## CAMBODIA FINANCIAL SECTOR OVERVIEW[1]

### A. Sector Descriptions and Performance

1. **Institutions.** Cambodia's financial system is undergoing a rebuilding process like most other institutions following the political instability and institutional destruction of the late 1970s and early 1980s. Before 1989, no formal financial intermediation was available and the Cambodian financial system was confined to one institution—People's Bank of Kampuchea, which had the dual role of issuer of national currency (the riel) and national treasurer to finance government operations. The treasury role was subsequently transferred to the Ministry of Economy and Finance (MEF) in 1990. This was a period of hyperinflation and steep devaluation of the riel. Inflows of dollars following establishment of the United Nations Transitional Authority in 1991 provided a safer alternative to the riel for cash holdings and protection against loss of purchasing power; the dollar has since gained legal tender status in Cambodia. In 1996, with the promulgation of the Law on the Organization and Conduct of the National Bank of Cambodia, NBC was established as the country's central bank. In 1999, the Government enacted the Law on Banking and Financial Institutions.

2. **Growth and Development.** At the end of August 2007, the formal financial system comprised NBC, 16 commercial banks, 7 specialized financial institutions, and 2 representative offices of foreign-based banks; 17 licensed and 26 registered microfinance institutions (MFIs); and 6 insurance companies. Cambodia has yet to establish bond or securities markets. The predominantly rural nature of the economy, high transaction costs, inability of the real sector to put together bankable projects, and low creditor confidence have been the main factors resulting in low formal intermediation and outreach within the sector, slow development in nonbank financial institutions, and limited range of products and services offered. The financial crisis in the late 1990s, the adoption of the Banking and Financial Institutions Law, and membership in the Association of Southeast Asian Nations in 1999 and the World Trade Organization in 2003 were among the events that provided a strong impetus for financial sector reform.

3. **Financial Intermediation.** The financial sector has been growing from a very low base (key financial data is in Table 2). The broad money (M2) to GDP ratio was around 21% at the end of 2006 compared to 13% in 2001. Credit to the private sector increased from 6.0% of GDP in 2001 to 12.2% in 2006, and total bank deposits to GDP was 17.9% in 2006 compared to 10.4% in 2001. Public confidence in the banking system is increasing as depicted by the entry of additional foreign banks and annual average growth of total deposits by 30% and assets by 27% between 2001 and 2006 (private sector credit increased by 52% in 2006). While growth in the banking system is facilitating economic development, the fast pace of growth requires strong supervision and surveillance to ensure banks are weighing all the risks properly. Lending is highly concentrated with the leading five banks accounting for 67% of total lending at the end of 2006 and competition is slowly picking up with some evidence of market segmentation emerging. Foreign banks do not face any legal barriers for entering the country, and by the end of 2006 eight commercial banks had majority foreign owners.

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[1] This section is based on data in the RRP on the Second FSP Cluster, approved in November 2007.

## B. Issues and Opportunities

### 1. Sector Challenges

4. **Early Stage of Development with Low Investor Confidence.** The weaknesses of the financial sector stem mainly from the fact that commercial development is still in its infancy. Since 1999, ADB has helped to implement reforms to establish the legal and regulatory foundation and incorporate strong norms within NBC in terms of how it discharges its prudential function. The capital base of the banking system has been strengthened but remains highly liquid. Given the high liquidity, to remain profitable banks offer short-term loans (longest duration of 3 years) at high interest rates. Competition is still very weak and profitable investment alternatives are lacking. Financial outreach is low with limited diversification in products and services available to potential customers. The ability of the real sector to maintain and prepare reliable financial reports continues to be a challenge. Efforts to develop appropriate accounting and reporting standards; strengthen the credit information-sharing system; and modernize the management information systems of banks (including NBC), and the payments and settlement system will boost confidence and financial intermediation in the sector. In particular, early standardization of financial sector architecture and the nationwide sharing of common platform and system applications are crucial for expanding the system to accommodate growing demand.

5. **Underdeveloped Commercial and Institutional Framework.** Like other developing economies, the fundamental weaknesses that stifle financial sector development in Cambodia stem mainly from its underdeveloped commercial and institutional framework, low formalized enterprise development, and limited human capacity and technical expertise. The court system lacks the judicial capacity to enforce contracts and resolve commercial disputes on a consistent basis. This contributes to the lack of public and investor confidence in the sector. Enterprises that have enjoyed many years of operating without any established rule of law prefer to remain informal. The majority of participants in the real sector are reluctant to enter into any form of formal financial transactions for fear of being exposed to the tax authorities. Efforts to get the National Assembly to adopt the remaining commercial laws and have the Government launch an online registry for secured transactions, establish dispute resolution mechanisms, and enhance institutional and technical capacity are beginning to succeed and when fully implemented will help mitigate these issues.

6. **Shallow Financial Sector.** Cambodia's financial sector has gone through major restructuring and reforms since the mid-1990s. For instance, NBC led the relicensing program that brought about the closure of 16 nonviable banks in 2002, raised capital requirements for the remaining banks to $13 million equivalent, and set the minimum capital adequacy ratio at 15% of risk-weighted assets. Privatization of the only state-owned commercial bank (Foreign Trade Bank) was completed in 2005. Banks have been free to set their own interest rates since 1995. Nevertheless, the financial sector is shallow and dominated by banks. Broad money at 21% of GDP is relatively low compared to neighboring countries (Figure 1) indicating that Cambodia has much work to do to deepen its financial sector. The average interest rate spread in Cambodia has been persistently high compared to neighboring countries, although in recent years it declined with increased competition from new banks, in particular with the entry of ANZ Royal. Improvements in financial intermediation in Viet Nam, for example, have helped reduce interest rate margins and deepen its financial sector. Several factors have contributed to higher transaction costs. First, the payments settlement system is underdeveloped lacking an efficient and real time electronic settlements system for clearing checks and other transactions. Second, until recently, banks have not had a mechanism for sharing credit information to help them

properly assess credit risk. Third, weak legal institutions for contract enforcement and bankruptcy increase the risk of lending in Cambodia.

7. **Bank Supervision and Vulnerability to Shocks.** The capacity of NBC for off-site supervision of banks has been upgraded and strengthened. Regulatory standards have been gradually improved and relevant prudential regulations added to maintain NBC's primary objective of enhancing soundness of the banking system. All banks adopted a uniform chart of accounts in 2004 and commenced publishing their annual audited financial reports in 2005. At the end of 2006, NBC's Bank Supervision Department published its second annual report providing a very detailed and comprehensive assessment of the banking system. These developments are evidence that NBC is serious about market transparency and has made significant progress to establish a sound regulatory and efficient supervisory regime to enhance integrity of the banking system. Although enforcement of prudential regulations is improving, compliance with prudential regulations remains patchy. However, NBC aims to bring banks into full compliance by the end of 2007, in particular, those of systemic importance

### 2. Sector Opportunities for ADB

8. ADB has supported reforms in the financial sector since 1999, beginning with the diagnostic assessment of the financial sector, which resulted in the formulation of the Financial Sector Development Blueprint 2001–2010. The blueprint, adopted in August 2001, sets out the long-term vision and development strategy for the sector and is in line with the Government's overall reform agenda of establishing a market-oriented and private-sector-led economy. Designed within the framework of the blueprint, the loan for the first Financial Sector Program (FSPL I) helped to (i) establish a legal and regulatory foundation for banking, insurance, and commercial development; (ii) enhance public confidence and financial intermediation by consolidating the banking system, and strengthening supervision and surveillance of financial institutions; (iii) prepare the foundation for developing interbank and money markets; (iv) develop key financial market infrastructure (accounting and auditing, credit information sharing system, secured transactions filing registry, etc.); and (v) establish key institutions with appropriate capacity support.

9. ADB's country strategy and program specifically states that ADB will continue its leading role in supporting financial sector development and that ADB's future involvement in the financial sector would depend on the outcome of the Financial Sector Development Blueprint update. The FSDS 2006–2015 (the updated blueprint) states that financial sector development is not an end in itself; rather it is one aspect supporting the development and reduction of poverty in Cambodia. While much work is needed to achieve this difficult goal, accelerating and diversifying growth is generally accepted as key and financial sector development must support this objective. Reform and change is essential for growth. At the same time, expanding finance brings risks; hence, the context in which financial development occurs must be carefully considered with a focus on prudential risk reduction, transparency, and uniform application of rules and regulations.

## C. Summary of PCR Findings (Ratings, Lessons, Recommendations)

## A. Overall Assessment (Ratings)

10. The FSPL I was implemented as conceived and was highly relevant to the Government's development strategy, ADB's partnership strategy with the Kingdom of Cambodia, and ADB's strategic objectives at the time of approval. Due to strong government commitment, a well

sequenced reform framework, and effective high level coordination among the executing and implementing agencies, the program was "highly effective and efficient" in achieving the expected outcomes. No issues relating to indigenous peoples were encountered during program implementation. Based on the Government's strong ownership of program reforms and ongoing commitment to further reforms as envisaged in the FSDS 2006–2015, sustainability of the program is rated "most likely." Overall the program is rated "highly successful."

## B. Lessons

11. Key lessons from FSPL I and the associated TA include the following:

(i) **Long-term perspective.** Adoption of the medium-term blueprint for the financial sector provided the Government with a set of long-term objectives to guide and shape medium-term policy design and implementation. Changes in the underlying policy environment necessitated updating of the blueprint; in February 2007, the updated blueprint (FSDS for 2006–2015) was adopted. The close consultative process involving the Government, ADB, and other development partners strengthened the Government's ownership and increased the potential for funding agency support.

(ii) **Flexibility in design.** Financial sector reforms are complex and involve major changes to the legal and regulatory framework, institutional arrangements, financial infrastructure, and human capacity. As a result, sufficient time must be allocated for program implementation. Design flexibility is also a key consideration. The use of the program cluster approach under FSPL I provided the opportunity to refine the proposed policy actions and allowed succeeding subprograms to reflect the Government's achievements, changes in the policy environment, and lessons from the previous subprogram.

(i) **TA resources.** Under FSPL I, the Government adopted legal, policy, and institutional measures, many of which were relatively new concepts and therefore required extensive coordination and consultation to build understanding and would be adopted. Substantial TA was necessary to ensure that best practices were incorporated and then consolidated throughout implementation to achieve the intended results. Consultants were selected not only on the basis of merit, but also on their perceived ability to work well with local counterpart staff and their sensitivity to the local culture, as these criteria were considered essential for successful knowledge transfer.

(ii) **National and commune council elections.** Implementation of subprograms 2 and 3 of FSPL I was delayed by elections. The commune and national elections affected the passage of the draft laws through the Council of Ministers and National Assembly and subsequently affected the achievement of targets set out in FSPL I in relation to those laws. This is a lesson for program design as the next national general election is scheduled for July 2008.

(iii) **Emerging risks.** The transition from a centrally controlled to a market-led economy creates new forms of risks. The presence of international banks, the offer of more sophisticated services to depositors, and the increase in lending demonstrate increasing investor confidence in Cambodia's financial system. However, with these encouraging developments come new risks and challenges; it is important to strengthen awareness of potential problems within both the public and the financial sectors and develop new ways of mitigating risks.

## C. Recommendations – Program Related

12. **Future Monitoring.** A growing commercial economy, rising foreign direct investment inflows and rapid credit expansion is adding to growth in real estate investment because of rising property prices. This has led to the assets of some banks becoming increasingly vulnerable to real estate risks. Sufficient resources are needed to support key reform initiatives related to strengthening of surveillance and enforcement and protection of NBC staff from frivolous and intimidating lawsuits. These areas require close monitoring and ongoing support.

13. **Additional Assistance.** Further program interventions should be designed within the FSDS 2006–2015 framework and implemented in a systematic manner to ensure that (i) market development parallels institutional and capacity developments, (ii) linkages across subsectors are exploited, and (iii) corresponding risks are mitigated. These interventions will continue in the second Financial Sector Program (approved in December 2007), and will be supported by TA to strengthen the awareness of risks, formulate mitigation measures, and implement key reform activities.

14. **Timing of the Program Performance Audit Report.** To further assess the impact of FSPL I reforms on the financial sector and the economy, it is proposed that a program performance audit report be conducted **before the end of 2008**.