



Rural Finance in the Lao People's Democratic Republic:

Demand, Supply, and Sustainability

Results of Household and Supplier Surveys

Brett E. Coleman
Jon Wynne-Williams

ADB



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Rural Finance in the Lao PDR

Rural financial markets have enormous potential to contribute to economic growth and poverty reduction in the Lao PDR, but they remain underdeveloped. Until recently, the Government's policy to deliver rural financial services was focused on channeling directed, subsidized credit through the Agriculture Promotion Bank (APB). As in many countries, this initiative was well intentioned but has had limited success. APB serves the credit needs of only 2% of rural households, while other formal and semiformal financial institutions reach another 5%. By contrast, 33% of rural households borrow from informal sources, such as friends, family, and moneylenders. Unmet demand for credit is 7 times larger than actual borrowing for the average rural household; for poor rural households, it is 40 times larger.

This study is based on a national survey of nearly 1,200 rural households, as well as all commercial banks and known microfinance initiatives in 2004. It attempts to provide a comprehensive overview of rural finance in the Lao PDR, to inform the Government's policy decisions and strategy formulation for developing the sector, to inform practitioners in designing microfinance initiatives, and to provide a baseline for monitoring development of the sector under the Government's Rural Finance Sector Development Program to be launched in 2006.

The key conclusion of this study is that the formal sector (banks) and semiformal sector (microfinance initiatives) are currently not meeting the demand for financial services of the vast majority of rural households in the Lao PDR. However, the study's critical assessment points to opportunities and hope for developing rural finance so it can achieve its potential contribution to growth and poverty reduction. The study notes that the Government's new policy, issued by the Prime Minister's Office in 2003, is based on a commercial, market-oriented approach driven largely by the private sector within an enabling policy and regulatory framework established by the Government. Such policies,

when implemented in other countries, have had significant positive impact on sector development.

Key recommendations of the study include the following:

- The Lao authorities should carry out concrete actions to operationalize the new market-oriented policy
- The Lao authorities should phase out policy lending from the banking sector, allowing APB and other banks to make loans on a strictly commercial basis under autonomous bank management
- The Government should continue to support commercial microfinance initiatives through improvements in the policy, legal, and regulatory environment
- The Government should attract foreign investment in the microfinance sector
- Microfinance donors and practitioners should ensure that their microfinance initiatives follow good practices and focus on sustainability from the outset—a key survey result is that the poor are more concerned with sustained access to financial services than with low interest rates
- The Government's Rural and Microfinance Committee should meet regularly with microfinance stakeholders to receive feedback, identify implementation and policy issues, and propose new solutions to further develop the sector

A greater variety of rural finance institutions will help meet the needs of a diverse population in the Lao PDR. Allowing market forces to meet this demand, under an enabling framework created by the Government, will be the most effective way of achieving this objective.

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Abbreviations

ADB	– Asian Development Bank	SBL	– State Bank of Lao PDR
ADB I	– Asian Development Bank Institute	SCB	– Siam Commercial Bank
APB	– Agricultural Promotion Bank	SCU	– savings and credit union
APR	– annual percentage rate	SOCB	– state-owned commercial bank
BAY	– Bank of Ayudhya	TMB	– Thai Military Bank
BBL	– Bangkok Bank Limited	UNCDF	– United Nations Capital Development Fund
BCEL	– Banque pour le Commerce Extérieur du Laos	UNDP	– United Nations Development Programme
BOL	– Bank of the Lao PDR	VCB	– Vientiane Commercial Bank
CCSP	– Coopérative de Crédit de Soutien aux Petits Producteurs	VSCG	– village savings and credit group
FAO	– Food and Agricultural Organization (of the United Nations)	VRF	– village revolving fund
FCB	– foreign commercial bank		
FIRST Initiative	– Financial Sector Reform and Strengthening Initiative		
INGO	– international nongovernment organization		
JDB	– Joint Development Bank		
JVCB	– joint venture commercial bank		
km	– kilometer		
KTB	– Krung Thai Bank		
Lao PDR	– Lao People’s Democratic Republic		
LDB	– Lao Development Bank		
LVB	– Lao-Viet Bank		
LWU	– Lao Women’s Union		
MAF	– Ministry of Agriculture and Forestry		
MOA	– Ministry of Agriculture		
MOF	– Ministry of Finance		
MFI	– microfinance institution		
NGO	– nongovernment organization		
NPL	– nonperforming loan		
PMB	– Public Bank Malaysia		
RDC	– Rural Development Cooperative		

Currency Equivalents

(as of January 2003, used throughout this report)

Currency Unit	–	Kip (KN)
KN1.00	=	\$0.000094
\$1.00	=	KN 10,622

Notes

- (i) The fiscal year (FY) of the Government and its agencies ends on 30 September.
- (ii) In this report, “\$” refers to US dollars.

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This report is the product of the collaboration of many people. Preparatory work began in 2003 with discussions between Mr. Brett Coleman (Asian Development Bank [ADB], Senior Microfinance Specialist) and Mr. Jon Wynne-Williams (Enterplan, Consultant Team Leader). While assisting the Government of the Lao PDR to reform its rural and microfinance policies and institutions under TA 3413-LAO: Rural Finance Development, and in making preparations to begin supporting the Government to design the Rural Finance Sector Development Program (RFSDP), we became acutely aware of the dearth of up-to-date information on rural finance in the country. During further discussions, officials in the Bank of the Lao PDR (BOL), the Ministry of Finance (MOF), and the Agriculture Promotion Bank (APB) confirmed the need for an updated survey. The United Nations Development Programme (UNDP) survey of 1996 was still the most recent and widely cited data. More current data was needed, especially on rural household access to and perceptions of financial services, to inform sound policy decisions.

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Jon Wynne-Williams
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Foreword

The Government of the Lao People's Democratic Republic (Lao PDR) has made significant efforts in the past 2 decades to extend financial services to poor and rural households. With 80% of Lao households, and 90% of poor households, based in rural areas, the provision of rural financial services can promote equitable growth and contribute to the Government's poverty reduction strategy by financing investment opportunities and risk-management strategies of poor and vulnerable households and their micro- and small enterprises.

Major financial sector reforms began in Lao PDR in 1988, with a view to making the financial system more efficient and market-oriented. This included the transformation of the country's mono-bank system into a two-tiered banking system consisting of a central bank and several state-owned commercial banks. In 1993, the Government created the Agriculture Promotion Bank (APB), with a mandate to extend credit and savings services to the rural areas of the Lao PDR. However, this has had limited success because APB's practice of carrying out policy lending at subsidized interest rates on behalf of the Government and donor-supported programs has resulted in some resource misallocation along with large losses that have eroded its capital, and therefore, limited the resources available for its expansion. Today, APB serves about 18% of all Lao households, but less than 5% of rural households.

The Government and international donors have also supported many microfinance projects across the country,

especially in the last 10 years, often working through the Lao Women's Union. Some 1,600 village revolving funds have been established, as well as dozens of microfinance components of larger development projects. Again, however, the vast majority of such initiatives have resulted in unsustainable provision of microfinance services because most made loans at subsidized interest rates or lacked sufficient emphasis on long-term institution building. Most became non-operational after outside funding ended. At the same time, a small number of microfinance projects and institutions have demonstrated that best-practice initiatives can succeed in the Lao PDR, provided they focus on demand-driven services, charge interest rates that cover costs and allow profits and growth, and build capacity for professional management necessary for long-term sustainability.

With the lessons learned from both Lao and international experience, the Government has committed to, and begun implementing, a major reform program in rural and microfinance. This program includes: (i) restructuring APB to be a financially self-sustainable, market-oriented rural finance institution; (ii) actively promoting best-practice microfinance institutions (MFIs) through piloting of private, professionally managed, and financially self-sustainable savings and credit unions; (iii) issuing a national Policy Statement on Sustainable Rural and Microfinance to encourage development of the sector, including a diversity of MFI models to serve a dispersed and diverse population;

(iv) preparing an enabling legal and regulatory framework allowing for multiple MFI models and products with minimum starting regulations, interest rate autonomy, private ownership and foreign investment; and (v) adopting and implementing an appropriate regulatory framework for prudential supervision of APB.

Before this study, the most recent national survey of rural and microfinance occurred in 1996 with support from the United Nations Development Programme. However, the data from this survey needed to be updated to form the basis for detailed policy formulation and project selection and design.

The present survey is intended to fill the gap in current knowledge, and results have already begun to inform the Government's policy decisions and strategy formulation, help design microfinance initiatives, and provide a baseline for monitoring development of the sector to assess the impact of reform and to make adjustments as necessary.

We would like to thank the survey respondents, especially the many rural households that generously contributed their time and their views in participating in this survey. Without their assistance, this report would not have been possible.



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Executive Summary

The main elements of this research report are as follows:

- Chapter 1 presents the motivation and objectives of the study, as well as the survey and statistical methodology.
- Chapter 2 presents an economic overview of rural households in the Lao People’s Democratic Republic (Lao PDR), based on a household survey conducted for the study.
- Chapters 3 and 4 present the institutional landscape of financial services in the Lao PDR. Chapter 3 presents details on the formal banking sector, while Chapter 4 presents the semiformal sources of rural and microfinance, including microfinance projects and sustainably oriented microfinance institutions (MFIs), as well as informal sources, including moneylenders, households, and *houay* or rotating savings and credit associations.
- Chapters 5 and 6 present results of a survey of 1,189 randomly selected rural households. ***These chapters represent the crux of the study and present the most salient results.*** These include analyses of households’ access to various means of savings, including formal and informal. They also include access to formal, semiformal, and informal sources of credit. Chapter 6 includes estimates of unsatisfied demand for credit in rural areas. Household preferences for different sources and characteristics of savings and lending products are also presented.
- Chapter 7 presents conclusions and recommendations.

Introduction—The Rural and Microfinance Survey

The Government of the Lao PDR has committed to carrying out a major rural and microfinance reform program consistent with the Policy Statement on Sustainable Rural and Microfinance that the Prime Minister’s Office issued in late 2003. This program includes: (i) restructuring the Agriculture Promotion Bank (APB) to be a financially self-sustainable, market-oriented rural finance institution; (ii) adopting an appropriate regulatory framework for prudential supervision of APB; (iii) preparing an enabling legal and regulatory framework for a diversity of MFI models with minimum starting regulations, interest rate autonomy, and private and foreign investment; and (iv) promoting the creation of best-practice MFIs that are private, autonomous, professionally managed, and financially self-sustainable.

Now that the Government has committed to a major reform program in rural and microfinance, it also wishes to monitor development of the sector to assess the impact of reform and to make adjustments as necessary. For these reasons, it was timely to conduct a new survey of rural and microfinance in the Lao PDR. The survey results will hopefully inform policy decisions and the design of microfinance initiatives, as well as provide a baseline from which the Government can assess the effectiveness of its reform program.

This study is based on surveys carried out in early 2004. First, a Household Survey gathered information on the household economy, financial management, assets and liabilities, and attitudes. Second, a Rural Financial Services Survey was carried out with banks, multilateral and bilateral development agencies, international nongovernment organizations (INGOs), and MFIs to capture information about the services provided, outreach, and the terms of savings and credit offered. Third, a survey of moneylenders was undertaken to supplement this data.

The Household Survey used four geographical areas to stratify villages. Map 1 illustrates the villages selected. The strata used were:

- “Peri-urban” (areas within 25 kilometers (km) of, but outside, the country’s four largest urban areas of Vientiane, Savannakhet, Luang Prabang, and Pakse);
- “Provincial Capital” (areas within 10 (km) of, but outside, the other provincial capital towns);
- “Rural Mekong” (areas with lowland rice farming systems, which do not fall within the Peri-urban or Provincial Capital strata areas); and
- “Other Rural” (areas using upland intensive and extensive systems, which do not fall within the Peri-urban or Provincial Capital strata).

A stratified random sample of 1,189 households was selected. The Household Survey collected information on household demographics, economic activities, assets, liabilities, and attitudes to financial services. Analysis was carried out on the sample as a whole, as well as by stratum and by wealth quartile using appropriate statistical techniques.

For the Rural Financial Services Survey, separate questionnaires were designed for (i) banks; (ii) multilateral

and bilateral development agencies, INGO, and MFI projects; and (iii) informal moneylenders. The questionnaires collected information on outreach of the institution, lending activities and loan portfolios, and savings services.

An Economic Portrait of Rural Households

Characteristics of rural households’ demographic structure and income-generating activities are important determinants of financial decisions such as borrowing, saving, lending, and risk management. Therefore, the study begins by presenting a brief economic portrait of rural households, based on the survey of 1,189 households.

Results indicate that the more remote Rural Mekong and Other Rural strata have larger proportions of poor households, while the Peri-urban and Provincial Capital strata tend to be wealthier. But they also indicate that all four rural strata have significant portions of poor households. Peri-urban households reported average income 1.44 times the average of Provincial Capital households, 2.14 times the average of Rural Mekong households, and 1.68 times the average of Other Rural households. The average income of the richest quartile of households was 5.08 times that of the average income of the households in the poorest quartile.

For 90.34% of rural households, the primary income source is from self-employment (including farming their own land) or ownership of a business. Only 5.38% of rural households have salaried work as the primary source of income, while wage labor provides the primary source of income for only 4.28% of rural households.

Rice production is the most common primary activity (64.65% of rural households), followed by livestock raising (10.24%), and trade (6.96%). Production of other crops is the primary activity for only 3.34% of households. The contrast between the poorest quartile, where rice production

is the main activity for about 70% of households and the richest quartile where it is the main activity for only 51% of households, suggests that relative poverty is linked with the production of the subsistence crop as the primary household activity.

However, there is a high degree of multifunctionality among rural households: 90% of rural households engage in multiple income-generating activities. The high level of multifunctionality is an important observation with implications for the rural finance system in the Lao PDR. While rural finance policies have traditionally focused on directed lending programs that target agricultural activities, the high frequency of multifunctionality suggests a need for financial services that serve a broad range of economic activities in rural households.

Overall, only 38% of reported income of rural households came from agriculture, livestock, or fishing. Over half of reported income came from business activities. Among wealth quartiles, the poorest derived only 35% of their income from agriculture, livestock, and fishing, and the richest derived 37%. The results highlight the importance of nonagricultural income in rural Lao PDR.

Rural Financial Services Supply—the Formal Sector

The supply of rural financial services in the Lao PDR can be broken down into the formal, semiformal, and informal sectors. The formal sector consists of the commercial banks; the semiformal sector comprises project-based interventions; and the informal sector comprises loans between friends and family members, informal moneylending, and lending through the traditional Lao houay.

The commercial banking industry in the Lao PDR has three principal groups:

- Three SOCBs: Banque pour le Commerce Extérieur du Laos (BCEL), Lao Development Bank (LDB), and the Agricultural Promotion Bank (APB). BCEL is focused on foreign trade, LDB on commerce, and APB on the agricultural sector.
- Three JVCBs: the Joint Development Bank (JDB), Vientiane Commercial Bank (VCB), and Lao-Viet Bank (LVB). The JVCBs mainly service customers in the country's principal cities.
- Six foreign commercial banks (FCBs), each operating a single branch office in Vientiane, and one British bank with a representative office in Vientiane. The FCBs primarily service their home country clients who have operations in the Lao PDR.

The formal sector banking industry is small and dominated by the SOCBs, which controlled a combined 64% of the KN5.4 trillion (\$507 million) in total banking assets at the end of 2003. Among the SOCBs, BCEL is the largest, followed by LDB and APB. However, BCEL has the lowest number of borrowers, with an average loan size of KN1.5 billion. APB has the smallest loan portfolio and the largest number of borrowers, with an average loan size per borrower of KN3 million.

The three SOCBs accounted for 59% of total outstanding loans in the banking sector at the end of the first quarter in 2004. The SOCBs' lending mandates are evident in their portfolio compositions. APB is the principal lender to forestry and agriculture borrowers, with 66% of the total portfolio. BCEL dominates lending to industry (50%), construction and equipment (37%), and trade (41%). LDB has a more balanced loan portfolio.

The commercial banking industry has experienced considerable growth over the past few years. As a consequence of this growth, as well as continuing supervisory weaknesses, nonperforming loans (NPLs) in the industry have also grown. Moreover, as the current three SOCBs are the result of mergers between the previous seven SOCBs, the current SOCBs have inherited the financial difficulties that caused these consolidations in the first place. Hence, as of 31 December 2003, the capital of the three SOCBs was significantly negative at -35.6% of total assets and their aggregate NPL rate was 58%. Ongoing restructuring efforts at the SOCBs and the Bank of the Lao PDR (BOL) are intended to address these problems.

The commercial banks' attention toward rural areas is very limited. APB, with its mandate to promote agriculture, is the most engaged in rural areas, but in practice, the vast majority of its clients are located in urban areas—survey results indicate that only 2% of rural households borrowed from APB in the 12 months prior to the survey. The remaining commercial banks have limited distribution networks. Residents of rural areas are mostly removed from commercial banks and the services they provide.

Rural Financial Services Supply—the Semiformal and Informal Sectors

The semiformal sector in the Lao PDR primarily comprises project-based interventions. They are “formal” in the sense that they either fall under the government-approved activities sponsored by multilateral and bilateral development agencies and INGOs, or they operate under BOL regulations. They are “informal” in that the savings and credit activities carried out are not supervised by BOL and their financial sector operations are not subject to official financial reporting requirements.

The survey had 23 respondents, who supported a total of 50 microfinance initiatives. The respondents comprised three groups. The first consisted of six multilateral and bilateral development agencies supporting microfinance components in larger projects. The second group consisted of 14 INGOs supporting microfinance components in larger projects. The third group consisted of three specialized MFIs set up specifically to provide sustainable microfinance services.

Multilateral, bilateral, and INGO projects are typically implemented through local partners. The Lao Women's Union (LWU) was the most frequent local partner, followed by the Ministry of Agriculture and Forestry (MAF). One of the sustainably oriented initiatives, established originally with UNDP support, works with the Ministry of Finance (MOF).

Three main types of microfinance organizational forms predominate in the Lao PDR. These are:

- Savings and Credit Unions (SCUs) and Credit Cooperatives operating under BOL regulations.
- Village Savings and Credit Groups (VSCGs) not operating under BOL regulations;
- Village Revolving Funds (VRFs) not operating under BOL regulations.

In the semiformal sector, there are no product offerings other than savings and loans.

Data show that funding for microfinance activities remains low, at less than \$1 million cumulatively over 5 years. Funding of capacity building has also grown but remains low, at less than \$100,000 cumulatively over 5 years.

The total number of villages reached by microfinance initiatives as of 31 December 2003 was reported as 930. The multilateral and bilateral microfinance components reached 211 villages; the INGO components reached 406 villages; and the MFIs reached 313 villages. Overall outreach of 33,392 savers remains low. Conservatively assuming each saver corresponds to one rural household, this implies outreach to only 3.7% of rural households.

As of 31 December 2003, the semiformal sector reported 12,365 outstanding borrowers with loans outstanding of KN12 billion. (The difference in the number of borrowers and savers was due to the fact that one INGO, FIAM, reported having 20,880 savers but was unable to report on its borrowers.)

Loans products offered by MFIs have a median effective interest rate of 48% per year, while loans products offered by INGO microfinance components have a median interest rate of 22% per year, and those of multilateral and bilateral development agency microfinance components have a median rate of 12% per year. Only the MFIs regularly charge interest rates at sustainable levels, thus creating the potential to provide permanent access to financial services.

MFIs also had the lowest percentage of borrowers in arrears, at 7.68%. Multilateral and bilateral development agency projects reported 13.71% of borrowers in arrears, while INGOs reported 14.84%. The data also indicate that groups are less likely to default than individuals, and that women are less likely to default than men.

In the Lao PDR, the informal sector comprises loans between households, informal moneylending, and lending through the traditional houay. Results indicate that rural households made an estimated 353,574 loans to friends, family, and other households valued at KN660.69 billion (\$62.2 million) in the 12 months preceding the survey, dwarfing the amount loaned in the semiformal sector.

The vast majority of lending (76%) was done by households in the wealthiest quartile. Households in the Other Rural stratum account for the vast majority of loans by number: they account for 60% of all loans (and 44% of loan volume), almost certainly the result of the lack of outreach by more formal and semiformal institutions in the remote Other Rural areas, and therefore the need to rely on informal inter-household loans.

In the 12 months before the survey, moneylenders made loans to about 25,300 rural households in an estimated amount of KN27.30 billion (\$2.57 million), a fraction of the informal lending done by households, but still more than twice as much as the semiformal sector. Moreover, about 3,100 rural households participated in houay which lent their members about KN18.53 billion (\$1.74 million), about 50% more than the semiformal sector.

Household Savings

It is commonly believed that many rural households in less developed countries, including the Lao PDR, are too poor to save. However, a considerable amount of research disproves this view. In fact, the poor do save but do not have ready access to savings facilities in formal financial institutions. Instead, they use alternative, informal vehicles for their savings such as livestock, gold and other precious metals, jewelry, and housing materials or other stocks of physical goods. Many of these informal savings mechanisms involve high risk and high transaction costs and result in savings that are not easily turned into ready cash. Experience has shown that households often value the availability of appropriate deposit services as much as, and sometimes more than, access to credit.

Extrapolating from the survey sample to the population, in early 2004 rural households in the Lao PDR held an estimated KN2,290.28 billion (\$215.62 million) in cash

savings. Almost 90% of rural households reported holding some cash savings—89% reported cash in-hand but only 5% reported any bank deposits, suggesting a low level of outreach by the Lao banking sector (including APB) in rural areas. However, bank deposits represented 55% of cash savings reported, while cash in hand represented 39.75%. Just over 4% of rural households reported savings in the semiformal sector, and this represented only 0.5% of cash savings.

The richest quartile of households accounts for 81.30% (KN1,862 billion) of the cash savings held in banks, while the poorest quartile of households accounts for only 2.10% (KN48.4 billion) of such savings. However, only 13.8% of households in the richest quartile and 1.5% of households in the poorest quartile maintain any savings in the banking system.

In rural areas of the Lao PDR, savings are mostly held in-kind. Non-cash savings amount to KN6,291.7 billion and account for 73.3% of total savings in rural areas. Non-cash savings exceed cash savings for each wealth quartile, and for three of four rural strata (the exception being Peri-urban households). Livestock is the most common means of non-cash savings in Lao rural households, used by 98.2% of rural households and accounting for KN4,268 billion. Livestock as a means of savings is especially important for households in the poorest quartile where it accounts for 77.09% of non-cash savings. Precious metals, jewelry, and housing materials are also commonly used as savings vehicles.

Although household preferences are revealed to some extent by actual practices, underlying preferences may differ from practice depending on the availability of options. Almost 30% of households said their first preference was to save in APB or another bank (12.43% in APB and 17.29% in another bank). Some 27.63% expressed some preference

(first, second, or third) for APB, while 35.6% expressed some preference for other banks. As less than 5% of households actually have savings in any bank, this suggests a large unmet demand for formal savings services in rural Lao PDR.

Among non-cash alternatives, livestock is the most preferred vehicle for savings, with preferences on the same order as that for banks. More than a quarter of all households (27.97%) stated that livestock was their first preference for saving, and 56.6% expressed some preference for this savings method. Examined by stratum and wealth quartile, results show a more frequent preference for non-cash instruments (especially livestock) as savings vehicles amongst the poorer and more remote households, and a greater preference for APB and other commercial banks amongst richer and less remote households.

Household Borrowing

One cause of poverty observed in less developed countries is the lack of access to credit, especially among rural households. The poor often find themselves in a vicious circle: producing at a subsistence level makes it difficult to accumulate assets, thus making it difficult either to invest any surplus or to gain access to credit in formal financial markets, which leads to low productivity and continued poverty.

Recognizing this, many government policy makers have promoted initiatives to deliver formal credit to rural areas. These have often included setting up special agricultural banks to lend to rural borrowers, and this has also been the case in the Lao PDR.

Overall, 40% of rural households borrowed in the 12 months before the survey. The formal sector made loans to less than 3% of rural households, while the semiformal sector reached 4% of rural households. In contrast, informal sources made loans to 33% of rural households. The poorest two

quartiles relied on informal sources significantly more than the richest two quartiles while the richest two quartiles had greater access to formal sources.

Extrapolating from the survey sample to the population, rural households borrowed an estimated KN636.82 billion (\$59.95 million) in the 12 months preceding the survey. Borrowing from family and friends was the most common: 25% of households borrowed from friends or family, in an amount equal to KN307 billion (48% of loan volume). The average loan size was KN1.38 million (\$130). Supplier credit was the next common means of financing, with loans taken by 6.14% of households, with estimated overall borrowing of KN134.81 billion (21% of loans by value). The average original loan size from suppliers was KN3.76 million (\$354). The third most common loan source, in terms of the number of households borrowing, was VRFs. An estimated 2.18% of rural households borrowed from VRFs. The average original loan size was KN612,000 (\$58).

APB was the fourth most common means of financing, reaching an estimated 18,267 rural households, or 2.01% of all rural households in the 12 months preceding the survey. It is noteworthy that APB reports about 87,000 total borrowers in the Lao PDR. The survey findings indicate that only 21% of APB borrowers are located in rural areas. This is also consistent with APB's lending records, which indicate that the large urban areas of Vientiane, Savannakhet, Pakse, and Luang Prabang absorb the vast majority of its lending. Average loan size for APB's rural borrowers was KN2.65 million (\$249).

Some 30.3% of households in the richest quartile had borrowed during the previous 12 months, compared to 43.1% of the households in the poorest quartile. The poorest quartile was more dependent on friends and family: 28.4% of the poorest households borrowed from this source but only 15.2% of richest households did so. Higher percentages of

households in the poorest quartile also borrowed from suppliers, moneylenders, and VSCGs. A higher percentage of the households in the richest quartile borrowed from APB and other banks: 5.5% of households in the richest quartile borrowed from a bank while only 1.9% of households in the poorest quartile did so. And despite APB's mandate to provide subsidized loans to the poor, its richest-quartile clients outnumbered its poorest-quartile clients by more than 3 to 1. However, outreach of APB and other banks was extremely low to all strata and all quartiles.

The average household in the richest quartile borrowed 17 times as much as the average household in the poorest quartile. Moreover, households in the richest quartile borrowed 33.6 times as much as households in the poorest quartile from banks. This included 12.6 times as much from APB. Overall, 77.7% of the borrowing from APB by value was by households in the richest quartile. The vast majority of borrowing by the poor comes from family and friends.

Similar to savings, household preferences are revealed to some extent by practices, but preferences may differ from practice depending on the availability of options. Overall, 57% of households said borrowing from family and friends was their first preference; 75% expressed some preference for this (i.e., either first, second, or third preference). Next was APB, with 19% of households expressing this as their first preference, and 36% expressing some preference for this. This compared to only 6% that expressed a first preference for borrowing from another bank and smaller percentages for other sources. As only 2% of rural households actually borrowed from APB in the 12 months before the survey, there is clearly a significant untapped market for APB.

Rural households were also asked to state what the important characteristics were for them when choosing where to apply for a loan. Consistently across all wealth quartiles,

“confidence that a loan will be made” was the most frequently cited important characteristic—households want to be sure of being able to access the loan. Almost 60% of households regarded this as an important factor in choosing where to apply for a loan. In all wealth groups, this was more frequently cited than the interest rate. Households in the poorest quartile named this characteristic almost twice as frequently as the interest rate (52.89% to 27.64%), indicating that confidence about receiving a loan (i.e., access to the loan) is significantly more important than price for them. These results for the Lao PDR are consistent with results in other countries: ***the poor are more concerned with sustained access to financial services than they are with low interest rates.***

For the poorest quartile of rural households, convenience in terms of a short journey to the source of the loan was almost as important as price (24.35% of the poorest quartile citing this as an important factor). For the richest quartile, 50% of households cited interest rates as being an important factor compared to only 26.68% who cited a short journey to the loan provider as being important.

The availability of long-term loans, low collateral requirements, and simple loan procedures were the next most important factors across all households. While long-term loan availability was the fourth most frequently cited important characteristic when determining where to apply for a loan, it is noteworthy that only 22.32% cited this; hence, 77.68% did not consider this to be important. A considerable amount of policy lending by the Government, as well as donor credit lines, has been justified by the perception that demand for long-term loans is high. The evidence of this survey indicates that such policies may be misguided.

In terms of loan purpose, borrowing is concentrated in the transport, services, and trade businesses, as well as livestock, rice production, and medicine and health care.

Virtually all borrowing for service businesses takes place in Peri-urban areas (99.3%); and virtually all is borrowed by households in the richest quartile (99.5%). While borrowing for trade is more equally distributed across strata, it is also concentrated in the richest quartile, who borrow 90.6% of such lending. Similarly, borrowing for transport businesses is concentrated in Peri-urban households (67.3%) and households in the richest quartile (91.7%).

Borrowing for rice production is predominant in Provincial Capital and Rural Mekong households, which together comprise 81% of such borrowing. Again, however, such borrowing is concentrated in the richest quartile, which borrowed 63% of total lending for rice production. Borrowing for livestock production is concentrated in Other Rural households, which borrowed 96.7% of such lending; again, the richest quartile account for most, borrowing 95% of total lending for livestock.

Results also point to the importance of loans for health and medical purposes in the three poorer quartiles, which together borrowed 95% of such lending. Households in the poorest quartile borrowed over five times as much as households in the richest quartile for health and medicines, and this accounted for 34.9% of all borrowing by households in the poorest quartile, compared to 0.4% for the richest quartile.

Overall, an estimated 308,884 loans or just over 72% of all loans (by number) were for nonproductive purposes (house construction, domestic consumption goods, health and medicines, education, marriage, funeral, or other purposes) at an average size of KN990,000 (\$93), evidencing the substantial demand for the type of lending that can often be delivered through MFIs more effectively than through formal banks.

About half of all loans taken by rural households (50.71%) had zero interest—the vast majority of these came

from family and friends. At the same time, 23.75% of loans had effective interest rates of more than 100% per year, and 13.50% had effective rates in excess of 200% per year. In other words, the vast majority of loans were either at zero interest or at extremely high interest—only a small minority fell in the mid-range.

The poorest quartile of households benefit from higher access to interest-free loans (53.7% of their loans compared to 26% of loans borrowed by the richest quartile and 50.7% of loans borrowed by the population as a whole), but they are also less able to access interest-bearing loans at the rates prevailing in the commercial banking sector. Only 8.9% of the interest-bearing loans received by the poorest quartile of households were at less than 60% interest per year, while 42.6% of the interest-bearing loans received by the richest quartile were at less than 60% per year. It is estimated that, nationwide, the poorest rural households borrowed 22,485 loans at interest rates over 100%, while the richest rural households borrowed 10,698 loans at these interest rates. Clearly, delivering sustainable, market-oriented credit at (unsubsidized) market interest rates to the poor through MFIs and APB could make a significant contribution to the well-being of the poor.

The results show considerable unsatisfied demand for credit among rural households. Overall, unsatisfied demand equals KN4,341 billion for all rural households, which is 6.7 times the amount actually borrowed over the previous 12 months. This difference between actual borrowing and unsatisfied demand is most pronounced among households in the poorest quartile—unsatisfied demand is 39 times as large as actual borrowing. In contrast, for households in the richest quartile, unsatisfied demand is only 3.93 times as large as actual borrowing. The Lao rural finance system is clearly failing to satisfy the demand for credit from the poorest households.

Geographically, the largest unmet demand is in the remote Other Rural households, with unsatisfied borrowing of KN2,250 billion. This accounts for 52% of all unmet demand in the country and is likely a result of the low level of outreach by financial institutions in the more remote areas. Relative to actual borrowing, Provincial Capital households and Other Rural households are the most underserved—with unmet demand exceeding actual borrowing by factors of 15.76 and 11.43, respectively. This contrasts with Provincial Capital households, whose unmet demand is only 2.28 times their actual borrowing. The conclusion is clear: there is a huge unsatisfied demand for loans by rural households, covering a wide range of production opportunities and nonproduction needs.

Conclusions and Recommendations

The most overriding conclusion of this study is that the formal sector and semiformal sector are failing to serve the demand for financial services of the vast majority of rural households in the Lao PDR. This is true for all geographic strata and for all wealth quartiles. The key findings of this study are:

- Only 5% of all rural households had any savings in a bank;
- Only 4% had savings in a microfinance initiative;
- Only 26.7% of rural savings is held in cash, while 73.3% is held in-kind;
- Only 2% had borrowed from APB in the 12 months before the survey, and only 3% had borrowed from any bank;
- Only 4% had borrowed from a microfinance initiative;
- In contrast, 33% had borrowed from an informal source, including friends, family, moneylenders, and houay.

These results are even more striking for households in the poorest quartile:

- Only 1.5% had savings in a bank;
- Only 1.4% had savings in a microfinance initiative;
- Only 8.5% of savings is held in cash, while 91.5% is held in-kind;
- Only 1% borrowed from APB, and 1.9% had borrowed from any bank;
- Only 4.1% had borrowed from a microfinance initiative;
- In contrast, 40% had borrowed from an informal source.

There is a high degree of multifunctionality among rural households: 90% of rural households engage in multiple income-generating activities, and this is similar across strata and wealth quartiles. And although 78% of households engaged in agriculture, livestock raising, or fishing as their primary economic activity, only 38% of total reported income came from these activities. Over half of reported income came from business activities, and this was similar across strata and wealth quartiles, including the poorest quartile. While rural finance policies have traditionally focused on directed lending programs that target agricultural activities, the high frequency of multifunctionality suggests a need for financial services that serve a broad range of economic activities in rural households.

Among the formal sector financial institutions, APB has the mandate to provide financial services to rural areas and has the largest rural service network. However, APB's past practices have significantly weakened it financially. It has high NPLs and a large capital deficit, greatly limiting its ability to extend outreach. It also has limited capacity for proper credit assessment of customers despite receiving significant levels of technical assistance since 1993. However, its most significant constraint appears to be its

lack of autonomy in operational decisions as it continues to carry out significant levels of directed, subsidized lending (policy lending) at the behest of the Government.

Three MFIs have begun to demonstrate the potential of sustainably oriented microfinance in the Lao PDR. Moreover, these three MFIs also had the lowest percentage of borrowers in arrears at 7.8% (lower than other microfinance initiatives, and much lower than the SOCBs, including APB). However, most microfinance initiatives demonstrated weaknesses in financial reporting.

It is also clear that, as in many other developing countries, rural households have substantial savings, including the poor. However, due to the low outreach of formal and semiformal financial institutions, the vast majority (73.3%) of savings is held in-kind.

Almost 30% of rural households said their first preference was to save in APB or another bank (despite the fact that only 5% had savings in a bank). Similarly, 25% expressed a first preference to borrow from APB or another bank, despite the fact that less than 3% of households had borrowed from a bank in the previous 12 months. There are clear opportunities for APB and perhaps other banks (e.g., LDB) to expand their outreach.

At the same time, the results also offer hope for the potential of sustainable microfinance. Rural households expressed large unmet demand for loans of the kind that MFIs can often deliver more effectively and efficiently than formal banks—small, short-term loans that do not require traveling long distances to obtain. Also, the evidence indicates that rural households (especially the poor) are willing to pay sustainable MFI interest rates in the 30–50% range. Indeed, when rural households (especially the poor) are unable to borrow interest-free from friends and family, they typically have to borrow in informal markets at interest rates over 100% or even 200%.

The key issue is *how* to expand formal and semiformal financial services in rural areas. The Government, BOL, and APB need to carry out the concrete actions to realize the policy embodied in the Prime Minister's Policy Statement on Sustainable Rural and Microfinance and the National Growth and Poverty Eradication Strategy. This includes phasing out policy lending in a short period of time and placing remaining policy lending, if any, in a non-bank, non-deposit-taking policy lending mechanism. APB must make loans on a strictly commercial basis. As illustrated by this study, market orientation and poverty reduction can be mutually reinforcing objectives. However, to do this, the Government must grant APB genuine management autonomy.

APB also needs to enhance its human resources management and upgrade its information and communications systems. Finally, APB must be authorized to write-off its loss-graded loans and be recapitalized by the Government, but conditional on a proven track record of improved performance. By operating in a sustainable, market-oriented manner, APB can generate profits, build its capital, finance its expansion, and generate tax revenues for the Government.

A major improvement in the microfinance operating environment was achieved in June 2005, with BOL's issuance of new regulations for MFIs. These regulations permit a variety of ownership and a variety of MFI models. They also distinguish between deposit-taking and non-deposit-taking MFIs, wisely requiring that non-deposit-taking MFIs only need to register, while deposit-taking MFIs must be licensed.

The Government should also continue to take concrete steps to attract foreign investment in the microfinance sector. The authors of this study are unaware of any country in the world where microfinance has been able to develop without significant funding and technical assistance from

international donors and development partners. Donors have recently become more and more concerned about the sustainability and professional, transparent management of MFIs that they support. Moreover, several international investment funds have developed in recent years. In this new environment, both donors and investors are requiring, as a condition of their support, a formal ownership share and seat on the board to allow them to oversee the proper use of their funds. The Government has recognized the need for foreign investment in many sectors of the economy to contribute to technology transfer and management expertise. This applies to microfinance also.

For their part, microfinance donors, sponsors, and practitioners must ensure that their microfinance initiatives follow good practices and focus on sustainability from the outset. Directed credit, interest rate subsidies, and other unsustainable practices should be avoided. "Smart subsidies" such as grants for training and capacity building, piloting of new and innovative services, accounting and management information systems, and start-up capital should be encouraged. Donors, sponsors, and practitioners should also actively participate in discussions with the Government to give feedback on the policy environment and suggest revisions when necessary to encourage sector development.

Finally, the Government should regularly monitor the development of the sector. BOL should create a central database of microfinance initiatives, thus allowing it to monitor the number and outreach of institutions of various types. In addition to this direct monitoring, the Government's Rural and Microfinance Committee should meet regularly with microfinance stakeholders to review progress in developing the sector, to receive feedback, to identify implementation and policy issues, and to propose new solutions to further develop the sector.

Chapter 1

Introduction—The Rural and Microfinance Survey

The Government of the Lao People’s Democratic Republic (Lao PDR) has committed to carrying out a major reform program in rural and microfinance consistent with the Policy Statement on Sustainable Rural and Microfinance, which the Prime Minister’s Office issued in late 2003. This program includes: (i) restructuring the Agriculture Promotion Bank (APB) to be a financially self-sustainable, market-oriented rural finance institution; (ii) adopting and implementing an appropriate regulatory framework for prudential supervision of APB; (iii) preparing an enabling legal and regulatory framework for a diversity of microfinance institution (MFI) models with minimum starting regulations, interest rate autonomy, and private and foreign investment; and (iv) actively promoting the creation of best-practice MFIs that are private, autonomous, professionally managed, and financially self-sustainable.

Prior to the present study, the most recent national survey of rural and microfinance had been conducted in 1996 with support from the United Nations Development Programme (UNDP). Results of this survey are still widely quoted as representing the situation and outreach of rural and microfinance in the Lao PDR. However, the data from this survey are now outdated and therefore not appropriate as a basis either to inform national policy formulation or project design. They do not present an accurate picture of current outreach by APB, MFIs, international nongovernment organizations (INGOs), Lao Women’s Union (LWU), or other development projects with microfinance components. Nor

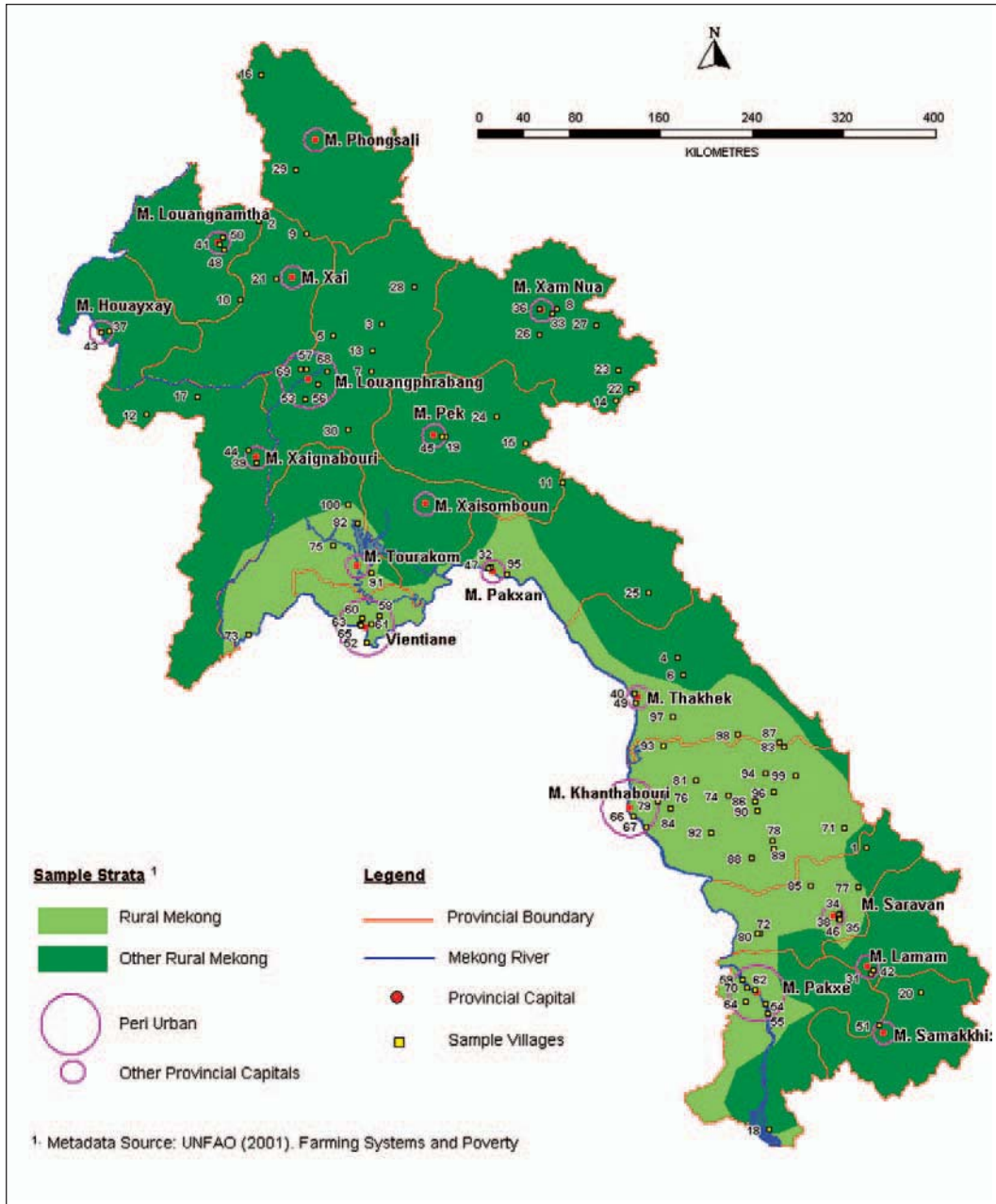
do they present an accurate picture of the characteristics, including poverty level, of the typical client. Hence, the degree to which existing programs are reaching the poor or various rural strata and therefore contributing to poverty reduction is not clearly known. Similarly, the sources and terms of finance for different strata of households are not clear. Moreover, the perception of potential clients regarding the financial services that they demand and their willingness to pay for such services is not well understood. Now that the Government has committed to a major reform program in rural and microfinance, it also wishes to monitor development of the sector to assess the impact of reform and to make adjustments as necessary. For these reasons, it was timely for the 1996 data to be updated through a new survey of rural and microfinance in the Lao PDR. It is hoped that the survey results will inform policy decisions and the design of microfinance initiatives, as well as provide a baseline from which the Government can assess the effectiveness of its reform program.

Survey Components and Design

The work that follows is based on a survey carried out in early 2004. The overall approach had two distinct components that required different survey designs and techniques.

First, a Household Survey gathered information on the household economy, financial management, assets and liabilities, and attitudes. This survey utilized a random

Map 1



sample of households in rural and semi-rural areas of the Lao PDR.

Second, a Rural Financial Services Survey was carried out with banks, multilateral and bilateral development agencies, INGOs and MFIs to capture information about the services provided, the outreach of services, and the terms of savings and credit offered.

A survey of moneylenders was undertaken to supplement this data, and was carried out in conjunction with the Household Survey.

The Household Survey

The Household Survey used four geographical areas to stratify villages. For rural areas that were not close to urban centers, villages were assigned to strata using farming systems delineations for the Lao PDR developed by the United Nations Food and Agricultural Organization (FAO).¹ Map 1 illustrates the villages selected.

The strata used were:

- “Peri-urban” (areas within 25 kilometers (km) of, but outside, the country’s four largest urban areas of Vientiane, Savannakhet, Luang Prabang, and Pakse);
- “Provincial Capital” (areas within 10 km of, but outside, the other provincial capital towns);
- “Rural Mekong” (areas with lowland rice farming systems, which do not fall within the Peri-urban or Provincial Capital strata areas); and

¹ www.fao.org/countryprofiles/Maps/LAO/01/fs/index.html illustrates the farming systems boundaries used. The farming systems classification was developed by the Food and Agricultural Organization (FAO) for the World Bank as part of Dixon J., Gulliver A., and Gibbon D., 2001, “Global Farming Systems Study—Challenges and Priorities to 2030.” This study identifies four farming systems for the Lao PDR: lowland rice (areas assigned to the Rural Mekong stratum in the Household Survey), Upland Intensive, Upland Extensive, and Sparse Forest (areas assigned to the Other Rural stratum in the Household Survey).

- “Other Rural” (areas using upland intensive and extensive systems, which do not fall within the Peri-urban or Provincial Capital strata).

These strata mirror those used in the 1996 UNDP-financed survey, and are based on the *a priori* assumption that the range and scale of economic activity are different in these different areas. It was expected that, while economic activity would be centered on agriculture in the Rural Mekong and Other Rural strata, there would be more nonagricultural diversity in the areas just outside provincial capitals and the major cities.

The sampling process involved classifying all villages in the Lao PDR into their strata according to their geographical location and the subsequent random selection of a predetermined number of villages within each stratum: 17 villages in each of the Peri-urban and Provincial Capital strata and 25 villages for each of the Rural Mekong and Other Rural strata. There was no intermediate stratification by district or province. In each village, a random sample of 20 households was drawn using the most recent census data. The survey covered 1,189 households, being on average 14.15 households in each of the 84 villages surveyed. In

total, there were 226 observations for the Peri-urban stratum, 256 observations for the Provincial Capital stratum, 333 observations for the Rural Mekong stratum, and 374 observations for the Other Rural stratum. Table 1.1 presents data on the sample.

The Household Survey questionnaire collected information on the following topics:

- household demographics;
- household financial manager;
- household economic activities;
- household assets;
- household liabilities; and
- attitudes and opinions to financial services.

To enhance the survey results, the analysis was also carried out by wealth quartile. To assign households to wealth quartiles for each household in the sample the probability that each household was sampled was calculated. The inverse of this probability was calculated to give the number of households that a sampled household represents in the population. Households were then sorted by wealth. Starting from the poorest household in ascending order of wealth, households in the survey were assigned to the poorest

Table 1.1 The Household Survey Sample by Stratum

Stratum	Number of Villages	Number of Villages in Sample	Number of Households	Number of Households in the Sample
Peri-urban	972	17	169,784	226
Provincial Capital	381	17	45,458	256
Rural Mekong	3,471	25	305,019	333
Other Rural	5,839	25	388,552	374
Xaysomboun Special Region	89	0	5,639	0
Total	10,752	84	914,452	1,189

Source: Household survey and National Statistics Center.

quartile until the cumulative number of households represented reached 25% of the total population. The process was continued in ascending order of wealth to assign households to the remaining three quartiles. The result was 291 survey observations for the poorest quartile, 290 observations for the second poorest quartile, 287 observations for the third poorest quartile, and 321 observations for the richest quartile.

The Rural Financial Services Survey

The Rural Financial Services Survey sought 100% coverage for the state-owned and private commercial banks operating in the Lao PDR. Every bank was interviewed. The Bank of Lao PDR (BOL) provided supplementary data.²

For multilateral and bilateral development agencies, INGOs, and MFIs, an initial telephone survey was carried out to establish which semiformal agents were active in rural and microfinance in the Lao PDR. Of the 25 semiformal agents that said they were active, a 100% coverage survey was then attempted. Six multilateral and bilateral

² Where data on individual banks is considered confidential, the survey results are reported on aggregate.

A survey in progress



development agencies, 14 INGOs, and 3 MFIs (a total of 23 organizations) responded to the survey.

A small sample survey of informal moneylenders was undertaken in conjunction with the Household Survey. In each village, the village head was asked to identify informal moneylenders, if any, in each sample village. Every informal moneylender identified was interviewed, if possible.³ A total of 17 moneylenders were interviewed.

Separate questionnaires were designed for banks; multilateral and bilateral development agencies, INGO, and MFI projects; and informal moneylenders. In general, the questionnaires collected similar information including the following:

- general information on the credit supplier, including the outreach of the institution;
- lending activities and loan portfolios; and
- savings services.

Survey Implementation

The Household Survey was carried out in January and February 2004. The survey of banks was carried out in November 2003 and was supplemented with data from BOL in February 2004. The survey of multilateral and bilateral development agencies, INGOs, and MFIs was carried out intermittently between January and June 2004.⁴

³ It is common for informal moneylenders not to want to be identified. Even where moneylenders are identified, they may have been reluctant to provide full information about their business. Accordingly, data from the moneylender survey can only be used to supplement data about household borrowing, and since the aggregate incidence of money lending is not necessarily indicated accurately by the survey (because of nondisclosure of moneylending activities), the overall scale of moneylending is best assessed from information collected in the household survey about sources of loans.

⁴ Multilateral and bilateral development agency projects with microfinance components, international nongovernment organizations (INGOs), and microfinance institutions (MFIs) faced considerable difficulty in providing much of the information requested in the questionnaires. INGOs, in particular, had difficulty providing information on financial performance and loan portfolios in a form that allowed an analysis of financial performance.

CHAPTER 2

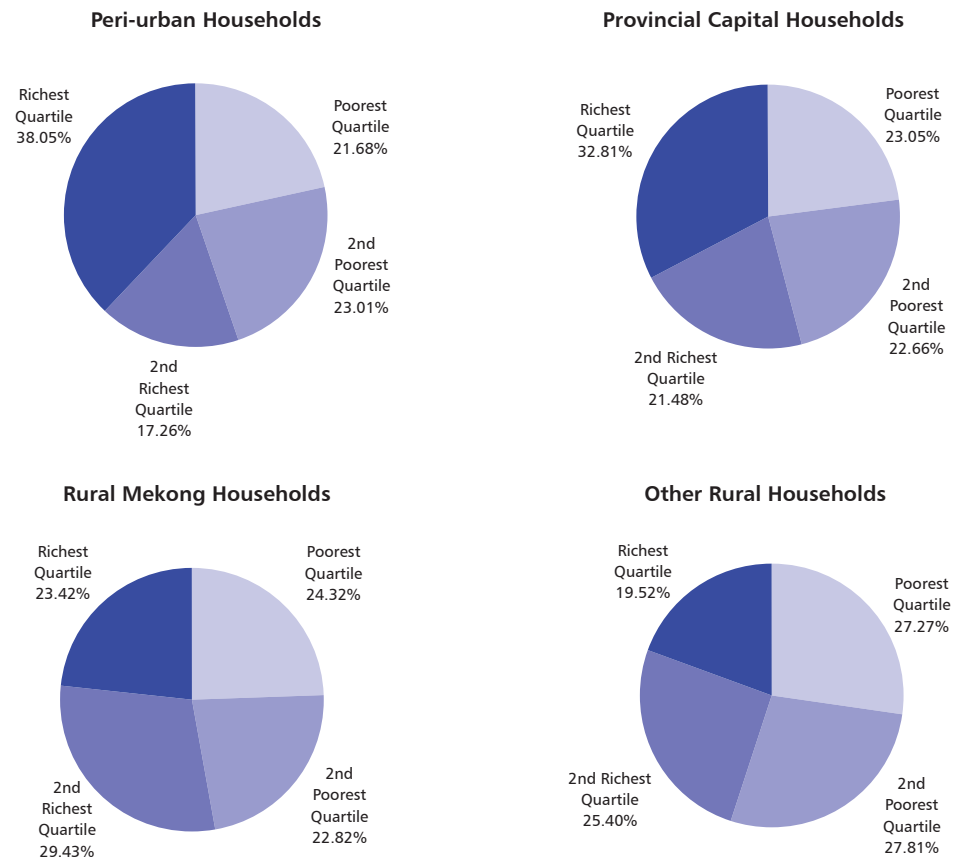
An Economic Portrait of Rural Households

Characteristics of rural households' demographic structure and income-generating activities are important determinants of financial decisions and needs such as borrowing, saving, lending, and risk management. Therefore, this study of rural and microfinance in the Lao PDR begins by presenting a brief economic portrait of the households surveyed. For the purposes of analysis, each sampled household was assigned to a geographic stratum and a wealth quartile following the methodology described in Chapter 1.¹ Figure 2.1 presents the distribution of households by wealth quartile in each stratum.

The occurrence of households in the poorest quartile is highest in the Other Rural stratum, where 27.27% of households are in the poorest quartile, and is progressively less frequent in the Rural Mekong, Provincial Capital, and Peri-urban strata, respectively. The occurrence of a household in the richest quartile follows the opposite pattern, being highest in the Peri-urban stratum (where 38.05% of households are in the richest quartile) and progressively less frequent in the Provincial Capital, Rural Mekong, and Other Rural strata, respectively. These results indicate that poverty is more prevalent in more remote rural areas, while the Peri-urban and Provincial Capital strata tend to be

¹ No effort was made to determine if households were under the official Lao poverty line as the data collection necessary for this was beyond the scope of this study. However, the poverty rate in rural Lao PDR is 37.6% according to Lao Info Common Indicators Database System, National Statistics Center (the overall poverty rate in Lao PDR is 33.5%). Hence, as a rough approximation, all households in the poorest quartile, as well as about half of households in the second quartile, can be considered poor.

Figure 2.1 Composition of Strata by Wealth Quartiles



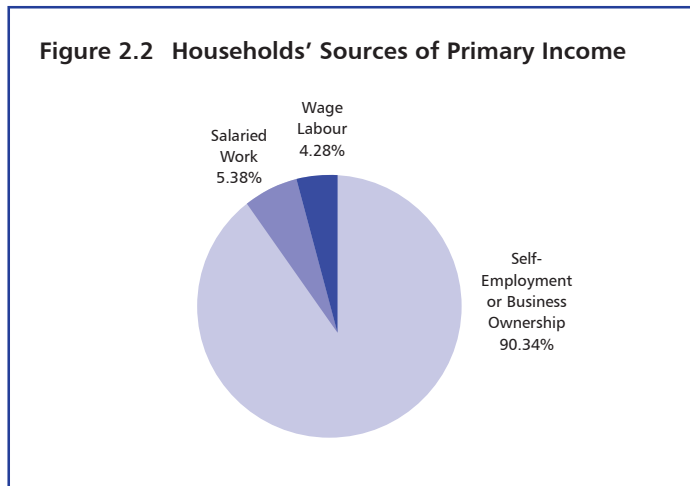
Source: Household survey

wealthier. However, they also indicate that large portions of households in each stratum fall into each wealth quartile.

Households' Income-generating Activities

Figure 2.2 shows the proportion of rural households that report deriving their primary source of income from self-employment or their own business (including self-employment in agriculture, i.e., working their own farm), salaried work, and wage labor.² For 90.34% of rural households, the primary source of income is self-employment or ownership of a business. Only 5.38% of rural households have salaried work as the primary source of income, while wage labor provides the primary source of income for only 4.28% of rural households.

Table 2.1 shows the distribution of sources of households' primary income, broken down by stratum and wealth quartile.



Source: Household survey

² In this study, the “self-employed” work for themselves or for the household and do not employ others, while “business owners” may or may not work in the business that they own, but always employ others in their business.

The table shows relatively small differences between strata in the percentage of households with primary income from self-employment or private business ownership as the primary income source. However, more households in the wealthiest two quartiles have income from salaried work, while more households in the poorest two quartiles have income from wage labor.

To break this down further, Figure 2.3 illustrates the frequency that households identified specific economic activities as their primary source of income. Rice production is the most common primary source of income (64.65% of rural households), followed by livestock raising (10.24%), and trade (6.96%). Production of other crops is the primary source of income for only 3.34% of households. The contrast between the poorest quartile—where rice production is the main activity for about 70% of households—and the richest quartile—where it is the main source of income for only 51% of households—suggests that relative poverty is linked with the production of the



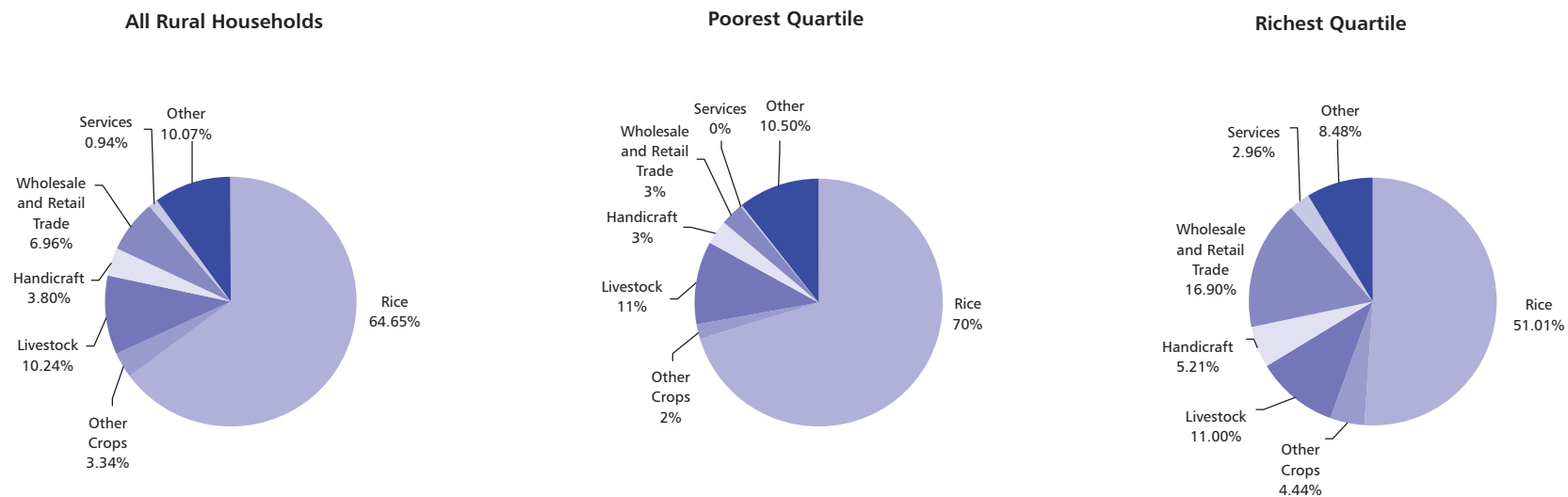
Women comprise 40% of households' financial managers

Table 2.1 Sources of Household Primary and Secondary Income

Income Source	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Primary Income from Self-Employment or Business Ownership (%)	90.34	88.05	88.67	92.49	89.84	89.87	90.57	89.40	91.52
Primary Income from Salaried Work (%)	5.38	6.19	6.64	2.40	7.22	3.32	4.50	7.66	6.04
Primary Income from Wage Labor (%)	4.28	5.75	4.69	5.11	2.94	6.81	4.93	2.93	2.45
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

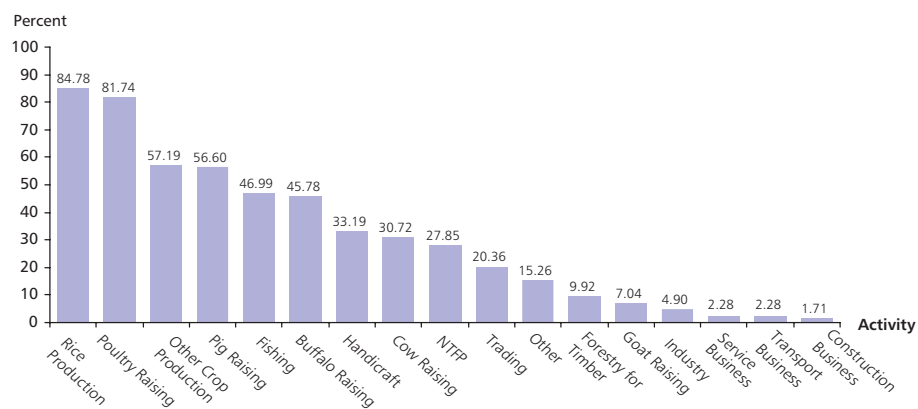
Source: Household survey

Figure 2.3 Household Primary Source of Income



Source: Household survey

Figure 2.4 Percentage of Households Engaged in Activities



Source: Household survey

subsistence crop as the primary household source of income. Households in the wealthiest quartile are also markedly more engaged in wholesale and retail trade as a primary source of income.

Figure 2.4 and Table 2.2 present the frequency that households reported engaging in specific income-generating activities (primary or otherwise). These data illustrate that:

- the incidence of rice production as a household activity is greatest in Rural Mekong households (92.79% of households) and least in Peri-urban households (65.93%);
- there is a similar pattern with poultry production;
- the percentage of households reporting other crop production was lowest for Rural Mekong households,

Table 2.2 Household Income Generating Activities (% of Households Engaged in Activity)

Income Source	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Rice Production	84.78	65.93	85.55	92.79	86.63	88.33	87.11	89.12	74.52
Poultry Raising	81.74	59.73	87.11	90.69	83.69	79.27	86.19	85.69	75.78
Other Crop Production	57.19	49.56	61.33	44.44	70.05	53.47	63.18	62.74	49.37
Pig Raising	56.60	24.78	61.33	63.96	64.17	60.68	57.83	61.82	46.04
Fishing	46.99	23.89	41.41	45.95	58.56	55.01	51.12	49.20	32.60
Buffalo Raising	45.78	33.19	42.97	52.25	46.52	29.57	49.40	56.32	47.83
Handicraft	33.19	20.35	29.30	39.94	33.96	30.78	34.42	35.55	32.02
Cow Raising	30.72	8.41	33.20	47.15	27.27	17.48	28.59	38.37	38.44
Non-Timber Forest Products	27.85	9.73	21.09	11.41	49.47	34.78	34.58	27.71	14.31
Trading	20.36	23.45	15.23	20.12	19.79	12.70	11.62	19.55	37.58
Other	15.26	19.47	18.36	16.22	12.30	17.52	13.70	0.13	0.17
Forestry for Timber	9.92	5.31	4.30	9.61	12.83	9.33	12.23	10.32	7.80
Goat Raising	7.04	2.21	10.94	12.31	4.55	5.75	5.71	9.79	6.89
Industry	4.90	3.98	4.30	6.31	4.28	2.21	4.08	5.66	7.67
Service Business	2.28	5.75	4.30	0.90	1.60	1.12	1.12	1.40	0.05
Transport Business	2.28	5.75	4.30	0.90	1.60	1.12	1.12	0.01	0.05
Construction Business	1.71	2.21	1.56	0.90	2.14	1.87	0.08	2.69	2.19

Source: Household survey

consistent with the dominance of rice in the farming systems in the Rural Mekong area, and highest in Other Rural households, consistent with the more diversified farming systems in the Other Rural stratum;

- other crop production was also less frequent in Peri-urban households, reflecting the lower overall dependence of these households on agriculture;
- livestock raising and fishing were consistently lower in Peri-urban households than elsewhere;
- non-timber forest products (NTFP) as a source of income were reported most frequently in Other Rural areas (49.47%), consistent with the farming systems in those areas;
- forestry was most common in Other Rural and Rural Mekong households, again consistent with their farming systems;
- trading was most common in Peri-urban households and least common in Provincial Capital households;

- service, transport, and construction businesses were more frequently reported as a source of income by households in the Peri-urban and Provincial Capital strata than by others, as would be expected given the greater demand for these activities near urban areas; and
- the richest quartile of rural households is less engaged in rice production and other agricultural activities, and more engaged in trading and industry than the other three quartiles.

Figures 2.5 and 2.6 illustrate the high frequency of multifunctional households in the Lao PDR, i.e., households that report receiving income from more than one source. Some 90% of rural households engage in multiple income-generating activities. Even the least multifunctional stratum, Peri-urban households, has an incidence of 81.42%, and all four wealth quartiles fall in the range of 88–92%. The high level of multifunctionality is an important observation with implications for the rural finance system in the Lao

Rural finance has focused on directed lending programs to agriculture, but there is a need for financial services that serve a broad range of household activities.

Figure 2.5 Multifunctional Households Stratum

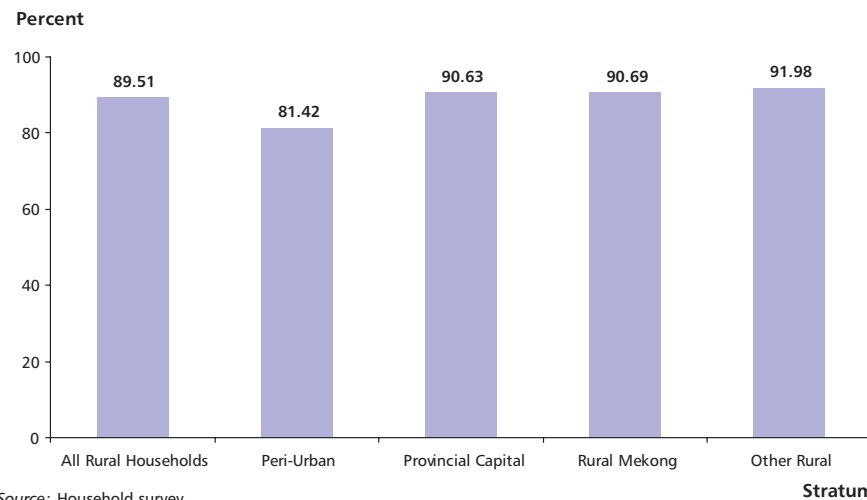


Figure 2.6 Multifunctional Households by Wealth Quartile

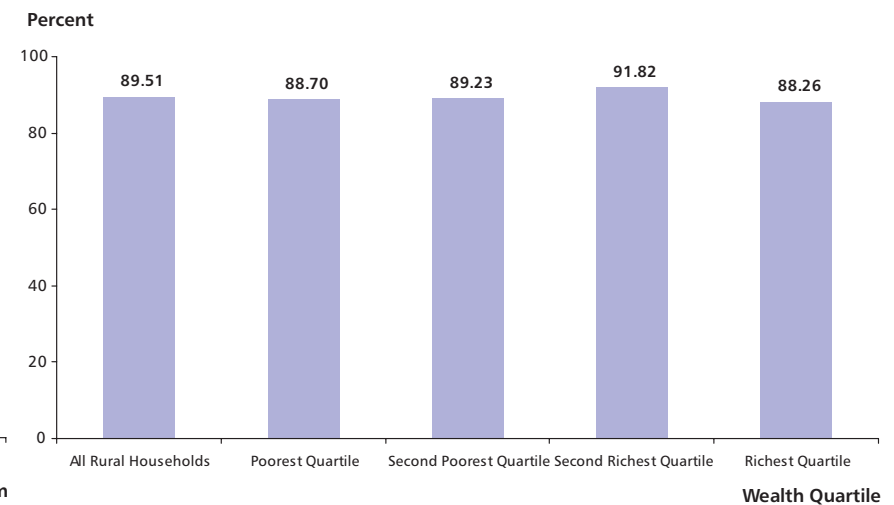


Figure 2.7 Average Household Income by Stratum

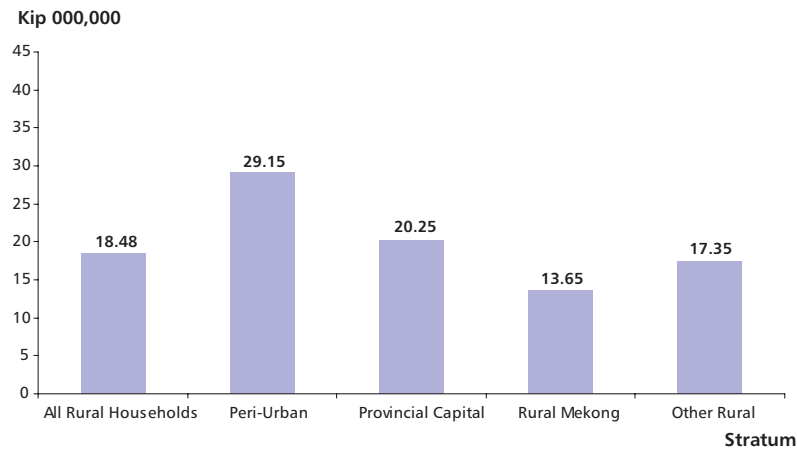
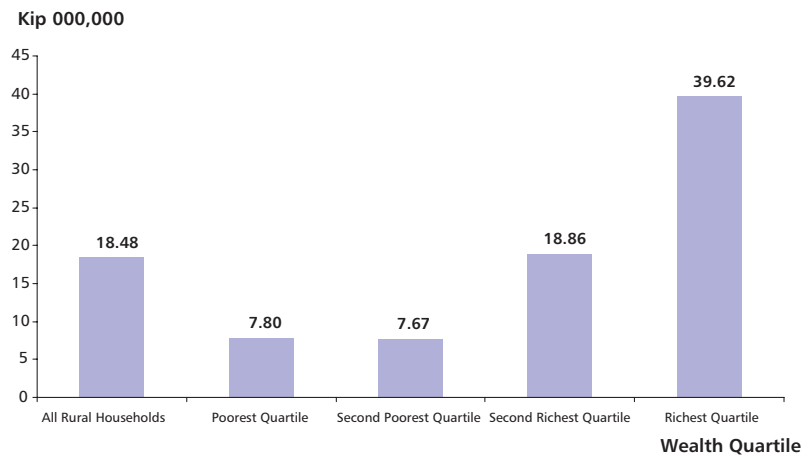


Figure 2.8 Average Household Income by Wealth Quartile



Source: Household survey

PDR. While rural finance policies have traditionally focused on directed lending programs that target agricultural activities, the high frequency of multifunctionality suggests a need for financial services that serve a broad range of economic activities in rural households.

Household Income

The frequency with which households report engaging in particular economic activities is not necessarily a reflection of the importance of those sources in overall income. This section expands further on the previous analysis by examining the amount of income derived from various sources. Figures 2.7 and 2.8 illustrate the average incomes of households by stratum and wealth quartile.³

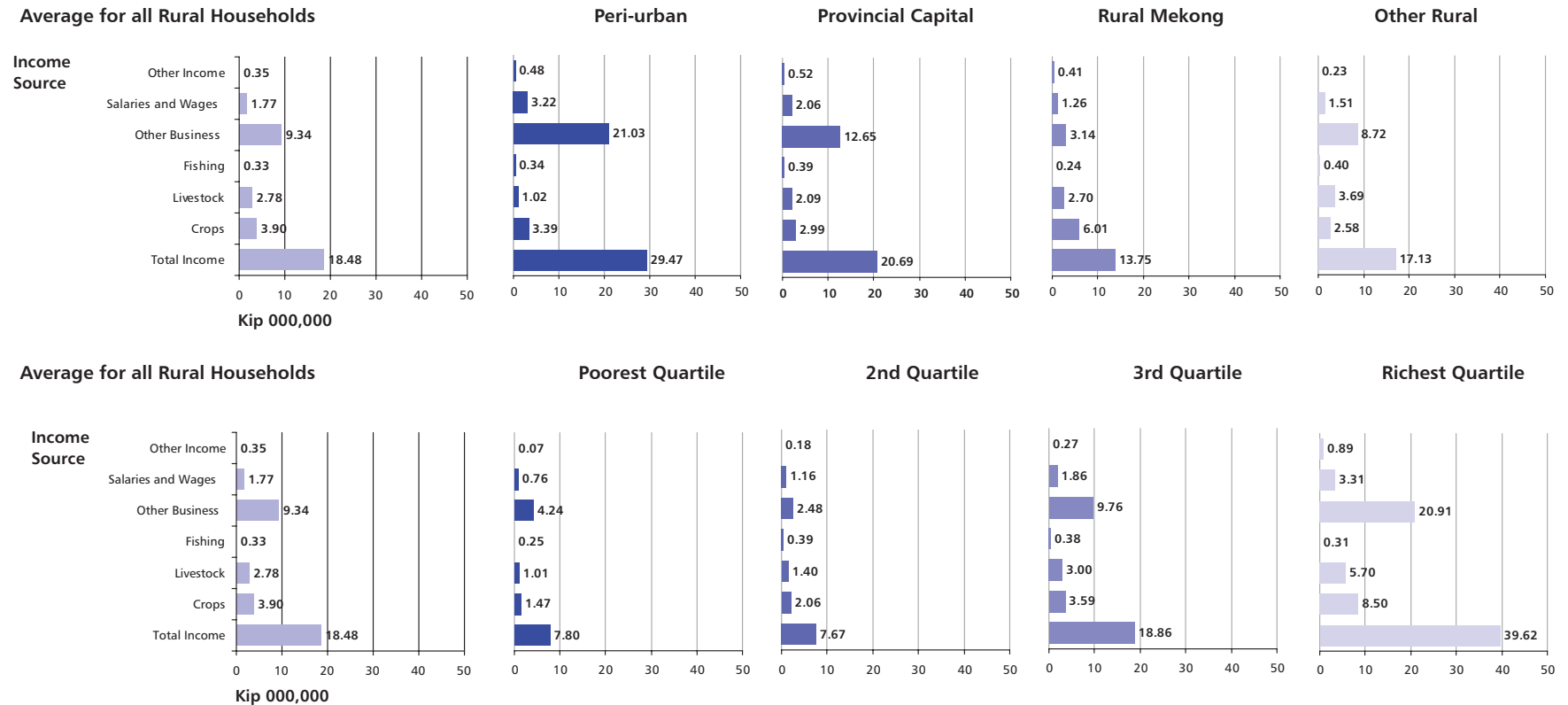
Peri-urban households reported an average income in the 12 months preceding the survey of KN29.16 million, some 1.44 times the average of Provincial Capital households, 2.14 times the average of Rural Mekong households, and 1.68 times the average of Other Rural households. The average income of the richest quartile of households at KN39.62 million was 5.08 times that of the average income of the households in the poorest quartile.⁴

Figure 2.9 provides a more detailed analysis of income sources and illustrates the greater income of Peri-urban and Provincial Capital households, especially from business, in comparison to Rural Mekong and Other Rural households.

³ Incomes include the value of household production consumed by the household itself.

⁴ In the survey the average income reported by the second poorest quartile was KN7.80 million compared to the marginally higher average income reported for households in the poorest quartile of KN7.67 million. For the purpose of assigning households to the wealth quartiles, assets rather than income were used because assets represent the cumulative wealth position of the household, while income data applies only to the 12 months preceding the survey. While it is beyond the scope of this analysis to investigate this further, it is noted that there are differences in the pattern of primary activities between the poorest quartile and the second poorest quartile. The second poorest quartile is more dependent on other crops and handicrafts as primary sources of income, and less dependent on rice crop production and livestock production than the poorest quartile of households.

Figure 2.9 Household Income by Source



Source: Household survey

It also illustrates the wide variation between the richest and the poorest, stemming again largely from differences in business income. The figure highlights the importance of nonagricultural income in rural Lao PDR. Overall, only 38% of reported income came from agriculture, livestock, or fishing. Over half of reported income came from business activities. Only the Rural Mekong households, who depend

primarily on rice production, reported more than half of their income from agriculture, livestock, and fishing. Among wealth quartiles, the poorest derived only 35% of their income from agriculture, livestock, and fishing; the second poorest derived 50% from these sources; and the richest and second richest each derived 37%.

Only 38% of income came from agriculture, livestock, or fishing. Over half came from business activities.

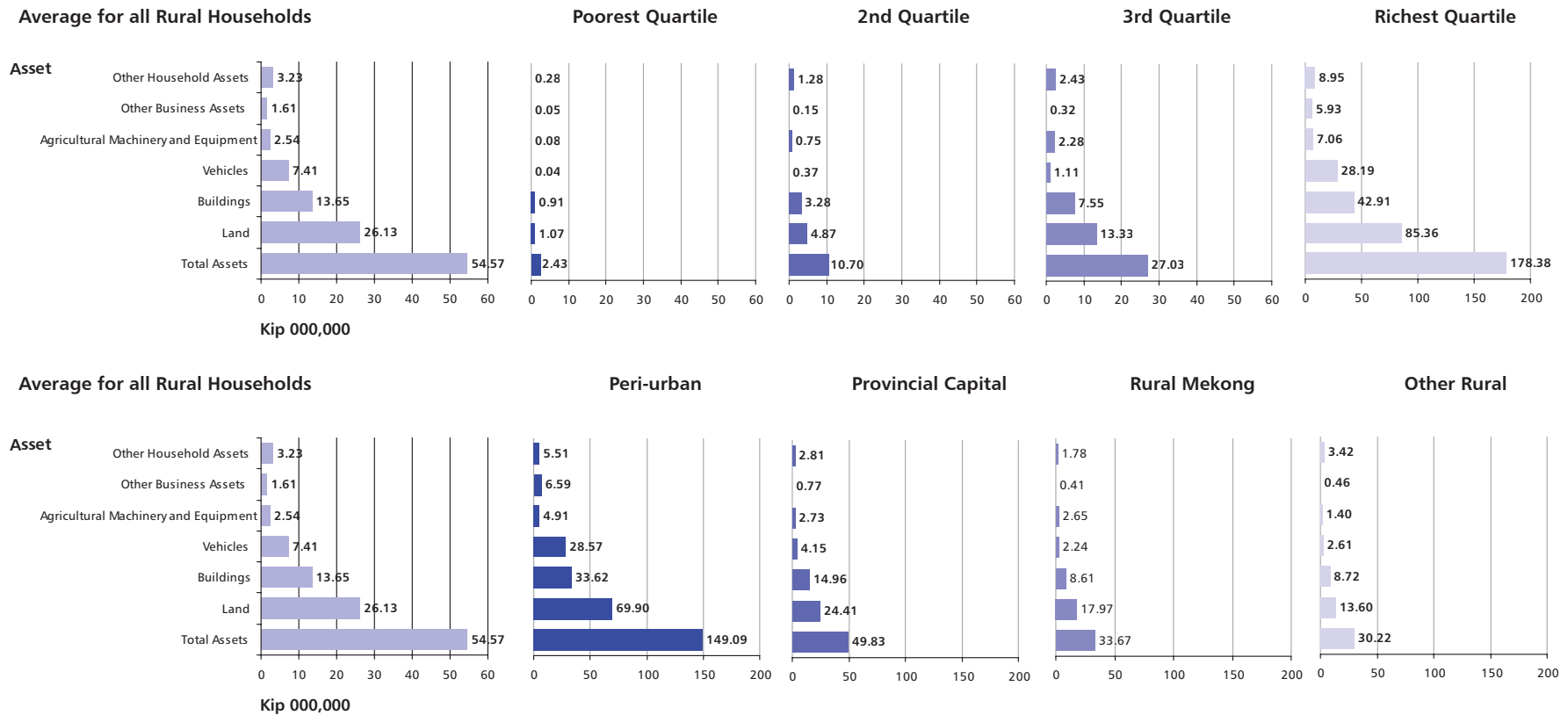
Household Assets

Figure 2.10 summarizes household fixed asset ownership, while Figures 2.11 and 2.12 summarize household working capital ownership. The figures highlight:

- households in the richest quartile have on average 73.41 times the average fixed assets of households in the poorest quartile, and these differences are pronounced across each type of fixed asset;

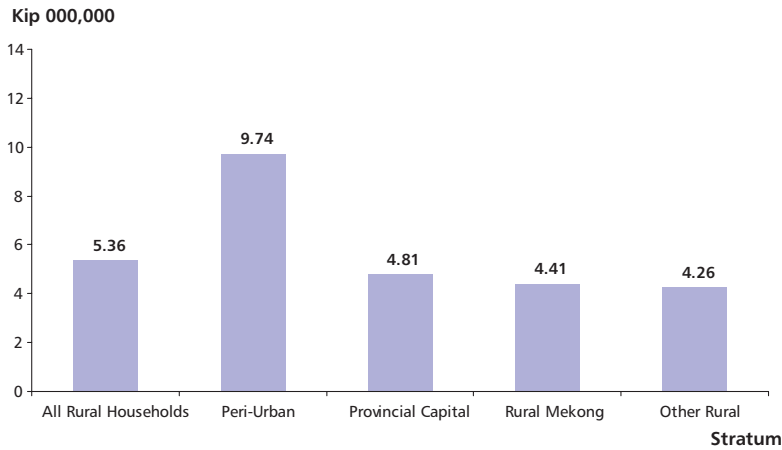
- Peri-urban households have fixed assets almost 3 times the average of rural households and almost 5 times the average of Other Rural households, and again these differences are pronounced across each type of fixed asset; and
- Peri-urban households have on average 3.46 times the working capital of the average rural household, and the richest quartile households have on average 10.31 times the working capital of the poorest households.

Figure 2.10 Household Fixed Asset Ownership by Wealth Quartile



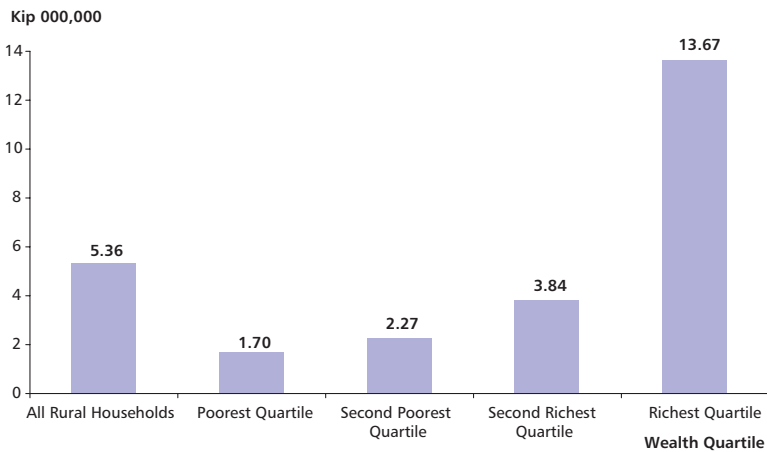
Source: Household survey

Figure 2.11 Average Household Working Capital by Stratum



Source: Household survey

Figure 2.12 Average Household Working Capital by Wealth Quartile

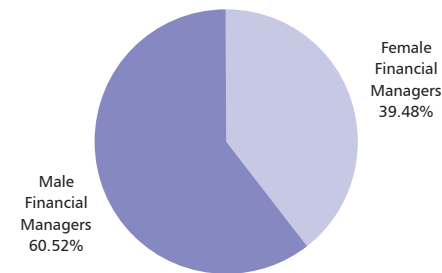


Characteristics of Household Financial Managers

During the survey, each household was asked to identify the household’s main financial manager. The financial manager was defined as the person most responsible for allocating household resources and managing the household’s money and financial decisions. As such, this person’s characteristics can influence the household’s overall economic and financial decisions and activities. Figure 2.13 and Table 2.3 present key characteristics of these financial managers, including: 60.5% of households had male financial managers, while 39.5% had female financial managers; the average age of household financial managers is almost uniform across strata; female household financial managers are most prevalent in Peri-urban and Provincial Capital households, and among the richer quartiles; and in general, the education level of the household financial manager is lower in more remote households (Rural Mekong and Other Rural strata) and in poorer quartiles.

60.5% of households had male financial managers, while 39.5% had female financial managers.

Figure 2.13 Financial Manager Gender



Source: Household survey

Table 2.3 Household Financial Manager Age, Gender and Educational Level

Financial Manager Characteristic	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Average Age of Financial Manager (Years)	43	43	42	45	42	40	43	44	46
Female Financial Managers (%)	39.48	53.10	42.19	37.84	34.49	29.04	37.37	44.73	46.78
Male Financial Managers (%)	60.52	46.90	57.81	62.16	65.51	70.96	62.63	55.27	53.22
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Financial Manager with No Formal Education (%)	26.08	20.35	25.00	38.14	19.25	34.93	25.60	28.45	15.33
Financial Manager with Primary School Education (%)	48.92	53.54	43.75	42.34	52.67	47.99	51.34	50.64	45.71
Financial Manager with Secondary School Education (%)	20.74	19.91	25.78	16.22	24.06	15.31	19.42	18.71	29.54
Financial Manager with Vocational School Education (%)	2.86	3.10	2.34	2.70	2.94	1.77	1.58	1.14	6.97
Financial Manager with Tertiary Education (%)	1.19	2.65	2.73	0.30	1.07	0.00	1.32	1.07	2.37
Financial Manager with Other Education (%)	0.20	0.44	0.39	0.30	0.00	0.00	0.73	0.00	0.08
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Household survey

Table 2.4 Household Financial Manager's Occupation

Financial Manager Characteristic	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Self-Employed (%)	83.64	78.32	82.81	87.69	82.89	91.13	88.10	84.98	70.33
Business Owner (%)	3.11	4.87	4.69	2.10	2.94	0.00	0.89	2.92	8.63
Employee in a Business (%)	1.22	1.77	2.34	0.60	1.34	1.14	1.45	0.61	1.69
Government Employee (%)	6.60	4.87	5.08	3.60	9.89	3.62	5.67	5.35	11.78
Unemployed (%)	4.08	9.29	3.52	5.11	1.07	3.32	3.02	4.22	5.77
Homemaker (%)	0.26	0.44	1.17	0.00	0.27	0.46	0.41	0.08	0.08
Retired (%)	1.09	0.44	0.39	0.90	1.60	0.33	0.46	1.85	1.72
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Household survey

Table 2.4 shows the distribution of the occupations of household financial managers by stratum and wealth quartile. The table illustrates that:

- across strata and quartiles, the vast majority of household financial managers are self-employed; however, household financial managers are most likely to be self-employed in Rural Mekong households and the poorest households;
- the financial managers in Peri-urban households and Provincial Capital households are more likely to own businesses than those in the other two strata, and financial managers in the richest households are more likely to be business owners than those in other quartiles;
- the employment of household financial managers by Government was higher in Other Rural households and in the richest households;
- unemployment among financial managers was most frequent in Peri-urban areas, and least in Other Rural areas; and

- there is a very low incidence of household financial managers being homemakers or retired people, with 98.65% of household financial managers being in the active labor force.

Basic Household Characteristics

Table 2.5 summarizes some basic characteristics of rural households in the Lao PDR according to the survey results. As already noted, there is noticeable inequality, with households in the richest quartile owning total assets whose value is, on average, 56.5 times that of households in the poorest quartile, 15.8 times that of the next poorest quartile, and 6.4 that of the next richest quartile. Relative poverty tends to be associated with areas that are more remote and more dependent on agriculture. Some 79% of households depend on agriculture, livestock, or fishing as their primary activity but derive, on average, only 38% of their income from these activities; almost 90% are multifunctional, engaging in more than one income-generating activity.

There is noticeable inequality, with households in the richest quartile owning total assets whose value is 56.5 times that of households in the poorest quartile.

Table 2.5 Basic Characteristics of Rural Households

Household Characteristic	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Self-Employed (%)	83.64	78.32	82.81	87.69	82.89	91.13	88.10	84.98	70.33
Business Owner (%)	3.11	4.87	4.69	2.10	2.94	0.00	0.89	2.92	8.63
Average Household Size (Persons)	6.1	5.5	6.3	6.5	6.0	5.7	5.9	6.5	6.2
Multifunctional Households (%) ¹	89.51	81.42	90.63	90.69	91.98	88.70	89.23	91.82	88.26
Agriculture, Livestock, or Fishing as Primary Activity (%)	79.18	71.67	77.34	81.97	80.47	84.18	83.56	82.44	66.53
Income (KN million)	18.48	29.47	20.69	13.75	17.13	7.80	7.67	18.86	39.62
Portion of Income from Agriculture, Livestock, or Fishing (%)	37.93	16.12	26.44	65.09	38.94	35.00	50.20	36.96	36.62
Average Physical Asset Value (KN million)	57.90	156.95	52.37	35.96	32.49	3.317	11.89	29.15	187.53
Average Physical Asset Value (\$)	5,450	14,772	4,929	3,384	3,058	312	1,119	2,744	17,650

Source: Household survey

Chapter 3

Rural Financial Services Supply—The Formal Sector

APB was created as a policy bank by a Prime Minister's Decree in 1993 to make subsidized loans for agriculture.

The supply of rural financial services in the Lao PDR, as with most developing countries, can be broken down into the formal, semiformal, and informal sectors. For the purposes of this study, the formal sector consists of the commercial banks, which will be covered in this chapter. The semiformal sector comprises project-based interventions to provide rural and microfinance services. The informal sector comprises loans between friends and family members, informal moneylending, and lending through the traditional Lao *houay*. The semiformal and informal sectors will be discussed in the next chapter.

The Formal Sector—A Brief History¹

The development of the Lao banking system can be divided into distinct phases. During the first phase (1975–1988), the Government instituted a mono-banking system comprised of the State Bank of Lao PDR (SBL) as the country's only bank. The introduction of the New Economic Mechanism in 1988 ushered in the second phase (1988–1992) by creating a two-tiered banking system. SBL's commercial banking activities were placed in three state-owned commercial banks (SOCBs), and BOL was created as the central bank. Four additional SOCBs were created in 1990–1991, but all seven of the resultant SOCBs remained

under the management control of BOL.² Moreover, the legal and regulatory framework was weak, bank supervision was limited, and bank performance was poor.

The third phase (1992–1995) was characterized by further growth in the number of banks in the Lao PDR. Following the issuance of Prime Minister's Decree No. 3 on the Management of Commercial Banks and Other Financial Institutions (1992), branches of foreign banks (five Thai and one Malaysian) were established, along with a joint venture bank. And, importantly for the evolution of the rural finance system, APB was created as a policy bank by another Prime Minister's Decree in 1993 to make subsidized loans for agriculture. Performance of the SOCBs remained weak, with nonperforming loans (NPLs) reported at 35% in 1994. To satisfy capital adequacy requirements, the Government then proceeded with a first round of recapitalization of the SOCBs.

The fourth phase (1996–2002) was marked by improvements in the legal and regulatory environment, with the issuance of several prudential regulations that applied to the SOCBs and other banks and a revised Decree on the Management of Commercial Banks. However, continued weak performance of the SOCBs led to a program to consolidate them—by the end of 2002, their number had

¹ The section draws on BOL, The Banking and Financial Sector of Lao PDR: Financial Sector Note, 15 July 2002.

² The seven SOCBs were (with year of creation in parentheses): Nakhornluang Bank (1988), Sethathirath Bank (1988), BCEL (1989), Lao May Bank (1990), Phaktai Bank (1990), Lanexang Bank (1991), and Arounmay Bank (1991).



been reduced to two SOCBs, along with APB.³ However, as of end-2002, all three banks maintained high NPLs, surpassing 80% in one case.

A fifth phase can be considered to have begun in early 2003 under the Government’s Banking Sector Reform Program. Under this program, two of the three state-owned banks (Banque pour le Commerce Exterieur du Laos [BCEL] and the Lao Development Bank [LDB]) have operated under governance agreements designed to improve corporate governance and reduce NPLs through enhanced loan collection and improved credit decision making. Similarly, under this program, APB has adopted a new corporate mandate and restructuring plan to become a

³ The status of APB—as a state-owned commercial bank (SOCB) or as a policy bank—was unclear after 1997. The wording of the revised decree and regulations indicated that they applied equally to APB (e.g., the revised decree included “agriculture promotion bank” in its definition of commercial banks). However, in practice, APB continued to be treated as a policy bank that was exempt from prudential regulations, and it was not supervised by BOL. Only in June 2005 did BOL clarify its status by issuing a directive notifying APB that it will be considered an SOCB and will be subject to the applicable regulations and supervision.

sustainable, market-oriented rural finance institution, operating free of subsidies and phasing out all policy lending. APB is due to receive further support for its reform program under the Government’s Rural Finance Sector Development Program, due to begin in 2006. All three banks are due to be recapitalized, contingent on satisfactory performance.

Formal Sector Participants

The commercial banking industry in the Lao PDR has three principal groups:

- Three SOCBs, namely: BCEL, LDB, and APB. All are wholly owned by the Government, with BCEL focused on foreign trade, LDB serving commerce, and APB serving the agricultural sector.
- Three joint-venture commercial banks (JVCBs), namely: the Joint Development Bank (JDB), Vientiane Commercial Bank (VCB), and Lao-Viet Bank (LVB). The JVCBs mainly service customers in the country’s principal cities. JDB was established in 1989. VCB began operating in 1995. LVB started operations in 1999. JDB is a joint venture between the Government of the Lao PDR (30%) and private Thai interests. VCB is a joint venture between Lao private investors (25%), and private Australian, Taiwanese, and Thai banking interests. LVB is a joint venture between BCEL and the Bank for Industrial Development of Viet Nam (BIDV).
- Six foreign commercial banks (FCBs), each operating a single branch office in Vientiane, and one other UK bank—Standard Chartered Bank—with a representative office in Vientiane. Five of the six FCBs are Thai—Bangkok Bank (BBL), Krung Thai Bank (KTB), Siam Commercial Bank (SCB), Bank of Ayudhya (BAY), and Thai Military Bank (TMB)—and one, Public Bank (PBM), is Malaysian. The FCBs primarily service their home country clients who have operations in the Lao PDR.

The formal financial sector also has a single insurance company, numerous foreign exchange bureaus, and a social security fund. Overall, the degree of diversity and specialization in the Lao PDR formal financial sector is rudimentary.

Financial Structure

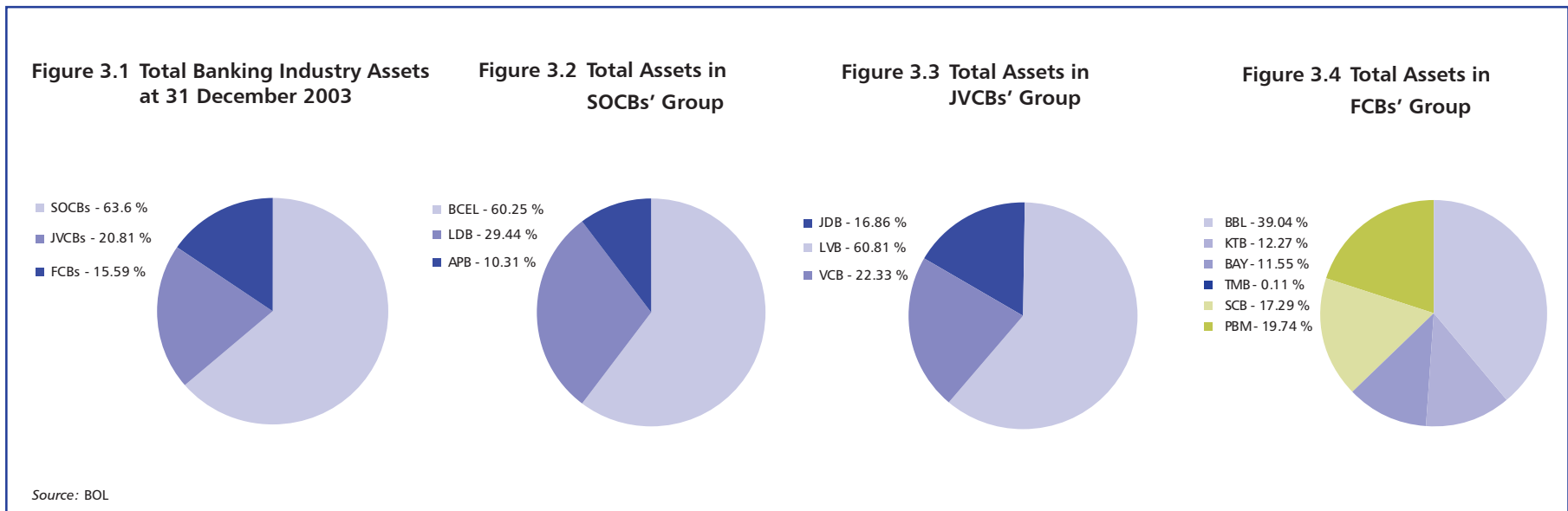
The formal sector banking industry is small and dominated by the SOCBs, which controlled a combined 64% of the estimated KN5.4 trillion (\$507 million) in total banking assets as of the end of 2003. Figure 3.1 shows the relative shares of the three banking groups based on total assets.

In the SOCB group, BCEL with KN2.1 trillion (\$194 million) in total assets is the largest, followed by LDB with KN1 trillion (\$95 million), and APB with KN0.4 trillion (\$33 million). The relative shares of the three SOCBs are shown in Figure 3.2

The JVCBs hold 21% of the assets in the banking industry. As shown in Figure 3.3, LVB is the largest bank in the group with KN680 billion (\$64 million) in total assets. VCB is the next largest JVCB with total assets of KN250 billion (\$24 million) and JDB follows with KN189 billion (\$18 million).

The six FCBs comprise the remaining 15% of banking assets. BBL is the largest FCB with KN327 billion (\$31 million) in total assets. As highlighted in Figure 3.4, the relative positions of the remaining FCBs in terms of total assets are PBM (KN165 billion or \$16 million), SCB (KN145 billion or \$14 million), KTB (KN103 billion or \$10 million), BAY (KN97 billion or \$9 million), and TMB (KN1 billion or \$94,000).

BOL prudentially regulates and supervises all commercial banks. Supervision of APB according to the prudential regulations applicable to other SOCBs began only in 2005.



The commercial banking industry has experienced considerable growth over the past few years. Between 2002 and 2003 alone, total banking assets grew by 28% in nominal terms.⁴ As a consequence of this growth, as well as continuing supervisory weaknesses, NPLs in the industry have also grown. Ongoing restructuring efforts at the SOCBs and BOL are intended to address these problems.

The commercial banks' attention toward rural areas and populations in the country is very limited. BCEL handles foreign trade and as such does not concentrate on rural areas. LDB, with its focus on commerce, has interest in financing small- and medium-sized enterprises (SMEs), some of which are in rural areas (though they are principally in provincial capitals and Vientiane Municipality). APB, with its mandate to promote agriculture, is the SOCB most engaged in rural areas but, in practice, the majority of its clients are located in urban areas. The JVCBs and FCBs do not service rural areas with the exception of financing investments in rural-based dams, mines, and the like.

Branch Networks

APB has the largest branch network in the Lao PDR. It has a head office branch in Vientiane Municipality and 17 other branches in the 17 provincial capitals. APB also operates 55 subservice units located at the district level.

LDB has its head office in Vientiane Municipality and operates 17 branches, one in each province. LDB also has 29 sub-branches at various district locations. LDB has the second largest branch network in the country, but its network may decrease as it intends to close some sub-branches.

BCEL has its head office in Vientiane Municipality and six branches in the major population centers of Champasak,

Khammouane, Luang Namtha, Luang Prabang, Oudomxay, and Savannakhet. For the most part, BCEL does not consider rural populations to be its client base.

The remaining commercial banks have very limited distribution networks. LVB has its head office in Vientiane Municipality and a single branch in Champasak. JDB has its head office branch in Vientiane Municipality and no other branches; it reports no intention of opening any new branches. VCB has a single branch in Vientiane Municipality, but intends to open new branches in Savannakhet and Champasak. The FCBs each have a single branch—all located in Vientiane Municipality—with no plans for new branches.

Hence, the population in Vientiane Municipality has the greatest access (in terms of physical proximity) to commercial banks, followed by residents of the large urban centers, and then by residents in the other provincial capitals. As would be expected, residents of rural areas are most removed from commercial banks and the services they provide.

Savings Products

All commercial banks offer basic saving products in kip, US dollars and Thai baht—current accounts, savings accounts, and fixed-term deposits. The SOCBs and JVCBs offer fixed term deposits out to 24 months in tenor, but the FCBs do not offer fixed-term deposits past 12 months in duration. LVB also offers Vietnamese dong savings accounts out to 12 months in tenor.

All commercial banks' savings products are voluntary in nature except for LDB and APB who have compulsory savings in addition to voluntary savings products. Compulsory savings are associated with group guarantee loan products. As the name suggests, borrowers are required to place funds in noninterest-bearing current accounts as a loan conditionality.

⁴ Inflation as measured by the consumer price index was 12.6% between December 2002 and December 2003, implying real growth in banking assets of about 13.7%. See IMF 2005. Lao People's Democratic Republic: Selected Issues and Statistical Appendix. January, p. 33.

APB offers additional, more specialized saving products such as daily deposit accounts, lottery payout deposit accounts, and 5-year certificates of deposit. These products were developed to improve deposit mobilization at APB. From a large deficit position in the mid-1990s, APB is now close to fully funding its loan portfolio with customer deposits. As shown in Table 3.1, most commercial banks can fund their loan portfolios with funds from their savings products—indeed, many banks have excess liquidity in the form of low loan-to-deposit ratios.

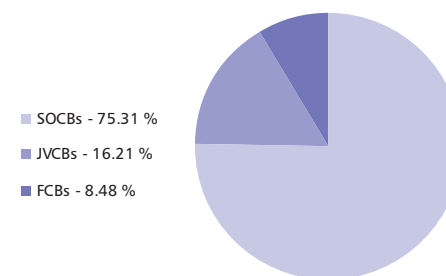
Of total deposits in the commercial banking industry, the SOCBs hold the dominant market share position of 75% as shown in Figure 3.5. Within the SOCBs, BCEL has the most deposits with 61% of the total amount. LDB held about 33% of the deposits in this group, while APB held about 6%.

Table 3.1 Loan to Deposit Ratios in Commercial Banks

Bank	Loans/Deposits Ratio
BCEL	0.39
LDB	0.20
APB	1.08
JDB	0.64
LVB	0.85
VCB	0.63
BBL	1.93
KTB	0.47
BAY	1.24
TMB	0.77
SCB	0.15
PBM	0.43

Source: BOL.

Figure 3.5 Total Banking Industry Deposits



Source: BOL

Interest Rates on Savings

On 31 December 2003, interest rates on kip-denominated deposit accounts of different maturities varied between the commercial banks. The SOCBs offered savings deposit rates at or slightly above the inflation rate. As shown in Figures 3.6 through 3.9, the SOCBs offer progressively higher rates at longer maturities.

However, BCEL and LDB did not seem to need these deposits as their aggregate deposits exceeded their outstanding loan portfolios almost threefold at 31 December 2003. APB was the only exception as its deposits almost equalled its loan portfolio. The deposit rates offered by BCEL and LDB appear to be more policy than commercially directed, e.g., as a tool to manage the money supply.

With the exception of LVB, the JVCBs offered deposit rates at a much lower level across the time horizon. JDB and VCB appeared to have sufficient liquidity to finance their current and projected loan portfolios. LVB is similar to the SOCBs in pricing its deposit products. This is expected as the bank is a joint venture between SOCBs of the governments of the Lao PDR and Viet Nam. LVB's deposits and borrowings exceed its loan portfolio need by almost two times.

Figure 3.6 Savings Deposit Rates

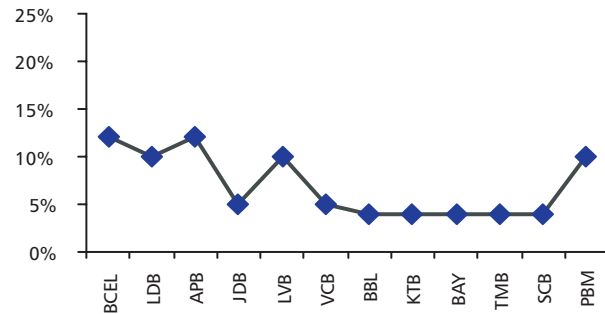


Figure 3.7 3 Months Deposit Rates

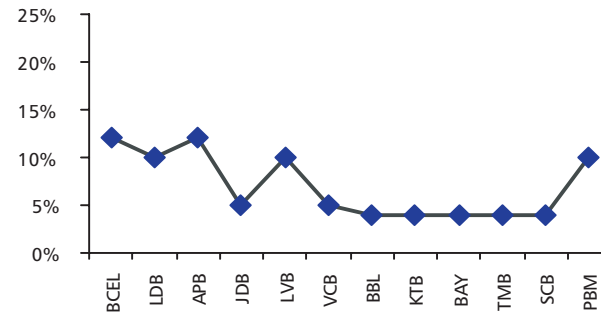


Figure 3.8 6 Months Deposit Rates

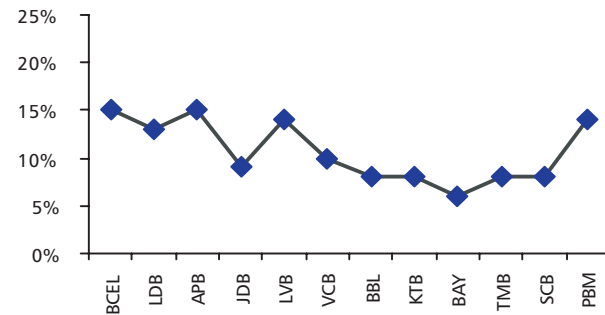
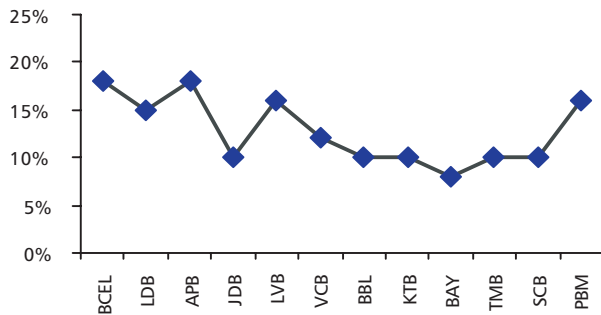


Figure 3.9 12 Months Deposit Rates



Source: BOL

The FCBs, except PBM, do not offer rates at or above the rate of inflation for their savings deposits. For longer-dated maturity deposit products, the rates offered range between 8–10 percentage points below the rates offered by the SOCBs. At their lower pricing levels though, the FCBs appear to be able to attract sufficient funding for their loan portfolios.

All commercial banks also offer deposit accounts in Thai baht and US dollars, some out to 2 years in maturity. The deposit rates offered on these foreign currency accounts are competitive with international rates.

Loans

Loan Characteristics

The commercial banks offer various loan products based on their target market segments and appetite for credit risk. APB lends only in kip, but all other banks offer loan products in US dollars and Thai baht in addition to kip. APB places its dollar and baht deposits with other banks. LVB also offers Vietnamese dong loan products. Loan products are term facilities as well as overdraft facilities.

Loan products for all banks are mainly for working capital purposes (financing short-term agriculture and commercial production) and longer-term financing of capital assets. Consumer loan products such as hire purchase and home purchase loan products are not yet offered in the market. Financial leasing products are still in the development phase.

Collateral in the form of land, buildings, pledged deposit accounts, and precious metal deposits are usually required for individual, SOE, and corporate borrowers. Group guarantee loan products, offered only by APB and LDB, are not secured by physical collateral; instead, they are secured by all members of the borrowing group guaranteeing repayment of the sum total borrowed by all members of the group. Foreclosure and bankruptcy laws are still in development, and a commercial bank's ability to seize and liquidate collateral in the case of default is weak.

While the SOCBs price their loan products at different rates based on the type of business in which the borrower is engaged, the other commercial banks use a single base lending rate approach in line with international practice—additional percentage margins are charged based on an analysis of the borrowers' credit risk characteristics.

BCEL offers loans for short- and medium-term periods to individuals, SOEs, and private companies. The maximum loan tenor for kip loans for individuals and SOEs is 1 year. Companies can borrow out to 3 years. The time limits are put in place to manage perceived credit risk. In general, BCEL requires borrowers to pay interest monthly and principal quarterly.

LDB offers loan products to group guarantee borrowers, individuals, SOEs, and companies at all maturities ranging from short-term to periods greater than 3 years. Like BCEL, LDB generally requires borrowers to pay interest monthly and principal quarterly.

APB's loan products range from the short-term to over 10 years in maturity for some policy-based loans. APB lends to group guarantee borrowers, individuals, SOEs, and companies. Most group guarantee customers borrow for periods of less than 1 year to finance agriculture production, though they can borrow money for up to 3 years for things such as tractors and other agriculture capital assets. APB has numerous repayment schedules for interest and principal based on the particular characteristics of each loan product. The terms of loans have, in the past, often been determined in consultation with donors providing project-specific credit lines.

The JVCBs restrict their loan products to fewer customer segments than the SOCBs. JDB only lends to individuals and companies at short maturities. VCB also lends to individuals and companies, but only for periods of less than 3 years. LVB restricts itself to lending to SOEs and



APB's Luang Prabang Branch

companies at short maturities. In general, the JVCBs all require their borrowers to pay interest and principal monthly.

The FCBs all offer some combination of overdrafts in kip, Thai baht, and US dollars, as well as short-, medium-, and long-term loans in all three currencies.

Because most SOCBs and JVCBs have significant NPL portfolios (this also being the case to a lesser extent for the FCBs), the banks do not aggressively market their loan products.

Credit Portfolios

The three SOCBs (BCEL, LDB, and APB) dominate the industry's loan portfolio. They accounted for 59% of total outstanding gross loans in the banking sector at the end of the first quarter in 2004. Figures 3.10 through 3.14 illustrate the loan portfolio breakdowns for all of the commercial banks. The SOCBs' lending mandates are evident in their portfolio compositions, which show their respective shares in various economic sectors.⁵

APB is the principal lender to forestry and agriculture borrowers. Of total industry lending to this sector, APB holds 66% of the total portfolio. On the other hand, BCEL dominates lending to industry (50%), construction and equipment (37%), trade (41%) and handicraft (62%). APB only has a 5% share of handicraft lending.

LDB has a more balanced loan portfolio. It does not dominate any principal loan portfolio category. In most cases, LDB holds a second or third place position in each loan portfolio class.

⁵ Within the limits of the survey budget and because of the confidentiality of records on individual bank customers, it was not possible to determine from bank records whether a borrower was "rural" as defined in this study, and therefore not possible to determine to which rural strata borrowers belonged. Instead, outreach of banks to rural areas (and to different wealth quartiles) must be inferred from the survey of 1,189 households, which is reported in Chapter 6.

Figure 3.10 Forestry and Agriculture Lending

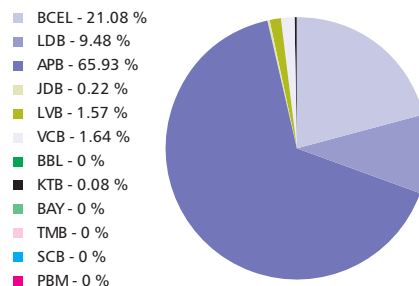


Figure 3.11 Industry Lending

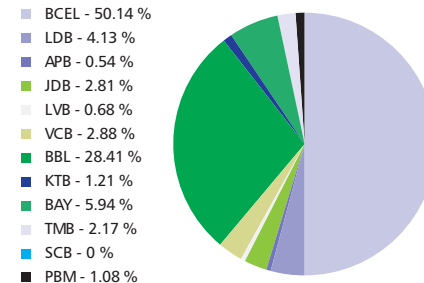


Figure 3.12 Handicraft Lending

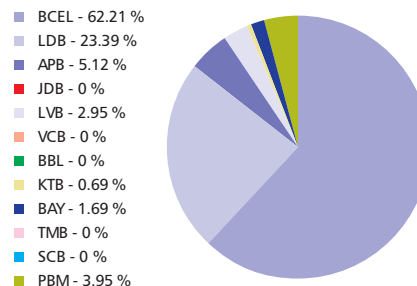


Figure 3.13 Construction/Equipment Lending

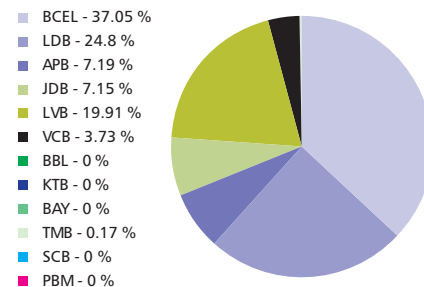
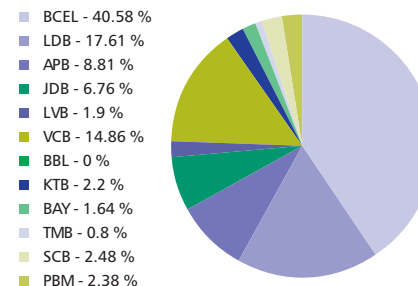


Figure 3.14 Trade Lending



Source: Commercial banks and BOL

Table 3.2 SOCBs' Portfolios

	BCEL	LDB	APB
Borrowers	556	5,246	86,886
Outstanding Loans (KN billion)	826	242	241
Loan Amount Per Borrower (KN million)	1,485	46	3
Loan Amount Per Borrower (US Dollars)	140,116	4,357	262

Source: BOL (31 March 2004)

Table 3.3 Published Bank Lending Rates for Kip Loans (Percent) at 1 December 2003

Bank	Sector	Overdrafts	Short-term	Medium/Long-term
BCEL	Agriculture	24	19	22
	Industry	24	22	24
	Services	24	25	27
LDB	Agriculture	28	19	22
	Industry	28	22	24
	Services	28	24	26
APB ⁶	Agriculture	30	12-30	7-30
	Industry	30	30	-
	Services	30	30	-
JDB	All Sectors	28	25	25
LVB	All Sectors	-	22	24
VCB	All Sectors	-	32	30
BBL	All Sectors	24	20	20
KTB	All Sectors	24	24	24
BAY	All Sectors	-	-	-
TMB	All Sectors	24	-	24
SCB	All Sectors	-	24	24
PBM	All Sectors	22	22	34

Source: BOL.

The JVCBs (JDB, LVB, and VCB) focus principally on the loan market in Vientiane Municipality and, to a lesser degree, the other principal cities. This loan market is mainly focused on construction and equipment, trade and transport, communications, and services lending.

The FCBs (BBL, KTB, BAY, TMB, SCB, and PBM) facilitate the borrowing needs of their home country clients. This fact can be seen in BBL's strong market share (28%) in lending to industry.

As shown in Table 3.2, the number of borrowers that SOCBs serviced is inversely related to the size of their loan portfolios. BCEL has the largest loan portfolio and the lowest number of borrowers. Its average loan size is KN1.5 billion (\$140,000). APB has the smallest loan portfolio among the three SOCBs and the largest number of borrowers with an average loan size per borrower of KN3 million (\$262).

Interest Rates

Table 3.3 shows the published lending rates as of 31 December 2003 for each bank, according to the type of loan. The JVBs and the FCBs in general price their loan products on the basis of perceived risk, the time value of money, and their underlying costs. They use a single base lending rate approach in line with international practice—the rates shown in Table 3.3 are their base rates. Additional percentage margins are charged based on an analysis of the borrowers' credit risk characteristics. Their final lending rates cover these risks, as well as funding costs, administrative expenses, and loan loss provisioning charges.

The SOCBs price their loans at similar or slightly lower levels, but vary rates by sector rather than by assessments of risk attached to any particular borrower. In addition, APB continues to conduct policy-based lending to agriculture at subsidized rates that are administratively determined.

⁶ Rates below 30% per year apply to policy lending under APB management.

However, APB is moving away from this practice and part of its loan portfolio is already based on charging market lending rates. Because the SOCBs’ practice of pricing across sectors does not factor in an assessment of the risk of an individual borrower, the SOCB loan pricing likely does not reflect the risk of the transactions as accurately as the loan pricing of other commercial banks. It is estimated from the survey that the SOCBs’ funding costs are in the range of 10–12%. The current lending rates charged provide a more than 10% margin to cover expenses and loan losses.

Given the level of kip lending rates in the market and the increased probability of default for longer-term loans, most loans are short term in duration.

Other Products and Services

In addition to savings and loan products, the commercial banks offer other credit-based as well as cash management and foreign exchange products. Products include letters of credit (LCs) for domestic and international trade; bank guarantees (BGs) such as bid bonds, performance bonds, and advance payments bonds; international money transfers such as SWIFT payments; domestic money transfers (Dom MT); spot foreign exchange (Spot FX) trades; automatic teller machines (ATM); VISA credit cards; and traveller’s cheques. Table 3.4 summarizes the product offerings of SOCBs and JVCBs. The FCBs are able to offer all these products.

Performance⁷

Generally, a commercial bank’s asset structure will consist of three primary categories—liquid assets, fixed assets, and loans and accrued interest receivable. The target level of each category with respect to total assets is determined by

⁷ At the request of BOL and some of the commercial banks, bank performance is reported here only in aggregate or by groups of banks to protect the confidentiality of data and performance specific to individual banks.

Bank	LCs	BGs	Int’l MT	Dom MT	Spot FX	ATM	VISA Checks	Traveller Cards
BCEL	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
LDB	Yes	Yes	Yes	Yes	Yes	No	No	No
APB	No	Yes	No	Yes	Yes	No	No	No
JDB	No	No	No	No	Yes	No	Yes	No
LVB	Yes	Yes	Yes	No	Yes	No	No	No
VCB	Yes	Yes	Yes	No	Yes	No	No	Yes

Sources: Commercial Banks.

central bank regulations and the bank’s internal risk guidelines. For liquid assets, the liquidity reserve requirement regulation (cash and readily convertible investment assets held against total deposits) will specify the minimal level of liquid assets acceptable. The international norm for commercial banks is that liquid assets range between 5% and 10% of total assets. Fixed assets, including a bank’s physical distribution network, are usually about 10% of total assets. The remaining 80–85% of assets are loans and interest receivable.

As shown in Table 3.5, commercial banks in the Lao PDR have much larger percentage holdings of liquid assets and lower percentage holdings of loans and receivables than the international norm. A possible explanation for the high degree of liquidity may be a general lack of profitable lending opportunities resulting from an excessive degree of credit risk in the overall economy. It is also possible that the banks retain large liquid asset holdings to provide depositors with additional confidence in terms of the banks’ ongoing sustainability. In the case of the SOCBs, large liquid assets may reflect their use as an instrument for managing the money supply, with high deposit interest rates used to increase deposits and reduce the money supply to keep inflation in check.

Asset Class	SOCBs	JVCBs	FCBs	All Banks
Liquid Assets	60.7	46.1	48.1	56.6
Gross Loans and Receivables	33.7	50.3	39.5	38.9
Net Fixed Assets	5.6	3.6	12.4	4.5
Total Assets	100.0	100.0	100.0	100.0

Source: BOL.

Asset Class	SOCBs	JVCBs	FCBs	All Banks
Deposits	117.1	64.6	45.9	93.3
Borrowings and Others	18.9	15.8	21.8	18.9
Equity and Reserves	-36.0	19.6	32.3	-12.2
Total Liabilities, Equity, and Reserves	100.0	100.0	100.0	100.0

Source: BOL.

A contributing factor to the lack of lending opportunities at the banks may be the low degree of investment the banks have made in their physical distribution networks as highlighted by the low percentage of fixed asset holdings.

Most central banks require commercial banks to have equity of at least 8% of their risk-weighted assets; this is the case in the Lao PDR too. The remaining 92% of funding capital will be deposits and borrowings. Deposits will usually be vastly greater than borrowings as they represent much cheaper fund sources.

As the current three SOCBs are the direct result of mergers between the previous seven SOCBs, the current SOCBs have inherited the financial difficulties that caused these consolidations in the first place.⁸ The SOCBs' problems relate mainly to significant NPL portfolios and corresponding capital impairments. As of 31 December 2003, the capital of the three SOCBs was significantly negative, amounting to -36% of total assets. The SOCBs are currently undergoing restructuring and performance-based recapitalization programs to address these problems.

Of the total NPLs in the system, the SOCBs hold the vast majority. At end-2003, the aggregate NPL rate in the SOCBs was 58%. The JVCBs hold a much lesser degree, and the FCBs with their limited loan portfolios and focus of foreign currency lending to clients from their home countries have the least percentage. Figure 3.15 highlights the relative NPL rankings within the industry.

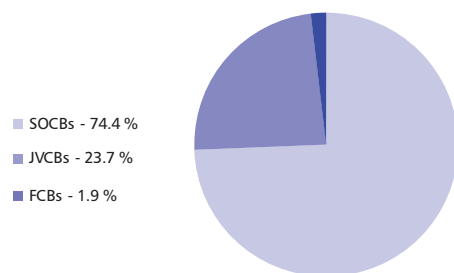
Given their large NPL portfolios, the SOCBs also have the largest share of protective coverage against their impaired loans. The Government of the Lao PDR aims to increase this level of loan loss provisioning further through the restructuring of the SOCBs. The SOCBs' loan loss provision

APB's subservice unit in Savannaket Province



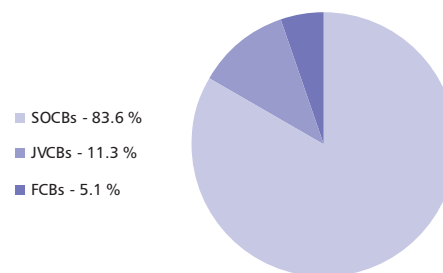
⁸ While APB did not result from the merger of other SOCBs, it inherited some agriculture loans that other SOCBs earlier made.

Figure 3.15 Share of Nonperforming Loans by Value



Source: BOL.

Figure 3.16 Share of Loan Loss Provisions by Value



percentages are similar percentages as their NPL holdings as shown in Figure 3.16.

The FCBs hold a larger percentage of loan loss provisions relative to their NPL position than the other commercial banks. This situation illustrates their general practice of prudently providing more than the total amount of their NPLs, provisions on average being about 190% of actual NPLs. The SOCBs currently have four-fifths coverage over their NPL portfolios, while the JVCBs have about one-third coverage. The JVCBs and FCBs have substantial equity positions, averaging about one third of total liabilities and equity, reflecting the high minimum capital requirements for nonstate-owned banks in the Lao PDR in relation to the overall size of their balance sheets. They are also more reliant upon borrowings to finance their assets than the SOCBs.

This is typical for FCBs with just one branch location. Normally, these types of operations are financed with a substantial loan from the parent commercial bank (quasi equity) located in another country. The JVCBs' borrowing percentage is skewed somewhat by a large borrowing of LVB, from its parent development bank in Viet Nam. For JDB and VCB, borrowings are less of a funding source as deposits provide 87% and 65% of their capital funding, respectively. All SOCBs, one JVCB, and a few FCBs recorded losses in fiscal year 2003. Loan loss provision expenditures to cover NPL portfolios were the primary reason for the losses. The other commercial banks reported positive earnings. Their return on equity (ROE) varies between 2% and 11%.

Chapter 4

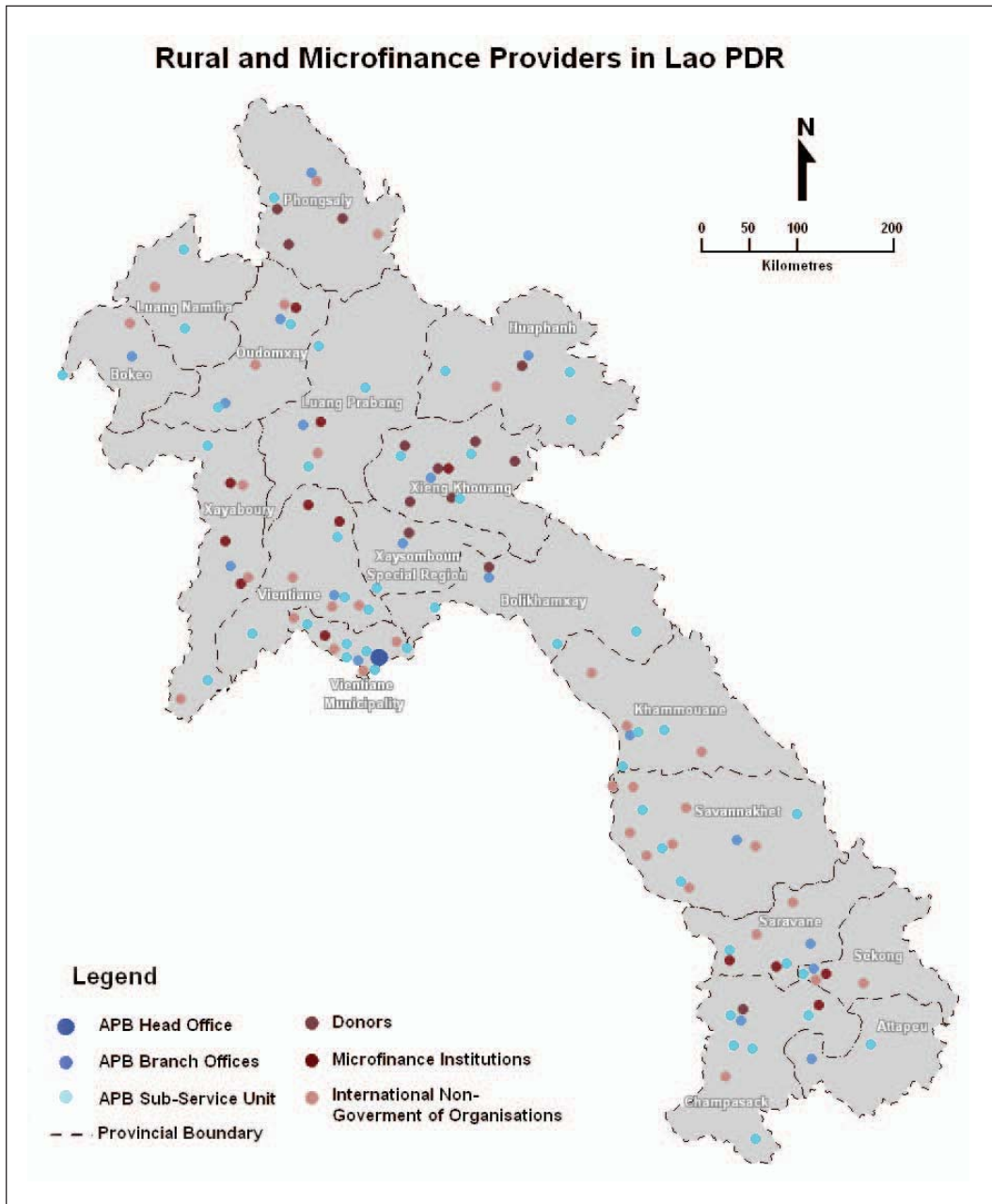
Rural Financial Services Supply—the Semiformal and Informal Sectors

The Semiformal Sector

Sector Participants

The semiformal sector in the Lao PDR primarily comprises project-based interventions that provide rural and microfinance services. They are labelled “semiformal” because they share some characteristics with the formal sector and other characteristics with the informal sector. These interventions are “formal” in the sense that they fall either under Government-approved activities sponsored by multilateral and bilateral development agencies and INGOs; or they operate under the current BOL regulations on credit cooperatives. They are “informal” in that the savings and credit activities carried out are not supervised by BOL and their financial sector operations are not subject to official financial reporting requirements.

Overall, the survey had 23 respondents (out of 25 organizations contacted), who between them supported 33 projects with a total of 50 microfinance initiatives. The respondents comprised three groups. The first consisted of 6 multilateral and bilateral development agencies supporting microfinance components in larger projects. These



Map 2

microfinance components took the form of providing credit lines for onlending as microcredit. The second group consisted of 14 INGOs supporting microfinance components that were included in larger projects. The third group consisted of three specialized MFIs set up specifically to provide sustainable microfinance services.¹

Not all projects and microfinance initiatives are strictly “rural” as defined in Chapter 1. Most operate exclusively or primarily in rural areas, but some operate equally in rural and urban areas, and a few are primarily urban but still with some rural clients. Moreover, data on their borrowers are not comprehensive enough to determine the proportions that are rural and urban. However, to give a comprehensive picture of the institutional terrain of rural finance, we attempt to include all known semiformal sector activities that touch on rural areas.²

Multilateral and Bilateral Development Agencies

On 31 December 2003, multilateral and bilateral development agencies financed six credit lines delivered through Lao PDR partners for onlending as microcredit. These are summarized in Table 4.1.

International Nongovernment Organizations

There are no domestic NGOs in the Lao PDR, but since the early 1990s several INGO-sponsored projects have been established. Sixteen INGOs were identified as having projects with microfinance components. As shown in Table 4.2, 14 responded to the survey.³ These 14 had 21 projects with a total of 28 microfinance components. The financial services provided through these components are generally ancillary to the wider projects of which they form part, and have generally not been established with a view to creating sustainable MFIs.

Table 4.1 Microfinance Funded by Multilateral and Bilateral Development Agency Credit Lines

Name of Organization	Local Partner	Name of Project with Microfinance Component	Location	
			Province	District(s)
European Union (EU)	Provincial and District Authorities	EU Phongsaly Forest Conservation and Rural Development Project (PFCRDP)	Phongsaly	Boun Neua, Boun Tai, Samphanh
GTZ Bokeo/Rural Development Project (RDP)	LWU and Department of Agriculture and Forestry (DAFO)	RDP Bokeo	Bokeo and Xaysomboun Special Zone	Four districts
International Fund for Agricultural Development (IFAD)	LWU	District Development Project	Xieng Khouang	Pek, Phoukout, Khoun, Phaxay, Kham, Nonghed
Lao Luxembourg Development	District Community Development Committee	Lao Luxembourg Integrated Rural Development Project	Bolikhamxay	Bolikhamxay
Asian Development Bank (ADB)	Not stated	Secondary Town Development Project	Champasack	Pakse
United Nations Office on Drugs and Crime (UNODC)	Not stated	Shifting Cultivation Stabilization Pilot Project	Huaphanh	Xamneua

Source: Rural Financial Services Survey

¹ See Map 2 for locations of semiformal sector projects.

² Chapters 5 and 6, which report the results of the household survey, present data on the rural coverage of various sources of financial services.

³ In a pre-survey review of INGOs, Concern Worldwide and CUSO stated they were each managing one project with a microfinance component. Both organizations were invited to participate in the survey but did not respond.

Table 4.2 INGOs with Projects with Microfinance Components

Name of Organization	Local Partner	Name of Project with Microfinance Component	Location	
			Province	District(s)
Adventist Development and Relief Agency (ADRA)	LWU	SME Development Project	Champasack	Pakse, Soukoumar
Care international	Ministry of Agriculture and Forestry (MAF)	Food Conservation and Livelihoods Project	Xayaboury	Paklai
Coopération Internationale pour le Développement et la Solidarité (CIDSE)	LWU	XayBouathong Integrated Community Development Program	Khammouane	Xaybouathong
Community Action Abroad (CAA)	LWU / MAF	Phin Self-Help Rural Development Program	Savannakhet	Phin
Cooperation Committee for Laos (CCL)	Local community	Sustainable Community Development Project	Vientiane, Saravane, Sekong	Med, Phuong (Vientiane); Thaoy, Toomhan (Saravane); Thanteng, Lamam (Sekong)
Danish Red Cross	Not stated	PDDP Prodesa	Phongsaly Xayaboury	Phongsaly Botene
Foundation for Integrated Agricultural Management (FIAM)	LWU	Primary Health Care Project	Huaphanh	Haumuong
	LWU	Women's development Project/FIAM	Vientiane Municipality, Vientiane, Khammouane	Xaithany, Xaithetta (Vientiane Municipality); Thoulakhom, Viengkham (Vientiane); Thakek, Hinboun (Khammouane)
		Women's development Project/FED/CODI	Vientiane Municipality	Pak Ngeum, Naxaithong
GAPE International/ Village Focus	Local community	Human Dignity Initiative Project	Vientiane Municipality	Sikhotabong, Xaysettha, Chanthabouly, Sisathanak
German Agro Action (GAA)	MAF, Ministry of Health, Ministry of Education	Nam Beng, Nam Mao Community Development and Conservation Project	Oudomxay	Xay, Beng
Norwegian Church Aid (NCA)	Local community	Integrated Poverty Reduction Project	Phongsaly	Mai
	LWU / DAFO	HIV/AIDS Protection Project	Savannakhet	Khanthanabury, Xaibouthong, Champorn, Songkhone, Xaiboury
	LWU	Long Alternative Development Project (LADP)	Luang Namtha	Mouanglong
Oxfam Belgium (Rural Development Project)	LWU	Bokeo Rural Development Project	Bokeo	Meung
Save the Children Australia	Not stated	Phonesoury Development Project	Vientiane	Phonehong
World Concern	LWU	Poverty Reduction at Community Level in Remote Areas Project	Xayaboury	Xayaboury
	Provincial Health Department	Salavan Community Development Project	Saravane	Wapi
World Vision	Not stated	Poverty Reduction Project: Savannakhet Kan River Poverty Alleviation Project	Savannakhet	Athsaphongthong
	LWU / MAF		Luang Prabang	Xieng Ngeun

Source: Rural Financial Services Survey

Sustainable Microfinance Initiatives

Initiatives targeting sustainable microfinance in the Lao PDR began in 1996. By the end of 2003, three such initiatives were identified. First, the *Coopérative de Crédit de Soutien aux Petits Producteurs* (CCSP) was established in 1996 by Lao entrepreneurs. It consists of 12 separately licensed credit cooperatives, listed in Table 4.3, all overseen by a central office in Vientiane. Second, the Microfinance Project was launched in 1997 with support from the United Nations Capital Development Fund (UNCDF) and the UNDP. It was transferred in 2002 to the Ministry of Finance (MOF), which continues to manage the project, now known as the Microfinance Office. It consists of three project components, listed in Table 4.3. Third, the Rural Development Cooperative (RDC) is a licensed credit cooperative and was started in August 2001 with support from the Vientiane Municipal Development Fund.⁴ Table 4.3 summarizes the 16 individual credit cooperatives or components of these three MFIs.⁵

Table 4.3 Sustainable Microfinance Initiatives⁶

Name of Organization	Location	
	Province	District(s)
CCSP	Xieng Khouang	M. Pek
CCSP	Vientiane	Vangvieng
CCSP	Vientiane Municipality	Hong Ngoa
CCSP	Champasack	Paksong
CCSP	Luang Prabang	Luang Prabang
CCSP	Vientiane Municipality	Saysettha; Naxaithong
CCSP	Saravane	Kongsedone
CCSP	Saravane	Lao Ngam
CCSP	Champasack	Pakse
CCSP	Vientiane	Kasi
CCSP	Sekong	Thateng
CCSP	Saravane	Nateut
Microfinance Office (Oudomsay)	Oudomxay	Xai
Microfinance Office (SIPSACRES)	Vientiane Municipality	Chanthabouly
Microfinance Office (Xayaboury)	Xayaboury	Xayaboury, Mounghpheng, Paklai
Rural Development Cooperative	Vientiane Municipality	Naxiaithong

Source: Rural Financial Services Survey

⁴ At the time of the survey, the establishment of three member-owned savings and credit unions (SCUs) with support from ADB was getting underway, but the SCUs had not opened for business and are not reported on here. Moreover, these three SCUs would fall outside the rural boundaries as defined in Chapter 1.

⁵ In the analysis that follows, each of the 16 cooperatives and components is treated as a separate microfinance initiative as each has considerable autonomy in determining its own products and prices. Hence, the number of observations for sustainable MFIs in the analysis is 16 and not 3.

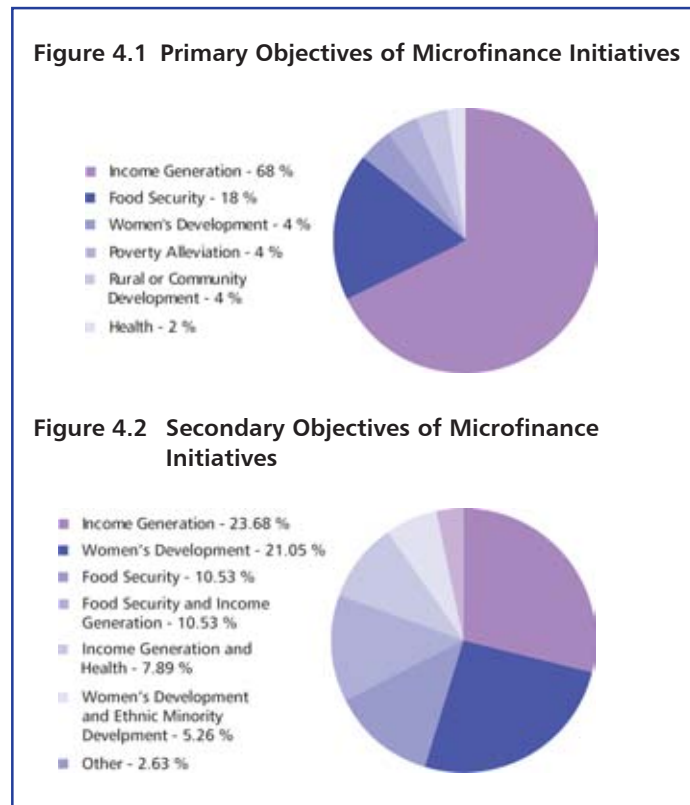
⁶ As indicated under "location," some MFIs are based in urban areas. As noted in the introduction to this chapter, data available from each organization did not permit a determination of how many customers were rural or urban, and we have included all semiformal initiatives that touch on rural areas, even those that are primarily (but not exclusively) urban. See Chapters 5 and 6 on the household survey for data on the rural outreach of financial services.



A village savings and credit group near Phon Hong, Vientiane Province

Objectives of Microfinance Initiatives

The reported objectives of the microfinance initiatives vary with the overall project of which they form a part. Figure 4.1 shows the percentage breakdown of the primary objectives of microfinance initiatives: 68% reported income generation as their primary objective, while 18% stated food security. Poverty alleviation, rural or community development, and health were also mentioned as primary objectives. Figure 4.2 shows the percentage breakdown of secondary objectives of microfinance components. Secondary objectives of microfinance initiatives were more varied than primary objectives.



Source: Rural Financial Services Survey

Local Partners

In the Lao PDR, multilateral, bilateral, and INGO projects are typically implemented through local partners. The LWU was the most frequent local partner. Three multilateral and bilateral development agencies cooperate with LWU in their microfinance components, and 9 INGO microfinance components are implemented through LWU. The Ministry of Agriculture and Forestry (MAF) was the next most frequent partner reported, being the partner in 4 INGO components (including 2 in conjunction with LWU and 1 in conjunction with other government departments). The 3 Microfinance Office project components worked with the MOF. Six project components reported various other local partners, while 3 components reported no local partner.

Types of Microfinance Organizational Forms

Three main types of microfinance organizational forms predominate in the Lao PDR. These are defined in this report as:

- Savings and Credit Unions (SCUs) and Credit Cooperatives operating under BOL regulations, which take savings and make loans; project funds and members' subscriptions and savings are combined to make loans that are disbursed and repaid in cash
- Village Savings and Credit Groups (VSCGs) not operating under BOL regulations, which take savings and make loans; project funds and members' savings are combined to make loans that are disbursed and repaid in cash or in kind, and
- Village Revolving Funds (VRFs) not operating under BOL regulations, which do not take savings; project funds are used for loans disbursed and repaid either in cash or in kind.

Five of the 6 multilateral and bilateral microfinance components were reported as VSCGs, and the remaining 1 operated as a VRF. Some 75% of INGO microfinance

components reported operating as VSCGs and the remaining 25% as VRFs. For the 3 sustainably oriented MFIs, CCSP and RDC operate as cooperatives, while the Microfinance Office continues to operate as a project administered by the MOF. In the semiformal sector, there are no product offerings other than savings and loans.

Financial Structure

The absence of mandatory financial reporting requirements and BOL supervision in the semiformal sector means that balance sheets for the rural financial services activities of the participants are not generally available. Although BOL is responsible for the supervision of SCUs, such supervision was not effectively in place at the time of the survey. The financial reporting requirements of INGO projects in particular are not geared to such reporting and, in almost all cases, INGO head offices in Vientiane did not have detailed financial performance information on savings and credit activities.

Data on recent funding in Table 4.4 shows the reported flows of funds into the semiformal sector since 1999. The data indicate:

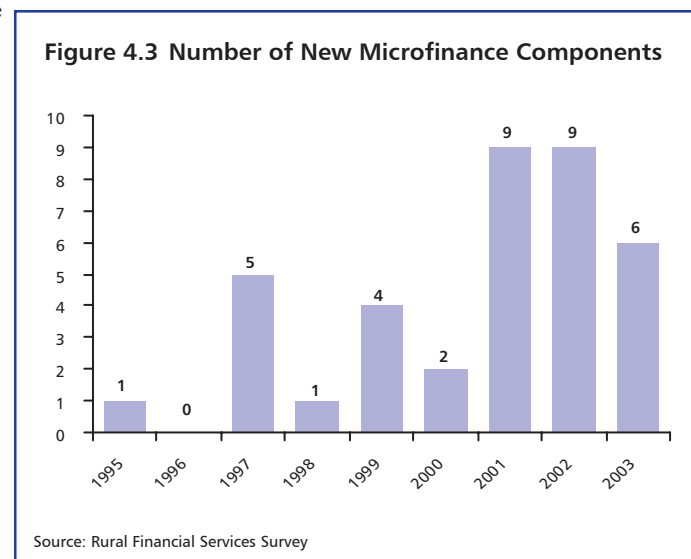
Source of Funding	1999	2000	2001	2002	2003	Total	Percent of Total
Loaned Funds for Onlending	224.07	444.80	678.36	2,003.64	2,353.09	5,703.95	58.43
Grant Funds for Onlending	90.76	148.50	417.59	574.74	1,449.01	2,680.60	27.46
Member's Shares	0.00	0.00	23.80	62.82	212.73	299.35	3.07
Subtotal Funds For Lending	314.83	593.30	1,119.75	2,641.20	4,014.83	8,683.90	88.96
Grant Funds for Capacity Building	18.23	28.23	78.23	219.55	727.68	1,071.92	10.98
Counterpart Funds	0.00	0.00	0.00	0.00	6.75	6.75	0.07
Subtotal Other Funds	18.23	28.23	78.23	219.55	727.68	1,072.92	11.05
Total	333.06	621.53	1,197.98	2,860.75	4,749.26	9,762.57	100.00

Source: Rural Financial Services Survey

- a rapid increase in funding for microfinance activities in the 5 years to the end of 2003, with the amount of funding doubling each year on average;
- however, overall, such funding remains low, at less than \$1 million cumulatively over 5 years;
- 58.43% of the funds provided have been borrowed for onlending, and 27.46% of funds have been injected as grants for onlending. When taken together with 3.07% of total funding from members' shares (in the cooperative-based organizations), a total of 88.96% of funding has been allocated to lending; and
- funding of capacity building has grown but remains low at less than \$100,000 cumulatively over 5 years.

Outreach

Figure 4.3 shows the number of new microfinance initiatives (e.g., credit cooperative or project component) established each year in Lao PDR since 1995. Overall, the number of new microfinance components in projects has been increasing, with about half (48%) of new microfinance components commencing operations in the 3 years from 2001 to 2003.



The total number of villages reached by microfinance initiatives as of 31 December 2003 was reported as 930. The multilateral and bilateral microfinance components reached 211 villages; the INGO microfinance components reached 406 villages; and the MFIs reached 313 villages.

Collectively, the microfinance initiatives reported reaching 33,392 clients. However, one INGO (FIAM) was able to report on savings but not on its lending portfolio. FIAM reported 20,880 savers in 107 villages. The rest of the semiformal sector, excluding FIAM, reported 12,512 savers and 12,365 borrowers in 823 villages.

Savings

Only 1 of the 6 multilateral and bilateral microfinance components mobilized savings. They did so by providing savings services to eligible borrowers only. Seventy-five percent of INGO microfinance components provided savings services to eligible borrowers only, and 14.29% offered savings services to both eligible borrowers and the general

public. Only 10.71% did not offer savings services. All 3 sustainably oriented MFIs collected savings: 14 of the 16 cooperatives or project components of these 3 MFIs (see Table 4.3) provided deposit services to eligible borrowers only, and 2 offered such services to both eligible borrowers and to the general public (namely, RDC and the SIPSACRES component of the Microfinance Project).

As shown in Table 4.5, data reported for the end of 2003 indicate that savings in the semiformal sector were KN7.50 billion (\$750,782). These include KN5.66 billion (\$532,922) reported by FIAM which, as noted in the previous section, was not able to report the corresponding amount of loans outstanding or the amount of funding it had provided over the previous 5 years.⁷ Removing the reported savings of FIAM from the analysis leaves a total of other savings in the system of KN1.84 billion (\$217,860), which together with the amount of funding provided over the last 5 years for onlending (KN8.68 billion or \$817,539) equals KN10.52 billion (\$1.04 million) in liabilities and is reasonably

Table 4.5 Savings Characteristics at 31 December 2003

Characteristic	Multilateral and Bilateral Development Agency Projects		INGO Projects		MFIs		Total	
	Value	Percent	Value	Percent	Value	Percent	Value	Percent
Number of savers	2,378	7.12	26,239	78.58	4,775	14.30	33,392	100.00
New Savers in Last 12 Months	1,298	33.47	2,125	54.80	455	11.73	3,878	100.00
Increase in Savers in Last 12 Months		54.58		8.10		9.53		11.61
Total Savings (KN million)	109.56	1.46	6,483.42	86.48	903.86	12.06	7,496.84	100.00
Average Savings (KN)	46,072		247,090		189,290		224,510	
Increase in Savings in Last 12 Months (KN million)	35.76	14.11	100.03	39.47	117.67	46.42	253.46	100.00
Savings Growth in Last 12 Months		48.46		1.57		14.97		3.50

Source: Rural Financial Services Survey

⁷ In view of the amounts involved, three callbacks were made on FIAM during the survey period to request the missing information, but FIAM did not provide information on its loan portfolio or invested funds.

consistent with the reported outstanding loans of KN12.03 billion (\$1.13 million).⁸

INGO microfinance components reported the highest number of savers with a total of 26,239.⁹ Multilateral and bilateral development agency microfinance components had a total of 2,378 savers, and the 3 MFIs had a total of 4,775 savers as of 31 December 2003. Overall, multilateral and bilateral microfinance components had the greatest percentage increase, 48.46%, in the value of savings over the previous 12 months. MFIs increased the total amount of savings by 14.97%, and INGO microfinance components increased savings by 1.57% in the year to 31 December 2003. However, overall savings of KN7.50 billion and outreach of 33,392 savers remains low—conservatively assuming each saver corresponds to one rural household, this implies outreach to only 3.7% of rural households. Even this is an overestimation because many MFI customers are urban, as are some participants in components supported by INGOs and multilateral and bilateral donors.

Loans

Mediums of Loan Disbursement and Repayment

Figure 4.4 shows the percentage breakdown of mediums of loan disbursement for microfinance initiatives. Three of the 6 multilateral and bilateral development agency microfinance components disburse loans in cash only, and 3 disburse in either cash or in-kind mediums.¹⁰ Among INGO microfinance components, 71.43% disburse loans in cash only; 10.71% disburse loans in cash, rice grain, or buffalo; 7.14% disburse loans in multiple in-kind mediums; and 3.57% disburse loans in cash and rice grain; and

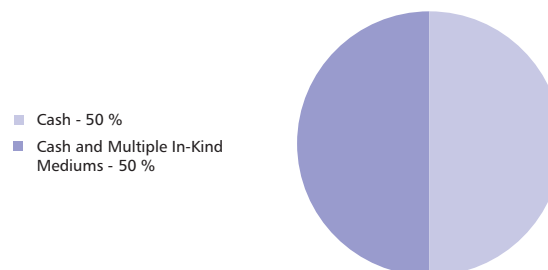
⁸ See the next section for details of loans.

⁹ This includes 20,880 savers reported by FIAM.

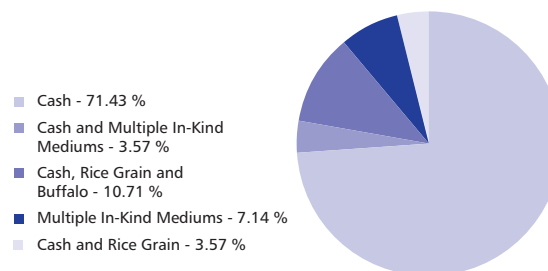
¹⁰ In-kind disbursement may not be limited to a single commodity. “Multiple in-kind” refers to a combination of rice grain, other seeds and grain, buffalo, cow, pig, goat, poultry, or fertilizer.

Figure 4.4 Semiformal Sector Mediums for Loan Disbursement

Multilateral and Bilateral Development Agencies



INGOs

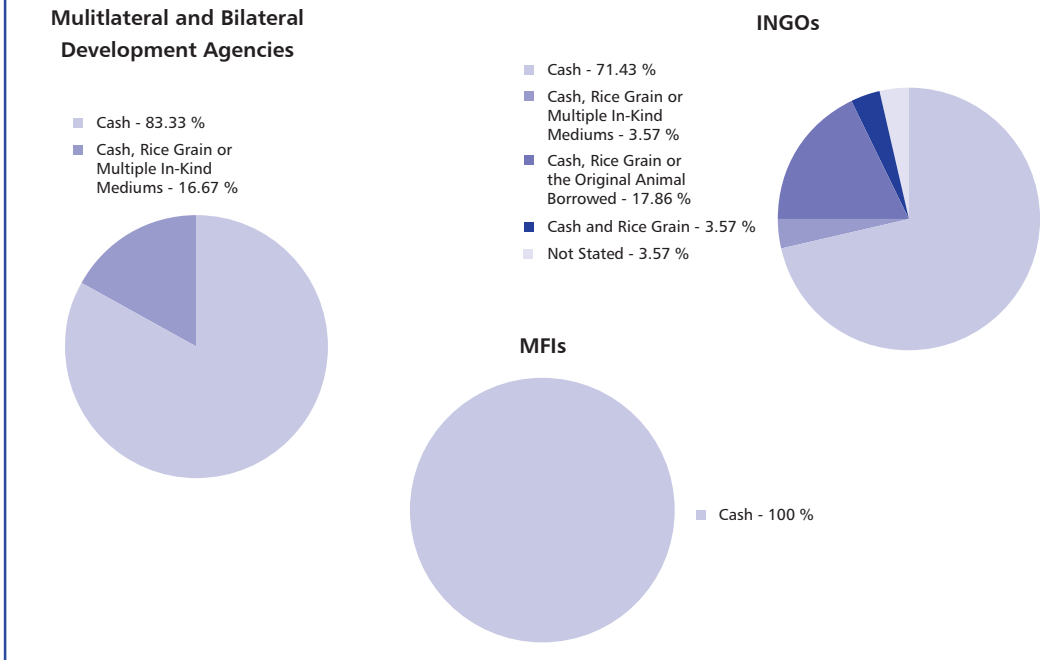


MFIs



Source: Rural Financial Services Survey

Figure 4.5 Semiformal Sector Mediums for Loan Repayment



3.37% disburse in cash and rice grain. All MFIs disburse loans in cash only.

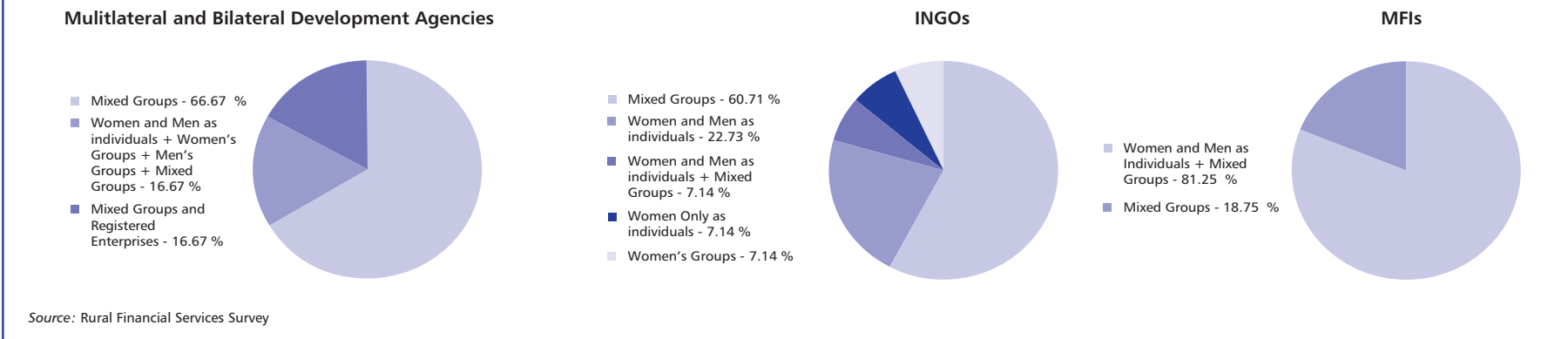
Figure 4.5 shows the percentage breakdown of mediums of loan repayment. Five of the 6 multilateral and bilateral microfinance components require loans to be repaid in cash only and one requires loans to be repaid in-kind. Mediums of loan repayment are more varied among INGO microfinance components: 71.43% require loans to be repaid in cash only; 17.86% require repayment in cash, rice grain, or the original animal borrowed; the remaining components require different combinations of cash and in-kind repayment. All MFIs require loans to be repaid in cash only.

Loan Clients

Figure 4.6 shows the percentage breakdown of loan clients for microfinance initiatives—66.67% of multilateral and bilateral development agency microfinance components provide loans to mixed groups only; 16.67% disburse loans to a broad spectrum of loan clients comprised of women and men as individuals, women’s groups, men’s groups, and

Source: Rural Financial Services Survey

Figure 4.6 Loan Clients in the Semiformal Sector



Source: Rural Financial Services Survey

mixed groups; and 16.67% provide loans to mixed groups and registered enterprises only. Individual INGO microfinance components tend to be more focused on lending specific to target client types: 60.71% provide loans to mixed groups only, 22.73% to women and men as individuals only, 7.14% to women and men as individuals and also mixed groups, 7.14% to women only as individuals, and 7.14% to women's groups. Thirteen of the 16 sustainably oriented MFI credit cooperatives or project components (81.25%) lend only to women and men as individuals and to mixed groups, and 18.75% lend to mixed groups only.

Credit Portfolios

Figure 4.7 shows the percentage breakdown of credit portfolios by borrower's declared loan purpose, according to the responses of the sponsoring organizations, as of 31 December 2003. The MFI portfolios are distinguished by their concentration in the trade and handicraft sectors, the INGOs by concentration in livestock and crop production, and multilateral and bilateral development agencies by concentration in livestock, crops, and handicrafts.

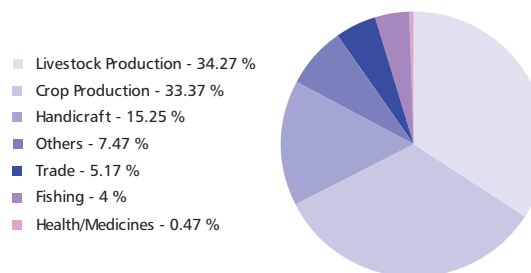
Loan Characteristics

Loan Duration

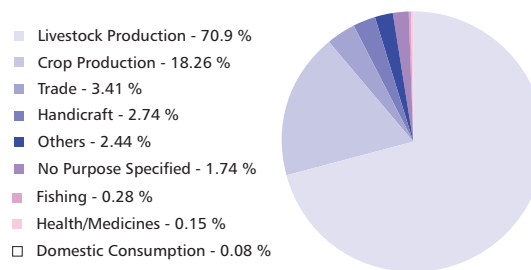
Figure 4.8 shows the terms of loan products offered by microfinance initiatives for various purposes. Loan products available from multilateral and bilateral development agency microfinance components have a median term of 12 months, while the median term for loan products from INGO microfinance components and MFIs is 6 months. The terms for loans offered by multilateral and bilateral development agency microfinance components vary from 3 to 84 months—for crop production, they vary from 6 to 84 months¹¹, and for livestock production from 12 to 60 months. Terms for loans

Figure 4.7 Credit Portfolios in the Semiformal Sector

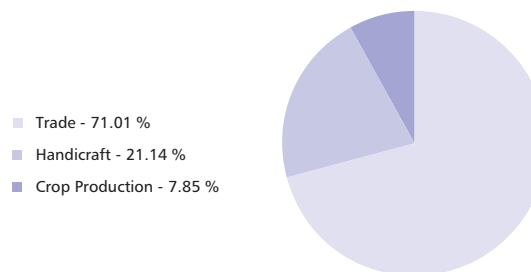
Multilateral and Bilateral Development Agencies



INGOs



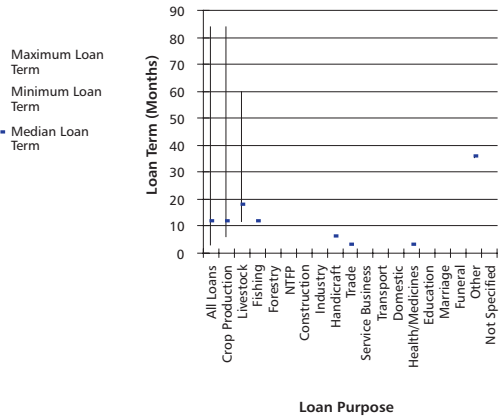
MFIs



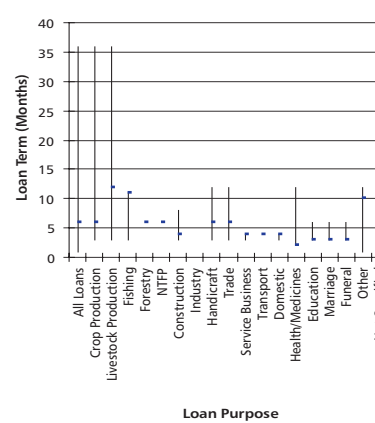
Source: Rural Financial Services Survey

Figure 4.8 Loan Terms in the Semiformal Sector

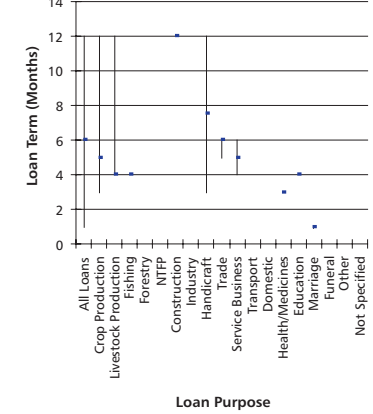
Multilateral and Bilateral Development Agencies



INGOs



MFIs



Source: Rural Financial Services Survey



Weaving is a common business activity of many women in the Lao PDR

from INGO microfinance components vary from 3 to 36 months, which is the same range for crop production and livestock production loans. Terms for loans from MFIs vary from 1 to 12 months—for crop production, from 3 to 12 months; for livestock raising, from 4 to 12 months; and for handicraft, from 3 to 12 months. Overall, the terms of MFI loans are shorter than those of multilateral, bilateral, and INGO components, particularly for lending for livestock and crops.

Loan Agreements

Twenty-two out of the 23 survey respondents stated that they required written loan agreements for all loans made. Only one INGO did not use written loan agreements.

¹¹ Lao Lux Development offers 7-year loans (84 months) for fruit trees. Other than this, the next longest loan term for multilateral and bilateral agencies is 60 months.

Collateral Requirements

Figure 4.9 shows the percentage breakdown of collateral requirements for microfinance initiatives: 54.35% of loan products offered by multilateral and bilateral development agency microfinance components required a group guarantee as collateral, 23.91% did not require any collateral, and 21.74% required physical collateral. For INGO microfinance components, 83.41% of loan products required no collateral, 11.71% required a group guarantee, and 4.88% required physical collateral. All loan products that MFIs offered required collateral: 81.82% required physical collateral, and 18.18% required a group guarantee.

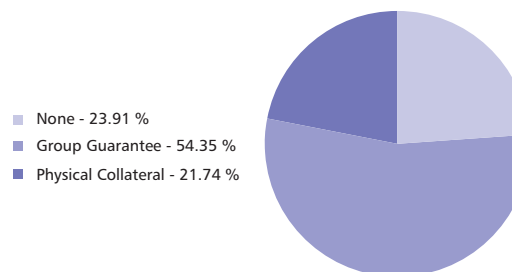
Interest Rates

Figure 4.10 shows the median, maximum, and minimum effective annual interest rates on loan products offered by microfinance initiatives.

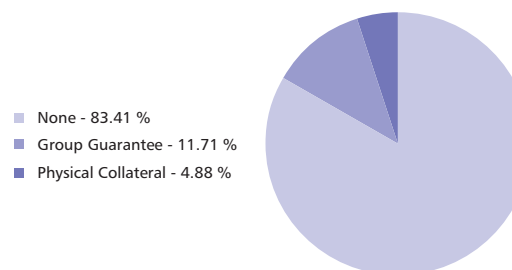
Loans products offered by microfinance initiatives have a median effective interest rate of 48% (annual percentage rate, APR) per year, while loans products offered by INGO microfinance components have a median rate of 22% per year (annual percentage rate, APR); and loan products from multilateral and bilateral development agency microfinance components have a median rate of 12% per year. However, median values of effective interest rates varied across different loan products for each group. For multilateral and bilateral development agency microfinance components, they ranged from 3 to 22%; for INGOs, from 3 to 108%; and for MFIs, from 24 to 84%. Survey results indicate that multilateral and bilateral development agencies and INGOs frequently subsidize interest rates and offer credit at well below costs. This is one reason why few, if any, of these initiatives are sustainable. Given the additional costs associated with microfinance, rates of between 35% and

Figure 4.9 Collateral Requirements in the Semiformal Sector

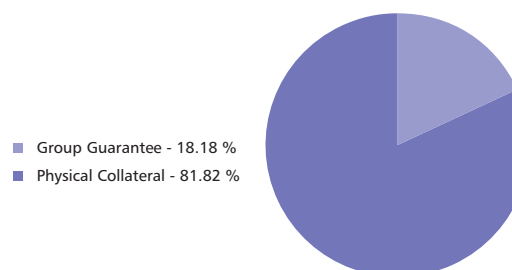
Multilateral and Bilateral Development Agencies



INGOs



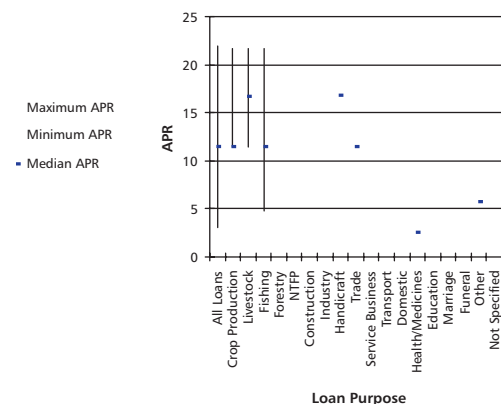
MFIs



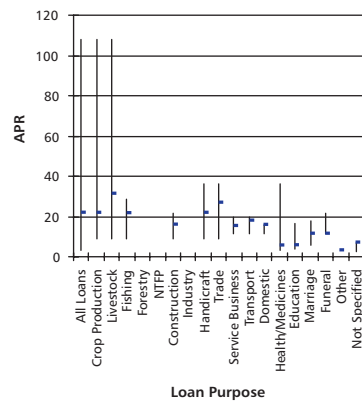
Source: Rural Financial Services Survey

Figure 4.10 Effective Interest Rates in the Semiformal Sector

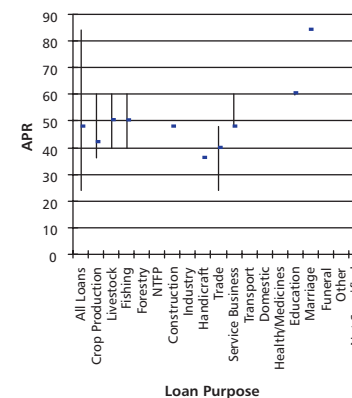
Multilateral and Bilateral Development Agencies



INGOs



MFIs



Source: Rural Financial Services Survey

50% would be expected for sustainable operations.¹² Only the three sustainably oriented MFIs regularly charge interest rates at these levels. As noted by CGAP: “Microcredit interest rates are set with the aim of providing viable, long-term financial services on a large scale. MFIs must set interest rates that cover all administrative costs, plus the cost of capital (including inflation), loan losses, and a provision for increasing equity. Unless MFIs do so, they may only operate for a limited time; reach a limited number of clients; and will tend to be driven by donor or government

goals, not client needs. Only sustainable MFIs can provide permanent access to financial services to the hundreds of millions who need them.”¹³

Repayment Methods

Some 57.53% of loan products were offered with repayment of principal and interest at loan maturity, while 41.78% of products were offered with monthly payments of interest and repayment of principal at loan maturity. Only 0.68% of products were offered with weekly payments of interest and repayment of principal at loan maturity.

¹² The cost of microfinance is higher than the cost of bank lending for various reasons. Some administrative costs for making a loan are fixed, regardless of the size of the loan. If those costs were \$10, then they would require an additional interest rate margin of 10% on a 12-month \$100 loan, but only 1% on a \$1,000 loan. Microfinance clients also tend to be more remotely located, and need MFIs to bring the services to them, adding additional transaction costs. Finally, microfinance clients tend to be poorer, with no documented credit history and unable to provide collateral, adding to the costs of screening out risky borrowers.

¹³ Consultative Group to Assist the Poor (CGAP). 2002. Making Sense of Microcredit Interest Rates. Donor Brief No. 6. September. (Emphasis in the original.)

Portfolio Performance

Table 4.6 summarizes the reported characteristics of semiformal sector portfolios. As of 31 December 2003, the semiformal sector reported 12,365 outstanding borrowers with loans outstanding of KN12 billion. This included 3,945 borrowers from multilateral and bilateral agency initiatives, with loans of KN4.4 billion; 5,544 from INGO initiatives, with loans of KN5.2 billion; and 2,876 from MFIs, with loans of KN2.5 billion. Over the 12 months before the survey, 11,165 new loans had been made, including 2,741 from multilateral and bilateral agency initiatives, 4,878 from INGO initiatives, and 3,546 from MFIs.

Figures 4.11 and 4.12 show the percentage of borrowers with overdues as of 31 December 2003, by type of microfinance project and by type of borrower.

MFIs had the lowest percentage of borrowers in arrears, at 7.68%. Multilateral and bilateral development agency projects reported 13.71% of borrowers in arrears. INGOs reported a slightly higher percentage of borrowers in arrears at 14.84%. When borrowers are considered by type, men's groups had the highest overdues, with 25% of groups in arrears. Mixed groups of men and women had the second highest level of arrears at 18.20%. The percentages of women's groups and men as individuals in arrears were 7.75% and 6.79% respectively. The lowest overdues were by women as individual borrowers at 3.05%. Overall this suggests that MFIs are better at controlling default, that individuals are less likely to default than groups, and that women are less likely to default than men when they borrow as individuals or as groups.

Table 4.6 Loan Portfolio Characteristics

Characteristic	Multilateral and Bilateral Development Agency Projects		INGO Projects		MFIs		Total	
	Value	Percent	Value	Percent	Value	Percent	Value	Percent
Number of Borrowers at 31 December 2003	3,945	31.90	5,544	44.84	2,876	23.26	12,365	100.00
Number of New Loans in Last 12 Months	2,741	24.55	4,878	39.45	3,546	28.70	11,165	100.00
Number of Borrowers with Overdue Loans	570	14.46	1,450	26.16	339	11.81	2,359	19.08
Total Loans Outstanding (KN million)	4,388	36.47	5,161	42.89	2,484	20.64	12,033	100.00
Total Loans Overdue (KN million)	184	4.19	514	9.97	101	4.05	799	6.64
Nonperforming loan rate (percent)	4.19		9.96		4.07		6.64	
Average Loan Outstanding (KN)	1,112,365		931,064		864,022		973,314	
Estimated New Loans in Last 12 Months (KN million)	3,049	28.62	4,542	42.63	3,064	28.76	10,655	100.00

Source: Rural Financial Services Survey

Figure 4.11 Percent of Borrowers with Overdues

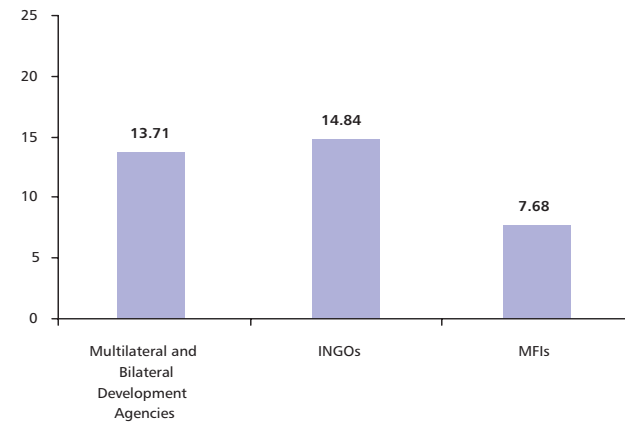
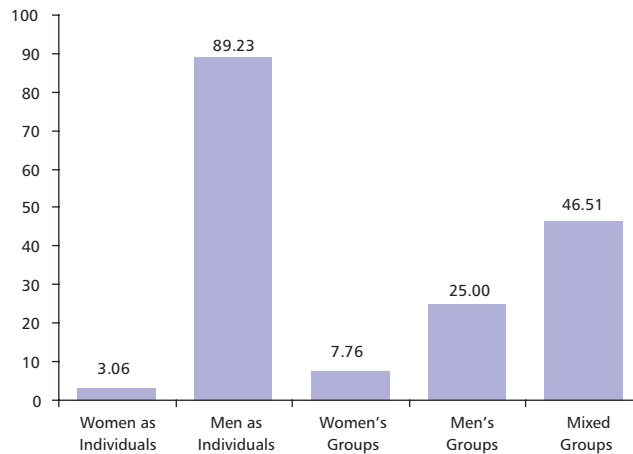


Figure 4.12 Percent of Borrowers with Overdues by Borrower Type



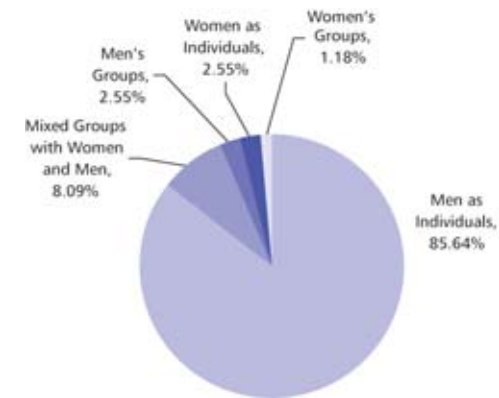
Source: Rural Financial Services Survey

Figure 4.13 shows the percentage of total amounts in arrears as of 31 December 2003 by borrower type.¹⁴ Consistent with Figure 4.12, men as individuals accounted for the largest amounts in arrears, followed by mixed groups, men's groups, women as individuals, and women's groups.

Profitability of Microfinance

Of the 33 microfinance initiatives, 13 did not provide profit and loss information for 2003 in response to the survey. Fourteen provided profit and loss information that did not reconcile; 7 provided profit and loss information that reconciled. Overall, the information is not sufficiently reliable to draw conclusions and indicates significant weaknesses in financial reporting in the semiformal sector generally.

Figure 4.13 Percentage of Total Amounts in Arrears by Borrower Type



Source: Rural Financial Services Survey

¹⁴ Nonperforming loan (NPL) rates were not available from these microfinance initiatives, which were able to report only the amounts of the installments overdue, rather than the full amount of the loan overdue. As a percentage of total loans outstanding, installments overdue amounted to 3.59% for multilateral and bilateral components, 8.95% for INGO components, and 2.19% for MFIs.

The Informal Sector

Sector Participants

In the Lao PDR, the informal sector comprises loans between households, informal moneylending, and lending through the traditional Lao houay. Additional information on the informal sector was gathered through the questions to households on their borrowing and is reported in greater detail in Chapter 6. In addition, the survey collected information about lending by households, and by 17 moneylenders who were prepared to identify themselves and participate in the survey. This section concerning the informal sector draws on all 3 sources of data.

Informal Loans by Households

Table 4.7 shows the estimated total lending by rural households in the 12 months preceding the survey, extrapolated to the entire rural population from household survey data on households making loans.

The table indicates that rural households made an estimated 217,415 loans to friends and family, valued at KN407.33 billion (\$38.34 million), and about 136,159 loans to others (households in the same village, other villages, and urban areas), valued at KN253.36 billion (\$23.9 million) in the 12 months preceding the survey. The total estimated value of loans made by households in the period is KN660.69 billion (\$62.2 million), dwarfing the amount loaned in the

Table 4.7 Lending by Rural Households to Friends and Family and Others

Loan Recipients	All Rural Households	Strata of Lending Household				Wealth Quartile of Lending Household			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest 25%	Next Poorest 25%	Next Poorest 25%	Richest 25%
Borrower Type (KN billion)									
Family and Friends	407.33	179.61	7.28	31.79	188.65	8.35	14.93	58.75	325.31
Others	253.36	100.54	3.83	45.10	103.90	14.35	5.24	56.15	177.62
Total	660.69	280.15	11.10	76.89	292.54	22.70	20.17	114.90	502.93
Borrower Type (Percent by Value)									
Family and Friends	61.65	64.11	65.52	41.35	64.49	36.78	74.00	51.13	64.68
Others	38.35	35.89	34.48	58.65	35.51	63.22	26.00	48.87	35.32
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Borrower Type (Number of Loans)									
Family and Friends	217,415	32,304	12,252	35,723	137,136	31,343	35,934	63,283	86,854
Others	136,159	23,289	6,925	31,143	74,801	20,503	19,943	30,700	65,014
Total	353,574	55,593	19,178	66,866	211,937	51,846	55,877	93,983	151,869
Borrower Type (Percent by Number of Loans)									
Family and Friends	61.49	58.11	63.89	53.42	64.71	60.45	64.31	67.33	57.19
Others	38.51	41.89	36.11	46.58	35.29	39.55	35.69	32.67	42.81
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Rural Financial Services Survey

semiformal sector (KN12 billion). Overall, about 61% of loans by value and by number were made to friends and family.¹⁵

As would be expected, the vast majority of lending was done by households in the wealthiest quartile: 76% of all lending (by volume) was done by the richest quartile, who also account for 43% of loans by number. Analysis by strata indicates that Other Rural households account for the vast

majority of loans by number: they account for 60% of all loans, almost certainly the result of the lack of outreach by more formal and semiformal institutions in the remote Other Rural areas and, therefore, the need to rely on informal inter-household loans. Other Rural areas also account for 44% of inter-household lending by volume.

Table 4.8 summarizes other key facts about loans made by rural households in the 12 months preceding the survey.

Table 4.8 Characteristics of Loans Made by Households

Loan Characteristic	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest 25%	Next Poorest 25%	Next Poorest 25%	Richest 25%
Loans Made in Cash by Value (KN billion)	593.46	273.60	9.08	62.68	248.10	17.47	16.37	99.62	459.99
Loans Made in Kind by Value (KN billion)	67.19	6.55	2.02	14.17	44.44	5.22	3.75	15.28	42.94
Loans Made in Cash by Number	259,201	51,085	16,869	45,799	145,447	33,829	44,285	70,514	110,572
Loans Made in Kind by Number	96,246	4,508	3,019	20,151	68,568	18,017	11,892	23,469	42,868
Loans Repayable in Cash by Value (KN billion)	607.30	255.49	9.19	73.99	268.63	14.06	17.39	111.83	460.56
Loans Repayable in Kind by Value (KN billion)	53.35	24.66	1.91	2.86	23.91	8.63	2.74	3.06	42.37
Loans Repayable in Cash by Number	274,844	50,960	15,271	55,109	153,887	30,724	44,530	82,435	116,140
Loans Repayable in Kind by Number	80,602	4,633	4,617	10,841	60,128	21,122	11,648	11,548	37,300
Loans Made in Cash by Value (%)	89.83	97.66	81.77	81.56	84.81	77.00	81.35	86.70	91.46
Loans Made in Kind by Value (%)	10.17	2.34	18.23	18.44	15.19	23.00	18.65	13.30	8.54
Loans Made in Cash by Number (%)	72.92	91.89	84.82	69.44	67.96	65.25	78.83	75.03	72.06
Loans Made in Kind by Number (%)	27.08	8.11	15.18	30.56	32.04	34.75	21.17	24.97	27.94
Loans Repayable in Cash by Value (%)	91.93	91.20	82.76	96.28	91.83	61.96	86.40	97.33	91.58
Loans Repayable in Kind by Value (%)	8.07	8.80	17.24	3.72	8.17	38.04	13.60	2.67	8.42
Loans Repayable in Cash by Number (%)	77.32	91.67	76.79	83.56	71.90	59.26	79.27	87.71	75.69
Loans Repayable in Kind by Number (%)	22.68	8.33	23.21	16.44	28.10	40.74	20.73	12.29	24.31
Loans with Written Loan Agreements (Number)	71,635	9,766	2,841	9,160	49,868	11,127	6,998	13,094	40,415
Loans with Written Collateral Agreements (Number)	22,007	1,503	888	916	18,700	4,333	916	3,294	13,463
Loans with Written Loan Agreements (%)	20.15	17.57	14.29	13.89	23.30	21.46	12.46	13.93	26.34
Loans with Written Collateral Agreements (%)	6.19	2.70	4.46	1.39	8.74	8.36	1.63	3.51	8.77
Average Loan Term (Months)	4	6	5	6	3	2	5	4	5

Source: Rural Financial Services Survey

¹⁵ The estimate for household borrowing from friends and family from rural households receiving loans in the same period is KN307.09 billion (\$28.91 million). This suggests that an estimated KN100.24 billion (\$9.4 million) was being lent by rural households to friends and family in nonrural households.

Informal Loans by Moneylenders and through Houay

In the 12 months before the survey, as estimated from the household survey more fully discussed in Chapter 6, moneylenders made loans to about 25,300 rural households in an estimated amount of KN27.30 billion (\$2.57 million)—a fraction of the informal lending done by households, but still more than twice as much as the semiformal sector. Moreover, about 3,100 rural households participated in houay, which lent their members about KN18.53 billion (\$1.74 million), about 50% more than the semiformal sector (excluding FIAM).

Table 4.9 compares some characteristics of household loans with moneylender loans.

The table highlights:

- the vast majority of lending is in cash, especially by moneylenders, but because loans in-kind are smaller on average than loans in cash, a larger percentage of loans by number are made in-kind;
- moneylenders are more than 3 times as likely to require written loan agreements and more than 4 times as likely to require written collateral agreements than households;
- moneylenders have a lower level of overdue loans than households and charge higher effective interest rates;¹⁶
- regular collection of payments is more frequent with moneylenders, who show only 28.43% of loans as maturing in bullet payments of all interest and principal, compared to 52.97% of household loans; and
- moneylenders are about 7 times more likely than households to give loans where the interest is payable monthly, though households are more likely to collect daily payments from their borrowers.

¹⁶ The percentage of the number of loans overdue based on borrower reporting was 2.35%, suggesting underreporting of overdue loans by borrowers.

Characteristic of Loan	Households	Moneylenders
Loans by Value (Percent)		
Loans Given in Cash	89.83	99.20
Loans Given in Kind	10.17	0.80
Loans by Number (Percent)		
Loans Given in Cash	72.92	90.20
Loans Given in Kind	27.08	9.80
Loans to be Repaid in Cash	77.32	92.16
Loans to be Repaid in Kind	22.68	7.84
Loan Terms (Months)		
Average Loan Term	4	5
Range of Loan Terms	1 – 48	1 – 48
Loan and Collateral Agreements (Percent)		
Loans With Written Loan Agreements	20.15	67.65
Loans With Written Collateral Agreements	6.19	28.43
Overdue Loans (Percent)		
Loans Overdue by Number	28.78	14.71
Effective Interest Rates (Percent per Year)		
Maximum Reported Rate	480	360
Average Effective Rate	44	136
Loan Repayment Methods (Percent of Loans by Number)		
Flat Rate Principal and Interest Daily	22.38	13.37
Flat Rate Principal and Interest Monthly	2.75	4.90
Flat Rate Principal and Interest at Loan Maturity	53.10	28.43
Interest Only Monthly and Principal at Loan Maturity	5.61	37.25
Others	16.16	16.05

Source: Rural Financial Services Survey

Chapter 5

Household Savings



Collecting savings at a village savings and credit group

It is commonly believed that many rural households in less developed countries, including the Lao PDR, are too poor to save. However, a considerable amount of research disproves this view.¹ In fact, the poor save constantly. However, most rural households in less developed countries, especially poor households, do not have ready access to savings facilities in banks or other formal financial institutions. Instead, they use alternative, informal vehicles for their savings, such as livestock, gold and other precious metals, jewelry, and housing materials or other stocks of physical goods. They also maintain cash at home, or may deposit savings with a friend, family member, or moneylender. Or they may participate in rotating savings and credit associations with trusted family members or neighbors. Many of these

informal savings mechanisms involve high risk and high transaction costs, resulting in savings that are not easily turned into ready cash. For example, livestock may die and lose its value. If a household needs only \$50, it may be

¹ E.g., Rutherford, Stuart. 2000. *The Poor and Their Money*. New Delhi: Oxford University Press; and Robinson, Marguerite. 2001. *Savings and the New Microfinance*, in *The Microfinance Revolution*. World Bank. Washington, DC. This section also draws on CGAP 2002. *Savings Are As Important As Credit: Deposit Services For the Poor*. Donor Brief No. 4. June.

required to sell a water buffalo for \$400, and it may take time to find a buyer.

Much of the focus of governments in the past 50 years has been on delivering credit to rural households. However, experience has shown that households often value the availability of appropriate deposit services as much as, and sometimes more than, access to credit. Poor rural households, as do most households, value deposit services that are secure, have low transaction costs, and are appropriate to their needs (e.g., allowing for small deposits and quick withdrawals when necessary). Although these households prefer making a positive real return on their savings, they will accept small negative real returns in return for these other characteristics.

This chapter, therefore, presents survey results regarding savings behavior and preferences of Lao rural households as well as the savings vehicles available to them.

The Volume of Cash Savings

Table 5.1 shows that, extrapolating from the survey sample to the population, rural households in the Lao PDR in early 2004 held an estimated KN2,290.28 billion (\$215.62 million) in cash² savings. Almost 90% of rural households reported holding some cash savings. Cash in hand was most frequently reported, with some amount held by 89% of surveyed households, although it represented only 39.75%

² "Cash" means cash in bank or other formal or semiformal financial institution or cash in hand.

of cash savings. Bank deposits represented the largest amount, at 55% of cash savings, but was held by less than 5% of rural households, suggesting a very low level of outreach by the Lao banking sector (including APB) in rural areas.

Of the balance, KN44.07 billion or 1.93% was held in rotating savings and credit associations (known as *houay* in the Lao PDR),³ while smaller amounts of KN10.62 billion or 0.47%, and KN0.91 billion or 0.04% were saved in VSCGs and SCUs respectively.

Total estimated savings in the banking system from rural households in early 2004 was KN1,254.37 billion. BOL reported that the total savings in the banking system at 31 December 2003 was KN4,023.78 billion.⁴ Hence, an estimated 31.2% of savings in the banking system comes from rural households.

Figure 5.1 shows total national cash savings for all rural households, as well as savings of the poorest and richest quartiles. Figure 5.2 shows the percentages of households with cash savings of a particular type for all rural households and the poorest and richest households.

The figures illustrate that:

- Banks hold 54.78% of rural households' cash savings (KN1,254 billion), with a further 39.76% (KN910 billion) being held as cash in hand and the balance of 5.46% (KN125 billion) being held in houays, VSCGs, SCUs, and other ways.

³ Rotating savings and credit associations, known in the Lao PDR as *houay* are commonly observed throughout the world, primarily but not exclusively in less developed countries. In a *houay*, members make a regular contribution to a fund, which is withdrawn for use by one member. For example, 12 members may contribute KN100,000 each month, with one of these members withdrawing this money (KN1.2 million) for use. Members who withdraw money early in a *houay* cycle are effectively net borrowers, while members who withdraw money late in the cycle are effectively net savers. Many variations of this basic model exist, including bidding on the fund and gradually increasing the amount paid into the fund during the cycle to ensure that savers receive a positive rate of return.

⁴ See Chapter 3 for further details of the supply of formal sector financial services.

Table 5.1 Household Cash Savings

Category of Savings	Percentage with Cash Savings in Category	Cash Savings by Rural Households (KN billion)	Cash Savings in Rural Areas (\$ million)	Percentage of Cash Savings	Average Cash Savings Per Household (KN thousand)	Average Cash Savings Per Household (\$)
Cash in Hand	88.98	910.72	85.74	39.76	1,002.10	94.34
Current Account	0.19	1.66	0.16	0.07	1.83	0.17
Savings Account	2.31	284.04	26.74	12.40	312.54	29.42
Deposit Account	2.45	968.67	91.19	42.29	1,065.86	100.34
Houay	2.02	44.07	4.15	1.93	48.49	4.57
VSCG	3.76	10.62	1.00	0.47	11.69	1.10
SCU	0.51	0.91	0.09	0.04	0.999	0.09
Other	1.15	69.59	6.55	3.04	76.57	7.21
Total	89.81	2,290.28	215.62	100.00	2,520.08	237.25

- The richest quartile of households account for 81.30% (KN1,862 billion) of the cash savings held in banks, while the poorest quartile of households account for only 2.10% (KN48.4 billion) of such cash savings;
- Only 13.8% of households in the richest quartile and 1.5% of households in the poorest quartile maintain any savings in the banking system; and
- Savings mobilization by semiformal and informal MFIs (including *houay*) at the grassroots level is only KN55.6 billion, reflecting the low level of intermediation by these organizations.

The results suggest the potential to reduce the amount of cash savings held as cash in-hand by rural households and increase the levels of savings in licensed financial institutions if they can be more widely established.

Table 5.2 shows the distribution of cash savings by survey stratum and wealth quartile. The table illustrates the marked differences between Peri-urban households with average cash savings of KN8.24 million, being:

- 4.03 times the average cash savings of Provincial Capital households;

31.2% of savings in the banking system comes from rural households. Only 13.8% of households in the richest quartile and 1.5% of households in the poorest quartile maintain any savings in the banking system.

Figure 5.1 Total National Cash Savings

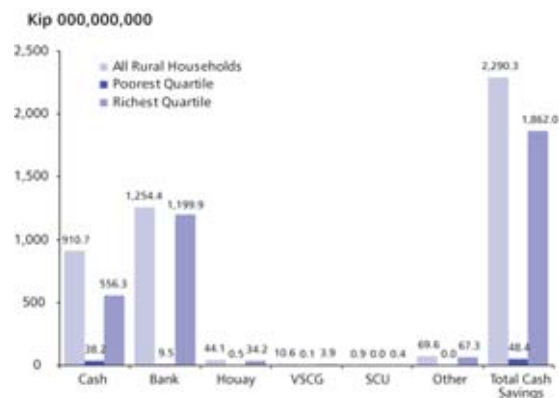
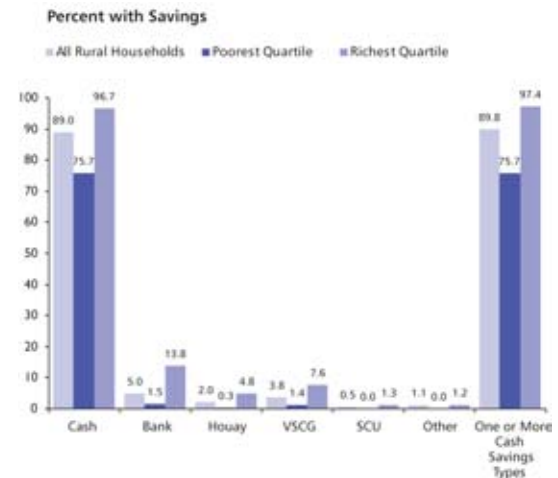


Figure 5.2 Percent of Households with Cash Savings Types



Source: Household survey.

Table 5.2 Average Household Cash Savings by Stratum and Wealth Quartile (KN Million)

Savings Type	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Cash	1.00	1.28	0.96	0.62	1.19	0.17	0.40	0.99	2.45
Current Bank Account	0.002	0.00	0.03	0.00	0.00	0	0.00	0.00	0.01
Savings Account	0.31	1.34	0.22	0.03	0.1	0	0.03	0.02	1.20
Term Deposits	1.07	5.14	0.25	0.03	0.19	0.04	0.001	0.15	4.08
Houay	0.05	0.16	0.06	0.03	0.02	0	0.02	0.02	0.15
VSCG	0.01	0.05	0.04	0.00	0.001	0	0.02	0.01	0.02
SCU	0.001	0.003	0.00	0.00	0.001	0	0.002	0.00	0.002
Other	0.08	0.27	0.47	0.005	0.003	0	0.01	0.004	0.30
Total Savings	2.52	8.24	2.04	0.71	1.50	0.21	0.48	1.19	8.21

Source: Household survey

- 11.67 times the average cash savings of Rural Mekong households; and
- 5.48 times the average cash savings of Other Rural households.

These variations are even more marked when savings are examined by wealth group. The poorest 25% of households had average cash savings of just KN213,000, compared to the richest 25% who had on average 38.58 times as much cash savings (KN8.21 million). The findings also reconfirm that Peri-urban and richer households are more likely to save in banks, while few of the poorest 25% of households hold savings in banks, or even in houay, VSCGs, and SCUs.

The Volume of Non-cash Savings

As discussed in the introduction to this chapter, rural households often save informally using in-kind savings vehicles such as livestock, gold, jewelry, or stocks of housing materials. Figure 5.3 shows total noncash national savings for all rural households in the Lao PDR, as well as the poorest and richest quartiles. Figure 5.4 shows percentages of households with non-cash savings of a particular type for all rural households and the poorest and richest households. The figures illustrate that:

- Livestock is the most common means of non-cash savings in Lao rural households, used by 98.2% of rural households and accounting for KN4,268 billion nationally;
- Livestock as a means of savings is more important for households in the poorest quartile where it accounts for 77.09% of non-cash savings, compared to 56.90% of non-cash savings in the richest quartile; and
- Precious metals and jewelry are the second most common means of savings for households in the richest quartile (with 60.8% of households reporting savings in this

Figure 5.3 Total National Non-Cash Savings

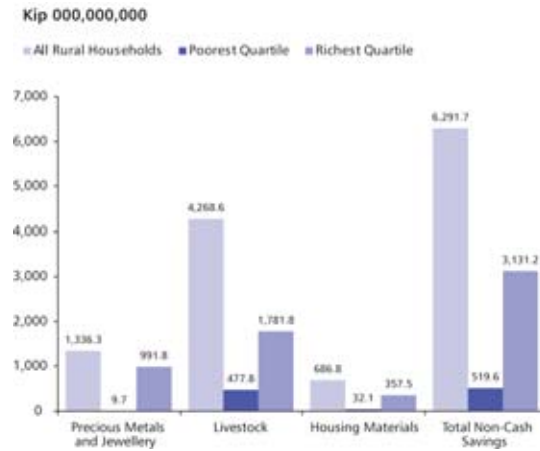
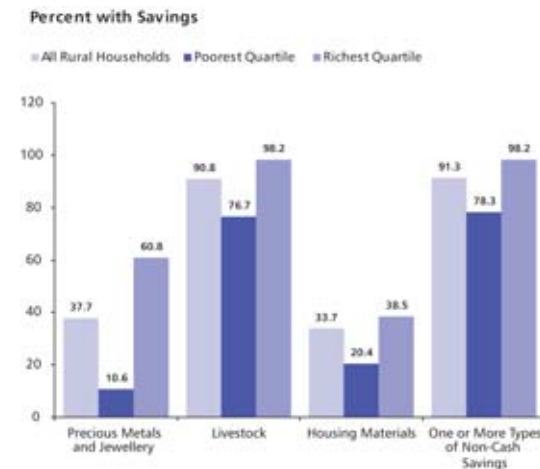


Figure 5.4 Households with Non-cash Savings Types



Source: Household survey.

Non-cash savings account for 73.3% of total rural savings. For the poorest quartile of households, non-cash savings constitute 91.48% of total savings

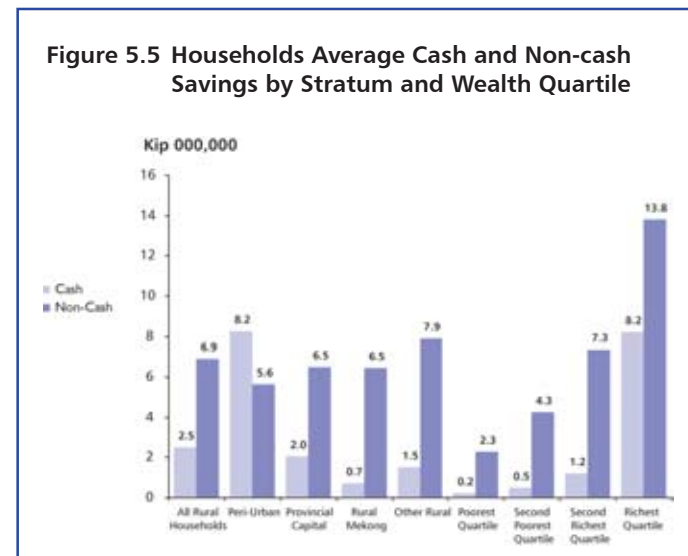
form), while housing materials were the second most common form of savings for poorest quartile households with 20.4% of households holding such savings.

Table 5.3 illustrates how non-cash savings are held in the most prevalent forms of precious metals and jewelry, livestock, and housing materials, by survey stratum and by wealth quartile.

Differences in non-cash savings across strata are less pronounced than differences across wealth quartiles. Other Rural households hold, on average, the greatest amount, primarily in the form of livestock. Peri-urban households hold proportionately more precious metals and jewelry and less livestock. Households in the richest quartile held on average 6.05 times the value of non-cash savings held by households in the poorest quartile.

Comparing Cash and Non-cash Savings

A comparison of the savings reported above indicates that total non-cash savings (KN6,291.7 billion) of rural households nationwide exceed cash savings (KN2,290.3 billion) by a factor of 2.75; i.e., non-cash savings account for 73.3% of total rural savings in the Lao PDR. Figure 5.5 illustrates the importance of non-cash savings in the Lao



Source: Household survey.

PDR across all strata and all wealth groups, especially for the poor and most remote households.

For example, for the poorest quartile of households, non-cash savings constitute 91.48% of total savings; for the second poorest quartile, 89.85% of savings, for the second richest quartile, 86.08%; and for the richest quartile,

Table 5.3 Average Household Non-cash Savings by Stratum and Wealth Quartile (KN Million)

Savings Type	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Precious Metals and Jewelry	1.47	2.43	1.26	0.58	1.78	0.04	0.39	1.08	4.37
Livestock	4.70	2.16	4.65	5.24	5.38	2.10	3.38	5.46	7.86
Housing Materials	0.76	1.06	0.57	0.65	0.72	0.14	0.50	0.80	1.58
Total Non-cash Savings	6.92	5.65	6.48	6.47	7.88	2.28	4.27	7.35	13.81

Source: Household survey

62.71%. Similarly, for Other Rural households, non-cash savings comprise 84.00% of total savings; for Rural Mekong households, it comprises 90.17% of total savings; for Provincial Capital and Peri-urban households, non-cash savings comprise 76.02% and 40.68%, respectively, of total savings. As shown in Table 5.3, the importance of livestock across all groups is evident, though it declines with wealth in favor of precious metals and jewelry.

Savings Vehicle Preferences

Although household preferences are revealed to some extent by actual practices illustrated above, underlying preferences for various savings vehicles may differ from practice depending on the availability of options. For example, the frequent use of livestock (by 98% of households) as a savings vehicle may reflect the dearth of other options rather than a preference for saving this way.

Table 5.4 shows the preferences of rural households for different types of cash savings. In the survey, 99.11% of households expressed a first preference, 89.26% expressed a second preference, and 59.76% expressed a third preference.

Almost 30% of households said their first preference was to save in APB or another bank (12.43% in APB and 17.29% in another bank). Some 27.63% expressed some preference (first, second, or third) for APB, while 35.6% expressed some preference for other banks. It will be recalled from Table 5.1 that less than 5% of households actually have savings in any bank, suggesting a large unmet demand for formal savings services in rural Lao PDR, and a large potential market for the banks.

In contrast, little preference was expressed for informal and semiformal facilities for cash savings: collectively, only 2.05% of households expressed a first preference for houay, VSCGs, or SCUs, and only 7.09% expressed any preference

Table 5.4 Households Savings Preferences

Type of Savings Vehicle	Percent with 1 st Preference	Percent with 2 nd Preference	Percent with 3 rd Preference	Total (Percent with 1 st , 2 nd , or 3 rd Preference)
Cash in Hand	14.62	17.22	17.52	49.36
APB	12.43	10.04	5.16	27.63
Other Bank	17.29	10.13	8.18	35.60
Houay	0.75	0.81	0.66	2.22
VSCG	0.17	0.44	0.17	0.78
SCU	1.13	1.62	1.34	4.09
Precious Metals and Jewellery	3.33	7.04	6.50	16.87
Livestock	27.97	19.90	8.73	56.60
Housing Materials	8.55	7.96	6.17	22.68
Other	12.86	14.10	5.34	32.30
Total	99.11	89.26	59.76	99.11

for them. In the case of SCUs, this low preference is likely due to the lack of familiarity with this model, as only a small handful of SCUs exist in the Lao PDR. By comparison, VSCGs have been widely established and are a familiar model.⁵ However, there appears to be little preference for them. A much stronger preference was expressed for simply keeping cash in hand as a savings vehicle: 14.62% expressed a first preference for this, and 49.36% expressed some preference for this.

Among non-cash alternatives, livestock is clearly the most preferred vehicle for savings, with preferences on the same order as that for banks. More than a quarter of all households (27.97%) stated that livestock was their first

Despite APB's extensive branch network, it is less preferred as a savings vehicle when compared to other commercial banks, cash in hand, or livestock

⁵ Some figures are conflicting. The UNDP/UNCDF survey in 1996 reported 1,650 village credit associations established in Lao PDR, often with the assistance of international donors and/or LWU. In the present survey, international donors reported that they helped establish additional village-based schemes in 580 villages. So, at a minimum, it would appear that some 2,230 schemes have been created, though it is unclear how many are still operating. Moreover, not all are VSCGs (which accept deposits)—many are less sustainable village revolving funds (VRFs) that do not accept deposits and have been frequently decapitalized. See Chapter 4 for a more detailed discussion of the supply of financial services by semiformal institutions.



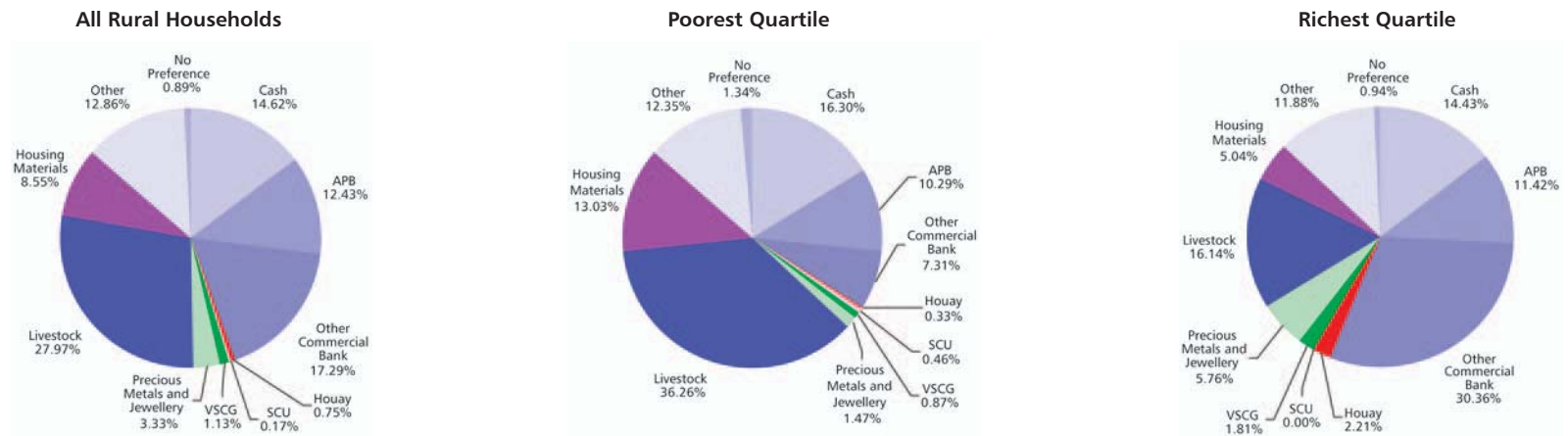
A village house in rural Champusak Province

preference for savings, and 56.6% expressed some preference for this savings method. A further 8.55% expressed a first preference for saving in housing materials, while 22.68% expressed some preference for this savings vehicle; and 3.33% expressed a first preference for precious metals and jewelry, while 16.87% expressed some preference of this method.

Traditional non-cash methods of savings continue to be the first preference of about half of Lao rural households, and despite APB's extensive branch network, it is less preferred as a savings vehicle when compared to other commercial banks, cash in hand, or livestock. This provides some evidence of the limited success of APB in providing savings services that rural households value.

Figure 5.6 and Table 5.5 break down rural households' first savings preferences by stratum and wealth quartile. The evident pattern is a more frequent preference for noncash instruments (especially livestock) as savings vehicles amongst the poorer and more remote households, and a

Figure 5.6 Households' First Preferences for Type of Savings



Source: Household survey.

Table 5.5 Households' First Preferences for Type of Savings by Strata and Wealth Group (% of Households)

Savings Type	All Rural Household	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Cash	14.62	14.16	14.45	14.11	15.24	16.30	15.86	11.90	14.43
APB	12.43	15.93	15.23	7.51	14.44	10.29	12.32	15.69	11.42
Other Commercial Bank	17.29	21.24	23.05	16.52	15.51	7.31	10.92	20.61	30.36
Houay	0.75	2.21	0.78	0.90	0.00	0.33	0.41	0.08	2.21
SCU	0.17	0.00	1.17	0.00	0.27	0.46	0.08	0.16	0.00
VSCG	1.13	3.98	3.13	0.00	0.53	0.87	1.43	0.41	1.81
Precious Metals and Jewelry	3.33	8.41	1.56	3.30	1.34	1.47	2.64	3.45	5.76
Livestock	27.97	17.70	18.75	24.02	36.63	36.26	34.44	25.01	16.14
Housing Materials	8.55	5.75	14.06	12.01	6.42	13.03	7.59	8.54	5.04
Other	12.86	10.62	7.03	20.12	8.82	12.35	13.46	13.75	11.88
Total Households Expressing a First Preference	99.11	100.00	99.22	98.50	99.20	98.66	99.14	99.60	99.06

Source: Household survey

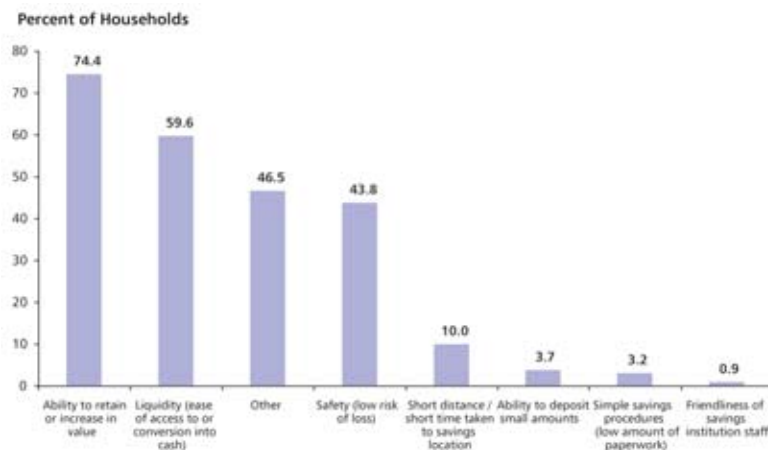
greater preference for APB and other commercial banks amongst richer and less remote households. While only 17.60% of the poorest quartile expressed a first preference for APB or other commercial banks as a savings vehicle, 41.78% of the richest quartile expressed a first preference for saving in the banking system. However, 30.36% of the richest quartile preferred other commercial banks and only 11.42% preferred APB.

Across the strata, it is noteworthy that Rural Mekong households were least likely to express a first preference for APB—only 7.5% compared to 14–15% of households in the other strata. As APB's traditional mandate has been to serve rice farmers who are primarily located in the Rural Mekong area, this result should give pause to policy makers regarding the success of APB in fulfilling its mandate.

A micro-entrepreneur in Saravan Province.



Figure 5.7 Percentage of Households Indicating a Savings Characteristic is Important



Source: Household survey.

Savings Characteristic Preferences

In the survey, rural households were asked to state what characteristics were important to them when choosing how to save. (Households were not asked to rank characteristics or express them in any order of preference) Figure 5.7 and Table 5.6 show the characteristics that rural households considered important in choosing how to save. Consistently, across all wealth groups, the ability to retain or increase in value was the most frequently cited characteristic in choosing a savings product. Almost three quarters of households said this was an important factor in choosing a savings product. Liquidity and low risk of loss were also very important factors. Other factors were of much less importance across all strata and wealth quartiles.

Table 5.6 Important Characteristics of Different Types of Savings (Percentage of households mentioning characteristics)

Savings Type	All Rural Household	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Ability to retain or increase in value	74.41	66.37	75.00	66.97	83.69	73.67	72.37	78.19	73.39
Liquidity (ease of access to or conversion into cash)	59.62	65.49	64.84	57.96	57.75	54.13	59.01	62.33	63.02
Safety (low risk of loss)	43.82	47.35	44.53	36.94	47.59	33.07	39.60	46.22	56.40
Short distance / short time taken to savings location	10.04	7.52	14.45	4.50	14.97	7.57	5.35	13.75	13.50
Simple savings procedures (low amount of paperwork)	3.16	6.64	5.47	1.50	2.67	2.56	2.34	4.13	3.60
Ability to deposit small amounts	3.74	5.75	3.52	0.60	5.35	3.35	3.41	2.57	5.63
Friendliness of savings institution staff	0.88	0.88	3.13	0.30	1.07	0.73	0.87	1.23	0.69

Source: Household survey

Chapter 6

Household Borrowing

One cause of poverty in less developed countries is the lack of access to credit, especially among rural households. The poor often find themselves in a vicious cycle: producing at a subsistence level makes it difficult to accumulate savings or other assets, thus making it difficult either to invest any surplus or to gain access to credit in formal financial markets, which leads to low productivity and continued poverty.

In many less developed countries, local moneylenders are a principal source of credit to rural households. However, moneylenders often charge annual interest rates of more than 100%. Given that interest rates in most formal credit markets are in the range of 10–24%, many potentially profitable projects are not undertaken in rural areas of less developed countries. Hence, finding ways to reduce delivery costs to provide sustainable credit to the poor should lead to increases in income and equity.

Commercial banks generally do not cater to the needs of the rural poor. The projects that most rural poor would undertake are small scale, requiring small loans. Therefore, the costs of obtaining the information necessary to select borrowers, evaluate their creditworthiness, monitor the use of the loans, and enforce repayment outweigh the potential profits to most lending institutions. Hence, government-led efforts to deliver formal credit to rural areas have often included setting up special agricultural banks to lend to rural borrowers. This has also been the case in the Lao PDR. However, such efforts have generally failed because such banks typically fail to enforce repayment of loans, and

because subsidized interest rates and incentives to maximize the amount loaned have resulted in lending primarily to the relatively wealthy and politically connected, rather than to the poor.¹

This chapter examines household borrowing in the Lao PDR, by lending source, by loan purpose, by strata, and by wealth quartile. It also examines household preferences for lending sources and for loan characteristics, and estimates unsatisfied demand for credit.

Household Borrowing

As noted in Chapter 3, the Lao financial sector (as is the case in the financial sectors of most developing countries) can be divided into the formal sector, semiformal sector, and informal sector. Generally speaking, loans from the formal sector tend to be larger and carry lower interest rates, while semiformal and informal loans will be smaller and often carry higher interest rates, though there may be individual exceptions (e.g.,

¹ This introduction draws on B. E. Coleman, “The Impact of Group Lending in Northeast Thailand,” *Journal of Development Economics*, October 1999.



Demand for microenterprise financing is high

The formal financial sector tends to favor relatively wealthy households, while poorer households are more dependent on the informal sector.

loans between family members and friends may be interest free). It is typically a goal of financial sector development to expand the outreach of the formal sector as much as feasible.

Table 6.1 shows comparisons between households that borrowed in the formal and informal sectors.

The table highlights:

- 35.89% of financial managers who borrowed in the formal sector had a secondary education or higher, compared to 30.00% who borrowed in the semiformal sector and 24.29% who borrowed in the informal sector—i.e., higher education level is correlated with greater access to formal sector loans;
- households who borrowed in the formal sector were slightly more likely to be engaged in industry or services as their primary activity than households who borrowed in the semiformal and informal sectors;
- conversely, households who borrowed in the semiformal and informal sectors were more likely to be engaged in agriculture as their primary activity, although even 66.67% of formal sector borrowers also engage in agriculture as their primary activity; and

- households that borrowed in the formal sector had average assets of KN105.42 million, about three times as much as households borrowing in the semiformal and informal sectors.

These findings indicate that the formal financial sector tends to favor relatively wealthy households, while poorer households are more dependent on the informal sector.

Overall, about 40% of all rural households had borrowed in the 12 months before the survey, including 41.0% of all households with male financial managers and 37.2% of all households with female financial managers. Among borrowing households, 9.4% of households with female financial managers accessed formal sector borrowing compared to 6.0% of the households with male financial managers. At the same time, 35% of households with male financial managers and 27.9% of households with female financial managers borrowed in the informal sector. Hence, contrary to the experience in many other countries, households with female financial managers (40% of all surveyed households) in the Lao PDR tend to have slightly greater access to the formal financial sector than households with male financial managers. This should not be unexpected, however, given the matriarchal tradition among the Lao Loum ethnic group, the most populous in the country.²

Table 6.1 Comparative Characteristics of Household Financial Managers and Households that had Borrowed in the Formal or Informal Sectors

Characteristics of Households	Formal Sector Borrowers	Semi-formal Sector Borrowers	Informal Sector Borrowers	Rural Households as a Whole
Financial Manager with Secondary or Higher Education (%)	35.89	30.00	24.29	24.99
Agriculture as Primary Household Activity (%)	66.67	80.00	72.42	80.60
Industry as Primary Household Activity (%)	2.56	0.00	1.16	2.43
Services as Primary Household Activity (%)	2.56	0.00	0.09	1.26
Average Household Assets (KN Million)	105.42	33.43	37.33	54.57

Source: Household survey.

² Further analysis, broken down by ethnic group, would presumably indicate greater access by men in patriarchal ethnic groups, but this analysis has not been done on the current data set.

Volume and Source of Borrowing

Table 6.2 and Figure 6.1 illustrate the total estimated number of households borrowing from formal, semiformal, and informal sources for rural households during the 12 months preceding the survey.

Overall, 40% of rural households borrowed in the 12 months before the survey. The formal sector made loans to less than 3% of rural households, while the semiformal sector reached 4% of rural households. In contrast, informal sources made loans to 33% of rural households. The poorest two quartiles relied on informal sources markedly more than the richest two quartiles; while the richest two quartiles had greater access to formal sources.

Table 6.3 shows that, extrapolating from the survey sample to the population, rural households had borrowed an estimated KN636.82 billion (\$59.95 million) in the 12 months preceding the survey.

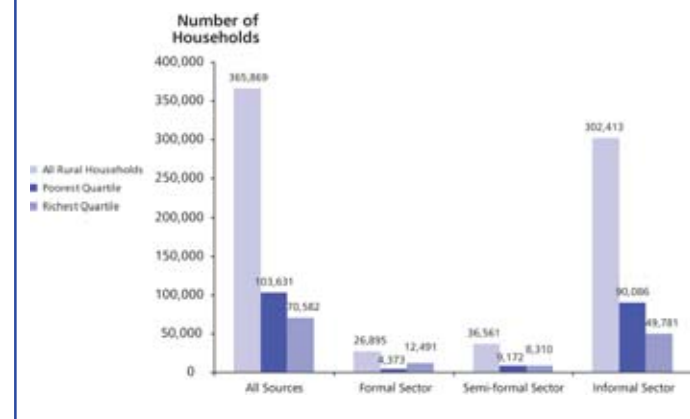
Borrowing from family and friends was the most common. Some 25.05% of households borrowed from friends or family in the preceding 12 months, in an amount equal to KN307 billion when extrapolating to the rural population of the Lao PDR. The average original loan size was KN1.38 million (\$130). Friends and family accounted for 48.22% of loans by value.

Supplier credit was the next common means of financing, with loans taken by 6.14% of households, with estimated overall borrowing in the previous 12 months being KN134.81 billion. The average original loan size from suppliers was KN3.76 million (\$354).

The third most common means of financing, in terms of the number of households borrowing, was VRFs. An estimated 19,812 or 2.18% of rural households borrowed from VRFs in the 12 months preceding the survey. The average original loan size was KN612,000 (about \$58).

APB was the fourth most common means of financing, reaching an estimated 18,267 rural households, or 2.01% of all rural households in the 12 months preceding the survey. It is noteworthy that APB reports about 87,000 total borrowers in the Lao PDR. The survey findings indicate that only about 18,267 of these borrowers (or about 21% of

Figure 6.1 Estimated Number of Households Borrowing by Sector in the 12 Months Preceding the Survey



Source: Household survey.

Friends and family accounted for 48.22% of loans by value.

Table 6.2 Estimated Number of Households Borrowing by Sector in the 12 Months Preceding the Survey

Borrowing Source	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest 25%	Next Poorest 25%	Next Poorest 25%	Richest 25%
All Sources	365,869	76,628	15,981	123,656	149,603	103,631	112,338	79,318	70,582
Formal Sector	26,895	8,264	1,953	7,328	9,350	4,373	2,596	7,435	12,491
Semiformal Sector	36,561	6,761	2,308	11,908	15,584	9,172	13,093	5,987	8,310
Informal Sector	302,413	61,603	11,720	104,421	124,669	90,086	96,649	65,896	49,781

Source: Household survey.

Table 6.3 Household Borrowing During Preceding 12 Months by Source

Source of Loan	Percentage of Rural Households Borrowing from Source in Preceding 12 months	Total Amount Borrowed in Preceding 12 months (KN Billion)	Percentage of Total Loan Volume	Average Original Loan Size (KN thousand)
Friends and Family	25.05	307.09	48.22	1,383
Supplier Credit	6.14	134.81	21.17	3,759
VRF	2.18	8.81	1.38	612
APB	2.01	35.28	5.54	2,650
Moneylender	1.87	27.30	4.29	1,606
VSCG	1.56	3.47	0.55	254
Other Bank	0.95	98.70	15.50	11,900
SCU	0.29	2.83	0.44	900
Houay	0.22	18.53	2.91	10,000
Total	38.13	636.82	100.00	2,149

Source: Household survey.

Only 2% of rural households borrowed from ADB.

all APB borrowers) are located in rural areas, suggesting that APB lends predominantly to urban households despite its rural mandate. This is also consistent with APB’s lending records, which indicate that the large urban areas of Vientiane, Savannakhet, Pakse, and Luang Prabang absorb the vast majority of its lending. Average loan size for APB’s rural borrowers was KN2.65 million (\$249).

Moneylenders provided loans to an estimated 16,994 households (1.87% of rural households) in the 12 months preceding the survey, with an average loan size of KN1.61 million (\$152), while VSCGs catered to an estimated 14,177 households with smaller loans averaging KN0.25 million (\$24).

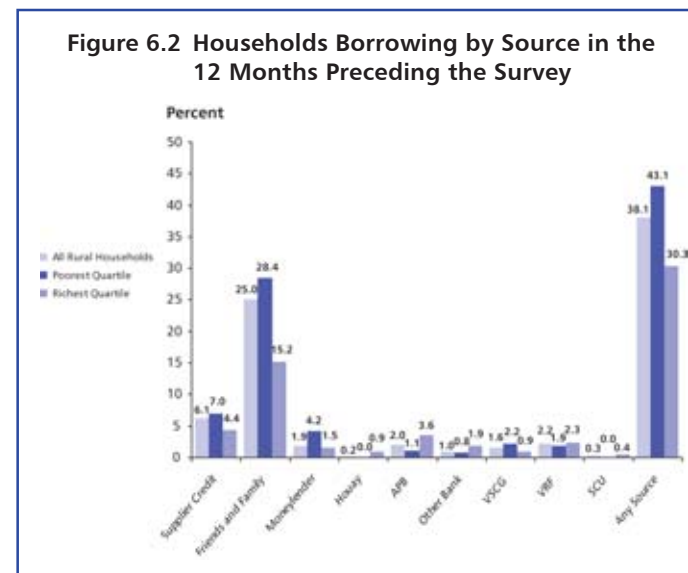
For an estimated 8,633 rural households (less than 1%), other commercial banks provided larger loans averaging KN11.9 million (\$1,120). No households reported borrowing both from APB and from another commercial bank, implying that 26,900, or only 2.96%, of rural households borrowed from a formal bank during the 12 months preceding the survey.

Houays, SCUs, and other sources of credit all accounted for small numbers of borrowers. Houays, provided larger loans, averaging an estimated KN10.0 million (\$941).

Figure 6.2 compares sources of borrowing for the rural population as whole with sources for the poorest and richest quartiles.

Overall 30.3% of households in the richest quartile had borrowed from some source, compared to 43.1% of the households in the poorest quartile. While borrowing from friends and family was the most common means of borrowing, 28.4% of the households in the poorest quartile borrowed from this source, but only 15.2% of households in the richest quartile did so. Higher percentages of households in the poorest quartile also borrowed from suppliers, moneylenders, and VSCGs.

However, a higher percentage of the households in the richest quartile than in the poorest quartile borrowed from APB and other banks, indicating that the outreach of these



Source: Household survey.

formal sources is more often to the richest than the poorest. Specifically, 5.5% of households in the richest quartile borrowed from a bank, while only 1.9% of households in the poorest quartile did so. and despite APB's mandate to provide subsidized loans to the poor, its richest-quartile clients outnumbered its poorest-quartile clients by more than 3 to 1. However, outreach of APB and other banks was extremely low to all rural households and all quartiles.

Table 6.4 shows average household borrowing by source in the 12 months preceding the survey by stratum and wealth quartile.

The table illustrates the marked differences between Peri-Urban households with average borrowing of KN1.71 million (\$161) and other households on average, being: 1.60 times the average borrowings of Provincial Capital households; 5.12 times the average borrowings of Rural Mekong households; and 3.41 times the average borrowings of Other Rural households. The difference comes almost

entirely from borrowing from friends and family. Households in the Provincial Capital stratum also borrow markedly more than all other households from both APB and other banks.

The variations are more marked when borrowings are examined by wealth group, and these differences are brought out in Figure 6.3, which compares the richest and poorest quartiles. Households in the poorest quartile borrowed just KN126,620 (\$12) on average, compared to the richest quartile which borrowed KN2.15 million (\$202) on average (some 17 times as much as the poorest households). In terms of access to the formal sector, households in the richest quartile borrowed 33.6 times as much as households in the poorest quartile from banks. This included 12.6 times as much from APB.

Figure 6.4 shows the composition of total borrowing by value in the 12 months preceding the survey for rural households as a whole and for the richest and poorest quartiles. The figure shows the greater access of the richest

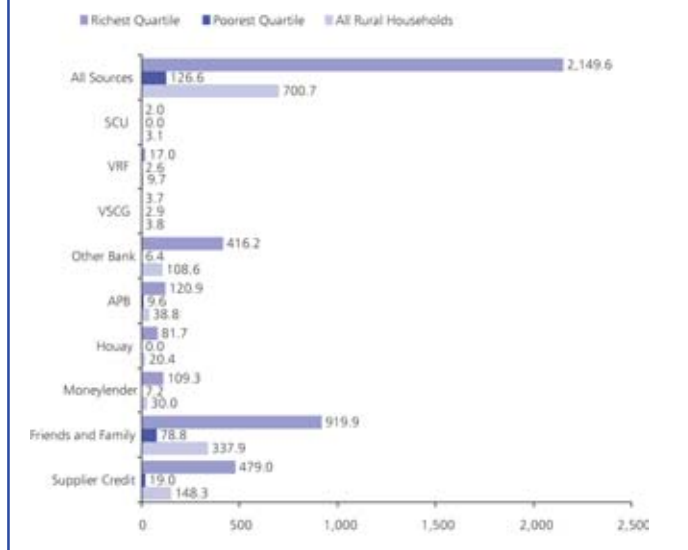
Despite APB's mandate to provide subsidized loans to the poor, its richest-quartile clients outnumbered its poorest-quartile clients by more than 3 to 1.

Table 6.4 Average Household Borrowing by Source in the 12 Months Preceding the Survey (KN Thousand)

Borrowing Source	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Supplier Credit	148.34	328.87	505.90	42.10	111.02	19.03	69.92	26.26	478.95
Friends and Family	337.91	1,126.40	91.04	189.34	138.87	78.83	148.93	205.33	919.86
Moneylender	30.03	146.44	14.11	2.70	2.49	7.19	2.81	1.03	109.28
Houay	20.39	35.40	46.88	0.00	26.74	0.00	0.00	0.00	81.70
Pawnshop	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
APB	38.82	42.88	162.89	8.59	46.26	9.56	5.67	19.33	120.89
Other Commercial Bank	108.60	20.80	207.03	64.86	169.79	6.44	0.00	12.46	416.19
VSCG	3.81	7.52	3.13	2.67	3.17	2.93	6.06	2.54	3.74
VRF	9.70	2.65	36.91	16.85	3.97	2.64	7.37	11.83	16.95
SCU	3.11	2.65	1.95	7.51	0.00	0.00	0.33	10.06	2.05
All Sources	700.71	1,713.62	1,069.84	334.62	502.30	126.62	241.10	288.86	2,149.61

Source: Household survey

Figure 6.3 Average Household Borrowing by Source in the 12 Months Preceding the Survey (KN Thousand)



Source: Household survey.

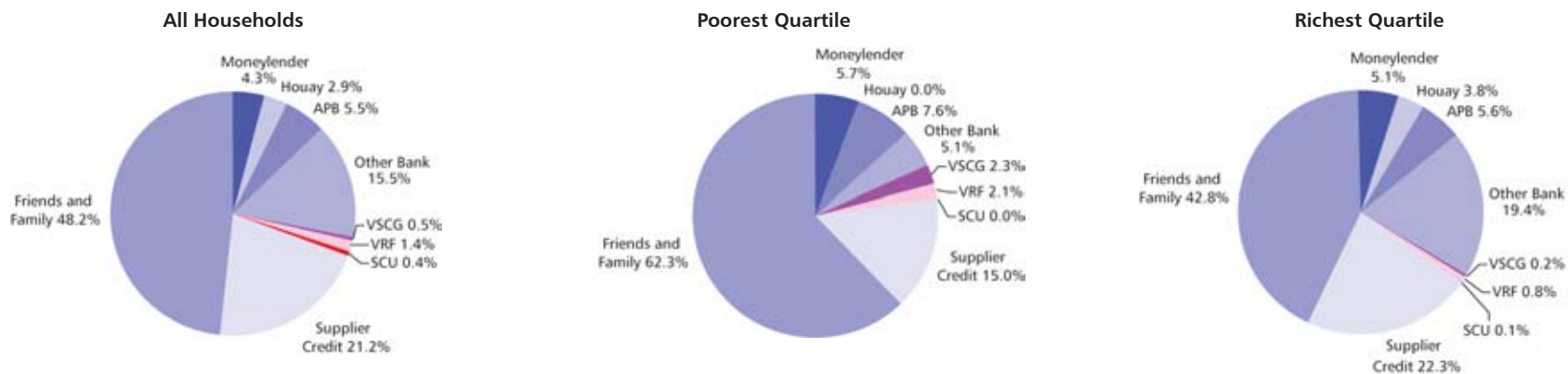
quartile to the banks and supplier credit in particular as a percentage of their overall borrowing, and the greater reliance of the poorest households on family and friends.

Figure 6.5 shows that overall, the richest quartile accounted for 76.6% of the borrowing by value in the 12 months preceding the survey. It also shows that 77.7% of the borrowing from APB by value was by households in the richest quartile. This further evidences that APB lending is not specially oriented to the poorest households, and that the richest quartile of households are APB's main clients in value terms.

Preferences for Lending Sources

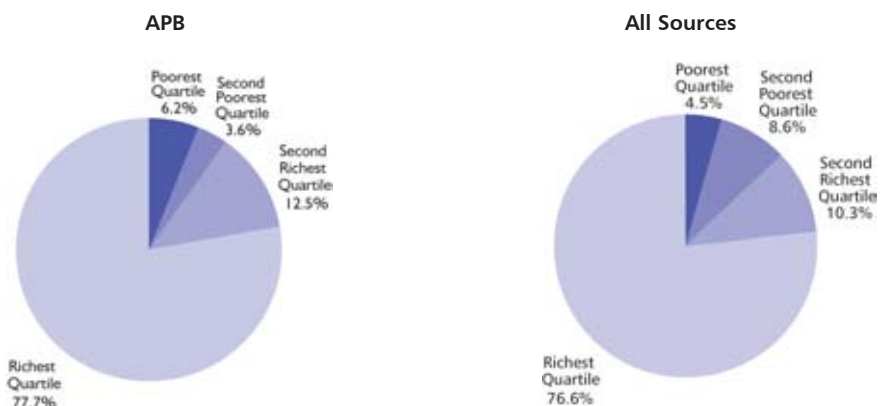
Table 6.5 shows the preferences of rural households for different sources of loans. Specifically, households were asked, "If your household needed a loan, please indicate the first three sources of finance you would approach in order of preference." In the survey, 94.63% of households expressed a first preference for a borrowing source, 55.77%

Figure 6.4 Composition of Borrowing in the 12 Months Preceding the Survey



Source: Household survey.

Figure 6.5 Share of Borrowing in the 12 Months Preceding the Survey by Quartile



Source: Household survey.

Table 6.5 Households Borrowing Preferences

Type of Borrowing	Percent with 1 st Preference	Percent with 2 nd Preference	Percent with 3 rd Preference	Total (Percent with 1 st , 2 nd , or 3 rd Preference)
Friends and Family	57.22	14.03	3.63	74.88
APB	18.94	14.24	2.98	36.16
Other Bank	5.78	6.09	3.05	14.92
VRF	2.67	4.88	3.53	11.08
Informal Moneylender	1.92	7.09	3.00	12.01
VSCG	1.44	2.18	1.27	4.89
Supplier Credit	1.04	0.75	0.32	2.11
SCU	0.30	0.77	0.32	1.39
Pawn Shop	0.23	0.80	0.53	1.56
Houay	0.10	0.39	0.82	1.31
Other	4.98	4.56	2.39	11.93
Total	94.63	55.77	21.83	94.63

Source: Household survey.

expressed a second preference, and 21.83% expressed a third preference; 5.37% expressed no preference.

Overall, 57.22% of households said borrowing from family and friends was their first preference; 74.88% said borrowing from family or friends was either their first, second, or third preference.

Next in order of first preference, 18.94% of rural households expressed a first preference for APB as a source of loans, and 36.16% expressed some preference for this. This compared to only 5.78% that expressed a first preference for borrowing from another bank and smaller percentages that expressed a first preference for other sources. It will be recalled, from Table 6.3, that only 2% of rural households actually borrowed from APB in the 12 months before the survey. Hence, despite this limited outreach, a large number of households (36.16%) expressed some preference for borrowing from APB. There is clearly a significant untapped market for APB, and perhaps for other lenders.

Table 6.6 shows rural households' borrowing first preferences by stratum and wealth quartile. Figure 6.6 illustrates these first preferences for rural households as a whole and for the poorest and richest quartiles.

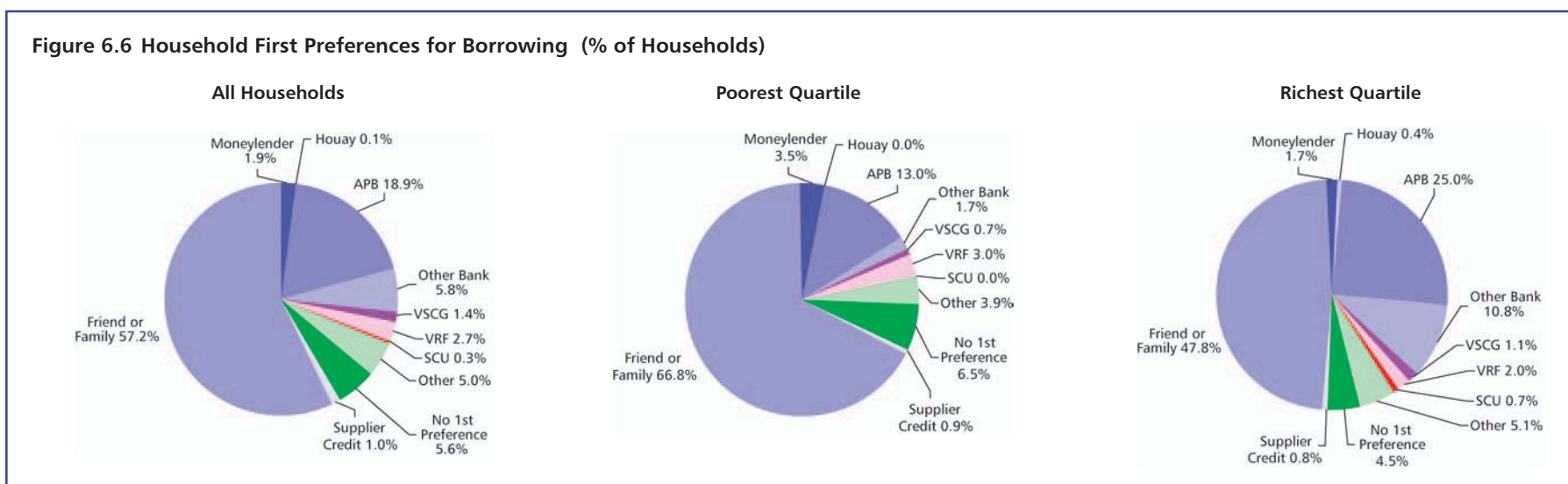
Across strata and wealth quartiles, preferences are dominated by (i) friends and family, (ii) APB, and (iii) other commercial banks. Each other source of loans was first-preferred by less than 4% of households. The results indicate that the richer the household, on average, the greater the preference for borrowing from APB and other banks. In contrast, the poorer the household, on average, the greater preference for borrowing from family and friends. While 13.01% of the poorest quartile of rural households expressed a first preference for borrowing from APB and 1.72% had a first preference for other commercial banks as a source of loans, 24.99% of the richest quartile of rural households expressed a first preference for APB and 10.82% a first

Table 6.6 Household First Preferences for Type of Borrowing by Wealth Group

Borrowing Source	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Friends or Family	57.22	52.65	54.69	69.67	49.73	66.77	60.61	53.72	47.75
Agricultural Promotion Bank	18.94	19.03	19.53	15.02	21.93	13.01	18.28	19.51	24.99
Other Commercial Bank	5.78	9.73	6.25	2.70	6.42	1.72	3.18	7.41	10.82
Village Revolving Fund	2.67	3.98	3.91	2.10	2.41	3.04	3.00	2.61	2.04
Informal Moneylender	1.92	3.98	1.17	0.60	2.14	3.53	1.52	0.89	1.73
Village Savings and Credit Group	1.44	1.77	3.52	2.10	0.53	0.69	1.91	2.02	1.14
Supplier Credit	1.04	1.77	1.56	1.20	0.53	0.89	0.86	1.59	0.82
Savings and Credit Union	0.30	0.44	0.00	0.30	0.27	0.00	0.46	0.00	0.74
Pawnshop	0.23	0.00	0.00	0.00	0.53	0.00	0.46	0.46	0.00
Houay	0.10	0.00	0.00	0.30	0.00	0.00	0.00	0.00	0.40
Other	4.98	3.98	3.52	1.20	8.56	3.88	6.18	4.78	5.09
Total Households Expressing a First Preference	94.63	97.35	94.14	95.20	93.05	93.53	96.46	92.99	95.53

Source: Household survey

Figure 6.6 Household First Preferences for Borrowing (% of Households)



Source: Household survey.

preference for other commercial banks. In contrast, while 66.77% of the poorest quartile households had a first preference to borrow from family and friends, only 47.75% of the richest quartile of households expressed this preference.

No strong pattern emerges from analyzing the stratum results. However, it is noteworthy, given APB’s mandate for channelling policy loans to rice farmers in the Rural Mekong region, that Rural Mekong households expressed less preference for APB (15.02%) than the other strata, and expressed a greater preference for friends and family (69.67%) than the other strata.

Borrowing Characteristic Preferences

In the survey, rural households were asked to state what the important characteristics were for them when choosing where to apply for a loan. (Households were not asked to rank characteristics or express them in any order of preference).

Table 6.7 and Figure 6.7 show the characteristics that rural households considered important in choosing where to apply for a loan.

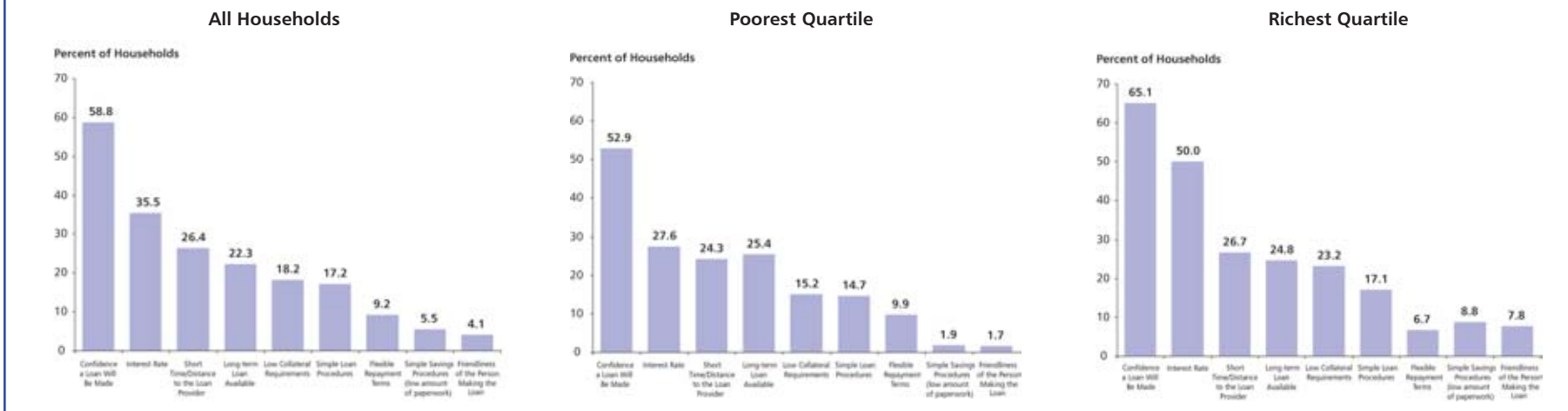
Consistently across all wealth quartiles, confidence that a loan would be made was the most frequently cited important characteristic—households want to be sure of being able to access the loan. Almost 60% of households regarded this as an important factor in choosing where to apply for a loan. In all wealth groups, this was more frequently cited as important than the interest rate. Households in the poorest quartile named this characteristic almost twice as frequently as the interest rate (52.89% to 27.64%), indicating that confidence about receiving a loan (i.e., access to the loan) is markedly more important than price for them. By contrast, while the richest quartile stated even more frequently than the poor that confidence that a loan will be made is important when choosing where to apply for a loan (65.11%), they cited the interest rate almost as often (50%). These results for the

Table 6.7 Important Characteristics of Borrowing (% of Households)

Borrowing Characteristic	Rural Household Average	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Confidence a Loan Will Be Made	58.75	61.50	64.06	57.36	58.02	52.89	59.40	57.62	65.11
Interest Rate	35.48	42.48	35.94	32.43	34.76	27.64	29.93	34.37	50.00
Short Time/Distance to the Loan Provider	26.42	19.03	31.25	37.24	20.59	24.35	25.74	28.90	26.68
Long-term Loan Available	22.32	35.40	29.69	11.71	24.06	25.41	23.14	15.95	24.77
Low Collateral Requirements	18.24	25.22	20.70	22.22	11.76	15.17	19.39	15.22	23.19
Simple Loan Procedures	17.19	13.72	10.16	18.92	18.18	14.66	20.28	16.75	17.09
Flexible Repayment Terms	9.22	12.83	5.47	1.80	13.90	9.88	11.54	8.78	6.68
Simple Savings Procedures (low amount of paperwork)	5.50	3.98	5.86	2.40	8.56	1.85	4.66	6.66	8.84
Friendliness of the Person Making the Loan	4.10	5.31	7.42	2.70	4.28	1.68	2.55	4.36	7.82

Source: Household survey

Figure 6.7 Important Characteristics of Borrowing



Source: Household survey.

Lao PDR are consistent with results in other countries: the poor are more concerned with sustained access to financial services than they are with low interest rates.

For the poorest quartile of rural households, convenience in terms of a short journey to the source of the loan was almost as important as price (24.35% of the poorest quartile citing this as an important factor compared to 27.64% who said the interest rate was an important factor in their choice). For the richest quartile, 50% of households cited interest rates as being an important factor compared to only 26.68% who cited a short journey to the loan provider as being important.

The availability of long-term loans, low collateral requirements, and simple loan procedures were the next most important factors across all households. While long-term loan availability was the fourth most frequently cited

important characteristic when determining where to apply for a loan, it is noteworthy that only 22.32% cited this. Hence, 77.68% did not consider this important. A considerable amount of policy lending by the Government, as well as donor credit lines (including those from ADB), has been justified by the perception that there is a high demand for long-term loans. The evidence of this survey indicates that such policies may be misguided.

For the poorest quartile of households, flexible repayment terms were more frequently cited as important than for the richest quartile, while for the richest quartile simple procedures and friendly service were more frequently cited as important than for the poorest quartile, but still less important than other factors.

The poor are more concerned with sustained access to financial services than they are with low interest rates.

Loan Purpose

Table 6.8 presents the estimated total borrowing by rural households (extrapolated to the entire rural population) in the 12 months prior to the survey, broken down by loan purpose, strata, and quartile. Table 6.9 does the same for the total number of loans borrowed by rural households.³

Table 6.8 indicates that, for all rural households combined, borrowing is concentrated in the transport, services, and trade businesses, as well as livestock, rice production, and medicine and health care. Virtually all borrowing for service businesses takes place in Peri-Urban areas (99.3%); and virtually all is borrowed by households in the richest quartile (99.5%). While borrowing for trade is more equally distributed across strata, it is also concentrated in the richest quartile, who borrow 90.6% of such lending. Similarly, borrowing for transport businesses is concentrated in Peri-Urban households (67.3%) and households in the richest quartile (91.7%).

Table 6.8 also indicates the dominance of borrowing for rice production in Provincial Capital and Rural Mekong households, which together comprise 81% of such borrowing. Again, however, such borrowing is concentrated in the richest quartile, which borrowed 63% of total lending for rice production. Borrowing for livestock production is clearly concentrated in Other Rural households, which borrowed 96.7% of such lending; again, the richest quartile account for most of this, borrowing 95% of total lending for livestock.

Finally, Table 6.8 points to the importance of loans for health and medical purposes in Other Rural areas, and in the three poorer quartiles, which together borrowed 95% of such lending. Households in the poorest quartile borrowed over five times as much as households in the richest quartile for health and medicines, and this accounted for 34.9% by value of poorest quartile households borrowings, compared to 0.4% by value of the borrowings of the households in the richest quartile. Domestic consumption goods accounted for 9.5% of the borrowing by value of households in the poorest quartile, compared to 0.8% of borrowing for richest quartile households. The importance of credit for nonproductive purposes by the poorest households is demonstrated by this pattern.

Households in the poorest quartile borrowed over five times as much as households in the richest quartile for health and medicines.

Testing new rice varieties in Savannakot province



³ It should be noted that the stated *purpose* of a loan may be different from the actual *impact* of the loan. For example, a household might state that it is borrowing to finance a marriage and might indeed use its loan to pay for the marriage. However, without the loan, the household might sell a water buffalo to finance the marriage. Hence, the impact of the loan would be to prevent the sale of a water buffalo, rather than to finance the marriage, which would have been financed even without the loan. For a fuller discussion of the difficulties and methodology of measuring impact, see B. E. Coleman, "The Impact of Group Lending in Northeast Thailand," *Journal of Development Economics*, October 1999.

Table 6.8 Estimated Borrowing by Rural Households by Loan Purpose in the 12 Months Preceding the Survey (KN Billion)

Loan Purpose	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Rice Production	50.91	4.54	23.12	18.12	5.14	1.57	11.87	5.43	32.05
Other Crop Production	5.97	4.55	0.00	0.32	1.10	1.53	0.27	1.44	2.72
Livestock	70.72	0.00	2.32	0.05	68.36	1.29	0.10	2.44	66.89
Fishing	5.23	2.70	0.13	2.29	0.10	0.00	2.94	2.29	0.00
Forestry	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Construction Business	0.62	0.00	0.00	0.00	0.62	0.00	0.21	0.42	0.00
Industry	6.00	0.77	0.04	0.00	5.19	0.02	0.04	5.19	0.75
Handicraft	16.44	0.00	0.14	11.82	4.48	2.49	3.69	1.56	8.70
Wholesale and Retail Trade	49.89	11.34	8.11	10.90	19.53	2.48	0.00	2.18	45.22
Services	56.43	56.04	0.12	0.27	0.00	0.00	0.00	0.27	56.16
Transport	72.00	48.46	6.96	1.83	14.76	0.01	0.15	5.87	65.99
House Construction	16.08	3.42	0.88	6.29	5.50	0.00	1.61	7.35	7.12
Domestic Consumption Goods	18.10	6.98	0.23	2.13	8.76	2.84	6.56	4.66	4.03
Health / Medicine	42.22	4.70	0.91	11.64	24.96	10.39	12.22	17.59	2.02
Education	7.20	1.05	3.63	2.11	0.42	0.00	0.19	1.32	5.70
Marriage	2.80	0.75	0.00	1.30	0.75	0.84	0.48	0.73	0.75
Funeral	5.87	2.86	0.36	1.83	0.83	0.00	3.34	0.83	1.71
Other	212.72	142.79	1.24	32.40	36.28	6.33	10.94	7.71	187.74
Total Borrowing	639.20	290.95	48.18	103.29	196.78	29.77	54.59	67.29	487.55

Source: Household survey.

Table 6.9 (showing the number of loans borrowed) confirms many of the findings from Table 6.8 (showing the amount borrowed). But it also brings out in stark relief the large number of loans borrowed for health and medical care. This loan purpose alone makes up 26.7% of all loans borrowed. The average size of these loans was KN370,000 (\$34). Borrowing for medicine and health care was concentrated in the more remote Other Rural and Rural Mekong strata, as well as in the three poorer quartiles—they made up 36.4% of all loans borrowed by the poorest quartile, while they comprised only 6% of loans borrowed by the richest quartile.

A further 14.93% of all loans, with an average size of KN0.28 million (\$26), were for domestic consumption goods.

These were concentrated in the Other Rural stratum (53.6% of such loans) and in the two poorest quartiles (combined, 79.8% of such loans).

Overall, an estimated 308,884 loans or just over 72% of all loans were for nonproductive purposes (house construction, domestic consumption goods, health and medicines, education, marriage, funereal or other purposes)⁴ at an average size of KN990,000 (\$93), evidencing the very substantial demand for the type of lending that can often be delivered through MFIs more effectively than through the formal banking system.

⁴ This is not to ignore the important increases in productivity that can be obtained through improved health, education, housing, etc. Rather, it is to emphasize the number of loans that are not invested directly in production activities.

Table 6.9 Estimated Numbers of Rural Loans by Loan Purpose in the 12 Months Preceding the Survey

Loan Purpose	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Rice Production	38,104	9,015	3,374	17,403	8,311	6,451	12,846	9,513	9,293
Other Crop Production	10,207	5,259	0	1,832	3,117	1,503	916	3,457	4,332
Livestock	9,076	0	888	916	7,272	2,994	1,039	1,394	3,649
Fishing	3,800	751	178	1,832	1,039	0	1,968	1,832	0
Forestry	0	0	0	0	0	0	0	0	0
Construction Business	2,078	0	0	0	2,078	0	1,039	1,039	0
Industry	2,719	1,503	178	0	1,039	751	178	1,039	751
Handicraft	22,036	0	533	10,076	11,428	9,897	4,826	3,404	3,910
Wholesale and Retail Trade	19,378	6,010	2,308	2,748	8,311	3,868	0	3,759	11,751
Services	2,774	1,503	355	916	0	0	0	916	1,858
Transport	9,430	2,254	1,065	916	5,195	1,039	929	3,868	3,594
House Construction	22,772	3,005	888	6,412	12,467	0	7,204	9,226	6,341
Domestic Consumption Goods	63,975	17,279	1,421	10,992	34,284	23,780	27,254	6,587	6,354
Health / Medicine	114,443	21,035	3,729	43,967	45,712	47,211	34,346	28,267	4,618
Education	6,123	1,503	710	1,832	2,078	0	929	2,829	2,365
Marriage	6,493	751	0	3,664	2,078	2,994	1,832	916	751
Funeral	3,813	1,503	355	916	1,039	0	1,667	1,039	1,106
Other	91,265	13,523	2,664	36,639	38,440	29,224	25,097	20,012	16,932
Total Loans	428,484	84,892	18,645	141,060	183,887	129,712	122,069	99,097	77,605

Source: Household survey.

Borrowing and Repaying In Cash and Kind / Loan and Collateral Agreements / Loan Terms

Table 6.10 summarizes some key facts about household borrowing. The table highlights:

- 81.34% of loans by value and 79.53% of loans by number were taken in cash; 18.66% by value and 20.47% by number were taken in kind;
- Provincial Capital households borrowed markedly more (45.67%) in-kind than households in other strata;
- households in the two poorest quartiles tended to borrow and repay in kind more than households in the two richest quartiles;
- only 22.81% of loans had written loan agreements and only 9.87% had written collateral agreements;

- written loan agreements and collateral agreements were most common in Provincial Capital households and least common in Rural Mekong households; and they were most common for households in the richest quartile, reflecting these households' greater access to the formal sector; and
- the average loan term is around 6 months, but some loans of up to 4- and 5 year-duration were found in households outside Peri-Urban areas.

Interest Rates

Table 6.11 shows the distribution of effective annual interest rates paid by rural households on their loans. About half of all loans (50.71%) had zero interest—the vast majority of

Table 6.10 Loan Characteristics

Loan Characteristic	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Total Loans Taken by Value (KN billion)	639.20	290.95	48.18	103.29	196.78	29.77	54.59	67.29	487.55
Total Loans Taken by Number	428,484	84,892	18,645	141,060	183,887	129,712	122,069	99,097	77,605
Loans Taken in Cash by Value (KN billion)	526.61	231.06	26.38	79.49	189.68	25.65	38.76	59.55	402.64
Loans Taken in Kind by Value (KN billion)	113.08	59.89	22.29	23.80	7.10	4.15	16.28	7.74	84.91
Loans Taken in Cash by Number	344,821	71,369	15,093	110,833	147,525	102,021	94,993	81,710	66,097
Loans Taken in Kind by Number	84,196	13,523	4,084	30,227	36,362	27,691	27,609	17,387	11,508
Loans Repaid in Cash by Value (KN billion)	607.49	285.36	45.75	87.65	188.73	24.09	39.06	62.44	481.90
Loans Repaid in Kind by Value (KN billion)	32.20	5.58	2.92	15.64	8.06	5.71	15.99	4.85	5.65
Loans Repaid in Cash by Number	350,206	71,369	16,514	119,992	142,331	97,238	98,340	83,596	71,032
Loans Repaid in Kind by Number	78,810	13,523	2,664	21,067	41,556	32,474	24,261	15,501	6,573
Loans with Written Loan Agreements (National Count)	97,860	18,030	6,393	25,647	47,790	28,033	22,033	15,458	32,335
Loans with Written Collateral Agreements (National Count)	42,352	11,269	4,262	9,160	17,661	6,012	8,023	10,265	18,053
Average Loan Term (Months)	5.56	4.52	7.25	6.04	5.44	4.35	4.30	6.62	7.09

Source: Household survey.

Table 6.11 Distribution of Interest Rates (% of Household Loans in Interest Rate Band)

Interest Rate Band	All Loans	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
0.0%	50.71	53.42	51.28	40.82	53.40	53.68	61.81	56.47	26.00
0.1 – 9.9%	1.23	1.37	0.00	2.04	0.97	1.50	0.00	0.00	3.60
10 – 29.9%	4.43	1.37	5.13	0.00	7.77	7.09	0.00	0.84	9.73
30 – 59.9%	12.21	13.70	15.38	6.12	13.59	0.26	13.52	11.07	29.34
60 – 99.9%	7.66	9.59	5.13	8.16	6.80	4.99	10.76	6.80	8.25
100 – 199%	10.25	8.22	6.41	24.49	5.83	12.99	7.60	13.46	6.84
200% and higher	13.50	12.33	16.67	18.37	11.65	19.49	6.32	11.36	16.24
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Household survey.

these came from family and friends. At the same time, 23.75% of loans had effective interest rates of more than 100% per year, and 13.50% had effective rates in excess of 200% per year. In other words, the vast majority of loans were either at zero interest or at extremely high interest—only a small minority fell in the mid range.

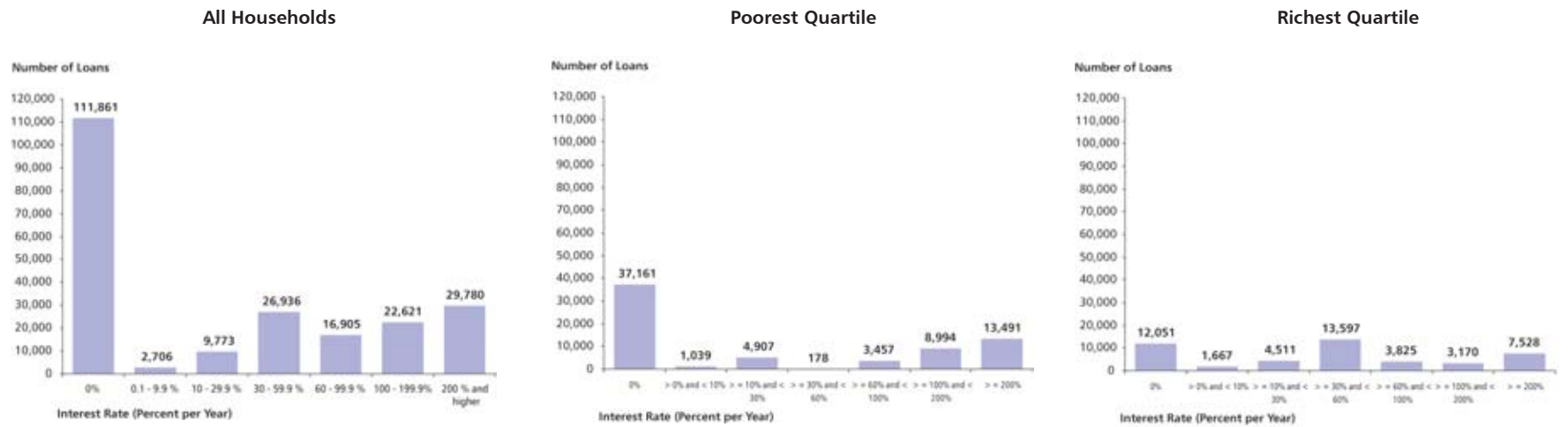
This illustrates clearly that any preoccupation with continuing to deliver subsidized credit through the formal sector in the Lao PDR is misguided. In a sustainable microfinance sector, effective interest rates are likely to be between 30% and 50%. Although this is higher than, for example, the administratively influenced rates of APB and other commercial banks, it is well below the average effective rates currently faced by many borrowers in rural the Lao PDR.

Figures 6.8 and 6.9 illustrate the differences in the distribution of interest rates on loans to all rural households, and the richest and poorest quartiles, by number of loans

and percentage of loans respectively. The figures show that although the poorest quartile of households benefit from a higher number and percentage of interest-free loans (53.7% of their loans compared to 26% of loans borrowed by the richest quartile and 50.7% of loans borrowed by the population as a whole), they are much less able to access *interest-bearing* loans at the rates prevailing in the commercial banking sector or typical of microfinance (in the region of 20–60% per year). More specifically, only 8.9% of the interest-bearing loans received by the poorest quartile of households were at less than 60% interest per year, while 42.6% of the interest-bearing loans received by the richest quartile were at less than 60% per year. In contrast, 37.5% of interest-bearing loans received by the poorest quartile of households were at interest rates of over 60%, compared to 31.3% of such loans for the richest quartile of households. Moreover, in sheer numbers, the poorest quartile borrowed at high interest more than twice as frequently as the richest

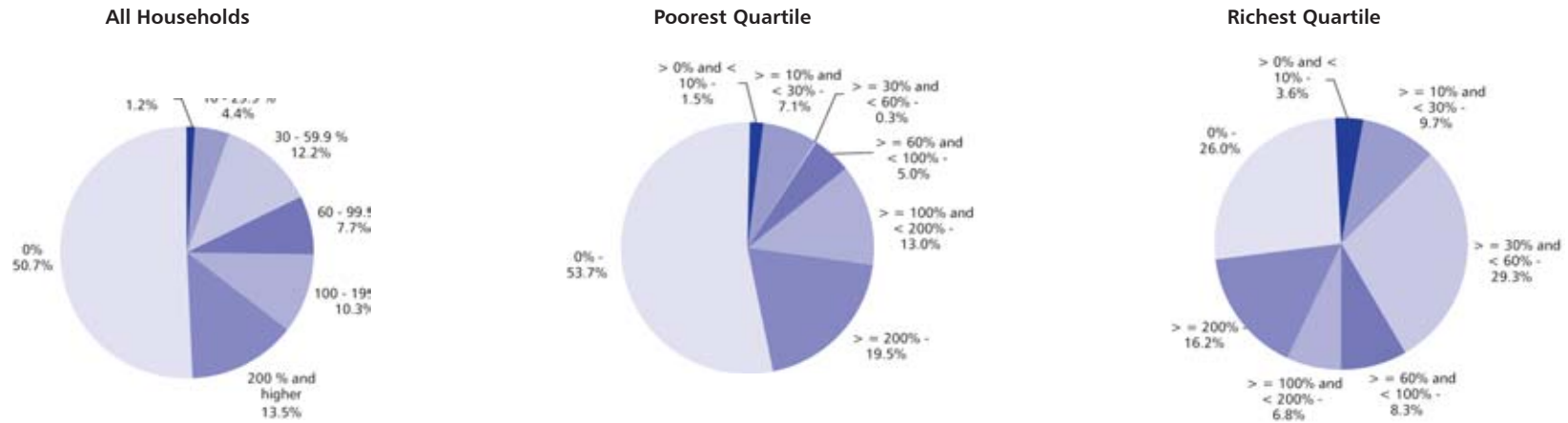
Many loans had effective interest rates of more than 100% per year. In a sustainable microfinance sector, effective interest rates are between 30% and 50%.

Figure 6.8 Distribution of Interest Rates (Number of Loans in Interest Rate Band)



Source: Household survey.

Figure 6.9 Interest Rate Ranges and Percent of Households Paying Rate in Interest Rate Band



Source: Household survey.

quartile. It is estimated that, nationwide, the poorest rural households borrowed 22,485 loans at interest rates over 100%, while the richest rural households borrowed 10,698 loans at these interest rates. Clearly, delivering sustainable, market-oriented credit to the poor through MFIs and APB could make a significant contribution to the well-being of the poor:

Physical Proximity to Credit Sources

Table 6.12 and Figure 6.10 show the average distances that borrowing households reported they had to travel to the sources of their loans.⁵

The data shows the “grassroots” level of the semiformal sector and informal moneylenders and houays compared to the more urban locations of formal banks. Distances of borrowers to their informal and semiformal sources,

especially in the more remote Rural Mekong and Other Rural Strata, are considerably less than distances of borrowers to formal sources. In contrast, distances for rural borrowers to their formal sector sources are relatively high reflecting the location of APB and other commercial bank branches in urban areas. The data also illustrate the greater proximity of APB and other commercial banks to rural households in the Provincial Capital and Rural Mekong areas compared to Other Rural areas. (It should be recalled that Peri-Urban households, by definition, are located in the area *outside* the municipal boundaries, but within 25 km of the urban center. Hence, they inevitably have to travel some distance to the nearest branches that are located in the urban centers).

Similarly, the poor (who depend much more on informal sources than formal sources) are on average much closer than the relatively rich to their informal and semi-formal sources of loans.

The poorest quartile borrowed at high interest more than twice as frequently as the richest quartile.

⁵ These data are only for borrowing households to the sources of their own loans. The data do not include distances of non-borrowing households to the various potential sources of loans.

Table 6.12 Average Distance from Borrowing Households to Source of Their Loans (Kms)

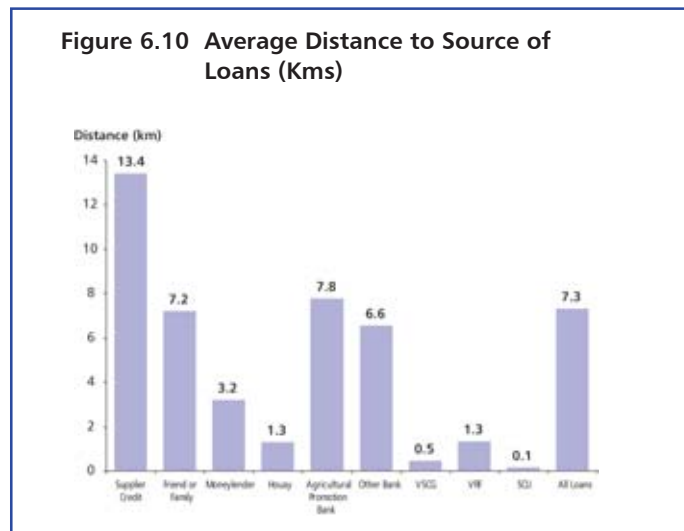
Source of Loan	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Suppliers	13.44	1.62	2.76	6.07	22.47	3.93	2.66	16.08	45.43
APB	7.80	10.00	3.63	2.30	10.67	6.21	10.75	3.75	9.77
Friends or Family	7.21	3.13	9.93	8.12	8.41	2.15	3.39	16.33	10.71
Other Bank	6.57	10.87	3.17	2.83	7.33	4.00	NA	16.82	1.58
Informal Moneylender	3.21	7.64	2.23	0.45	0.72	0.09	1.60	2.37	13.84
VRF	1.32	0.03	2.35	0.87	1.70	0.06	2.01	2.16	0.86
Houay	1.30	3.00	0.00	NA	0.30	NA	NA	NA	1.30
VSCG	0.46	0.13	0.52	0.05	0.91	0.96	0.28	0.00	0.15
SCU	0.15	0.25	0.01	0.00	NA	NA	0.00	0.00	0.41
All Loans	7.33	3.88	6.22	6.48	9.91	2.23	3.13	14.30	13.66

Source: Household survey.

Important policy conclusions derive from these results. The poor typically have less mobility than the relatively wealthy, both because they have less to spend on transportation and because of lower transportation infrastructure in poor, remote areas. Accordingly, financial services need to be taken to the poor. In the Lao PDR, policy makers have focused on two means of doing this: APB, through its mobile credit officers, and village level organizations. The data shows that APB is failing in extending its catchment area through mobile credit officers - it is only serving areas slightly larger than ordinary commercial banks, and in so doing, it is primarily reaching rural households in the richer quartiles and urban households.

The data also reflect the paucity of outreach of sustainable microfinance institutions, which typically work at more of a grassroots level and practice mobile banking that reaches more villages. These results should encourage policies to develop sustainable MFIs operating at the village level.

Figure 6.10 Average Distance to Source of Loans (Kms)



Source: Household survey.

Table 6.13 Household Estimated Unsatisfied Loan Demand in the 12 Months Preceding the Survey (KN Billion)

Loan Purpose	All Rural Households	Strata Results				Wealth Quartile Results			
		Peri-Urban	Provincial Capital	Rural Mekong	Other Rural	Poorest Quartile	2nd Quartile	3rd Quartile	Richest Quartile
Livestock	1,022.18	52.06	67.56	154.51	748.05	185.04	255.50	348.10	233.54
Non-Income Generating Activities	992.57	219.52	39.65	217.56	515.84	448.38	56.49	179.52	308.17
Other Crop Production	663.52	11.42	527.02	5.50	119.59	11.24	27.95	28.61	595.72
Other	421.47	87.66	16.89	90.23	226.70	203.06	22.45	71.81	124.16
Wholesale and Retail Trade	326.80	95.75	22.52	11.45	197.08	5.61	8.42	32.96	279.81
Rice Production	223.91	46.08	8.50	43.51	125.82	99.86	21.83	35.90	66.32
House Construction	203.63	43.83	7.93	43.51	108.36	94.87	11.22	35.90	61.63
Transport	201.56	43.83	7.93	43.51	106.29	89.47	11.22	35.90	64.96
Services	143.82	31.48	40.84	22.90	48.60	3.12	0.00	21.59	119.11
Fishing	79.04	18.79	13.96	34.35	11.95	3.90	18.71	35.59	20.84
Handicraft	50.14	12.02	1.86	0.00	36.26	16.05	1.15	0.00	32.94
Forestry	8.27	0.00	1.24	1.83	5.19	0.36	0.89	1.83	5.19
Construction Business	3.55	0.00	3.55	0.00	0.00	0.00	0.00	0.00	3.55
Industry	0.75	0.75	0.00	0.00	0.00	0.00	0.75	0.00	0.00
Total	4,341.23	663.18	759.46	668.86	2,249.73	1,160.95	436.59	827.72	1,915.96

Source: Household survey.

Unsatisfied demand is 6.7 times the amount borrowed. In the poorest quartile, unsatisfied demand is 39 times the amount borrowed.

Unsatisfied Loan Demand

Table 6.13 and Figure 6.11 show the estimated unsatisfied loan demand of rural households by stratum, quartile, and loan purpose. Specifically, each survey household was asked, “Was your household unable to carry out planned activities in the last 12 months because it could not borrow sufficient funds?” If a household answered “yes” then it was asked to specify the amounts and purposes of loans that it was unable to obtain.

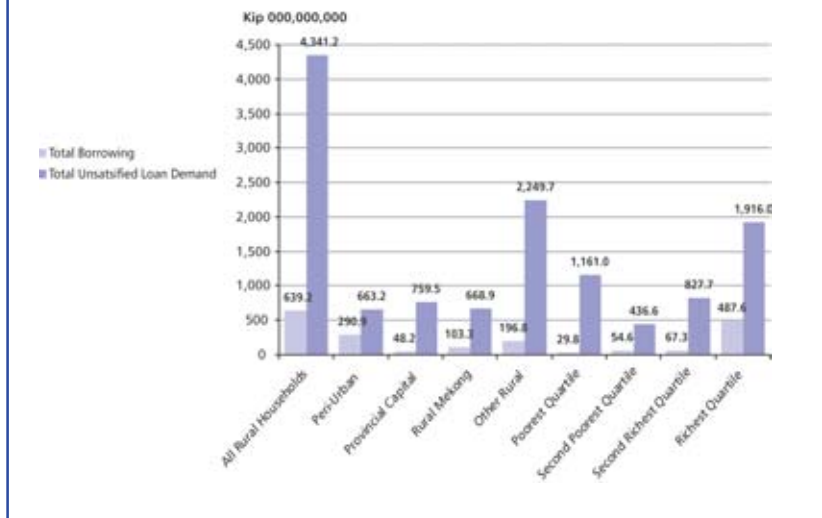
The results show the considerable unsatisfied demand for credit among rural households. Overall, unsatisfied demand equals KN4,341 billion for all rural households, which is 6.7 times the amount actually borrowed over the 12 months before the survey. This difference between actual borrowing and unsatisfied demand is most pronounced

among households in the poorest quartile—unsatisfied demand is 39 times as large as actual borrowing. In contrast, for households in the richest quartile, unsatisfied demand is only 3.93 times as large as actual borrowing. Currently, the Lao rural finance system is clearly failing to satisfy the demand for credit from poorest households.⁶

Table 6.13 shows that the highest unmet demand is for livestock loans, which account for 23.5% of total unsatisfied

⁶ This is not to say that prudent lending decisions would necessarily satisfy the entire difference between actual and unmet demand for borrowing. On the other hand, the poor have, time and time again, in the Lao PDR and other countries, demonstrated high repayment rates when loans are structured to meet their needs and when cost-saving measures are introduced to reduce the higher transaction costs of serving the poor. In the Lao PDR, nonperforming loan rates of sustainable MFIs, which target the poor, are considerably lower than NPLs in the state-owned commercial banks. The data presented here, therefore, merely suggest the degree to which the current system is failing to serve the needs of the poor.

Figure 6.11 Comparison of Actual Borrowing to Unsatisfied Demand



Source: Household survey.

demand; Other Rural households account for 73% of this unmet demand. This is followed closely by unsatisfied demand for non-income generating activities (e.g., education, medicine and health care, marriage and funeral ceremonies, domestic consumption), which accounts for 22.9% of unsatisfied demand; the poorest quartile accounts for 45% of this. The third highest unsatisfied demand is for “other crop production” (i.e., non-rice crops), which comprises 15.3% of all unmet demand; the richest quartile accounts for 90% of this. High unsatisfied demand (exceeding KN140 billion) also exists for trade, rice production, house construction, transport business, and services business.

Geographically, the largest unmet demand is in the remote Other Rural households, with unsatisfied borrowing of KN2,250 billion. This accounts for 52% of all unmet demand in the country and is likely a result of the low level of outreach in the more remote areas. Relative to actual borrowing, Provincial Capital households and Other Rural households are the most underserved—with unmet demand exceeding actual borrowing by factors of 15.76 and 11.43, respectively. This contrasts with Provincial Capital households, whose unmet demand is only 2.28 times their actual borrowing.

In Peri-Urban areas the highest demand (after non-income generating purposes) is for trade. In Provincial Capital areas the demand for loans for non-rice crop production is the highest and comprises 79% of such demand. In the Rural Mekong and Other Rural areas, demand for livestock loans is highest.

The conclusion is clear: there is a huge unsatisfied demand for loans by rural households, covering a wide range of production opportunities and nonproduction needs.

Conclusions and Recommendations

Conclusions

The most overriding conclusion of this study is that the formal sector (banks) and semiformal sector (microfinance initiatives) are failing to serve the demand for financial services of the vast majority of rural households in the Lao PDR. This is true for all geographic strata and for all wealth quartiles, but it is especially so for the poor and most remote households. The key findings of this study are:

- Only 5% of all rural households had any savings in a bank;
- Only 4% had savings in a microfinance initiative;
- Only 26.7% of rural savings is held in cash (bank deposit, cash in hand, etc.), while 73.3% is held in-kind (primarily livestock but also precious metals and jewelry, and housing materials);
- Only 2% had borrowed from APB in the 12 months before the survey, and only 3% had borrowed from any bank;
- Only 4% had borrowed from a microfinance initiative;
- In contrast, 33% had borrowed from an informal source, including friends, family, moneylenders, and houay.

These results are even more striking for households in the poorest quartile:

- Only 1.5% had savings in a bank;
- Only 1.4% had savings in a microfinance initiative;

- Only 8.5% of rural savings is held in cash, while 91.5% is held in-kind;
- Only 1% borrowed from APB, and 1.9% had borrowed from any bank;
- Only 4.1% had borrowed from a microfinance initiative;
- In contrast, 40% had borrowed from an informal source.

As a result of the low outreach of the formal and semiformal sectors, rural households depend largely on informal sources. Informal loans accounted for 55% of total loan volume for rural households—KN353 billion out of KN637 billion. Moneylenders made loans to about 25,300 rural households, in an estimated amount of KN27.30 billion, a fraction of the informal lending done by households, but still more than twice as much as the semiformal sector.

There was a large reported unmet demand for credit. Unsatisfied demand for credit was almost 7 times as large as actual borrowing by all rural households: actual borrowing from all sources was KN639 billion, while unsatisfied demand was KN4,341 billion. Again, this was most striking among the poorest quartile, for whom unsatisfied demand was almost 40 times as large as actual borrowing (KN30 billion vs. KN1,161 billion). Geographically, the largest unmet demand is in the remote Other Rural households, with unsatisfied borrowing of KN2,250 billion. This accounts for 52% of all unmet demand.

While each stratum and each wealth quartile expressed unmet demand for a diversity of economic activities, unmet demand was also strongly related to the economic opportunities in the particular geographic strata. For example, in remote Other Rural areas, there was high unmet demand for livestock loans. In Provincial Capital areas, there was high unmet demand for non-rice crop production. In Peri-urban areas, there was high unmet demand for trade and other business. In all areas except Peri-urban areas, there was a high unmet demand for non-income generating activities (e.g., education, medicine and health care, marriage and funeral ceremonies, domestic consumption), which accounts for 23% of unsatisfied demand. The conclusion is clear: outreach of financial services is low, and there is a huge unsatisfied demand for loans by rural households, covering a wide range of production opportunities and nonproduction needs.

The economic characteristics of households also point to the diversity of needs for financial services. Perhaps most importantly, there is a high degree of multifunctionality among rural households: 90% of rural households engage in multiple income-generating activities, and this is similar across strata and wealth quartiles. And although 78% of households engaged in agriculture, livestock raising, or fishing as their primary economic activity, only 38% of total reported income came from these activities. Over half of reported income came from business activities, and this was similar across strata and wealth quartiles, including the poorest quartile. The high level of multifunctionality is an important observation with implications for the rural finance system in the Lao PDR. While rural finance policies have traditionally focused on directed lending programs that target agricultural activities, the high frequency of multifunctionality suggests a need for financial services that serve a broad range of economic activities in rural

households. The results highlight the importance of nonagricultural income in rural Lao PDR.

Among the formal sector financial institutions, APB has the mandate to provide financial services to rural areas and has the largest rural service network. However, APB's past practices have significantly weakened it financially. It has high NPLs and a large capital deficit, greatly limiting its ability to extend outreach. It also has limited capacity for proper credit assessment of customers despite receiving significant levels of technical assistance since 1993. However, its most significant constraint appears to be its lack of autonomy in operational decisions as it continues to carry out significant levels of directed, subsidized lending (policy lending) at the behest of the Government.

LDB also has a significant branch network and therefore the potential to increase its provision of rural financial services. Like APB, it also has experience in group lending techniques, which are well suited to lending to groups of rural households without collateral or credit history. LDB is particularly well suited, however, to lend to rural small and medium enterprises, including agriculture processing operations. Also like APB, however, it has high NPLs and a large capital deficit, limiting its ability to extend outreach. It also has limited capacity, but again its lack of autonomy appears to be the most important constraint. No other banks have a significant branch network in rural areas, or an interest in increasing provision of rural financial services.

While funding for semiformal microfinance initiatives has significantly increased in recent years (roughly doubling each year from 1999 to 2003), overall funding remains low, at less than \$1 million cumulatively over 5 years. Funding of capacity building has also grown but remains low, at less than \$100,000 cumulatively over 5 years. As a result, outreach of these initiatives remains low, as does their capacity.

However, three MFIs have begun to demonstrate the potential of sustainably oriented microfinance in the Lao PDR. Loan products offered by the three MFIs that are striving for sustainability have a median effective interest rate of 48% per year, while loan products offered by INGO and multilateral/bilateral microfinance components have median interest rates from 12% to 22% per year. Only the MFIs charge interest rates at sustainable levels, thus creating the potential to provide permanent access to financial services. Moreover, these three MFIs also had the lowest percentage of borrowers in arrears at 7.8% (lower than other microfinance initiatives, and much lower than the SOCBs, including APB). However, most microfinance initiatives demonstrated weaknesses in financial reporting.

Households' expressed preferences for financial services are also telling. In assessing the importance of various characteristics of loan products, households most frequently cited "confidence that a loan would be made" (59%), whereas the interest rate was cited less frequently (38%). Households in the poorest quartile named "confidence that a loan would be made" almost twice as frequently as the interest rate (52.89–27.64%). These results for the Lao PDR are consistent with results in other countries: *the poor are more concerned with sustained access to financial services than they are with low interest rates.*

It is also clear that, as in many other developing countries, rural households have substantial savings, including the poor. However, due to the low outreach of formal and semiformal financial institutions, the vast majority (73.3%) of savings is held in-kind. And even among cash savings, almost 50% is held outside formal financial institutions.

Recommendations

Embedded in the critical assessment and conclusions above lie the seeds of opportunity and optimism for developing the rural finance sector in the Lao PDR.

When it comes to preferences for savings vehicles, almost 30% of rural households said their first preference was to save in APB or another bank (despite the fact that only 5% had savings in a bank). Similarly, regarding preferences for loan sources, 25% expressed a first preference for APB or another bank, despite the fact that less than 3% of households had borrowed from a bank in the previous 12 months. There are clear opportunities for APB and perhaps other banks (e.g., LDB) to expand their outreach.

At the same time, the results also offer hope for the potential of sustainable microfinance. Although few rural households expressed a preference for borrowing or saving in an MFI, this is probably the result of their lack of familiarity with using MFIs. Moreover, unfortunately, with so few microfinance initiatives operating sustainably, many such initiatives have had short lives, thus discouraging households' reliance on them for sustainable access. At the same time, however, rural households expressed large unmet demand for loans of the kind that MFIs can often deliver more effectively and efficiently than formal banks—small, short-term loans that do not require traveling long distances to obtain. Also, importantly, rural households (especially the poor) more frequently noted the importance of sustained access to loans than they did the interest rate. Hence, the evidence indicates that they are willing to pay sustainable MFI interest rates in the 30–50% range. Indeed, when rural households (again, especially the poor) are unable to borrow interest-free from friends and family, they typically have to borrow in informal markets at interest rates over 100% or even 200%.

The key issue then is *how* to expand formal and semiformal financial services in rural areas. The Government has already taken important and helpful steps in recent years. The Policy Statement on Sustainable Rural and Microfinance, issued by the Prime Minister's Office in late

2003, establishes a new and improved framework for developing the sector. Much of this policy has also been incorporated in the National Growth and Poverty Eradication Strategy (NGPES) approved by the National Assembly in 2004. These high-level documents call for phasing out directed, subsidized lending by APB and transforming it into a self-sustaining, market-oriented rural financial institution with genuine management autonomy in operational decisions. This is indeed a key and necessary reform. APB, with its branch and service network, has the greatest potential to rapidly expand access to rural finance on a sustainable basis. When such transformations from agricultural policy bank to market-oriented rural bank occurred in Indonesia and Mongolia, both outreach and bank profits grew rapidly.

The Government, BOL, and APB therefore need to carry out the concrete actions to realize the policy embodied in the Policy Statement and NGPES. This includes adopting a concrete plan to phase out policy lending in a short period of time and placing remaining policy lending, if any, in a non-bank, non-deposit-taking policy lending mechanism, preferably on the Government budget where it can be transparently monitored. APB must make loans on a strictly commercial basis, but within the framework of the Government's poverty reduction objectives. As illustrated by this study, market orientation and poverty reduction can be mutually reinforcing objectives. However, to do this, the Government must grant APB genuine management autonomy. While the Government can (and should) set the overall objectives of APB, APB management must then have full independence in operational decisions (including credit allocation) to meet those objectives.

APB must also be brought under the full prudential, regulatory, and supervisory regime for state-owned commercial banks to ensure sound operations, rather than being treated as a special "policy bank" that is not

supervised. APB also needs to enhance its human resources management and develop a comprehensive staff training program to ensure capacity. External assistance may be necessary. APB's information and communications systems also need to be upgraded for it to operate as a modern bank, providing quality services and lowering costs. Finally, APB has inherited a precarious financial position as a result of its past operations—capital is highly negative and NPLs are high. APB must be authorized to write-off its loss-graded loans and be recapitalized by the Government, but conditional on a proven track record of improved performance. By operating in a sustainable, market-oriented manner, APB can generate profits, build its capital, finance its expansion, and generate tax revenues for the Government.

At the same time, the Government should continue to support the microfinance sector through improvements in the policy, legal, and regulatory environment, as well as supporting pilot projects focused on the creation and development of sustainable MFIs. The Prime Minister's Policy Statement notes that donors and private businesses, both local and foreign, would invest in microfinance if the environment were conducive, and that MFIs need to have access to national and international public and private investors to expand. Moreover, the Policy Statement calls for a sector comprised of several new, autonomous MFIs with a diversity of legal ownership, including private and public ownership, and practicing a variety of methodologies to meet demand.

The Policy Statement marks a sea change in Government policy to support microfinance. Again, the key is to operationalize these policies through concrete actions. A major improvement was achieved in June 2005, with BOL's issuance of new regulations for MFIs. These regulations permit a variety of ownership—including public, private, domestic, and international—and a variety of MFI models. They also distinguish between deposit-taking and non-

deposit-taking MFIs, wisely requiring that non-deposit-taking MFIs only need to register, while deposit-taking MFIs must be licensed. At the same time, the regulations allow BOL to authorize registered MFIs to accept some deposits if no other deposit services are available from a licensed financial institution in a given location. These regulations are in fact a model that many other countries would benefit from following.

The Government should also continue to take concrete steps to attract foreign investment in the microfinance sector. The authors of this study are unaware of any country in the world where microfinance has been able to develop without significant funding and technical assistance from international donors and development partners. As microfinance has evolved over the past 20 years, shifting from a “social” to a more “commercial” orientation, donors have become more and more concerned about the sustainability and professional, transparent management of MFIs that they support. Moreover, several international investment funds have developed in recent years in response to the recognition that MFIs often need equity investments more than they need credit lines for onlending. In this new environment, both donors and investors are requiring, as a condition of their support, a formal ownership share and seat on the board to allow them to oversee the proper use of their funds. The Government has recognized the need for foreign investment in many sectors of the economy to contribute to technology transfer and management expertise. This applies to microfinance also. Such investments will

also complement the currently limited capacity and resources of BOL to supervise MFIs.

For their part, microfinance donors, sponsors, and practitioners must ensure that their microfinance initiatives follow good practices and focus on sustainability from the outset. Directed credit, interest rate subsidies, and other unsustainable practices should be avoided. “Smart subsidies” such as grants for training and capacity building, piloting of new and innovative services, accounting and management information systems, and start-up capital should be encouraged. Donors, sponsors, and practitioners should also actively participate in discussions with the Government to give feedback on the policy environment and suggest revisions when necessary to encourage sector development. They should also consider developing a “code of conduct” to reflect their commitments to supporting sustainable microfinance.

Finally, the Government should regularly monitor the development of the sector. Under the new microfinance regulations issued by BOL, all microfinance initiatives will need to either register or be licensed by BOL. BOL should create a central database of such initiatives, thus allowing it to monitor the number and outreach of institutions of various types. In addition to this direct monitoring, the Government’s Rural and Microfinance Committee should meet regularly with microfinance stakeholders to review progress in developing the sector, to receive feedback, to identify implementation and policy issues, and to propose new solutions to further develop the sector.