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Innovating the Financial System in Lao PDR: Current Status and Policy Directions

Lao PDR

2024/25 KSP POLICY BRIEF

Presented by the MOEF, Republic of Korea

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Prepared for

The Government of the Lao People's Democratic Republic (Lao PDR)

In Cooperation with

The Bank of the Lao P.D.R (BOL)

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Preface

In today's rapidly evolving global landscape, international cooperation has become indispensable for addressing shared challenges such as economic instability, climate change, and digital transformation. As countries become increasingly interconnected, collaborative efforts not only accelerate problem-solving but also foster innovation, peace, and sustainable development across the globe. In this context, the importance of knowledge sharing among nations cannot be overstated. Knowledge sharing empowers countries to build institutional capacity and develop evidence-based policies by learning from one another's experiences. It also plays a pivotal role in bridging development gaps and promoting sustainable development worldwide.

The Knowledge Sharing Program (KSP), launched in 2004 by the Ministry of Economy and Finance (MOEF) of the Republic of Korea, serves as a vital platform for fostering mutual understanding and offering practical policy solutions tailored to each partner country's unique development needs. KSP facilitates close collaboration between Korea and its global partners, sharing Korea's socio-economic development experiences and supporting capacity-building efforts to tackle global challenges together and help build a resilient and sustainable world.

As the implementing agency for the 2024/25 KSP with Lao PDR, the Korea Institute of Finance (KIF)—established to provide expert analysis and support for the advancement of Korea's financial industry—is honored to contribute to the KSP's mission. Drawing on Korea's extensive experience in financial development, KIF aims to deliver valuable insights to Lao PDR under the 2024/25 KSP theme: "Innovating the Financial System in Lao PDR: Current Status and Policy Directions." The project provides practical knowledge by sharing Korea's comprehensive journey in developing its financial sector and is expected to serve as a meaningful reference for Lao PDR. It is anticipated that this will support, respectively, the enhancement and modernization of financial legislation and institutional frameworks for payment systems, the deposit taking microfinance industry, and the bond market.

On behalf of the KIF, I would like to extend my sincere gratitude to the Korea Development Institute (KDI) and the Bank of the Lao P.D.R (BOL) for their invaluable support—especially to Senior Advisor Mr. Taesoo Kim, Project Manager Dr. Daehee Jeong, and Secretary General Mrs. Phengsy Phengmuong for their unwavering commitment throughout the KSP process. I would also like to acknowledge the KSP team including Principal Investigator Dr. Hyoung-Seok Lim, as well as Dr. Minkee Song and Dr. Taiki Lee. Special thanks go to the local consultants for each sub-topic: Ms.

Kingthong Phiakeo, Ms. Chindavanh Phommabouth, and Ms. Soudthavine Lorvanhxay. The successful completion of this project is a testament to the remarkable dedication, collaboration, and professionalism demonstrated by everyone involved.

I firmly believe that the 2024/25 KSP with Lao PDR will strengthen bilateral cooperation between Korea and Lao PDR and lay a solid foundation for socio-economic development. Furthermore, it will enhance resilience in addressing global challenges and contribute to the long-term achievement of the Sustainable Development Goals (SDGs).

Hangyong Lee
President
Korea Institute of Finance

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Summary

This study is the first initiative of the three-year KSP Plus with Lao PDR, aiming to explore policy directions that can drive innovation in payment systems, Deposit Taking Microfinance Institutions (DTMFIs) in the non-bank financial industry, and the bond market in Lao PDR.

Payment systems were investigated to propose strategies for transitioning from a cash-based to a digital financial ecosystem. Despite progress in electronic transactions and fintech adoption over recent years, Lao PDR requires additional growth to align with ASEAN standards in bank account penetration, financial literacy, and payment infrastructure density. This study identifies key challenges including inefficient infrastructure distribution, regulatory gaps in consumer protection and cybersecurity, and limited financial inclusion. The report recommends a phased approach with short-term priorities on regulatory modernization, fintech sandboxes, and infrastructure expansion, while long-term objectives include digitizing government transactions, implementing open banking systems, and enhancing regional payment cooperation. These reforms are expected to expand financial access, improve economic productivity, and strengthen governance transparency, ultimately supporting broader economic development and regional integration.

DTMFIs, which primarily serve low-income residents in local communities, play a crucial role in the financial authorities' efforts to expand financial inclusion. To identify regulatory and supervisory measures that enable the DTMFI sector to maintain financial soundness while promoting long-term sustainability, this study draws insights from the experience with Savings Banks (SBs), which play the same role in Korea. In the short term, it is essential to prioritize strengthening the risk management capabilities of DTMFIs by

redefining the role of Lao Credit Information Company, which was established in 2019, so that it can provide practical support for enhancing DTMFIs' risk management capabilities related to credit-based lending. In the long term, efforts should be made to enhance governance transparency by implementing a rigorous Fit and Proper Test for major shareholders and secure the financial resources required for potential restructuring by mandating participation in the deposit insurance system.

Establishing a robust domestic bond market is crucial for achieving the government's fiscal policy goals as Lao PDR presently faces economic conditions that require proactive fiscal policy. Regarding primary market operations, Lao PDR has exhibited significant expansion over the past years. In contrast, secondary market bond transactions continue to show restricted activity. This condition arises from inadequate incentive structures for government bond trading. Short-term policy priorities include adjusting reserve requirement ratios to enhance bond trading incentives and implementing an efficient primary dealer system to enhance market participation incentives. The long-term policy agenda includes establishing and activating a domestic repurchase agreement market that can enhance the collateral value of bonds, and pursuing cross-border collateral arrangements through both bilateral agreements and a multilateral approach.

1. Introduction

The Lao People's Democratic Republic (Lao PDR) is the only landlocked country in Southeast Asia, sharing borders with five nations: Vietnam to the east, Thailand to the west, Cambodia to the south, China to the north, and Myanmar to the northwest. Following its independence from France through a treaty in 1954, Lao PDR experienced both internal and external conflicts, leading to the abolition of the monarchy and the establishment of the Lao People's Democratic Republic in December 1975. Currently classified as a Least Developed Country (LDC), Lao PDR is striving to graduate from LDC status by 2026 and transition into an upper-middle-income country by 2030. To achieve this, the government has implemented the 9th National Socio-Economic Development Plan (2021–2025) and the long-term Vision 2030 framework, established in 2016.

However, since 2022, Lao PDR has faced economic challenges characterized by the "three highs"—high exchange rates, high inflation, and high external debt (World Bank, 2022). In this context, strengthening the foundations for economic growth and enhancing the financial system for supporting the real economy has become increasingly critical. Recognizing the critical need for financial system innovation, Lao PDR submitted a KSP project proposal to request policy advisory support and capacity-building training to develop comprehensive strategies for financial system innovation on November 4, 2022.

Considering this, the 2024/25 KSP with Lao PDR was initiated under the main theme of "Innovating the Financial System in Lao PDR: Current Status and Policy Directions." This project aims to support the advancement of financial policies and institutional frameworks by conducting a comprehensive assessment of Lao PDR's financial system, identifying key constraints to financial development, and analyzing relevant South Korean case studies.

This policy brief is structured around three key areas of the financial system: payment systems, deposit taking microfinance institutions (DTMFIs), and the bond market. Each area is examined through in-depth diagnosis and comparative analysis in Chapter 2, followed by tailored policy recommendations in Chapter 3.

Chapter 2 provides a diagnostic overview of Lao PDR's financial system across three key areas. Firstly, the payment systems were examined. Lao PDR stands at a critical juncture in its financial system transformation, experiencing remarkable payment sector growth over the past five years while facing significant challenges requiring strategic policy intervention. The country's transition from a predominantly cash-based economy toward digital payment adoption presents opportunities that can benefit from examining successful regional experiences, particularly Korea's sophisticated payment

ecosystem development.

Lao PDR's payment market reveals a dynamic but uneven landscape. With 7.5 million people, the country has witnessed substantial electronic transaction growth, expanding tenfold since 2019, alongside 53 payment service providers including banks and fintech companies. Mobile banking users have reached 1.8 million, while QR payment systems gained traction with 200,000 merchant acceptances. However, persistent challenges remain: only one-quarter of the population holds bank accounts, financial literacy rates are below regional averages, and two-thirds of internet users remain financially excluded from digital payments (DataReportal, 2025).

Korea represents a contrasting mature digital payment ecosystem with minimal cash usage, supported by systematic infrastructure development and regulatory refinement. Korea's experience demonstrates how government-led initiatives, combined with balanced competition between traditional financial institutions and fintech innovators, create a comprehensive digital financial environment. The Korean model features sophisticated regulatory frameworks accommodating innovation while maintaining stability, extensive payment system interoperability, and high consumer trust through robust cybersecurity and consumer protection mechanisms.

The regulatory landscape presents striking contrasts between both countries. While Lao PDR operates under Payment Service Providers Regulation No.288/BOL as its primary oversight tool, the framework contains significant gaps in consumer protection, cybersecurity standards, and emerging technology guidelines. Korea's multi-layered approach, encompassing electronic financial transaction regulations and sophisticated supervisory mechanisms, provides comprehensive frameworks that accommodate rapid technological changes while maintaining financial stability.

Second, DTMFIs were investigated. They share the same characteristics as Korea's Savings Banks (SBs) in that they are corporations that handle deposits despite being non-bank institutions. Both DTMFIs and SBs operate with a business model that primarily targets low-credit individuals with limited access to traditional banking services. As banks expand their customer base to include low-income and low-credit individuals, they experience a narrowing of profit margins. In Korea, this competitive pressure became a reality after the 1997 financial crisis, when banks shifted their business strategy from focusing on large corporations to personal finance. Recently, DTMFIs have also been facing increasing competitive pressure from both banks and private lenders. Banks are attracting DTMFI customers by offering lower interest rates and a variety of non-face-to-face services enabled by digital technologies. Additionally, various informal lenders based in local communities are threatening DTMFIs by simplifying and streamlining their lending processes, enabling rapid loan disbursement.

Third, the bond market was analyzed. Lao PDR currently faces economic circumstances that necessitate an active role for fiscal policy. The implementation of such fiscal measures requires substantial government financing through debt instruments. Consequently, the development of an efficient domestic bond market has become essential to support the government's fiscal policy objectives. A well-functioning bond market would facilitate cost-effective government borrowing while providing investors with reliable investment opportunities.

Chapter 3 builds on the findings of Chapter 2 to propose a set of actionable policy recommendations. First, with respect to the payment systems, the policy recommendations present draw from global best practices and regional experiences to propose a phased development strategy tailored to Lao PDR's unique context. The core framework centers on three strategic pillars: immediate regulatory improvements addressing critical gaps while establishing innovation-friendly environments through regulatory sandboxes, systematic infrastructure expansion targeting specific accessibility goals, and long-term digital integration initiatives encompassing open banking systems and enhanced regional ASEAN cooperation.

The implementation of these strategies promises significant socio-economic benefits including expanded financial access for underserved populations, improved economic productivity through efficient transactions, and enhanced transparency in private and government operations. Successful payment system development positions Lao PDR for effective regional economic integration and cross-border payment cooperation within ASEAN, supporting broader economic development objectives.

Secondly, as for DTMFIs, when BOL considers regulatory easing to foster the DTMFI industry as DTMFIs face intensifying competition from both banks and informal lenders, it is better to pay attention to the experience of Korean SBs. The Korean experience suggests that deregulation without a corresponding enhancement in risk management capacity can lead to the deterioration of DTMFIs. Further, SBs in Korea are not subject to ownership restrictions and only require a review of major shareholders' qualifications. As a result, whenever the government implemented policies to stimulate business activity, some major shareholders exploited the relaxed regulations for personal gain. The illegal activities that occurred in this process became a major cause of SBs' financial distress. In light of this, future regulatory frameworks for DTMFIs should aim to strengthen risk management capabilities and enhance transparency in corporate governance. It is considered important to explore ways to activate credit-based lending by enabling the Lao Credit Information Company, which was established in 2019, to produce and provide practically useful credit evaluation information to DTMFIs.

Regarding the establishment of a supervisory framework, it is necessary to prepare

policy tools for restructuring, taking into account the potential need for restructuring in the future. If regulatory easing is introduced to promote the DTMFI industry, there will be incentives to pursue excessive risks in order to overcome profitability pressures caused by a limited customer base. In particular, mandating participation in the deposit insurance system, which is currently optional, will become a fundamental prerequisite for effectively responding to potential future restructuring needs.

Finally, concerning the bond market, Lao PDR has demonstrated remarkable growth in recent years from the perspective of the primary market. Unfortunately, however, trading activity in the secondary bond market remains limited. This situation stems from the current lack of strong incentives to hold and trade government bonds. Nevertheless, with appropriate policy efforts to realign these incentives, there exists potential for transitioning from the current undesirable equilibrium characterized by insufficient liquidity and limited market participation to a favorable equilibrium featuring abundant liquidity and active market participation. Going forward, the development of an efficient government bond market provides the foundation for the growth of corporate bond markets as well as green bond markets in the future.

Drawing on Korea's bond market development experience, the implementation of an efficient primary dealer system enhances market participation incentives by improving liquidity. Adjusting reserve requirement ratios more tightly could generate bond trading incentives as commercial banks optimize their portfolios to comply with regulations while maximizing capital efficiency. Establishing and activating a domestic repurchase agreement market can strengthen incentives to trade bonds by increasing the collateral utilization of bonds. The collateral use of bonds can extend across borders, necessitating both the pursuit of bilateral agreements and a multilateral approach through ABMI.

2. An Overview of Lao PDR's Financial System

2.1. Payment Systems

2.1.1 Lao PDR's Payment Market and Regulatory Status

Lao PDR's payment market has experienced significant transformation over recent years, evolving from a predominantly cash-based economy to one embracing digital payment innovations.

Lao PDR's payment market has experienced significant transformation over recent years, evolving from a predominantly cash-based economy to one embracing digital payment innovations. The country's economy, based primarily on agriculture, hydropower, and mining activities, supports a population of 7.5 million with GDP growth projected below 5% during 2024-2025 (World Bank, 2022). Within this economic context, the financial and payment systems play increasingly crucial roles in ensuring transaction efficiency and economic transparency.

The payment ecosystem has expanded considerably, now encompassing 53 payment service providers including 35 banks and 18 non-bank entities such as fintech companies. This diversification reflects growing market interest in digital payment solutions, with electronic transaction volumes reaching 738 million transactions in 2023, representing a tenfold increase from 2019 levels (Bank of the Lao P.D.R, 2023). Transaction values have similarly grown eightfold over the same period, demonstrating accelerating digital payment adoption aligned with technological advancements.

Consumer behavior patterns reveal significant shifts toward digital payment methods. E-money transactions have emerged from negligible levels in 2019 to capture 18% of the total transaction volume by 2023, while bank transfers have become increasingly preferred, rising from 48.8% to 82.9% of the total transaction value. Conversely, cash transactions have declined substantially from 50.4% to 13.8% of the transaction value, although cash remains dominant in rural areas and for small-scale commerce due to accessibility constraints and cultural preferences.

Mobile banking adoption has accelerated dramatically, with users growing from 400,000 in 2019 to 1.8 million in 2023. However, this figure represents only one-third of the country's internet users, indicating that two-thirds of the population remain financially excluded despite having digital access capabilities. QR payment systems have emerged as particularly successful innovations, with 200,000 merchants now accepting

QR payments and total transaction volumes exceeding 119 million transactions worth over 83,676 billion Kip in 2023.

Despite these advances, structural limitations persist. Financial inclusion remains low, with approximately one-quarter of the population holding bank accounts, highlighting significant urban-rural accessibility gaps. Infrastructure density remains challenging, with only 0.22 ATMs per 1,000 people and 1.5 agents per 1,000 people, far below optimal accessibility ratios. Financial literacy rates average 12.2 out of 21, lower than neighboring countries such as Thailand and Vietnam (Morgan and Long, 2019), constraining broader digital payment adoption.

The regulatory framework governing Lao PDR's payment systems centers on BOL as the primary oversight authority, responsible for ensuring secure and seamless payments while maintaining compliance with international standards. The current legal structure encompasses multiple pieces of legislation including the Law on Payment System (Lao PDR National Assembly, 2017), Law on Commercial Bank, Law on Anti-Money Laundering and Counter-Terrorism Financing, and Law on Electronic Transaction. The Payment Service Providers Regulation No.288/BOL, issued in March 2020, serves as the principal regulatory tool, establishing clear processes for licensing, risk management, consumer protection, and violation remediation.

However, significant regulatory challenges remain. The framework contains gaps in comprehensive consumer protection coverage, cybersecurity standards, and guidelines for emerging technologies such as blockchain, central bank digital currencies, and distributed finance solutions. Regulatory update processes lag behind rapid technological developments, creating uncertainty for market participants seeking to implement innovative solutions while maintaining compliance. Inter-agency coordination between BOL, the Ministry of Finance, and the Ministry of Technology and Communication remains insufficient, leading to delayed approvals and inconsistent policy implementation.

Monitoring and inspection systems are still under development, limiting the central bank's capacity for effective surveillance due to outdated regulations and insufficient resources. This reduces authorities' ability to identify financial risks, fraud, and money laundering activities proactively. The regulatory environment would benefit from enhanced data-driven supervisory methodologies and real-time monitoring technologies to strengthen overall system oversight.

However, significant regulatory challenges remain. The framework contains gaps in comprehensive consumer protection coverage, cybersecurity standards, and guidelines for emerging technologies.

2.1.2. Global Payment Service Trends

The global payment market is undergoing rapid transformation driven by digital technology advancement, with innovative services led by big tech companies and fintech firms expanding consumer options beyond traditional financial institution offerings. This evolution has been accelerated by e-commerce growth, mobile device proliferation, blockchain technology utilization, and supportive government policies worldwide.

Mobile payments and digital wallets represent the most significant global trend. In advanced economies, companies like Apple Pay and Google Pay have transformed mobile payments from convenience services to core payment methods through partnerships with traditional financial institutions, offering secure and user-friendly contactless payment solutions. The COVID-19 pandemic accelerated this adoption by highlighting convenience and hygiene benefits, establishing mobile payments as essential rather than auxiliary services.

Emerging markets have experienced even more dramatic transformations through "leapfrog" phenomena, as demonstrated in various developing countries including Lao PDR.

Emerging markets have experienced even more dramatic transformations through "leapfrog" phenomena, as demonstrated in various developing countries including Lao PDR (UN Capital Development Fund, 2018), where mobile payment adoption has outpaced traditional financial infrastructure development. China's Alipay and WeChat Pay have penetrated virtually all aspects of daily

life using QR code technology, while India's Paytm and Kenya's M-Pesa have successfully included previously underbanked populations in formal financial systems. These success stories demonstrate how smartphone distribution can enable comprehensive financial services access even where traditional banking infrastructure remains limited.

Innovative payment models such as Buy Now, Pay Later have gained significant traction, with companies like Klarna and Afterpay providing installment payment services that simplify credit access for online shopping. While these models offer consumer convenience through simplified credit evaluations using alternative data sources, they also raise concerns about potential debt accumulation and financial stability implications requiring careful regulatory oversight.

Central Bank Digital Currency (CBDC) development represents another major trend reshaping global payment landscapes. China's People's Bank has advanced digital yuan pilots for small-scale payments in selected regions, while Sweden's Riksbank conducts e-Krona experiments. CBDCs offer potential benefits including strengthened monetary sovereignty, improved payment efficiency, and expanded financial inclusion, although they also present challenges regarding commercial bank intermediation roles and monetary policy implementation.

Cross-border payment innovation addresses long-standing inefficiencies in international remittances and trade payments. Companies like Ripple propose blockchain-based protocols enabling low-cost, high-speed international transfers, while various startups experiment with stablecoin-based payment solutions. Despite regulatory challenges including foreign exchange compliance and cryptocurrency volatility concerns, market demand for improved cross-border payment efficiency continues driving innovation in this sector.

2.1.3. Major Countries' Payment Systems and Policy Experiences

Southeast Asian countries provide particularly relevant examples for Lao PDR's development planning, having successfully transitioned from cash-dominant economies to sophisticated digital payment ecosystems through coordinated government and private sector initiatives.

Thailand's PromptPay system exemplifies successful national payment infrastructure development. Launched as a real-time retail payment system, PromptPay enables instant transfers using mobile phone numbers or national identification numbers, dramatically simplifying peer-to-peer payments and bill payments. Building on this domestic success, the recent launch of cross-border QR payment linkage between Thailand and Lao PDR demonstrates the potential for regional integration (Bank of Thailand and Bank of the Lao P.D.R, 2024). The system's success stems from government leadership in establishing interoperable standards while encouraging private sector innovation, resulting in widespread adoption across all demographic segments.

Singapore's payment ecosystem demonstrates advanced integration capabilities through initiatives like PayNow for instant transfers and SGQR for unified QR code payments. Singapore's approach emphasizes regulatory clarity combined with innovation support through regulatory sandboxes, allowing fintech companies to test new services within controlled environments while maintaining consumer protection standards. The Monetary Authority of Singapore's balanced regulatory approach has fostered both innovation and stability.

Indonesia's QRIS (Quick Response Code Indonesian Standard) represents successful standardization efforts enabling interoperability across different payment service providers. By establishing unified QR code standards, Indonesia eliminated fragmentation issues that previously hindered digital payment adoption,

Southeast Asian countries provide particularly relevant examples for Lao PDR's development planning, having successfully transitioned from cash-dominant economies to sophisticated digital payment ecosystems through coordinated government and private sector initiatives.

allowing consumers to use any payment app at any merchant supporting QRIS. This standardization approach significantly accelerated digital payment penetration nationwide.

Malaysia's DuitNow system similarly demonstrates effective real-time payment infrastructure development, enabling instant fund transfers between banks and e-wallets using mobile numbers or identification numbers. Malaysia's regulatory approach combines licensing requirements for e-money issuers with consumer protection measures and anti-money laundering compliance, creating a stable foundation for digital payment growth.

Korea achieved advanced digitalization through systematic government-led infrastructure development combined with competitive dynamics between traditional financial institutions and innovative fintech companies.

Korea's payment system evolution offers valuable lessons for comprehensive digital financial ecosystem development (Bank of Korea, 2023). Korea achieved advanced digitalization through systematic government-led infrastructure development combined with competitive dynamics between traditional financial institutions and innovative fintech companies. The Korean model features sophisticated regulatory frameworks encompassing multiple laws including the Electronic

Financial Transactions Act and Specialized Credit Finance Business Act, providing comprehensive oversight while accommodating rapid technological changes. Recent statistics demonstrate the continued growth of mobile payment transactions in Korea's mature digital ecosystem (Financial Supervisory Service, 2024).

Korea's success factors include the Korea Financial Telecommunications and Clearings Institute's role in providing shared infrastructure for interbank transactions, the government promotion of electronic payments in public sector transactions, and balanced competition between established financial institutions and emerging

fintech innovators. The regulatory approach emphasizes consumer protection through detailed requirements while maintaining flexibility for innovation through mechanisms like regulatory sandboxes and innovative financial service designations.

These international experiences highlight common success factors including government leadership in infrastructure development, the establishment of interoperable payment standards, balanced regulatory approaches combining innovation support with consumer protection, and strategic public-private sector collaboration.

These international experiences highlight common success factors including government leadership in infrastructure development, the establishment of interoperable payment standards, balanced regulatory approaches combining innovation support with consumer protection, and strategic public-private sector collaboration. For Lao PDR, these examples demonstrate

that successful payment system modernization requires coordinated efforts across multiple stakeholders, with the government playing a crucial catalytic role in establishing foundational infrastructure and regulatory frameworks that enable private sector innovation while ensuring financial stability and consumer protection.

2.2. Deposit Taking Microfinance Institutions (DTMFIs)

DTMFIs and SBs share similarities in terms of their origins, primary business models, and roles as key financial institutions considered by policymakers in promoting financial inclusion. First, both financial institutions share the commonality of having been established as part of the authorities' efforts to absorb informal finance into the formal system and enhance the sustainability of financial services. Second, both financial institutions share an identity centered on serving local residents and low-income populations as their primary client. Third, due to their identity as financial institutions serving local communities and low-income populations, both SBs and DTMFIs are key targets of government policy initiatives aimed at promoting financial inclusion.

Since their inception, both the DTMFI and SB industries have experienced remarkable growth. The asset size of DTMFIs increased significantly from LAK 1,591 billion in 2020 to LAK 2,780 billion by the end of 2024. In particular, both deposits and loans outstanding have also shown substantial growth. In the case of SBs, their total assets grew from approximately KRW 42 trillion in 2015 to over KRW 100 trillion in 2021, reaching around KRW 130 trillion by 2023.

To explore policy implications for DTMFIs based on the experiences of SBs, this study identifies the stages of development for each industry. Each industry has evolved in response to economic growth, financial inclusion policies, and regulatory frameworks. The development process of SBs can be categorized into the following five periods: establishment and settlement (1972-1979), growth (1980-1996), weakening of the business base after the foreign exchange crisis (1997-2009), restructuring (2010-2014), and reestablishment of identity (2015-present). The development procedure of DTMFIs can be divided into four stages: early stage of MFI development (1990s), normalization phase: emergence of formal MFIs (2000~2009), strengthening and expansion (2010~2017), and digitalization & market maturity (2018~present). The identified stages of development of DTMFIs reveal that the key challenges currently faced by DTMFIs can be broadly categorized into three main areas.

DTMFIs and SBs share similarities in terms of their origins, primary business models, and roles as key financial institutions considered by policymakers in promoting financial inclusion.

First, competition from both formal banks and informal lenders is a significant challenge for DTMFIs. As commercial banks expand their reach and increasingly target low- and middle-income segments, they frequently offer more appealing interest rates, broader service options, and the convenience of digital banking advantages that most DTMFIs struggle to match due to limited resources and infrastructure. Simultaneously, informal lenders remain strongly embedded in many rural and semi-urban communities, providing quick and flexible lending without the bureaucracy and documentation requirements that formal institutions impose. Although informal loans frequently have higher interest rates and a higher risk of exploitation, their ease of access makes them a persistent competitor, particularly among clients with limited financial knowledge or legal identity. These combined pressures from both sides of the financial spectrum have diminished DTMFI's market share and have required them to compete on pricing, thereby eroding their already tight profit margins. Furthermore, competition makes it more difficult for DTMFIs to retain clients and build their portfolios, limiting their ability to scale operations and achieve their purpose of promoting accessible financial services throughout Lao PDR.

Second, high operational costs and low profitability are major issues for DTMFIs. Because of their specialization in assisting low-income and frequently geographically dispersed clients, DTMFIs incur significant costs for outreach, client monitoring, and service delivery, especially in rural and isolated locations with little infrastructure. These institutions often have tiny branch networks and use labor-intensive processes, which raises administrative and human costs. At the same time, individual loans and deposits are tiny in size; hence, the revenue generated per client is low, restricting the institution's capacity to achieve economies of scale. Furthermore, many DTMFIs lack advanced digital systems that may expedite operations and cut costs because investing in such technology needs funding that is frequently unavailable. Regulatory compliance expenses add to the financial burden since institutions must allocate resources to meet more strict reporting and supervision requirements. Together, these issues result in tight profit margins, making it difficult for DTMFIs to establish long-term financial viability. Without strategic support, innovation, or access to more efficient delivery methods, DTMFIs in Lao PDR would continue to struggle to strike a balance between social mission and financial sustainability.

Third, regulation and compliance challenges are also a factor influencing DTMFIs' operational efficiency and growth. One key difficulty is the developing and sometimes ambiguous regulatory framework governed by BOL. Despite efforts to tighten supervision, many DTMFIs continue to lack clarity on compliance standards, particularly with anti-money laundering (AML), counter-financing of terrorism (CFT), and customer due diligence (CDD) requirements. These requirements, while necessary,

are frequently complex and resource-intensive, putting an undue strain on smaller institutions with limited manpower and technological capacity. Furthermore, DTMFIs also face issues complying with new format of reporting standards that were developed by BOL. Moreover, the lack of clear guidance on digital financial services legislation, such as mobile banking and electronic Know Your Customer (e-KYC), stifles innovation and limits institutions' capacity to develop their services via digital channels. Overall, these regulatory and compliance problems pose substantial impediments to DTMFIs, restricting their expansion, operational efficiency, and contributions to larger financial inclusion objectives. Additionally, the increase in minimum registered capital by BOL is making it difficult for the small institutions to increase their minimum registered capital to meet the regulatory standard.

2.3. The Bond Market

The bond market's development can be understood through a multiple equilibria framework, where markets may evolve along distinctly different trajectories. A desirable equilibrium is characterized by high trading volumes that enhance liquidity, reduce transaction costs, and attract diverse investors, creating a virtuous cycle of sustained growth and market deepening. Conversely, a stagnant equilibrium features persistently low trading activity that impairs liquidity, increases perceived risks, and deters market participation, establishing a vicious cycle that constrains market development.

Lao PDR's bond market currently exhibits characteristics consistent with a stagnant equilibrium, reinforced by macroeconomic conditions. The volatility of the Lao Kip exchange rate heightens investment risks and fosters risk aversion, particularly among foreign investors. Additionally, substantial fiscal pressures and large-scale government bond issuances saturate the domestic financial system's absorption capacity, leading investors to prefer primary market purchases over secondary market trading.

The lack of liquidity in the bond market is also directly associated with an inadequate primary dealer system, as the absence of dealers standing ready to provide two-way quotes makes it difficult for market participation to flourish. Without efficient price discovery and given the risk of significant price volatility from even modest increases in order size, market participants have incentives to wait until the primary dealer system matures. However, at the same time, primary dealers face high costs in performing market-making functions when market participation remains limited, creating a typical unfavorable equilibrium pattern where neither market participants nor dealers have sufficient incentives to actively engage. However, this is not the only equilibrium, and a desirable equilibrium where the primary dealer system functions smoothly alongside

The transition from the current stagnant equilibrium to a desirable equilibrium simply requires either a favorable shock or the commitment of resources.

active market participation is entirely feasible. The transition from the current stagnant equilibrium to a desirable equilibrium simply requires either a favorable shock or the commitment of resources.

Current financial regulations also inadvertently weaken bond market trading incentives. Typically, reserve requirements generate incentives for commercial banks to trade bonds through active asset management. When unexpected deposit outflows reduce required reserve amounts, banks have incentives to temporarily purchase highly liquid government bonds to minimize the opportunity costs of holding excessive cash. Conversely, when temporary deposit increases raise required reserve amounts, banks tend to sell government bonds to secure cash for regulatory compliance. However, focus group interviews revealed that commercial banks currently maintain reserve requirements at levels substantially exceeding the mandated ratio without difficulties. Under these circumstances, deposit fluctuations do not generate incentives to purchase or sell government bonds, as banks continue to satisfy the reserve requirement ratio in spite of such variations.

The absence of necessity for active asset management to meet reserve requirement regulations impedes the development of an active interbank short-term money market in Lao PDR.

The absence of necessity for active asset management to meet reserve requirement regulations impedes the development of an active interbank short-term money market in Lao PDR. This particularly constrains the need for short-term funding transactions collateralized by government bonds. It ultimately weakens one of the important incentives for commercial banks in Lao PDR

to hold and trade government securities. In contrast, in a typical economy with a significant reserve requirement system, banks engage in short-term interbank lending and borrowing using government bonds as collateral to manage temporary reserve surpluses and shortages. Trading short-term funds with government bonds as collateral reduces counterparty risk and consequently lowers the interest rate costs associated with borrowing. However, an interesting finding emerges from focus group interviews with Lao PDR commercial banks. One reason the banks do not require collateral in interbank transactions is that their concerns about counterparty bank default risk are considerably limited. This represents a paradoxical situation where confidence in the central bank's ability to maintain financial stability even during crises actually reduces individual banks' perceived necessity for active risk management. This suggests that if the central bank were to impose greater risk management responsibilities on individual commercial banks, collateralized interbank short-term funding transactions using government bonds could become more active than at present.

3. Policy Recommendations

The 2024/25 KSP with Lao PDR aims to support the enhancement and modernization of financial legislation and institutional frameworks related to payment systems, the DTMFI industry, and the bond market. By strengthening the legal and institutional foundations across critical financial sectors based on Korean experiences, the project seeks to contribute meaningfully to Lao PDR's broader development objectives and long-term financial stability in line with its national development goals.

3.1. Payment Systems

3.1.1. Evaluation of Current Payment Systems

Lao PDR's payment systems have demonstrated considerable progress over the past five years, transitioning from a predominantly cash-based economy toward increasing digital payment adoption. However, comprehensive evaluation reveals both achievements and persistent challenges requiring strategic intervention for sustainable development and broader financial inclusion.

Market Entry and Competition Dynamics: The current market structure reveals concerning disparities in regulatory treatment between traditional banks and emerging fintech companies. While established commercial banks benefit from streamlined licensing processes and automatic authorization under commercial banking laws, fintech companies face significantly more complex approval procedures, higher compliance costs, and extended review periods. This regulatory discrimination creates barriers for innovative startups that could contribute valuable technological solutions and competitive pressure.

The dominance of commercial banks in Lao PDR's relatively small payment market limits competitive dynamics and innovation potential. Most fintech applicants represent new market entrants focused on developing innovative solutions. While these smaller companies are unlikely to directly compete with established banks, they offer significant opportunities for technological collaboration and service enhancement. Foreign

Lao PDR's payment systems have demonstrated considerable progress over the past five years, transitioning from a predominantly cash-based economy toward increasing digital payment adoption. However, comprehensive evaluation reveals both achievements and persistent challenges requiring strategic intervention for sustainable development and broader financial inclusion.

investment promotion has established minimum capital requirements including 10 percent Lao shareholder participation, although investors face challenges including limited local IT resources, a small market size, and low financial literacy levels.

Financial Accessibility and Infrastructure: Financial accessibility represents a critical challenge with current infrastructure deployment revealing significant inefficiencies and disparities. The national ratio of 0.22 ATMs per 1,000 people masks substantial urban-rural disparities that require differentiated strategies. Urban areas demonstrate sufficient ATM availability but face surprisingly low utilization rates, suggesting that accessibility issues extend beyond mere infrastructure numbers and point to problems with user experiences, financial literacy, or service integration. Conversely, rural areas face cost-prohibitive deployment challenges, making traditional ATM expansion economically unfeasible and necessitating alternative approaches.

The inadequate agent network density of 1.5 agents per 1,000 people further compounds accessibility challenges, particularly in underserved rural communities where digital solutions and agent banking could provide more cost-effective access than physical infrastructure. Mobile banking adoption represents only 236 users per 1,000 people, indicating that only 23.6% of the population maintain bank accounts and only 0.046% hold e-money accounts. These figures highlight substantial financial exclusion affecting two-thirds of the population despite widespread internet access, suggesting that the strategic placement of access points and innovative delivery channels, rather than the simple numerical expansion of traditional infrastructure, should guide future development efforts.

Consumer Protection and Cybersecurity: Consumer protection mechanisms remain insufficient for supporting widespread digital payment adoption. Current regulatory frameworks rely primarily on basic protection decrees, leaving financial service providers responsible for implementing appropriate safeguards independently. Recent fraud incidents demonstrate consumers' vulnerability to technological manipulation, with many unable to distinguish legitimate bank representatives from fraudulent actors. Financial literacy rates averaging 12.2 out of 21, significantly below neighboring countries, compound these vulnerabilities.

Technology infrastructure requires robust cybersecurity frameworks to ensure reliability and trustworthiness. Current regulatory approaches rely on general security principles, requiring providers to develop guidelines independently. The absence of comprehensive cybersecurity regulations, national digital identification systems, and centralized financial security centers limits the system's ability to prevent and respond to emerging threats as digital payment volumes continue growing.

3.1.2. Regulatory Improvement Strategies

Successful payment system development requires constant evaluation and adaptation to market dynamics and technological developments. Establishing strong, flexible regulatory frameworks will reduce risks, encourage innovation, and support financial inclusion while promoting economic development through stakeholder consultations and regulatory capacity building (Khiaonarong and Goh, 2022).

Short-term Policy Priorities: Immediate regulatory improvements should concentrate on extending and enhancing digital finance regulations to ensure alignment with rapidly evolving technology. Priority areas include reviewing and amending existing regulations to provide payment service providers with better clarity and operational guidance. Strengthening consumer protection legislation represents a critical first step, establishing comprehensive safeguards that protect users while encouraging system adoption.

Immediate regulatory improvements should concentrate on extending and enhancing digital finance regulations to ensure alignment with rapidly evolving technology.

Enhanced cooperation among regulatory authorities requires immediate attention, with improved coordination between the BOL, Ministry of Finance, and Ministry of Technology and Communication essential for consistent policy implementation. Streamlining license application processing will reduce market entry barriers while maintaining appropriate oversight standards. The implementation of technical and legal criteria enabling smooth integration will increase interoperability among payment system participants.

Cybersecurity policy development specifically addressing data privacy and electronic know-your-customer standards ensures that all payment service providers follow consistent security protocols. Comprehensive regulations covering advanced payment technologies, cross-border transactions, and data security will provide necessary frameworks for continued innovation. Building public awareness about digital payment security and fraud prevention will enhance consumer confidence and promote broader electronic payment system adoption.

Establishing fintech regulatory sandboxes represents a crucial innovation support mechanism, enabling companies to test new ideas within controlled environments while allowing regulators to evaluate policy effectiveness before broader implementation. These sandboxes will facilitate risk exploration and mitigation while creating appropriate solutions for financial service innovation.

A long-term policy agenda should focus on creating comprehensive implementation roadmaps for payment system advancement, providing clear direction for all stakeholders.

Long-term Policy Agenda: A long-term policy agenda should focus on creating comprehensive implementation roadmaps for payment system advancement, providing clear direction for all stakeholders. Building entirely integrated digital financial ecosystems aligned with international best practices while serving Lao PDR's unique economic and social context, as outlined in the

Financial Inclusion Roadmap (Bank of the Lao P.D.R, 2019), requires upgrading the entire regulatory structure to accommodate developing financial innovations including distributed finance solutions and central bank digital currencies.

Creating legislation encouraging digital inclusion and financial literacy ensures that all societal segments understand payment system developments and can participate effectively. Allocating dedicated funding for continuous regulatory staff training will maintain currency with global financial trends and technological innovations. Additionally, increasing monitoring capabilities through modern financial technology tools, specifically supervisory technology, will enable more effective payment service oversight.

Continuously encouraging cooperation between fintech companies and financial institutions will generate innovative solutions meeting local market needs while ensuring regulatory compliance. Enhanced regional cooperation with ASEAN partners will facilitate cross-border digital payments, building on recent regional initiatives such as the MOU signed by five ASEAN central banks on cross-border payments (Reuters, 2022).

Advanced supervisory framework modernization requires combining risk-based regulatory approaches with fintech-driven regulatory technology implementation to enhance inspection and control capabilities. Automated reporting systems will enable the real-time monitoring of compliance issues and financial transactions. Establishing dedicated financial intelligence units to examine unusual transactions, particularly from non-bank companies, will ensure regulatory compliance across all payment service providers.

Implementing internationally accepted compliance frameworks, including Financial Action Task Force recommendations, will enhance Lao PDR's financial system credibility while reducing illicit financial flows. Strengthening regulatory institution accountability and transparency, alongside improved inter-agency coordination, will support continued regulatory improvements. Creating independent regulatory review agencies to assess financial oversight effectiveness can help improve policy execution and enforcement.

3.1.3. Digital Payment Adoption Strategies

Short-term Policy Priorities: Systematic digital payment infrastructure expansion requires the Bank of the Lao P.D.R to encourage all payment service providers to demonstrate concrete commitments through specific targets. By 2027, QR payment acceptance should cover at least half of all merchants nationwide, with agent networks reaching five agents per 1,000 people.

Rather than pursuing simple numerical ATM expansion targets, infrastructure development should focus on strategic placement and innovative delivery channels. Urban areas demonstrate sufficient ATM availability but face low utilization rates, indicating that accessibility issues extend beyond mere infrastructure numbers. Therefore, ATM infrastructure development should prioritize strategic placement through shared networks among multiple banks to reduce operational costs and improve efficiency. Alternative access points through convenience stores and retail locations, following successful models from countries like South Korea, can provide cost-effective solutions.

Payment system interoperability represents a primary challenge for seamless transactions across service providers. BOL should develop comprehensive payment standards while encouraging all participants to join the national payment switching system. The current participation of 16 out of 19 card issuers and 20 out of 38 mobile-based providers requires improvement, with all card issuers joining by 2027.

Long-term Policy Agenda: ATM infrastructure should achieve three ATMs per 1,000 people by 2030, while ensuring 50 percent of merchants utilize digital payment systems. Rural areas face cost-prohibitive deployment challenges, making traditional ATM expansion economically unfeasible. Digital platform expansion should serve as the primary solution, particularly for rural areas where physical ATM deployment is not economically viable. Mobile and agent banking expansion should be prioritized in rural areas where digital solutions offer more cost-effective access than physical ATM deployment.

All mobile providers should join the national payment switching system by 2030. Enhanced interoperability will reduce transaction costs, improve convenience, and facilitate regulatory monitoring. The implementation of alternative access point strategies will address infrastructure gaps more effectively than traditional expansion. Partnerships with convenience stores and retail chains can provide banking services through existing commercial infrastructure, leveraging economies of scale. Additionally,

Systematic digital payment infrastructure expansion requires the Bank of the Lao P.D.R to encourage all payment service providers to demonstrate concrete commitments through specific targets.

establishing interoperable cash-in/cash-out points through existing merchant networks will leverage QR payment infrastructure for basic banking services.

Government leadership should extend to direct public sector implementation, integrating digital payment systems with revenue collection and expenditure management. Processing at least 50% of government budget transactions through digital methods by 2030 will provide substantial transaction volume supporting system development while demonstrating reliability to encourage broader adoption. Working with government agencies to support e-government initiatives will create synergistic effects supporting both public sector efficiency and private sector adoption.

Effective oversight requires establishing precise structural and procedural frameworks supporting financial stability while encouraging innovation.

Effective oversight requires establishing precise structural and procedural frameworks supporting financial stability while encouraging innovation. BOL should define key risk indicators and performance indicators for monitoring system risks, developing specific KRIs and KPIs tailored to each payment system category.

Payment operators must comply with financial market infrastructure principles, with concentrated oversight on major operators whose failures could affect the entire system. Supporting innovation while ensuring stability requires building flexible regulatory environments. BOL should establish comprehensive cybersecurity standards ensuring consistent security requirements across all participants. Establishing open banking and financial ID systems will strengthen data sharing capabilities and security, enhancing financial service productivity through reliable data sharing while benefiting both providers and consumers through shortened processes, reduced fraud, and enhanced trust.

Enhancing governance transparency and securing restructuring tools represent critical long-term policy objectives for sustainable payment system development. Digital payment systems will improve transaction traceability and accountability mechanisms, reducing opportunities for corruption and financial misconduct while strengthening overall system integrity. Simultaneously, developing comprehensive restructuring frameworks will ensure system resilience during periods of financial stress, providing necessary tools for maintaining stability and the continuity of payment services during challenging economic conditions.

3.1.4. Expected Impact

Financial Inclusion and Economic Productivity Enhancement: Digital payment system expansion will significantly improve financial inclusion by bringing underserved populations into formal financial systems, reducing cash dependency while providing access to comprehensive financial services including savings, credit, and insurance. Enhanced accessibility will particularly benefit women and rural populations who traditionally face greater barriers to financial participation, contributing to poverty reduction through formal economic participation and productive investment opportunities. Digital payment systems will enhance economic productivity by accelerating transaction speeds and reducing business operational costs. Small and medium enterprises will benefit from improved cash flow management, reduced handling costs, and enhanced record keeping for supporting better business planning and tax compliance. An efficient digital payment infrastructure will facilitate trade and investment by providing reliable transaction mechanisms that reduce counterparty risks and costs while attracting additional investment through demonstrated technological sophistication.

Digital payment system expansion will significantly improve financial inclusion.

Transparency and Governance Improvement: Digital payment adoption will increase transaction transparency and reduce corruption opportunities through improved record keeping and audit capabilities. Trackable digital transactions will enable better financial flow monitoring, supporting anti-money laundering efforts and reducing illicit activities. Government expenditure digitization will reduce budget leakage and corruption by creating transparent, auditable payment processes for salaries, subsidies, and procurement activities while improving tax collection efficiency through enhanced transaction visibility.

Digital payment adoption will increase transaction transparency and reduce corruption opportunities

These comprehensive improvements will position Lao PDR for stronger regional economic integration while supporting broader socio-economic development objectives, demonstrating a commitment to technological advancement and enhancing attractiveness for international investment and regional cooperation initiatives.

3.2. Deposit Taking Microfinance Institutions (DTMFIs)

3.2.1. Lessons from Policy Experiences in Korea

SBs were established as financial institutions for regional and lower-middle income class people to supply funds to those underserved by traditional banks. To promote these policy effects through SBs, financial authorities implemented various business activation policies to foster the SB industry. However, these policies were introduced without simultaneously enhancing risk management capabilities, leading to repeated deterioration in soundness and insolvency due to excessive risk-taking based on moral hazard. In particular, as reliance on real estate project financing (PF) loans—highly sensitive to economic fluctuations—increased, criticism arose that SBs were straying from their original role as financial institutions for individuals and small businesses in the surrounding areas.

In addition, due to the lack of stringent ownership regulations comparable to those applied to banks, and the reliance solely on eligibility assessments for major shareholders, the ownership of SBs became concentrated among a small number of individuals. This concentration, coupled with their unlawful conduct, deteriorated the financial soundness of SBs and led to the frequent restructuring of the SB industry.

During the process of restructuring insolvent SBs, financial authorities promoted market-driven affiliations and mergers. As a result, some SBs came to operate in multiple regions, raising further questions about their identity as regional financial institutions. Further, polarization within the SB industry has recently intensified as the number of SBs operating in multiple regions has increased.

Taking all these aspects into account, it is considered essential from a regulatory standpoint to pursue the deregulation of business activities accompanied by strengthened risk management capabilities, as well as to establish ownership regulations that enhance transparency in governance structures. From a supervisory standpoint, it is essential to proactively establish the legal and institutional framework required to carry out restructuring should DTMFIs face insolvency.

3.2.2. Short-term Policy Priorities

To vitalize the DTMFIs industry, it may be necessary to ease operational regulations. As previously mentioned as one of key challenges, DTMFIs have been facing increasing competitive pressure from both banks and informal lenders. In Korea's case, following the financial crisis, changes in bank business strategies led to a contraction of their operational base. In response, regulatory relaxations were

implemented, such as increasing microfinance limits, allowing the use of the term 'bank' in names, and abolishing credit limits for individual borrowers. However, since these deregulations were pursued without a corresponding enhancement in the risk management capabilities of SBs, they became a major cause of financial distress for SBs when economic conditions shifted. Considering Korea's experience, any deregulation aimed at vitalizing operations must be accompanied by measures to strengthen the risk management capacity of DTMFIs.

BOL established the Lao Credit Information Company (LCIC) in 2019 as a legal entity, of which BOL holds 100% of the shares and DFMFIs must become a member of

this company. However, not all DTMFIs are currently members, and there are still some DTMFIs that have not yet joined. Therefore, it is necessary to mandate their membership to enhance the overall risk management capabilities of DTMFIs. Further, to enable the LCIC to fulfill its role effectively, it is essential to monitor member institutions to ensure the provision of accurate credit information. Above all, the lack of activation in credit-based lending by DTMFIs may be due to the possibility that the LCIC is not providing useful credit information that DTMFIs can utilize. Therefore, it is necessary to explore ways to strengthen the practical functions of the LCIC.

Considering Korea's experience, any deregulation aimed at vitalizing operations must be accompanied by measures to strengthen the risk management capacity of DTMFIs.

3.2.3. Long-term Policy Agenda

Enhancing Governance Transparency: As previously mentioned as one of key challenges, the low profitability of their business models may result in excessive risk-taking tendencies of major shareholders, potentially leading to illegal lending practices. To prevent this institutionally, it may be necessary to either strengthen ownership regulations for DTMFIs to the level applied to banks or implement a rigorous Fit and Proper Test for major shareholders. In particular, regarding the latter, establishing the necessary infrastructure to conduct regular assessments of major shareholder eligibility is considered essential.

Additionally, enhancing the audit function could help strengthen DTMFIs' internal control mechanisms. In the long term, improving governance transparency may require reducing ownership concentration and reinforcing market discipline through public listings.

Securing Restructuring Tools: If operational regulations for DTMFIs are relaxed, some institutions may experience insolvency, as was the case with certain SBs in Korea, making restructuring inevitable. To prepare for such scenarios, it is necessary to establish legal frameworks for resolution mechanisms and introduce a deposit insurance system.

First, resolution methods can be broadly categorized into two types: open bank assistance, which maintains the license of the failed DTMFIs and includes approaches such as mergers, sales, and rehabilitation; and closed bank assistance, which involves revoking the license and exiting the institution from the market through liquidation, bankruptcy, purchase and assumption (P&A), or the establishment of a bridge institution. In particular, for the latter, a differentiated approach can be applied: liquidation or bankruptcy for small-scale DTMFIs, and P&A or the creation of a bridge institution for large DTMFIs that may pose systemic risks. Under the P&A method, sound assets and liabilities of the failed DTMFIs are selectively transferred to a third-party acquirer through an open bidding process. In the case of a bridge institution, a temporary financial entity is established to take over the sound assets and liabilities, and its shares are later sold to complete the resolution. Since DTMFIs are relatively small in terms of asset size, encouraging market-driven restructuring measures such as mergers could serve as an orderly approach to restructuring. However, as seen in the case of SBs, it is important to be mindful of the potential emergence of large DTMFIs, which may introduce anti-competitive concerns into the market.

Second, it is necessary to introduce a deposit insurance system. This system protects depositors by establishing a deposit insurance fund—financed through premiums collected from insured financial institutions—and providing payouts in the event of institutional failure. The system also helps prevent insolvency through the proactive risk management of financial institutions and contributes to financial

Further, it is essential to mandate participation in the currently optional deposit insurance system, as this will help secure the financial resources needed to effectively respond to potential future restructuring.

market stability by enabling the swift resolution of failed institutions. To prevent abrupt shifts of funds between sectors, it is important to maintain a uniform deposit insurance coverage limit across all financial sectors. Further, it is essential to mandate participation in the currently optional deposit insurance system, as this will help secure the financial resources needed to effectively respond to potential future restructuring.

3.3. The Bond Market

3.3.1. Short-term Policy Priorities

Developing a Primary Dealer System: A favorable equilibrium in bond markets is characterized by abundant liquidity and active market participation. To encourage market participants to willingly engage in trading, primary dealers must be able to

consistently offer narrow bid-ask spreads, which imposes significant cost burdens on primary dealers in low-liquidity markets. However, if sufficient resources are allocated to government subsidies for these primary dealers' costs, this could serve as a catalyst for a virtuous cycle transitioning toward a favorable equilibrium. In such a process, adequate resource support for primary dealers must be accompanied by corresponding obligation requirements. The most critical aspect is ensuring that the imposed obligations and provided benefits achieve an appropriate balance. This fundamentally involves a trial-and-error process. However, there is the potential to reduce errors by benchmarking existing successful cases, with Korea serving as an ideal case.

Korea's primary dealer system reforms represent a never-ending journey to strike an appropriate balance between obligations and benefits, which continue to this day (Republic of Korea, Ministry of Economy and Finance, 2025). The interesting aspect is that the starting point of the reform was the 1997 financial crisis. Government bond issuance increased substantially during the process of raising funds to overcome the financial crisis and restructure the financial sector. This surge heightened the need for a primary dealer system that could absorb government bond issuances more efficiently than the existing syndicate system. Furthermore, a big-push approach was implemented to simultaneously reform various aspects of bond market structure. These reforms included the activation of the secondary bond market and liquidity enhancement, the establishment of benchmark government bonds, and the development of competitive trading markets among dealers. Korea's case demonstrates the importance of adopting a "never waste a crisis" approach even under adverse economic conditions.

The Korea Treasury Bond (KTB) Trading System in Korea Exchange (KRX) was introduced in March 1999 as an electronic trading system with the objective of improving liquidity and transparency in the secondary market (Korea Exchange, 2019). The KRX KTB market became substantially activated when mandatory on-exchange trading requirements were imposed on primary dealers in October 2002 to promote exchange-based trading activities. Primary dealers were required to trade the entire volume of benchmark bonds and at least 20% of their total trading volume in general government bonds through the exchange market. The mandatory trading ratio was subsequently increased to 40% in January 2003 and further raised to 50% in June 2004 in a phased manner. As a result, trading volumes increased not only for benchmark

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Korea's primary dealer system reforms represent a never-ending journey to strike an appropriate balance between obligations and benefits, which continue to this day.

bonds but also for non-benchmark bonds (Park et al, 2007). The participation of non-primary dealers who were not subject to the mandate also increased in the on-exchange market. Furthermore, the bid-ask spread, which had exceeded 18 basis points before the mandate, decreased significantly to below 3.5 basis points. In addition, volatility in the on-exchange market decreased, and volatility in the over-the-counter market was also found to have declined.

Primary dealers should be subject to various obligations. Korea's primary dealers are currently required to underwrite at least 10% of benchmark bond issuance volumes and maintain a quarterly average balance of at least one trillion won in government bonds held for proprietary trading (Republic of Korea, Ministry of Economy and Finance, 2025). As market makers, they must continuously submit bid and ask quotes for benchmark bonds throughout exchange operating hours, with quotes requiring a minimum face value of one billion won. Primary dealers must maintain trading activity levels exceeding 110% of their sector's average trading volume and conduct open repurchase agreement transactions of at least five trillion won per quarter. The Preliminary Primary Dealer (PPD) system was introduced in February 2011 as an incentive scheme to promote competition among primary dealers. The system serves as a preparatory stage where institutions undergo one-year evaluations before potential promotion to primary dealer status. Since 2012, underperforming primary dealers can be demoted to PPD status, whereas, beginning in 2021, high-performing PPDs can be promoted after only six months. Additionally, strict qualification requirements are imposed, with institutions required to obtain proper authorization under the Financial Investment Services and Capital Markets Act and meet stringent financial soundness, personnel, and performance standards for designation.

In exchange for the aforementioned obligations, primary dealers need to be granted various benefits. In Korea, primary dealers possess exclusive rights to participate in competitive government bond auctions and are permitted to underwrite up to 30% of the planned issuance volume. Prospective primary dealers may also participate in auctions; however, their underwriting capacity is limited to 15%. Additionally, high-performing primary dealers are eligible to receive loans at preferential interest rates from the government's surplus funds, utilizing government bonds as collateral. Previously, support was extended to six primary dealer firms based on quarterly performance evaluations; however, to enhance competitive dynamics, the system was reformed in 2021 to expand support to the top ten primary dealer firms.

Restructuring Reserve Requirement Incentives: Adjusting the currently lenient reserve requirement ratio to an appropriate level could help strengthen incentives for holding and trading government bonds. An appropriate level can be characterized

as one that necessitates active asset management by commercial banks to comply with reserve requirements. Currently, Lao PDR's reserve requirement ratio stands at 8% for Lao Kip-denominated deposits, which cannot be considered a high level. In the case of Korea, the reserve requirement ratio exceeded 10% not only during the early 1980s when inflation was elevated but also until the mid-1990s (Bank of Korea, 2017). Currently, a 7% reserve requirement ratio is applied to demand deposits in Korea.

The maximum ratio at which government bonds can be substituted for reserve requirements is also related to an incentive for banks to trade government bonds. The stronger the regulatory requirement to hold reserve requirements in cash, the greater the opportunity costs associated with regulatory compliance become. This situation leads commercial banks to engage more actively in bond trading to enhance asset efficiency. Previously, under BOL's Decision No. 12, commercial banks were permitted to hold a maximum of 20% of their Kip-denominated compulsory deposits as unencumbered securities. However, the succeeding Decision No. 190, announced on March 6, 2025, reduced the securities holding limit to a maximum of 10% of the required reserve amount. This adjustment represents a welcome move in line with this report's policy recommendations to strengthen incentives to trade bonds. However, such regulatory adjustments should not be a one-time occurrence but require continuous fine-tuning based on ongoing market conditions and banking sector behavior.

3.3.2. Long-term Policy Agenda

Developing Repurchase Agreement Markets: The utility of government bonds as collateral enhances their liquidity and marketability, thereby stimulating trading activity in the secondary market (Korea Securities Depository, 2018). First of all, until market practices are established, it is necessary to mandate or recommend utilizing government bonds as collateral in interbank short-term funding transactions. Furthermore, close monitoring is required to ensure pricing mechanisms function smoothly so that borrowing costs are reduced in transactions using government bonds as collateral. More fundamentally, the desirable direction forward requires individual banks to take greater responsibility in preparing for situations where counterparty credit risk intensifies during periods of sudden short-term financial market instability.

In the long term, it is necessary to design a roadmap for establishing and developing a repurchase agreement market. Repurchase agreements constitute financial

Adjusting the currently lenient reserve requirement ratio to an appropriate level could help strengthen incentives for holding and trading government.

In the long term, it is necessary to design a roadmap for establishing and developing a repurchase agreement market.

arrangements whereby financial institutions dispose of bond assets for immediate liquidity. Concurrently, these arrangements establish contractual obligations to reacquire the securities at predetermined valuations within specified timeframes. When designing the repurchase agreement market, laws and regulations must be meticulously crafted to resolve various legal uncertainties. These uncertainties include the attribution of interest income during the contract period and debt obligations in the event of bankruptcy. Furthermore, haircuts should be priced efficiently and autonomously by the market. In addition, consideration must be given in advance to standard contract forms that are compatible with international standards. Ultimately, integration with future monetary policy frameworks is also necessary to consider.

Cross-Border Collateral Arrangements: A potentially significant catalyst for fostering the development of the domestic bond market could emerge from policy initiatives that establish mechanisms enabling the use of local currency-denominated bonds as eligible collateral in cross-border financial transactions. Two principal pathways

Two principal pathways of implementing cross-border collateral arrangements can be considered: a bilateral approach with specific counterparty nations, and participation within established multilateral frameworks.

of implementing cross-border collateral arrangements can be considered: a bilateral approach with specific counterparty nations, and participation within established multilateral frameworks. Each approach presents distinct advantages and potential drawbacks that warrant careful consideration.

The bilateral approach offers the primary advantage of potentially expeditious implementation, contingent solely upon achieving mutual accord. A noteworthy and

potentially instructive reference case may be the Cross-Border Collateral Arrangements of the Monetary Authority of Singapore (MAS) with a diverse group of central banks, including the Bank of Thailand and the Bank Negara Malaysia. Pursuing direct bilateral Cross-Border Collateral Arrangements with these central banks could be a pragmatic option. Alternatively, seeking informal consultations regarding their own historical experiences and negotiation processes with the MAS could also prove beneficial.

Cross-border Collateral arrangements can be pursued through established multilateral frameworks such as the Asian Prime Collateral Forum (APCF) of the Asian Bond Markets Initiative (ABMI). This approach eliminates the need for Lao PDR to independently negotiate multi-sectoral cooperation proposals. However, this advantage may be offset by significant coordination challenges inherent in multilateral approaches, which require aligning the diverse and sometimes conflicting interests of multiple participating countries. Consequently, this may result in protracted negotiation timelines and potential delays in reaching and implementing final agreements.

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