered during the onsite examination.

39. **The format used for ROX is largely as recommended.** The BSD has adopted and is using the ROX format recommended. The challenge going forward is for examiners to identify and properly evaluate risk levels, trends, and causal factors, and to provide well-supported analytical comments—condition, cause, impact—in the ROX. This requires more on-the-job work conducting examinations, writing reports, and coaching from TA experts.

40. **Recommendations have been offered for the BSD to disclose and discuss with bankers the CAMELS rating assigned at the conclusion of onsite examinations.** At present, the BSD prepares two copies of an examination report (ROX): one copy retained internally by the BSD shows the individual CAMELS component ratings and the overall rating; a second copy provided to the bank does not show the ratings. Examiners do verbally discuss risk levels, trends, and concerns in the wrap-up meeting with bankers but do not yet disclose ratings. The BSD staff indicated that disclosure of ratings may be done at some point in the future.

**Recommendations:**

- *Statistical data, FSI ratios, and some analytical text can be prepared prior to start of onsite activities; however, properly verified and well-supported examination findings and conclusions can only be written after conducting an examination.*
- *The BSD should give priority to conducting bankers' informational seminar to explain RBS and CAMELS rating system so that ratings can be shared and discussed with board of directors and managers of each examined bank.*

**V. FUTURE TA NEEDS**

41. **The Deputy Governor and senior management of the BoL expressed a desire for continued TA.** Transition to RBS from compliance-based supervision requires extensive capacity building and hands-on training for all BSD staff. Most TA activity so far has focused on developing the concepts, manual, and tools; going forward, there must be more practical application, experience, and learning-by-doing/on-the job training for BSD staff, preferably related to specific bank(s) being evaluated for periodic RAS and examination planning. In addition, bankers must be better informed about RBS methods and what will be expected of them.

42. **Future TA to further enhance its RBS framework and facilitate implementation will depend on priority and funding.** If funding were to be available and the authorities approve it, at the technical level the mission would examine the option of having peripatetic visits. The BoL does not presently have its own experts in RBS, although the mission encourages the development of RBS skills with a view toward the BoL developing and providing its own introductory and intermediate courses. At this stage, capacity development can best be achieved by working closely with staff analyzing actual bank data. Offsite analysts and onsite examiners need more coaching and on-the-job experience to identify risks, assign ratings, and prepare well-supported narrative reports. This can best be achieved by TA visits at regular intervals.

43. **In terms of modality, future missions can be provided to the BSD staff with classroom training on specific risk areas (e.g., credit, liquidity, or market risks) for one week; followed by an onsite examination of that risk area for one week.** The subject matter experts would help enhance the pre-examination planning, risk analysis, and assist with or coach onsite examination activities if needed. This process would cover the full range of pre-examination discussions, documenting preliminary risk assessments, formal presentation request from a bank, and team interviews with a bank's executive and functional heads in banks. On completion of the examination, the experts could work with examiners to collate the findings and conclusions and develop a draft report of examination.

44. **The future missions on RBS will be designed in consultation with the World Bank to avoid overlaps and ensure consistency in TA advice.** The BoL has requested the World Bank to provide TA covering a broad range of financial sector issues in Lao P.D.R. These include TA on prudential regulations (e.g., capital adequacy, liquidity, large exposures, consolidated supervision, etc.) and reporting and disclosure requirements of banking data. The IMF will provide TA on hands-on coaching with a focus on supervisory tools and practical implementation of these new rules.

## APPENDIX I. SUPERVISORY CATEGORIES AND TYPES OF RESPONSES

### A. Supervisory Categories

At the conclusion of an onsite examination, banks will be assigned a CAMELS rating and grouped into one of five Supervisory Categories as shown in Table 3 below. The Supervisory Category reflects the CAMELS rating, Risk Profile and Capital Adequacy of the bank. The assigned Supervisory Category will be the basis for an initial decision on the type of supervisory response.

Table 1. Supervisory Categories				
Overall Condition	Composite CAMELS	Description		
		Risk Profile	Capital Adequacy	Other Characteristics
<b>Sound; Non-problem</b>	1, or 2 with no adverse trends	Low; or Moderate and decreasing	Adequately to well-capitalized	No material problems or matters of significant supervisory concern; deficiencies are correctable in normal course of business.
<b>Potential Problem</b>	3, or 2 with only modest adverse trends	Low but increasing, or Moderate and steady, or High but decreasing	Inadequate; somewhat under-capitalized	Limited to moderate supervisory concern; capital ratios may be slightly above minimums but not adequate; deficiencies require immediate, ongoing attention to avoid financial deterioration.
<b>Problem; Troubled</b>	4, or 3 with adverse trends	Moderate and increasing, or steadily High	Under-capitalized to significantly under-capitalized	May still be operationally profitable and tangible equity capital may be above 2.0 percent of total assets, but adverse reports indicate poor condition.
<b>Failing; Imminently Insolvent</b>	5, or 4 with serious adverse trends	Steadily High and or increasing	Significantly under-capitalized	Tangible equity capital less than 2.0 percent of total assets and bank operationally unprofitable (losing money before loan loss provisions and non-cash charges for depreciation and amortization).
<b>Failed; Insolvent</b>	5	(Risk Profile irrelevant)	Critically under-capitalized	Negative tangible equity capital, i.e., liabilities exceed assets after making adjustments to establish adequate loan loss provisions and eliminate assets of negligible or non-bankable value.

## B. Types of Responses

Supervisory responses may be informal or formal. In either case, the objective is to (a) restore troubled banks to an acceptable condition as quickly as possible and (b) remove banks that are not salvageable at least possible cost. Types of responses are discussed below.

**(a) Informal Responses**—informal supervisory responses are used under general authority to supervise and regulate banks. Informal responses may be developed in cooperation with a bank, but implicit in the process will be strong encouragement that boards of directors should agree to the corrective measures suggested by the BSD. Two types of informal responses commonly used are Board Resolution and Memorandum of Understanding.

**(b) Formal Actions**—formal supervisory actions, such as corrective orders and enforcement actions, are taken as circumstances or the Banking Law requires. Formal actions will cite the legal authority under which the action is taken and the unsafe and unsound practices/conditions justifying the action, and will list specific measures that must be taken to correct problems. Failure to substantially comply with an enforcement action will be a basis for imposing more restrictive sanctions.

Formal actions are unilaterally imposed by the Bank of Lao P.D.R. as the law requires. There may be leeway for compromise on specific provisions, but major provisions of formal actions will not be negotiated with bank directors, managers, or shareholders. Banks may not agree with a formal action but must acknowledge that they have received, read and understand an action.

**(c) Penalties and Fines**—violations of the Banking Law or applicable regulations are a basis for imposing fines. Fines have limited value for improving a bank in weak condition and may weaken a bank further if fines are paid from resources of the bank. Fines also have limited value for correcting unsafe and unsound practices because of the time and legal challenges involved. Fines, however, can be useful to deter future misconduct.

<b>Table 2. Minimum Recommended Responses</b>	
<b>Supervisory Category</b>	<b>Minimum Response</b>
<b>Sound; Non-Problem Bank</b>	Normal Surveillance and Examination. Meeting with board of directors at end of examination. Bank to send Written Response to examination findings.
<b>Potential Problem Bank</b>	Any or all the above plus: Board Resolution to address deficiencies. Memorandum of Understanding. Corrective Order. Corporate Leverage (e.g., branch approvals).
<b>Problem; Troubled Bank</b>	Any or all the above plus: Order to Appoint Consultant/Advisor. Removal/Suspension of Directors or Officers. Reorganization, Restructuring, Merger. Notice of Intent to Cancel License. Directions/Conditions after Notice of Intent to Cancel License. Restriction/Suspension of Banking Activities.
<b>Failing, Imminently Insolvent; and Failed, Insolvent Banks</b>	Any or all the above plus: Capital Demand and Order Taking Control. Liquidation and Revocation of License. Vesting. Monetary Penalties.

## APPENDIX II. INTERVALS BETWEEN ONSITE EXAMINATIONS

Table 1. Intervals Between Onsite Examinations

Interval (in months)	Last Mission Mar-2019	This Mission Sept-2019
≥ 24	11	4
24	5	2
21	7	--
18	1	8
15	4	5
12	7	1
9	1	--
6	--	7
3	2	4
< 3	--	4
No Exam	5	2
	<b>43</b>	<b>37</b>

**Source:** Bank of LAO P.D.R.

**Note:** Change in number banks from last mission to now reflects actual banks operating in Lao P.D.R., rather than branches.