

Lao People's Democratic Republic: Technical Assistance Report-The Development of Risk-Based Supervision



# LAO PEOPLE'S DEMOCRATIC REPUBLIC

## TECHNICAL ASSISTANCE REPORT—THE DEVELOPMENT OF RISK-BASED SUPERVISION

May 2018

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Monetary and Capital Markets Department



**LAO People's Democratic Republic.**

## **THE DEVELOPMENT OF RISK-BASED SUPERVISION**

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**February 2018**

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**GLOSSARY**

BoL	Bank of Lao
BSD	Bank Supervision Department
CAELS	Capital, Asset Quality, Earnings, Liquidity, and Sensitivity to Market Risk
CAMELS	Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk
FIRST	Financial Reform and Strengthening Initiative
FSIs	Financial Soundness Indicators
IP	Institution Profile
MCM	Monetary and Capital Markets Department (IMF)
NPL	Nonperforming Loan
RAS	Risk Assessment Summary
RBS	Risk-Based Supervision
ROX	Report of (Onsite) Examination
TA	Technical Assistance

**PREFACE**

At the request of Bank of Lao P.D.R. (BoL), a Monetary and Capital Markets Department (MCM) technical assistance (TA) mission visited Vientiane, Lao P.D.R., during the period November 13–24, 2017. The main objective of the mission was to further assist the Banking Supervision Department (BSD) of the BoL in transitioning to risk-based supervision (RBS) of banks. The mission team held discussions with Deputy Governor Vathana Dalaloy and staff from the BSD. The mission is grateful to the BoL’s management and staff for their excellent cooperation and warm hospitality which greatly facilitated its work.

## EXECUTIVE SUMMARY

**Over the past few months, the BoL has made great strides in preparing for implementation of risk-based supervision of banks.** A new supervisory manual reflecting key principles of risk-based approach to supervision has been drafted. The manual includes templates of Institutional Profile (IP), Risk Assessment Summary (RAS), and Report of Onsite Examination (ROX). The work on benchmarking financial soundness indicators (FSIs) and enhancing onsite examination procedures has advanced. New staff members with specialist skills have been recruited.

**The adoption of the supervisory manual and preparation of IP and RAS for all banks operating in Lao P.D.R. will be an important milestone in a move to RBS.** The mission provided recommendations to improve the structure and content of the draft supervisory manual and supported the BoL's plan to adopt the manual before the end of 2017. The mission also reviewed draft IP, RAS, and ROX templates, and provided guidance to the BSD staff on the preparation of IP and RAS for one bank. While the BoL's plan to finalize the IP and RAS for all commercial banks before the end of 2017 is welcome, the mission stressed that this ambitious, self-imposed deadline should be met only if it does not compromise the quality of the work.

**The mission welcomed the drafting by BSD staff of benchmarks for 17 out of 19 financial indicators.** It offered a few specific recommendations to improve the benchmark analysis and emphasized the importance of collecting relevant and reliable data. The mission also noted that any quantitative assessment must be supported by a qualitative analysis.

**The new draft template of the ROX is broadly in line with the past TA recommendations.** Some improvements could (i) support the analysis of trends over longer periods of time, and (ii) emphasize exceptions to prudential and/or regulatory norms. Planning an onsite examination using new RBS methods is a logical next step.

**Implementation of RBS remains a multi-year project.** The adoption of new procedures should be followed by appropriate training of all BSD staff. The supervisors would need to become more analytical and able to explain the rationale for their assessments to the management or directors of the bank. The legal and regulatory frameworks will require a comprehensive review to support the implementation of RBS. Finally, it will be essential for BSD not just to focus on assessing individual institutions, but also to ensure the adoption of corrective measures as well as the monitoring of how the bank responds.

Key recommendations of the report are summarized in Table 1. The report also presents an agenda for the future IMF TA missions.

**Table 1. Main Recommendations**

<b>Recommendations</b>	<b>Priority</b>	<b>Timeframe<sup>1</sup></b>
<b>General</b>		
Finalize working version of RBS manual and supporting documents (IP, RAS, ROX)	High	ST
Continue development of RBS analytical and examination skills among all BSD staff through appropriate training	High	ST
Conduct periodic reviews of the coverage and quality of the collected data	Medium	LT
Review the legal and regulatory frameworks to support the risk-based approach to supervision	Medium	LT
Begin developing internal BoL policy for applying appropriate regulatory responses and corrective/enforcement actions	Medium	MT
<b>Offsite Supervision</b>		
Prepare and utilize IP and RAS for all banks	High	ST
Further develop and refine benchmarks for FSIs	Medium	MT
<b>Onsite Supervision</b>		
Prepare risk priority-based onsite examinations schedule for 2018	High	ST
Apply RBS onsite examination procedures for all examinations	High	LT
Formulate the scope and areas of focus for onsite examinations using IP/RAS/last ROX and discussing with offsite analysts	Medium	LT

<sup>1</sup> ST means short-term (3–6 months), MT means medium-term (6 month to one year), LT means long-term (more than one year).

## I. BACKGROUND

### A. Overview of the Banking Sector

1. **The banking system in the Lao P.D.R. grew rapidly in recent years.** At present, there are 42 banking institutions, up from only 12 in 2006. There are 28 branches or subsidiaries of foreign banks, 7 locally owned private banks, 3 joint-venture banks, 3 state-owned banks, and 1 specialized bank. The three state-owned banks hold approximately 43 percent of total assets, the foreign banks 28 percent, the private banks 19 percent, and the joint-venture banks 10 percent.

2. **Rapid growth has led to concerns about financial stability.** The rapidly increasing number of banks placed a significant burden on the BSD's compliance-based supervision and limited its effectiveness. The three-fold increase in the number of banks and rapidly growing portfolios of banks have led to rising concerns about financial stability.

3. **The reported financial soundness indicators may mask vulnerabilities.** The reported financial soundness indicators may be misleading due to the rapid—albeit decelerating—credit growth. Of particular concern is the recent increase in foreign currency lending which is financed by external borrowing. There are weaknesses in regulatory and supervisory capacity, with most supervision staff having relatively little experience.<sup>1</sup>

### B. Progress Since the Last Technical Assistance Mission

4. **In 2016–17, MCM provided TA to BoL to strengthen banking supervision.** The TA project, financed by the FIRST Initiative, was designed to help BoL transition to RBS. The project consisted of three short-term missions at approximately six-month intervals. The first mission (April 2016) identified gaps in BSD's supervisory approach and created a road-map for transitioning to RBS. The second mission (November 2016) provided high-level recommendations on preparing an RBS manual. The third mission (April 2017) provided more focused technical recommendations on the manual and associated supervisory tools, which included IP, RAS, and ROX. The project also assisted BoL in developing a more useful supervisory information system for offsite monitoring.

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<sup>1</sup> At end-2016, less than one-third of the combined staff of the on-site and off-site supervision divisions had more than five years' experience.

**Table 2. Status of Recommendations of the April 2017 TA Mission**

<b>Recommendations</b>	<b>Status</b>
<b>General</b>	
Proofread, edit, and finalize draft RBS manual	Expected to be adopted by end-March 2018
Train all staff on use of the RBS manual	Ongoing
Communicate RBS system to banks and other stakeholders	To be done
After implementation, reassess procedures in RBS manual, adjust if needed	To be done
Adopt a process for responding to identified problems in supervised institutions	To be done
Establish Memorandum of Understanding with home country supervisors of foreign bank branches, subsidiaries, and joint venture banks operating in Lao P.D.R.	To be done
<b>Offsite Supervision</b>	
Begin using new RBS offsite procedures and prepare test IPs	Done
Calculate new set of 19 key indicator ratios for all banks	Done <sup>1</sup>
Review new key indicator ratios for all banks; benchmark data for preliminary ratings	Done
Using new key indicator ratios for all banks, analyze, and report on system performance	Done
Prepare IPs for all banks and update them appropriately <sup>2</sup>	Ongoing
<b>Onsite Supervision</b>	
Begin applying RBS onsite examination procedures	Done
Use IP and RAS for pre-examination planning	Done
Use CAMELS rating system and ROX for reporting findings and conclusions	Done

<sup>1</sup> 17 indicators have been benchmarked; work is under way for the remaining indicators.

<sup>2</sup> Quarterly, after an onsite examination, or when the bank's risk profile changes significantly.

5. **The TA project enjoyed strong ownership of the BoL.** The BoL established two dedicated teams of five people covering the onsite and offsite supervision. The team format proved to be very useful in knowledge exchange, hands-on training (i.e. “learning-by-doing”), and capacity building. The 10 members of the 2 task forces remained in place throughout the project, which was a sign of commitment and interest in the project. BoL staff have demonstrated an increased willingness to engage with the missions and have been enthusiastic about moving forward.

6. **As a result, BSD has achieved substantial progress in implementation of the past TA advice (Table 2).** Under the guidance of BoL senior management, the two dedicated teams have worked together to finalize a comprehensive draft manual that incorporates step-by-step procedures for both offsite analysis and onsite examinations. BSD staff have also been proactive by undertaking field testing of the new methods. An IP and RAS was prepared for one bank, and a ROX was prepared using the revised format that incorporates the CAMELS components.<sup>2</sup>

## II. CURRENT CHALLENGES IN IMPLEMENTING RBS

### A. Supervisory Manual

7. **The adoption of the supervisory manual and preparation of IP and RAS for all banks operating in Lao P.D.R. will be an important milestone in a move to RBS.** The mission provided recommendations (below) to improve the structure and content of the draft supervisory manual, draft IP and RAS templates, and draft ROX format. The mission supported the BoL’s plan to adopt the manual shortly. The mission also welcomed the intention to draft IPs and RASes for all banking institutions before the end of 2017, but noted that the initial drafting of an institution’s IP or RAS requires thought and care, which should not be compromised by a tight deadline. As of late November 2017, the IP and RAS for only five banks were completed.

***Recommendations: Finalize and adopt the RBS manual. Complete the IP and RAS for all banking institutions. Draft the supervisory strategy in consultation between Offsite and onsite, each providing perspective on managerial capacity and risk management effectiveness.***

8. **Drafting the IP and RAS requires close cooperation between different divisions of the BSD.** The BoL should have one strategy, IP, RAS, and CAMELS rating for each bank. Information sharing and regular exchange of views between different divisions of BSD is

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<sup>2</sup> The CAMELS components are Capital adequacy, Asset quality, Management quality, Earnings, Liquidity, and Sensitivity to market risks. The RAS matrix focuses on seven primary banking risks: Credit, Market, Liquidity, Operational, Compliance/Legal, Reputational, and Strategic; these are evaluated in terms of level, trend, and the quality of the risk management/mitigation efforts of a bank’s board of directors and executive management.

crucial for effective implementation of RBS. It will be important for both onsite and offsite divisions to utilize the uniform format for all these RBS tools. The onsite and offsite examiners have committed to work together during each phase of examination planning, execution, problem correction, and monitoring.

**a. Offsite Analysis**

9. **Recently drafted benchmarks for 17 financial indicators will need further refinements.** Benchmarks proposed by task force members provide a good starting place for discussions and a good basis for comparing bank performance using standardized measures. Benchmarks have been organized into ranges based on banks' performance in the Lao P.D.R. during the last 3½ years. Prudential indicators and operating norms widely accepted in the industry were considered when setting the ranges. The mission reviewed the benchmarks with task force members and offered recommendations including possible use of two or three peer groups, refinement of one indicator, and review of the benchmark ranges once during the first year of use.

*Recommendation: Continue referencing and testing data benchmarks when analyzing bank performance, assessing risk levels, and proposing supervisory strategies in the IP and RAS. Test possible use of peer groups. Review the effectiveness of the key indicators listed in the manual.*

10. **Implementation of the new set of financial indicators revealed data gaps in the BoL's database.** Preparation of three ratios focused on short-term liquidity was not possible due to the absence of information regarding remaining maturity of less-than-one year for assets and liabilities. To achieve a better granularity, BoL drafted a new reporting requirement. More generally, data collection should be reviewed periodically to ensure that the collected data are relevant and reliable.

*Recommendation: Conduct periodic reviews of the coverage and quality of the collected data. Test and implement the new liquidity reporting requirement to provide data to prepare short-term asset and liability ratios.*

11. **Supervisory conclusions must be supported by qualitative analysis.** The offsite team has completed five reports for banks using the RAS agreed by the task force. The mission reviewed with the offsite members of the task force the financial data and qualitative information summarized in the RAS for one bank. Discussions were thoughtful and areas of risk were identified appropriately.

12. **Members of the offsite team described challenges in estimating approximate levels of risk and risk management summarized in the RAS.** The mission offered sample descriptions of low, moderate, above average, and high risk and strong, acceptable, needs improvement, weak risk management. The mission also suggested that a small chart showing

the cross-relationships of risk levels and quality of risk management be added to the manual (Figure 1).

***Recommendation: Define qualitative descriptions of risk levels and risk management quality and incorporate them in the manual. Also, add a cross-relationship matrix of risk quantity and risk management quality to encourage consistent conclusions and appropriate emphasis.***

Figure 1. Risk Level and Mitigation Relationship

Aggregate Quality of Risk Management	Level of Inherent Risk			
	Low	Moderate	Above Average	High
Net Risk Assessment				
Strong	Low	Low	Moderate	Above Average
Acceptable	Low	Moderate	Above Average	High
Needs Improvement	Moderate	Above Average	High	High
Weak	Above Average	High	High	High

Source: Office of the Superintendent of Financial Institutions Canada, December 2010

13. **The RBS manual includes detailed discussions and examples of the interrelationships between CAMELS components and RBS risks.** The manual offers good conceptual guidance, and it is anticipated that BSD staff will fully grasp the interrelationships when summarizing CAMELS ratings and evaluating levels of risk.

14. **Guided discussions using actual data helped build capacity.** The BoL provided the mission with data points from one supervised institution, and the mission worked with task force members to review and discuss the preparation of the IP and RAS. This hands-on approach proved very useful to task force team members. The exercise also identified some opportunities to improve offsite presentation of data for evaluation, including a holistic review of data and verification that income ratios have been annualized.

***Recommendation: Implement a review or quality control process for analytical data in the IP.***

#### **b. Onsite Examination Procedures**

15. **The new draft ROX template can be improved.** The ROX format developed by the onsite team is largely based on the sample format provided at the previous TA mission.

Improvements should (i) support the analysis of trends over longer periods of time, and (ii) emphasize exceptions to prudential and/or regulatory norms. For example, presentation of FSIs and key ratios for the CAELS factors can be improved by using a longer time horizon. The onsite team considers that ratios from five previous quarters (15 months) provide a more accurate picture of performance than the three year-ends plus year-to-date (3+ years) as recommended by the mission.

**16. Analytical comments tend to emphasize compliance and changes over risks.**

Having reviewed a recent draft examination report prepared in the new format, the mission was favorably impressed with BSD's first attempt at a forward-looking, risk-based analysis of findings. However, analytical commentary remains more on compliance issues and changes in stocks rather than on the underlying reasons and probable future impact. This is normal for examiners in the nascent stages of transition to risk-focused analysis. Further exposure to working with actual data will substantially accelerate the learning curve, and reports of examination will be significantly improved.

**17. Evaluating bank management—the “M” in CAMELS rating—was cited by BSD staff as one of the immediate challenges.**

Evaluation and rating of management is a qualitative process based mainly on an assessment of the adequacy of policies, procedures, controls, and oversight. Risk management in banks is an important component of management evaluation.<sup>3</sup> In contrast to the CAELS components, which are quantitative and reflective of past performance, an assessment of “M” is more forward-looking. The “M” component is not currently rated by offsite analysts, but an attempt is made during onsite examinations relying primarily on the ratings assigned to the CAELS components. The mission discussed with BSD staff the advantages of using a more detailed methodology for evaluating the written risk-management policies and practices of bank management. One objective of future TA missions will be to help BSD staff develop their skills in making appropriate qualitative judgments.

**18. Plans for 2018 onsite examination schedule were discussed with BSD staff.**

The mission discussed planning methods for the 2018 onsite examination schedule with staff and offered input on the priority, selection, and timing of banks to be examined. Although the RBS manual has not yet been formally put into practice, the mission was impressed with BSD's awareness of risks and common sense approach to scheduling inspections. Use of the IP and RAS will support further refinements and improvements to examination scheduling and scoping.

**19. Planning an onsite examination using new RBS methods is a logical next step.**

The mission provided assistance to staff in planning an actual onsite examination using the risk-based methods and offsite data. The mission also responded to staff questions on practical

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<sup>3</sup> At present, risk management practices in local banks seem to be very basic and underdeveloped, while some foreign banks are applying risk management practices of their parents.

application of rating methodologies. Once IPs and RASes have been prepared for all banks, the planning process will be much improved and a more practical, “real-time” task.

***Recommendation: Onsite inspectors should formulate the scope and areas of focus for onsite examinations by reviewing IP/RAS/last ROX data and discussing with offsite analysts.***

## **B. Capacity Building of BSD Staff**

20. **The implementation of RBS will require capacity building of the BSD staff.** The supervisors are currently accustomed to more finite judgments (i.e. point-in-time, comply-not-comply) and understandably are anxious about making forward-looking *risk-based* judgments. The members of the two task force teams (offsite and onsite) are now familiar with the concepts and procedures and are beginning to implement them.

21. **Transition will take time as confidence in judgments is a learning process.** The implementation of RBS methods is planned to start in 2018, but based on experiences of other countries, full and effective implementation of RBS is likely to take 3–5 years as examiners and analysts become more proficient in making judgments about levels of risks and the quality of risk mitigation. The RBS manual is analogous to a comprehensive guidebook; detailed instructions are provided for various inputs but achieving master level skills requires much practice and learning-by-doing. Staff should become more analytical and proactive in their approach. They also should be able to explain the rationale for their assessment to the management or directors of the bank.

22. **Practical support from BoL senior management will promote effective transition.** During the learning/implementation phase, it will be critical for BSD managers and BoL senior management to give practical support to staff. This would include embracing new report formats, emphasizing forward-looking assessments of risks and qualitative judgments, and giving lesser attention on checking compliance to rules, some of which may have impractical requirements or unintended consequences (see below).

23. **Managers for onsite and offsite divisions noted that job descriptions for respective staff may need to be reviewed/revise to reflect practical changes resulting from the transition to RBS.** For instance, although offsite staff may have primary responsibility for preparing and regularly up-dating the IP and RAS, close cooperation and input is required from onsite staff.

***Recommendation: BSD staff should develop the necessary analytical skills to become more proactive while avoiding undue anxiety regarding the accuracy of judgments.***

### C. Consolidated Supervision and Cross-Border Supervisory Cooperation

24. **An effective RBS requires supervision of banking institutions in a holistic manner.** As discussed in more details in the previous TA reports, the consolidated supervision is needed in order for the BoL to fully understand risks faced by individual institutions, and improve the BoL's ability to take supervisory action when necessary.

25. **Information on foreign banks is critical to effective RBS.** The majority of banks operating in the Lao P.D.R. are subsidiaries or branches of foreign banks or have foreign joint-venture owners, so it is imperative that the BoL establish good lines of communication and cooperation with home country regulators, preferably by adopting reciprocal MOUs for data sharing. Authority for sharing information and cooperating with foreign regulatory authorities should be made explicit in the new banking law. In the interim, BSD managers should continue to maintain informal communication channels with their home country counterparts.

### D. Review of the Legal and Regulatory Frameworks

26. **Effective RBS must be supported by appropriate legal and regulatory frameworks.** As the new risk-based methods are put into practice, issues relating to prudential regulations and the banking law may become apparent, indicating that either RBS procedures need to be amended or that laws/regulations need some revisions. The legal framework should provide the BoL with sufficient powers, which would not constrain it in the process of implementation of RBS. The regulations should be practical and enforceable, contributing to a sound risk management in banks. The BoL is in the process of drafting a new banking law and relevant regulations.<sup>4</sup> For the new law and regulations to fully support an effective RBS system, close coordination between the onsite and offsite divisions of BSD and the legal and regulations divisions will be beneficial.

27. **The current banking law does not provide adequate legal protection for BSD staff performing their lawful duties.**<sup>5</sup> The best international practices require that supervisors have immunity from prosecution in the lawful performance of their duties. Failure to provide such an immunity often leads to supervisory forbearance, which undermines sound financial discipline and denigrates the reputation of the BoL. These aspects of the banking law and accompanying regulations will need to be addressed in the future to ensure full support for effective RBS.

28. **Bank regulation in Lao P.D.R. has historically relied on compliance with specified parameters, some of which may have unforeseen consequences.** Well-defined

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<sup>4</sup> The World Bank is providing technical assistance to the BoL in drafting the new banking law and prudential regulations.

<sup>5</sup> Under the current law, BoL's bank supervisors may be alleged personally liable for making adverse conclusions about a bank's condition or performance if the banker disagrees.

limits such as a minimum leverage capital ratio or a maximum single borrower limit are appropriate to control some risks; however, RBS methods often require judgments. Attempts to minimize banking risks by imposing artificial limits may have unintended consequences. For example, the 3 percent maximum threshold for the ratio of NPLs to total loans could be problematic because a loan may be properly structured at origin, but this does not ensure that a borrower will always be able to repay. Attempts to comply with this limit may prompt bankers to artificially renew or extend delinquent loans, a practice known as “evergreening”. Or, in a pre-emptive attempt to comply, a banker may restrict loans to only the very best customers, thereby contributing to a credit crunch. These situations illustrate the need to carefully review rules to ensure that the requirements are realistic and do not prompt adverse results.

***Recommendation: The legal and regulatory frameworks should be properly reviewed to support the risk-based approach to supervision.***

### **E. Regulatory Response**

29. **Risk-based approach to supervision has the potential weakness to focus more on diagnosis than on cure.** There is a risk that a disproportionate amount of regulatory efforts will be spent on assessing individual institutions rather than actions taken by banks to correct problems. It is also important for the regulator to address both.

30. **Regulatory response and corrective actions of the BoL should be reinforced.** BSD staff are accustomed to monetary penalties and fines as the standard approach for addressing deficiencies. The function of supervisors is primarily fact-finding with decisions on regulatory responses being made at higher levels of BoL. Nevertheless, it is important that BSD staff understand the need for clear and accurate analyses of condition and cause in order to recommend effective responses for senior BoL management. The mission conducted a presentation for BSD staff on the fundamental elements of effective regulatory responses and corrective measures.

31. **Regulatory responses should be applied in a firm, prompt, and consistent manner.** As RBS methods are implemented, it will become increasingly necessary for BoL to apply responses in a firm, prompt, and consistent manner to support effective supervisory efforts. In this regard, just as a manual was developed to provide guidance to staff in conducting offsite analyses and onsite examinations, it is recommended that BoL adopt a formal policy for applying regulatory responses and corrective/enforcement actions. As discussed during the mission, useful policy guidance is available from the Basel Committee on Banking Supervision paper of July 2015 “Guidelines for identifying and dealing with weak banks.”<sup>6</sup>

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<sup>6</sup> Available at <https://www.bis.org/bcbs/publ/d330.pdf>. Sections 2 and 6 of this paper are especially important for policy development.

***Recommendation: BoL should develop and adopt a formal policy for applying regulatory responses and corrective/enforcement actions.***

### III. FUTURE TA NEEDS

32. **Further TA will be critical in supporting progress made thus far.** Senior management of BoL expressed a desire for more TA on a peripatetic basis. The transition from compliance-based supervision to RBS requires extensive capacity building for all BSD staff, especially during the initial implementation stage. All BSD staff should be able to fully and effectively apply the new risk-based supervisory methods.

33. **At present, MCM is seeking external financing for a multi-mission project on strengthening RBS.** The mission laid the groundwork for this new multi-mission project by agreeing with the BoL on specific project outcomes, verifiable indicators, and deadlines. The long-term goal is to establish effective RBS and address weaknesses when identified. At the same time, a corollary goal is to ensure that banking system remains prudently responsive to the need for financial services in Lao P.D.R.

34. **The TA program for assisting the BoL in its transition from compliance-based supervision to risk-based methods comprises three broad phases.** The first is developing a framework, i.e., the RBS manual and supporting templates and documents; the second is training BSD staff in practical use of RBS methods and also explaining the concept and methods of RBS to bankers; and the third phase is developing a more formalized policy for applying appropriate and consistent regulatory responses and/or corrective actions when problems are identified. The third phase will include revisions to the manual in order to fully support an effective risk-based supervision regime. In this regard, the mission tentatively identified the following areas where TA will be beneficial:

- *Assist with the practical application of RBS manual and associated supervisory methods;*
- *Review/updating IPs, RASes, CAMELS ratings, and benchmark criteria;*
- *Review/update the annual examination plan;*
- *Review/advice on writing a ROX;*
- *Review BSD reporting to BoL senior management; and*
- *Designing/applying appropriate regulatory responses.*