

Policy Advisory: Lao NSPF Capitalization (Part II)

Executive Summary

This report is the second part of a 2-part report on the capitalization of the National Social Protection Fund (NSPF) of Lao PDR (Laos). In this report, we focus on (1) Major criteria for selecting ideal funding solution; (2) A range of funding solutions; and (3) our recommendation for NSPF capitalization, which will be based on Laos' National Social Protection Strategy (NSPS).

NSPS aims for Lao citizens to have access to basic but equitable social protection services which includes (1) healthcare insurance; (2) social security; and (3) social welfare by 2030. Major criteria for funding NSPF includes Laos' current macroeconomic situation and NSPS blueprint. Since our last report on Lao NPSF, Fitch downgraded Laos' issuer credit rating to CCC from B- on 23-Sep-20. The downgrade is per our prediction (See our Capital Market Investment & Bond Appetites for Laos report dated 10-Sep-20) and leads to our prediction that Laos will not be able issue international bonds on a stand-alone basis in the next 12 months.

From NSPS document and our discussions with Lao officials, there has not been a concrete discussion on the optimal size of NSPF beyond the minimum size which should at least cover social welfare. Using Thailand and Cambodia as proxies, we estimate Laos' social protection funding gap to be c.USD980m in the next three years.

We believe the Lao government should use NSPF as a single entity to fund social security, healthcare, and social welfare through government expenditure, grants and official development assistance (ODA), and borrowing in addition to better enforcement of employee's and employer's contributions.

Rising allocation from government expenditure should be achieved through more efficient management of the government budget while ODA and grants can be achieved through Laos' relationship with development institutions. Additional borrowing should be through NSPF bonds guaranteed by a multilateral development banks or Chinese Renminbi-denominated bonds guaranteed by a Chinese bank. The country should also explore concessional loans from multilateral development banks such as Asian Development Bank (ADB) and Asian Infrastructure Investment Bank (AIIB). Last but not least, we believe NSPF should be professionally managed by an international asset manager with a track record in managing life and health insurance liabilities.

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Criteria for Selecting Financing Solutions

The two main criteria for selecting financing solutions are the following:

Laos’ current macroeconomics situation (See our previous reports dated 24-Sep-20 and 10-Sep-20)

The current macroeconomics situation in Laos stems from (1) declining government revenue on the COVID-19 pandemic (which led to depleting foreign exchange reserves) and (2) heavy debt maturity relative to the country’s foreign exchange reserves.

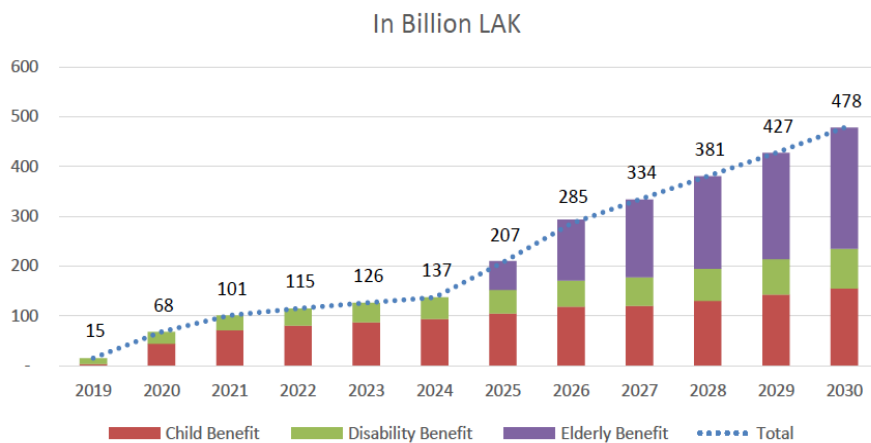
The lack of transparency and information disclosure has hurt the country’s credibility further and helps lead to a rating downgrade. Deteriorating GDP leads to the austerity program to reduce fiscal deficit which impacts Laos’ ability to fund NSPF from the government budget. Moody’s and Fitch’s rating downgrades to “Caa2” and “CCC”, respectively, have led to Laos’ limited capacity to borrow. Needless to say, worsening macroeconomics will limit the capacity by the workforce to contribute to the social protection program.

NSPS as a blueprint for Laos to set up a social protection fund. In general, the Lao government looks to fund the following elements of NSPS:

2.1 Social welfare

NSPS suggested that contribution to social welfare should come from ODA, debt financing, the government’s budget allocation, and other assistance from development institutions such as ASEAN or United Nations, and ADB. The National Social Protection Committee (NSPC) will coordinate with development institutions to mobilize funds under the Social Welfare Funding Mechanism (SWFM). NSPS stated social welfare benefits as (1) child benefits; (2) disability benefits; and (3) senior citizen benefits. NSPC predicted the social welfare fund to be LAK68bn in 2020, rising to LAK207bn in 2025 (EXHIBIT 1) when senior citizen benefits are offered for the first time.

EXHIBIT 1: Social Welfare Cost Estimate



Source: NSPC

2.2 Healthcare insurance

NSPS suggested that contribution to healthcare insurance should come from insured individuals and the government's matching fund. We are of the opinion that the key question is the funding for healthcare of an informal sector¹ which are under the Community-based Health Insurance (CBHI) and Health Equity Fund (HEF), both of which are funded by multilateral development organizations such as United Nations Humanitarian Security Fund (UNHSF). The sizes of CBHI and HEF are not available to us at the time of this report².

2.3 Social security

NSPS suggested that contribution to social security should come from workers, employers and the government's matching fund. Social security system under the Civil Servant System (CVS) or Social Security Office (SSO) under the National Social Security Fund (NSSF) had a shortfall of LAK84bn (USD9m) and a surplus of LAK210bn (USD22m) in 2018, respectively. According to MoLSW, SSO's fund size was LAK1.8trn (USD196m) at the end of June. We do not have the CVS size from MoLSW but, with a series of recent budget shortfalls in CVS, we believe the CVS size is negligible.

Similar to healthcare insurance, we believe the key funding question is the funding for social security in an informal sector. The Lao government launched the National Health Insurance (NHI) which is intended to be a combination of CBHI, HEF, and SSO in 2017 with a budget of LAK180bn (USD20m). NHI offers a low flat co-payment system, similar to Thailand's 30Baht-cure-all universal health care, in our view. However, we have no information on the current size of NHI. In 2019, the Lao government allocated LAK1.2trn to NSSF and social welfare.

The study funded by Thailand's Chulalongkorn University³ in December 2019 (The Dec-19 study) found that NHI offers better accessibility to healthcare for low-income households (<LAK1m a month) than the voluntary CBHI. According to the Dec-19 Study, both CBHI and HEF have a very low enrollment rate. HEF is funded directly by grants from external donors and the Dec-19 found the funding to be unsustainable and inefficient in the long run. In our view, though NHI has the potential to cover a larger population, NHI will require a high level of government subsidy. Furthermore, the Dec-19 study found that SSO enrollment has been poorly enforced since its inception and many employers cancelled memberships of the SSO. Many state-owned enterprises and private employers failed to enroll in the program in the first place.

EXHIBIT 2 shows Laos' rising per capita spending on healthcare while healthcare expenditure as % GDP dropped steadily to 2.53% in 2017 versus 5.9% for Cambodia, 4.7% for Myanmar, 5.5% for Vietnam, 4% for ASEAN⁴, 6% for the world average, and 12.5% for OECD countries, according to the World Bank.

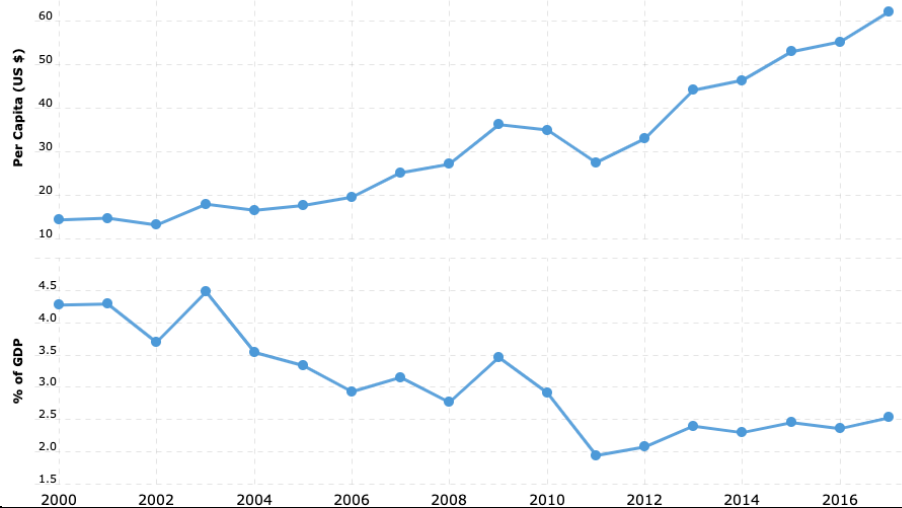
¹ An informal sector means (1) enterprises not registered with the government and/or without accounts of businesses and (2) employees informally employed in households

² UNCDF can only obtain sizes of HEF and CBHI from World Health Organization (WHO) and Ministry of Health (MOH) with an official letter from Ministry of Labour and Social Welfare (MoLSW).

³ Bodhisane, S., Pongpanich, S. The impact of National Health Insurance upon accessibility of health services and financial protection from catastrophic health expenditure: a case study of Savannakhet province, the Lao People's Democratic Republic. *Health Res Policy Sys* 17, 99 (2019). <https://doi.org/10.1186/s12961-019-0493-3>

⁴ WHO

EXHIBIT 2: Lao Healthcare Expenditure Per Capita and as a Percentage of GDP



Source: World Bank

In 2017, Laos' healthcare expenditure per capita was USD62.1 compared to USD82.1 for Cambodia, USD247 for Thailand, USD129.6 for Vietnam, and USD58 for Myanmar, according to the World Bank. In our view, the healthcare expenditure per capita can be misleading as it does not account for more affordable healthcare cost in countries such as China, India or Thailand or more expensive healthcare cost in the US, for example.

In order to recommend the capitalization of NSPF, here are the assumptions and recent events we took into considerations:

- Laos' public social protection spending include healthcare expenditure and funding for NSSF.
- The Lao government allocated LAK1.2trn (USD130m) to NSSF in 2019. Assuming healthcare expenditure at 2.53% of GDP in 2017 remains the same in 2019, at Laos' GDP of USD18.2bn⁵ in 2019, we estimate Laos' healthcare expenditure at USD460m in 2019. Therefore, we estimate Laos' public social spending at USD590m or 3.2% of GDP in 2019.
- Our estimate of USD460m in 2019 healthcare expenditure results in per capita healthcare expenditure of USD65.7 which is close to the 2017 figure. We then align Laos with its peers with similar healthcare cost such as Cambodia. That said, if we want to increase healthcare expenditure by USD20 per head to align Laos with Cambodia in terms of health expenditure per capita, we will need to inject a minimum of USD146m per year (based on a population of c.7.3m in 2020, according to UN data). Assuming that Laos' debt situation will improve within the next 3 years, we will need the funding of USD438m (USD146m x 3) in order to leave enough time for the country's tax revenue to bounce back and, hence, enabling the country to set aside higher budget allocation to healthcare.
- Aiming at a target public social spending of c.5% of GDP which is where Thailand is, we estimate that Laos needs to increase its public social spending from 3.2% to 5% of GDP, which results in a gap of USD327.6m per year or c.USD983m for the next 3 years, of which a minimum of USD438m should be allocated to healthcare expenditure in the next 3 years.
- NSPF will need c.USD983m to capitalize from the Lao government expenditures, ODA/grant, members' contribution, and borrowing. In this report, we will focus on the strategy to borrow in light of the country's debt situation to supplement other funding sources.

⁵ The World Bank

- UNCDF foresees the development⁶ of (i) budget expenditure codes; (ii) the generation of a coherent business plan for the development of NSPF; (iii) the development of an investor prospectus and investor matching event to attract new partners (traditional and non-traditional) to invest in the NSPF; and (iv) undertaking a credit rating for the fund as a pre-cursor for the development of a social protection fund bond for the Thai market (THB Bond issue). UNJP⁷ will be implemented across ministries and organizations until 2021 and will receive financial support of USD 2m from the Joint SDG Fund and USD 0.7m from Australia's Department of Foreign Affairs and Trade (DFAT) and technical support from ILO, UNICEF and UNCDF.

Funding Solutions

We believe the following are NPSF funding solutions for Laos in the long term:

1. Tax revenue through tax hikes, more efficient tax collection, and broader revenue base

We believe this solution involves a structural change in tax collection methods. We, therefore, do not expect to see the results in the near term. Laos's 93.6% of population in an informal sector, versus 77.7% for an ASEAN average means many potential tax payers will remain out of reach. We see the following solutions as priorities:

- More efficient tax collection in the corporate sector
- Additional taxes in a new area such as personal wealth and estate which belongs to high net worth individuals
- Direct linkage of higher tax revenue in the hydro sector to the funding of NSPF
- More taxes on the businesses which are seen as harmful or unfair to the general population such as liquors, tobacco, and luxury cars

2. Government expenditure

The expenditure can come from budget reallocation or an increase in healthcare expenditure which could lead to more budget deficits for Laos. We believe the Lao government needs to reprioritize its expenditures toward NSPF as its population is aging. At the end of the day, NSPF needs to operate in a long term on the government budget commitment, not grants or loans from external sources, in our opinion.

3. Grants and ODA

UNHSF has donated to HEF in the past and the Lao government should approach UNHSF for NSPF funding. According to the World Bank, Laos' ODA figure in 2018 was USD80m, up from USD56m in 2016. The central government announced in November 2019 that it would centralize administration of ODA⁸ which could lead to more ODA allocation to NSPF.

4. More contributions from employees and employers

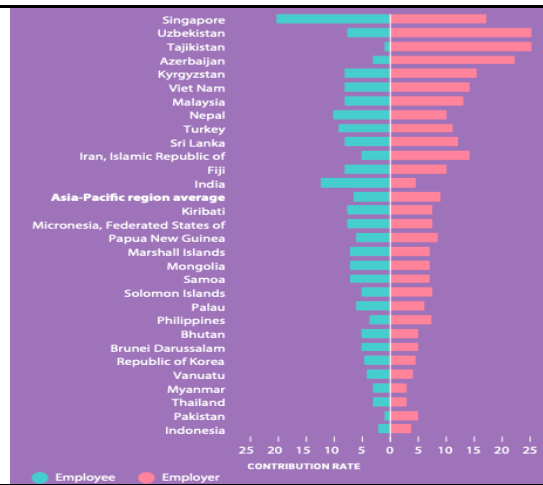
This solution should be achieved through stricter enforcement, including fines for contributors which do not comply with the rules, rather than an increase in contribution rates. The government could reconsider increasing contribution rates from employees and employers to be in-line with its Asia Pacific peers (EXHIBIT 3) when the COVID-19 pandemic subsides and when the country starts to see its GDP growing again.

⁶ <https://www.uncdf.org/article/6105/innovating-social-protection-financing-in-lao-pdr--factsheet>

⁷ On September 30th, the Lao Ministry of Labour and Social Welfare and the UN Country Team inaugurated NSPS 2025 and a Joint Programme to "Leaving No One Behind: Establishing the basis for social protection floors in Lao PDR" (UNJP). (<https://www.unicef.org/laos/press-releases/inauguration-national-social-protection-strategy-2025-and-launch-new-programme>)

⁸ http://www.xinhuanet.com/english/2019-11/04/c_138527033.htm

EXHIBIT 3: Contribution Rates to Social Insurance and Provident Fund in Asia Pacific (latest year available)



Source: ILO, World Social Protection Report 2017–2019

5. Elimination of Illicit financial flows and corruption

We believe the Lao government needs to increase its transparency and information disclosure in order to make it more difficult for officials and business persons to commit corruption. Better disclosure on the country’s financial health will also improve investors’ confidence, leading Laos back into the international capital market.

6. Borrowing and debt restructuring

As we pointed out in our previous reports dated 24-Sep-20 and 10-Sep-20 coupled with the recent Fitch’s downgrade, we believe Laos is not in a position to issue stand-alone international bonds in the next 1-2 years and will need to resort to debt restructuring first and foremost. Then the government should attract more foreign direct investment to repay debt. Last but not least, the Lao government should approach development institutions such as ADB or AIIB for either direct concessional loans or guarantee of the government bonds with proceeds dedicated to NSPF. Another option is to leverage on the country’s good relationship with China to restructure the country’s current debt through a concessional loan from China’s state-owned banks or a Panda bond⁹ issuance with a stand-by letter of credit by one of the major Chinese banks.

7. Combination of social protection plans

Judging from Laos’ current debt situation, declining tax revenue and the inability to issue bonds in the near term all calls for the combination of social protection funds to make sure the fund can be allocated for social welfare, social security and healthcare.

⁹ Panda bond is a bond denominated in Chinese Renminbi and issued in China by a non-Chinese issuer

Recommendation

Size and funding sources

As per Criteria for Selecting Financing Solutions, we estimate that NPSF has a funding gap of c.USD980m (c.USD983 minus a USD2.7m grant organized by UNJP) in the next three years. The funding gap should be filled from recurring sources such as the government expenditure and members' contributions. Borrowing and grants/ODA should be used to top up the fund on a one-off basis either to address social issuers or to replenish the fund at the time the government expenditure cannot be sufficiently allocated to NSPF. We note that the recent social protection floor collaboration with UNJP, DFAT, ILO, UNICEF and UNCDF can be a source of additional grants for NSPF. In addition, a coherent plan to administer the fund is crucial to move this project forward, in our judgment.

In order for the government to allocate more public social funding, we believe Laos need to restructure its debt to extend maturities and attract more foreign direct investments which may come in a form of a direct equity injection or a public listing of Lao assets in overseas exchanges. For the latter, we believe a listing in Singapore and Thailand should be preferred on investors' familiarity with Laos. One example can be for Laos to launch an infrastructure trust in Thailand by selling its revenue from its hydro and other renewable projects into the trust. The infrastructure trust will bring in much needed cash to repay national debt.

Borrowing plan

We do not expect the global economy to be back to a pre-COVID-19 level until 2024 and Laos should continue to suffer through declining government revenue and depressed GDP per capita at least in the next 2-3 years. However, we believe Laos' issuer credit rating can still be upgraded when the government is able and willing to (1) restructure its debt through a multilateral development organizations, bilateral loan extension and (2) seek foreign direct investments in its state-owned enterprises and use the proceeds to pay down the debt.

We believe Laos' issuer credit rating will need to be back to "B-" or "B3" at a minimum for the country to be able to issue its international bonds on a stand-alone basis. Assuming the worst case scenario, we do not expect Laos to be able to issue stand-alone bonds until 2023.

In order to borrow in the near-term, we believe Laos needs to create NSPF as a state-owned enterprise which will seek debt financing through at least two of the following options:

1. NPSF can issue c.USD140m 3 to 5-year THB bonds with multilateral development banks to guarantee the debt principal and interest. The example of which can be a senior unsecured bonds, guaranteed by ADB's Credit Guarantee & Investment Facility (CGIF). The maximum issuance with CGIF guarantee is USD140m. We are also of the opinion that NSPF bonds can be qualified as a social bond according to ICMA¹⁰'s Social Bond Principles (SBP)¹¹ which will attract ESG¹² investors. The bonds guaranteed by CGIF will have the following benefits:
 - Better credit rating than that of the Lao government as the bonds will receive an issue credit rating close to that of CGIF's senior unsecured bonds (CGIF is rated "AA" by S&P versus Laos' Caa2 by Moody's)
 - Lower funding cost for NSPF, based on the CGIF's credit fundamentals
 - No additional debt on Laos as the bonds are guaranteed by CGIF

¹⁰ International Capital Market Association

¹¹ <https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2020/Social-Bond-PrinciplesJune-2020-090620.pdf>

¹² Environment, Social, and Governance

- The 3 to 5-year tenor for the social bonds will allow Laos to fix its debt problems and regain its “B-“ or “B3” issuer credit rating which we view as a minimum to issue international bonds on a stand-alone basis. The social bonds may be refinanced in 2023 or 2025 with NSPF’s new bonds which may be issued on a stand-alone basis should the Lao government succeed in convincing the rating agencies to upgrade the country’s ratings.
 - We recommend issuing bonds in THB due to (1) Laos’ history of bond issuance in Thailand; (2) familiarity of Thai investors on Laos; and (3) CGIF’s goal to support local currency bond issuance in Southeast Asia.
2. NSPF can leverage on Laos’ good relationship with China to restructure the current debt through a concessional loan from China’s state-owned banks or a Panda bond¹³ issuance with a stand-by letter of credit by a major Chinese commercial banks such as Bank of China, China Construction Bank, Agricultural Bank of China, or Industrial and Commercial Bank of China or a policy bank such as China Development Bank.

Similar to the first option above, the Panda bonds will offer a better credit rating, lower funding cost, and maturity extension to Laos. Needless to say, the bonds will be denominated to Chinese Renminbi and the bonds may be rated on a Chinese national-scale rating by local credit rating agencies such as China Chengxin International Credit Rating (CCXI) or Lianhe Global Ratings, both of which are number 1 and 2 rating agencies in China.

3. NSPF can be funded by concessional loans from multilateral development banks such as ADB and AIIB.

Fund management

We are of the opinion that NSPF should be professionally managed by an international external asset manager with client relationship in Singapore and/or Thailand. Hiring an external asset manager boosts transparency and disclosure of NSPF, in our judgment. We chose investor bases in Singapore and Thailand on Singapore as the most developed financial market in Southeast Asia and Thailand as the market with best knowledge of Laos.

Such asset managers should be familiar with life and health insurance liability management which can dictate how NSPF liquidity is invested in terms of asset class, tenor, volatility, and return. NSPC and relevant authorities such as State Authority of Social Security (SASS) can act as an investment committee and administrators to set rules for investments and liabilities and leave the liquidity and investment management to the asset manager in charge. In our judgment, NSPF investment portfolio should consist of liquid and conservative fixed income investments and no private securities should be allowed.

¹³ Panda bond is a bond denominated in Chinese Renminbi and issued in China by a non-Chinese issuer