ASIAN DEVELOPMENT BANK

RRP: CAM 32431

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON A

PROPOSED PROGRAM LOAN CLUSTER

TO THE

KINGDOM OF CAMBODIA

FOR THE

FINANCIAL SECTOR PROGRAM

October 2001

CURRENCY EQUIVALENTS
(as of 17 October 2001)

Currency Unit	–	Cambodian riel (KR)
KR1.00	=	$0.00026
$1.00	=	KR3,835

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
ADTA	–	advisory technical assistance
BSD	–	Banking Supervision Department
CAMINCO	–	Cambodia National Insurance Company
CBS	–	Centre for Banking Studies
CDC	–	Council for the Development of Cambodia
FSPL	–	Financial Sector Program Loan
FSSC	–	financial sector steering committee
FTB	–	Foreign Trade Bank
GDP	–	gross domestic product
IAS	–	International Accounting Standards
IFC	–	International Finance Corporation
IMF	–	International Monetary Fund
ISA	–	International Standards on Auditing
Lao PDR	–	Lao People’s Democratic Republic
MEF	–	Ministry of Economy and Finance
MFI	–	microfinance institution
MOC	–	Ministry of Commerce
MOU	–	memorandum of understanding
MPDF	–	Mekong Project Development Facility
NBC	–	National Bank of Cambodia
NGO	–	nongovernment organization
PPTA	–	project preparatory technical assistance
PRGF	–	Poverty Reduction and Growth Facility
RCSP	–	Rural Credit and Savings Project
RDB	–	Rural Development Bank
SDR	–	special drawing rights
SEC	–	Securities and Exchange Commission
SEDP I	–	Socioeconomic Development Plan I
SEDP II	–	Socioeconomic Development Plan II
SME	–	small- and medium-sized enterprise
TA	–	technical assistance

NOTE

In this report, "$" refers to US dollars.

CONTENTS

LOAN AND PROGRAM SUMMARY

Borrower Kingdom of Cambodia

The Proposal The proposal comprises (i) a program cluster concept for the Financial Sector Program Loan (FSPL), and (ii) a proposed loan of $10 million to the Kingdom of Cambodia for Subprogram I of the FSPL. The FSPL consists of three back-to-back subprograms that will be implemented within 36 months after loan effectiveness.

The Program

Rationale Cambodia's financial sector is at a rudimentary stage with limited financial intermediation and low public confidence. An underdeveloped financial system is one of the most significant constraints to achieving broad-based sustainable economic growth and socioeconomic development objectives of the Royal Government of Cambodia (the Government), including poverty reduction. Financial sector development has been hampered by numerous constraints: (i) high risk related to uncertainties regarding law and contract enforcement due to lack of the rule of law, (ii) high information costs stemming from lack of common accounting and auditing standards and other information infrastructure, (iii) high operating costs due to the absence of liquidity management mechanisms and other market infrastructure, and (iv) weak supervisory system and capacity.

The FSPL will support the Government's efforts to address these constraints and lay the foundation for financial sector development. A sound, efficient, and integrated financial system is crucial for achieving broad-based sustainable economic growth and reducing poverty by enlarging job opportunities, lowering the transaction costs of economic activities, and extending the outreach of the formal financial sector to poor and rural areas. An efficient financial system will promote private sector development as well as foreign direct investments. Further, a robust financial sector will protect the economy from unfavorable exogenous shocks that are becoming more common in increasingly globalized financial markets.

Objective and Scope The FSPL aims to promote the development of a sound, market-based financial system to support enhanced resource mobilization and sustainable economic growth by establishing a foundation for the banking and insurance industries as well as financial markets. the FSPL will focus on the following activities:

(i) enhancing banking intermediation and public confidence by establishing and strengthening banking supervision, developing key information infrastructure and safety net, and building capacity in both public and private sectors by reinforcing capacity-building institutions;

(ii) establishing legal and regulatory frameworks for insurance development by institutionalizing a supervisory system and prudential regulations, fostering private sector development in the insurance business, and developing compulsory insurance;

(iii) laying the foundation for the development of interbank and money markets through public-private sector partnership and by establishing a basic legal framework; and

(iv) developing the financial market infrastructure by establishing common accounting standards and enforcement mechanisms and promulgating laws to underpin the commercial activities and financial markets.

Classification Economic growth

Environmental Assessment Category C. Environmental implications were reviewed, and no significant adverse environmental impacts were identified.

The ADB Loan

Amount and Terms The FSPL adopts the program cluster approach with three back-to-back subprograms totaling $30 million. Each subprogram loan will be for $10 million and will be processed upon the successful completion of the previous subprogram.

Subprogram I of FSPL will be drawn from the Asian Development Fund, which will have a repayment period of 24 years, including a grace period of 8 years, and carry an interest rate of 1.0 percent per annum during the grace period and 1.5 percent per annum thereafter. Subprogram I will be implemented within 12 months after loan effectiveness.

Subprogram II will be presented for Board consideration, based on progress in implementing Subprogram I. Policy conditions for Subprogram II are subject to revision to reflect the Government's achievements and changing policy environment. Subprogram III will be processed in a similar manner. Subprograms II and III will be implemented within 12 months after loan effectiveness.

Program Period and Tranching The loan for Subprogram I will be utilized within 18 months, commencing from the date of loan effectiveness. The loan proceeds may be used to finance eligible imports procured 180 days before the date of effectiveness. The loan will have two tranches; the first will be available upon loan effectiveness, and the second will be released upon satisfactory compliance with specified conditions indicated in the policy matrix.

Executing Agency The National Bank of Cambodia (NBC) will be the Executing Agency for the FSPL and Implementing Agencies will be The Ministry of Economy and Finance (MEF), the Ministry of Commerce (MOC), NBC, and the bankers association when formed. A financial sector steering committee (FSSC) will be established to oversee implementation of the FSPL. FSSC will be chaired by the governor of NBC and will include senior representatives from MEF, MOC, NBC, and the Council for the Development of Cambodia. A working group will be also established under FSSC to assist FSSC and oversee day-to-day program implementation.

Procurement and Disbursement The proceeds of the FSPL will be disbursed for a broad range of imports, subject to compliance with a negative list of ineligible items. All procurement of goods and services produced in and originating in member countries of the Asian Development Bank (ADB) will be made with due consideration to economy and efficiency in accordance with standard public sector procedures in Cambodia and normal private sector commercial practices, acceptable to ADB. The Borrower will certify that the volume of eligible imports exceeds the amount of the projected disbursements under the ADB loan in a given period. ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the Borrower's certification.

Counterpart Funds The policy framework for the FSPL includes specific components that bear distinct costs of structural adjustments. The counterpart funds to be generated from the loan proceeds will be used to finance the structural adjustment costs under the FSPL.

Risks and Safeguards The principal risk lies in unexpected political disturbance. Cambodia will go into a political season in early 2002, as the National Assembly and the Senate of Cambodia passed the Commune Election and Commune Administration Laws in January and February 2001, respectively. There may be risks associated with weak capacity at the institution level, the ability to recruit and retain qualified cadres and staff, and poor coordination between policy-making agencies. There may be another risk related to "law fatigue." Given the deficient legal environment in Cambodia, the Government has been expediting substantial volume of legislation in a relatively short period. However, there have been some cases where adopted laws are not fully implemented, despite all the efforts of the Government and aid agencies.

The FSPL includes safeguards in the design of the overall framework of assistance. First, it adopts the program cluster approach, which introduces flexibility to accommodate various types of risks by allowing further refinement of policy conditions reflecting changing circumstances. The FSPL will be also supported by technical assistance (TA) to reduce the downside risks from weak capacity. An advisory TA will assist the Government in implementing the policy reform measures. Risks associated with "law fatigue" can be minimized by instituting procedures for broad and regular consultation with the private sector stakeholders. On 25 January 2001, the Government adopted the Prime Minister's Decision on the Formation of a Sectoral Working Group for Consultation Partnership with the Private Sector, which mandated the creation of procedures for private sector consultation in seven major areas including banking and financial services. While it is understood that the procedure can also be utilized as a private sector consultation procedure for legislation, the FSPL supports the adoption of a formal consultation procedure for legislation in the banking sector as one of the policy conditions of Subprogram I.

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on a (i) proposed program cluster concept for the Financial Sector Program Loan (FSPL); and (ii) proposed loan to the Kingdom of Cambodia for Subprogram I of the FSPL.

II. INTRODUCTION

2. In May 1999, the Royal Government of Cambodia (the Government) requested assistance from the Asian Development Bank (ADB) to develop its financial sector. In response, ADB assisted the Government in developing a preliminary financial sector road map for the next 20 years through a financial sector study, which was completed in June 1999. With technical assistance (TA)[1] and building on the preliminary road map, a comprehensive financial sector diagnostic review was completed in January 2001, and the Financial Sector Blueprint for 2001-2010 (Appendix 1) was prepared in March 2001 to serve as the long-term development strategy and phased financial sector development plan. On 24 August 2001, the Government adopted the Blueprint as its official development plan in the financial sector at a Cabinet meeting chaired by the Prime Minister.

3. The Loan Fact-Finding Mission[2] which visited Cambodia in April 2001 reached understanding with the Government on policy reforms that are to be supported by the ADB loans, the program structure (use of the program cluster approach for the FSPL), its subcomponents and tranching conditions, and the implementation arrangements. The Appraisal Mission[3] in July 2001 confirmed and refined the policy conditions for the proposed FSPL and implementation arrangements, and drafted a development policy letter in consultation with the Government. The development policy letter and policy matrix for the FSPL are in Appendixes 2 and 3.

III. MACROECONOMIC CONTEXT

A. Development Objectives, Strategy, and Plans

4. After a long-standing domestic turmoil and subsequent international isolation in the 1980s, Cambodia started returning to a period of peace in 1993. The period saw Cambodia making steady efforts to recover in all aspects of socioeconomic development and to maintain social, political, and macroeconomic stability. International aid agency operations also resumed to assist Cambodia.

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[1] TA 3467-CAM: *Preparing for the Financial Sector Development Program*, for $800,000, approved in July 2000. The TA commenced implementation in December 2000 and was completed in June 2001. The purpose of the TA was to formulate a long-term financial sector development plan and a financial sector program loan as well as to conduct the preparatory work for the proposed financial sector program loan.

[2] The Mission comprised Byoung-Jo Chun (Financial Economist, IWFI/Mission Leader); X. Zhang (Economist, IWFI); R. O'Sullivan (Counsel, OGC); and P. Long (Program Assistant, CARM). T. Crouch (Manager, IWFI), assisted the Mission in the field.

[3] The Mission comprised Byoung-Jo Chun (Financial Economist, IWFI/Mission Leader); B. Frielink (Senior Programs Officer, PW3); R. O'Sullivan (Counsel, OGC); X. Zhang (Economist, IWFI); and P. Long (Program Assistant, CARM).

5. The Socioeconomic Development Plan for 1996-2000 (SEDP I) marked the Government's first systematic efforts toward economic development to achieve economic growth and poverty reduction and broad participation in the development process. After the successful implementation of SEDP I, the Government is finalizing SEDP II for 2001-2005, which identifies poverty reduction, as the primary development goal. SEDP II targets reducing the poverty rate from 36 percent[4] in 1999 to around 31 percent in 2005, as well as lessening the degree of deprivation. These will be achieved by (i) promoting broad-based sustainable economic growth at 6-7 percent with equitable income distribution, (ii) social and cultural development, and (iii) ensuring sustainable management in the use of natural resources and protecting the environment.

6. The Government's strategy to achieve the poverty reduction target is to promote growth in all sectors, especially in agriculture because about 90 percent of the poor live in rural areas. Mobilization and efficient allocation of resources are at the core of the economic development strategy. Specifically, the Government targets the following areas:

(i) implementing fiscal reforms and maintaining a stable macroeconomic environment;

(ii) improving efficiency and effectiveness of the public sector through reforms in the civil service, judiciary, and public enterprises;

(iii) enhancing private sector development while protecting public interest by (a) improving physical infrastructure, (b) developing the legal and regulatory frameworks within which business enterprises operate, (c) liberalizing trade and investment policies, and (d) supporting banking system reform and financial sector development;

(iv) promoting agricultural development and creating off-farm employment in both rural and urban areas; and

(v) empowering the poor to participate in, and thus benefit from, the growth process by improving their access to nature assets, health and education services, appropriate technology, and credit; and by removing any anti-poor distortions in the product and factor markets.

B. Recent Economic Performance and Prospects

7. Social and political stability and the Government's effort for economic reform have enabled Cambodia to achieve robust economic growth. During 1995-2000, the average annual growth rate of gross domestic product (GDP) was 4.6 percent, an impressive performance compared with 3 percent growth rate for Southeast Asia over the same period. Although the regional financial crisis and domestic political instability caused a substantial slowdown in 1998 when the GDP growth rate plummeted to 1.5 percent, the economy regained momentum in the following years. However, an average annual population growth of 2.5 percent has dragged per capita GDP, which stagnates at around $270.

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[4] The poor are those with a per capita income level below the poverty line of KR54,050 per head per month, equivalent to about $14 (less than $0.50 per day).

8. The agriculture and service sectors dominate Cambodia's economy, contributing 37.6 percent and 37.7 percent of GDP, respectively, in 2000. Agriculture in particular absorbs more than 70 percent of employment. On the other hand, the industry sector contributed only 14 percent of GDP in 1995, but has been the fastest growing sector. Led by manufacturing, the industry sector recorded a strong average growth rate of 14.7 percent per year from 1995 to 2000. In 2000, the sector contributed 21.7 percent of GDP.

9. Low levels of savings and investments and heavy reliance on official development assistance and foreign direct investment have limited the economic growth potential. The gross domestic savings ratio averaged 5.7 percent while the ratio of gross domestic investment to GDP averaged around 14.6 percent during 1995-1999, fluctuating with volatile public confidence. The gap between domestic savings and investments was filled by official transfers, which averaged 8.4 percent of GDP over the observed period.

10. SEDP I saw a small surplus in the overall balance of payments due to the improved trade balance and current account, although the regional financial crisis deteriorated the country's capital account during 1997-1999. The current account deficit declined from 17.3 percent of GDP in 1996 to 8.6 percent in 2000, with the increase in income receipts and private transfers. In addition, the rapid growth of exports and slower-than-expected growth of imports contributed to an improved trade balance. Exports rose from 6.3 percent of GDP in 1995 to 30.3 percent in 2000 due to trade reform and concomitant opening of the economy to foreign direct investment.

11. Although the overall budget is still in deficit, the Government improved fiscal management in the SEPD I period, which registered a positive current budget balance in 1997, 1999, and 2000. With the introduction of the value-added tax in 1999, tax revenue more than doubled from KR446 billion in 1995 to KR1,040 billion in 2000, that is, from 5.9 percent of GDP to 8.8 percent of GDP. The structure of expenditures was also rationalized, as more funds were allocated to health, education, agriculture, and rural development areas than to defense and security.

12. Expanding economic activities under a stable social and political environment have boosted financial transactions and intermediation. M2[5] increased by 26.9 percent in 2000, mainly due to a 41.7 percent increase in foreign currency deposits.[6] During the same period, bank loans increased 31 percent to an equivalent of $249 million, while deposits increased 40 percent to an equivalent of $382 million. The increase in the loan volume occurred predominantly in the manufacturing and service sectors.

13. The increased financial intermediation was accompanied by reinforced dollarization of the economy, as the growth of bank deposits was driven by a sharp increase in foreign currency deposits. Dollarization delays the development of effective monetary policy and limits the outreach of formal financial intermediation into the rural and poor areas where local currency is used. Under SEDP II, the Government adopted a policy "to promote the de-dollarization of the

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[5] M2 is a broad monetary aggregate, which consists of currency in circulation, demand deposits, time and savings deposits, and foreign currency deposits in Cambodia.

[6] During the same period, Viet Nam exhibited a similar pattern in trends in monetary aggregate and foreign currency deposits. In 2000, M2 increased by 39 percent and the foreign currency deposits increased by 42.7 percent.

economy through sustained macroeconomic stability and financial sector reform with the development of local currency (Cambodian riel) – denominated asset markets."[7]

14. Achieving a sustainable high rate of economic growth is crucial to reduce pervasive poverty and to absorb the growing labor force with increased labor productivity and real wages. The Government has set a long-term, real annual GDP growth target of 6.0–7.0 percent under the assumption that the Government will successfully implement full-scale governance reform packages, assisted by ADB and other funding agencies, during the SEDP II period, including legal and judicial, public finance, civil service, and anticorruption measures. If the growth target is achieved, implying real annual GDP per capita growth at or above 4.0 percent, then it is expected that Cambodia can achieve a poverty ratio of 31 percent at the end of SEDP II, a 5 percent point reduction from the level in 1999.[8]

15. In the short term, Cambodia is expected to gradually recover with modest economic growth owing to export growth primarily in the garments sector, continued expansion of tourism, and recovery in agriculture from the flood-related contraction in 2000. With these factors considered, it is expected that Cambodia can achieve a 5.0 percent range of economic growth in 2001. In the long-term, agricultural productivity must rise above subsistence levels and the proportion of the population engaged primarily in agriculture must fall. The most important medium-term constraints to reaching that goal appear to be (i) the inability to mitigate the damages caused by flooding and drought, (ii) inadequate natural resource management (particularly forest and fisheries), and (iii) insecure land rights.[9]

IV. THE SECTOR

A. Background, Constraints, and Issues

1. Overview

16. Cambodia's financial sector is at a rudimentary stage with limited financial intermediation and low public confidence. Cambodia still has one of the lowest rates of banking intermediation in the world: in 2000, bank loans and deposits accounted for approximately 8 percent and 12 percent of GDP, respectively.[10]

17. In 1989, Cambodia started the transformation from a mono-banking system to a two-tiered system. In 1990, treasury operations were transferred to the Ministry of Economy and Finance (MEF) and the National Bank of Cambodia (NBC) was designated as a ministry and used largely to finance budget deficits. In 1996, NBC was established as the central bank with

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[7] The Ministry of Planning, Cambodia. 2001. First Draft of *the Second Five-Year Socioeconomic Development Plan, 2001-2005.* p. 10. De-dollarization needs a comprehensive policy framework to regain public confidence in local currency, which includes, among others, (i) sustained macroeconomic stability, (ii) provision of local-currency-denominated assets, and (iii) promotion of the money function of local currency. Improved financial intermediation with enhanced public confidence in the financial system would expedite the de-dollarization process. The proposed subprogram, combined with the Government's efforts in the three strategic areas, will contribute to de-dollarization by bolstering public confidence in the financial system.

[8] The Ministry of Planning, Cambodia. 2001. First Draft of *the Second Five-Year Socioeconomic Development Plan*, 2001-2005. p. 1.

[9] CER CAM 2000-14: *Country Economic Review, Cambodia*, December 2000.

[10] The levels of bank lending to GDP in Lao PDR and Viet Nam stood at 17 percent and 22 percent, respectively.

the promulgation of the Law on the Organization and Conduct of the National Bank of Cambodia (the Central Banking Law).

18. There has been steady progress in the Government's efforts toward financial sector development thanks to political stability. Following the establishment of NBC in 1996, the Government adopted the Law on Banking and Financial Institutions (the Banking Law) in 1999 and a new Insurance Law in 2000. Furthermore, from 2000, the Government embarked on a comprehensive bank restructuring program with the assistance of the International Monetary Fund (IMF), to enhance public confidence in the banking system and strengthen intermediation.

19. Currently Cambodia has 20 commercial banks as a result of NBC's relicensing program, which revoked the licenses of 12 nonviable banks. Other operating financial institutions are insurance companies, currency exchange bureaus, and microfinance institutions (MFIs). Banking activities are scarce in the rural areas, where microfinance operations of nongovernment organizations (NGOs) are the main and de facto providers of credit. The insurance sector is composed of a Government-owned insurance entity, Cambodia National Insurance Company (CAMINCO), which acts as regulator, underwriter, and broker; and four private insurance companies that are agents for CAMINCO and risk underwriters through fronting agreements. There are no recognized interbank and money markets and capital markets in Cambodia. Development of these markets will depend on such things as proper legal and accounting infrastructure, necessary regulatory and institutional structures, and human resource capacity.

20. Weak financial infrastructure hampers the development of the sector. First, Cambodia has yet to develop or strengthen laws pertaining to such things as accounting, insurance, negotiable instruments, secured transactions, commercial enterprises, bankruptcy, contracts, and commercial credit. Furthermore, public confidence in the legal and judicial system is extremely low. The lack of the rule of law has hampered the development of a formal, contract-based credit culture and thus has been one of the primary impediments to private sector development as well. Second, Cambodia has yet to adopt common accounting and auditing standards. Few companies produce financial statements, and different companies produce financial statements using different standards. Lack of common accounting standards and enforcement system has not only increased risk and the cost of banking operations, but has also prevented the early development of financial markets.

2. The Banking Sector

21. **Background.** To strengthen the banking system, NBC recently launched a comprehensive bank re-licensing program based on strengthened capital adequacy requirement and CAMELS rating system.[11] In November 2000, just before the first phase of NBC's bank relicensing program under IMF support, the commercial banking system consisted of 31 banks: 2 Government-owned banks, 22 locally incorporated banks, and 7 foreign bank branches. On 8 December 2000, NBC revoked the licenses of 12 banks classified as nonviable, and placed 13 banks classified as conditionally viable under memoranda of understanding (MOUs) requiring compliance with restructuring measures and the prudential regulations (i.e., the minimum capital requirement) by the end of 2001.

[11] A bank evaluation system is to assess the bank's soundness in terms of capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to the market.

22. The five largest commercial banks, including the Government-owned Foreign Trade Bank (FTB), hold more than 50 percent of total banking assets and deposits. Deposits in foreign currencies, predominantly US dollars, comprise 93 percent of total banking deposits. The US dollar is the primary medium of exchange with the Cambodian riel, which is used primarily in rural areas. The formal banking sector is concentrated in Phnom Penh, although 84 percent of the population resides in rural areas.

23. As of December 2000, the total assets of the banking system stood at KR2,517 billion ($644 million) or 20 percent of GDP. This represents an increase of 20 percent since the end of 1999. During the same period, loans increased 31 percent to an equivalent of $249 million, while deposits increased 40 percent to an equivalent of $382 million. Loan growth has occurred predominantly in the manufacturing and service sectors.

24. Despite the low level of lending, asset quality in the banking system is poor. According to NBC, the volume of nonperforming loans in the banking system is substantial and growing. Lack of common accounting standards and a uniform chart of bank accounts compounds concern about the accuracy of the reported nonperforming loans. The banking system provides a narrow range of financial instruments usually limited to demand, saving, and time deposits on the liability side. Loan portfolios tend to be confined to a narrow range of better-known firms. Moreover, most banks maintain a high level of liquidity with the percentage of cash to total assets at roughly 19 percent, and approximately 33 percent of total assets of the whole banking system appear to be nonearning assets.

25. High risks and operating costs associated with bank lending are reflected in both high interest rate spread and short-term lending. The spread between loan and deposit interest rates is estimated at 10 to 13 percentage points, as loan interest rates are around 20 percent per annum or higher. Typical loan maturity is three to six months. Term finance is unavailable, and banks are reluctant to provide loans with terms of one year or longer. To overcome this problem, the usual practice is to continue rolling over short-term loans.

26. **Constraints and Issues.** A number of factors contribute to the low level of intermediation, poor asset quality, and high operating costs of banks, which lead to poor public confidence and limited deposit mobilization. First, uncertainties regarding enforceability of security interests impede bank lending and contribute to poor asset quality. The collateral registration system is rudimentary and unreliable due to the absence of laws and regulations governing secured transactions as well as an inadequate public registration system that specifies lenders' positions and priority rankings in secured property. The system is cumbersome, as it forces banks and other concerned parties to go through several steps to identify, confirm, and register secured interest. In addition, lack of a proper collateral valuation system inhibits sound lending.

27. Second, lack of a reliable borrower information system impedes bank lending and leads to poor asset quality as well. Cambodia lacks a credit bureau or an arrangement for banks to share credit information. Further, few firms produce financial statements and no common accounting standards are enforced. Thus, banks are unable to lend based on cash-flow analysis due to lack of clients' financial information. Consequently, they are compelled to lend against collateral as the primary source of repayment, which is further compromised by the lack of infrastructure for secured transactions.

28. Third, rudimentary liquidity management mechanisms cause substantial opportunity losses to banks, increasing their operating costs. Except for occasional exchange of interbank

deposits among a few banks, there are no formal interbank market arrangements where banks can borrow or lend to manage liquidity. Thus, most banks maintain abnormally high levels of liquidity. Lack of interbank markets stems from, among others, the absence of mutual confidence among banks. In addition, although the Central Banking Law provides a legal basis for rediscount facilities,[12] NBC is unable to provide liquidity service to commercial banks to meet temporary liquidity shortages, because no eligible negotiable instruments (i.e., bills of exchange, promissory notes, etc.) are available due to lack of the necessary legal infrastructure (i.e., negotiable instruments law).

29. Fourth, weak supervisory capacity and a regulatory framework impedes early identification of banking problems, as well as the timely and orderly resolution of problem banks. Public confidence has been undermined mainly because the supervisory system failed to convince the public that all banks are under the oversight of the supervisory authorities, due to the apparent lack of systematic supervision and prudential regulations. In fact, the basic framework and capacity for on- and off-site supervision, as well as a prompt corrective action system are yet to be in place. Weak capacity and shortcomings in the legal and regulatory framework for bank liquidation have hampered and delayed early and orderly liquidation of delicensed banks. Both the existing bank regulations and the capacity of the Bank Supervision Department (BSD) of NBC need strengthening. In addition, the current system lacks a requisite basis for effective bank supervision and prudential regulations, such as a uniform chart of bank accounts and disclosure rules. Like their borrowers, commercial banks adopt different accounting standards. Furthermore, a review of sample financial statements of commercial banks revealed inconsistency in the quality of the audits performed by international firms partially due to the lack of common accounting and auditing standards in Cambodia.

30. Finally, the banking system suffers from scarce human resource and capacity. Capacity gap in the public sector is one of the most acute problems hampering banking sector development. The bank supervisory authority especially needs substantial capacity and institution building to properly discharge its responsibilities. The private sector also requires substantial capacity building. The Government's proactive market opening policy in the early stage of financial sector development has enabled Cambodia to attract many experienced foreign commercial bankers into the banking sector. As a result, most of the senior managers are experienced and competent bankers. However, most banks have difficulty in finding qualified working-level staff due to the legacy of long-standing domestic strife and international isolation. Thus, most working-level staff need substantial professional training in basic banking operations such as credit analysis, loan monitoring, and problem loan management.

3. Rural Finance

31. **Background.** The rudimentary banking system and its urban bias neither addresses the demand from the poor for microfinance to smoothen consumption, build assets, and develop microenterprises; nor is it structured to meet the demand from the middle and upper segments of the rural markets for financing commercial cultivation, agricultural-trading, and rural and agriculture related enterprises (e.g., rice milling and dairy).

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[12] "The Central Bank shall determine the procedures or repurchase from, sell to, discount and rediscount for banks and financial institutions: (a) bills of exchange and promissory notes drawn or made for bona fide commercial, industrial, or agricultural purposes, bearing two or more good signatures one of which must be that of a commercial bank and maturing within 90 days from the date of their acquisition by the Central Bank…; and (c) any private negotiable claims on the money market as well as all bankers claims bearing creditworthy signature and appearing on a list recognized by the Board," Article 36, the Central Banking Law.

32. Nearly 40 percent of the population has no access to formal bank branches. Only 6 percent of the total banking sector advances is for agriculture or related activities, primarily short-term, dollar-denominated loans. The estimated rural finance demand of $120 million-$130 million per annum, of which one third is for microcredit loans ranging from $50 to $300, is only fractionally met from institutional sources. Reliable savings facilities are generally not available in rural areas and to the poor.

33. Currently, about 90 NGOs supported by funding agencies provide microfinance to nearly 270,000 poor households, or 15 percent of the total. Most of the borrowers are women. The estimated aggregate outstanding microcredit is $17 million and savings mobilized amount to $1 million. Service delivery is through "village banks" comprising 100-200 members and managed by a village credit committee. Members are organized into groups, provided some basic training and individual credit with group liability. Loans varying from $50 to $300 are provided for 3-12 months, with equal installments and incentives for timely repayment. Interest rates on loans are 3.0–5.0 percent per month. Repayment rates are 80-95 percent. The balance of microfinance supply is from informal sources either based on reciprocity and social obligations or from money-lenders and input suppliers.

34. Cognizant of the issues, the Government adopted a rural credit policy with the aim to develop an effective rural financial system. It has initiated the following measures under the ongoing ADB-funded Rural Credit and Savings Project (RCSP) [13] and TA for Rural Financial Services: (i) introducing an enabling provision in the Banking Law for eligible NGOs and other rural finance service providers to become regulated licensed MFIs; (ii) creating a microfinance supervision department within NBC to undertake off-site and on-site supervision of licensed MFIs, and to monitor the financial activities of NGOs; (iii) establishing the Rural Development Bank (RDB) as an apex institution to provide financing for MFIs and commercial banks, and to extend technical support and training for MFIs; and (iv) enhancing collaboration between the Government, NBC, and NGOs in promoting sustainable rural finance. The Government intends to actively encourage the entry of commercial banks in rural finance, strengthen NBC's capacity to ensure orderly development of the sector, and make RDB a sustainable apex institution.

35. **Constraints and Issues.** While many factors contribute to poverty, its most obvious manifestation is insufficient household income, lack of productive assets, and inaccessibility of affordable financial services. The Government has prioritized the development of a policy and institutional framework for rural finance.

36. The demand and supply gap for institutional rural finance even at the current level of economic activities is significant. Demand for savings, though not quantified, is significant and largely unmet due to the absence of (i) reliable savings facilities, (ii) appropriate products, (iii) high cost of service delivery, (iv) inaccessibility, and (v) relative inexperience of NGOs in managing savings. The supply side is dominated by microcredit characterized by short-term loans. The supply of term credit for agriculture and rural sectors is seriously constrained by lack of institutions capable of delivering and managing term credit, and lack of long-term funds. The latter undermines the efforts of agricultural diversification and export promotion. Weak contract enforcement also deters term financing. The network, orientation, institutional capability, and financial health of commercial banks combine to make them only marginal suppliers of short-term rural finance.

[13] Loan 1741-CAM: *Rural Credit and Savings Project*, for $20 million, approved on 20 April 2000.

37. The majority of the NGOs, the sole as well as de facto suppliers of microfinance in rural areas, exhibit (i) a poorly motivated part-time volunteer workforce; (ii) weak systems and procedures; (iii) reliance on Government and external assistance; (iv) lack of commitment to sustainability; and (v) little, if any, realization of the need to specialize for efficient delivery of financial services.

4. The Insurance Sector

38. **Background**. Although the insurance sector is still at its nascent stage, there will be substantial potential for growth once adequate legal and regulatory infrastructure is put in place. For example, legislative actions to require a third-party-liability motor insurance and life insurance would create substantial demand for insurance to comply with the laws and regulations. The insurance sector plays an important role in mobilizing long-term domestic resources, complementing the intermediation role of the banking sector, even in the early stage of financial sector development as demonstrated in many developing countries.

39. The insurance sector consists of the Government-owned insurance entity CAMINCO, which acts as regulator and underwriter, and four private insurance companies that act as agents for CAMINCO. As part of the current restructuring and corporatization program, CAMINCO will be transformed into a private company through joint venture with one of the private insurance companies. The Government is expected to sign up a joint-venture agreement with the candidate company soon, in which MEF will still hold the lion's share.

40. Most policy purchasers in Cambodia are foreign investors and international organizations. And the main sources of business include property, health, marine cargo, and motor vehicles. CAMINCO has also made reinsurance arrangements with foreign partners in the region and European countries. Other products expected in the future are livestock insurance, crop insurance, and life insurance.

41. The year 2000 was a watershed period in insurance sector development. The National Assembly adopted a long-awaited Insurance Law in July 2000, and the Government committed itself to gradual commercialization and privatization of CAMINCO. The new Insurance Law covers: general provisions; property insurance, life, and personal insurance; compulsory third-party-liability motor insurance; construction insurance and insurance for passenger transport; insurance company and state control; insurance agents and brokers; and legal penalties. The Government is now drafting a subdecree that will flesh out detailed prudential regulations and procedures to implement the law. The first draft was submitted to the Council of Ministers for approval in March 2001, and is expected to be effective this year.

42. As part of the commercialization/privatization effort of CAMINCO, its regulatory responsibility was transferred to the Insurance Office that was established under the Financial Industry Department of MEF in March 2001. Key officials in the Insurance Office were transferred from the supervisory unit of CAMINCO. The Government also nominated the former president of CAMINCO as the Insurance Commissioner.

43. **Constraints and Issues.** The insurance sector has been constrained by weak supervisory and regulatory framework and capacity, let alone low income and lack of public awareness of the insurance sector. Although the Government adopted the Insurance Law in 2000, it has yet to adopt a subdecree implementing the law and basic prudential regulations on such things as uniform chart of accounts, disclosure rules, investment guidelines, and solvency requirements.

44. Second, an effective enforcement and monitoring mechanism to implement compulsory insurance needs to be established. While the introduction of compulsory insurance in the Insurance Law (i.e., compulsory third-party-liability motor insurance, construction insurance, and insurance for passenger transport) was hailed as a breakthrough by the private sector, compulsory insurance cannot be fully implemented by a framework law alone. Implementation critically relies on a well-organized enforcement and monitoring system that is supported by a couple of supporting laws that require the purchase of compulsory insurance policy. This, in turn, requires interministerial efforts and coordination.

45. Third, the framework for private sector development in the insurance sector needs to be strengthened. The introduction of compulsory insurance is expected to create a policy-driven demand for insurance. However, without a framework that fosters fair competition between state-owned and private companies, and between incumbent and prospective companies, the compulsory insurance market will be susceptible to distortions in pricing and quality of services, which will in turn undermine public confidence in compulsory insurance. The Government has already taken an important initiative toward private sector development by adopting a privatization policy for CAMINCO. However, a couple of issues remain to be addressed. The Government should exert efforts to divest its ownership in the insurance sector. Since MEF is now responsible for insurance supervision, the Government's holding the lion's share in the largest insurance company will not only pose conflict of interest in supervision, but also undermine fair competition. Thus, the partial privatization of CAMINCO through joint venture should be ultimately linked to divestiture of the Government shares in the joint venture in the medium-term. Secondly, the Government needs to develop a transparent entry mechanism, to foster competition by giving equal opportunities to both state-owned and private companies.

46. Finally, the new insurance supervisor needs substantial capacity building. MEF has successfully retained experienced regulators from CAMINCO, but additional staff and substantial capacity building are still needed to help them discharge responsibilities anticipated under the Insurance Law, as well as to undertake the development role in the insurance sector. Recently, the authorities sought international cooperation, such as from the Malaysia Insurance Institute, in training the current supervisory staff and establishing an insurance training institution in Cambodia over the medium term. Capacity building must target the key staff in the Insurance Office of MEF, as well as those in the line ministries, which will be involved in enforcing and monitoring for compulsory insurance.

5. Interbank and Money Markets

47. **Background.** There are no recognized interbank and money markets operating in Cambodia other than intermittent occasional exchange of deposits among a few banks who trust each other. The lack of interbank markets increases banking operating costs. Since there is no way to manage liquidity, most banks are forced to maintain a high level of non-earning assets, incurring opportunity costs. The percentage of cash to total assets amounts to roughly 19 percent, and 33 percent of total assets are nonearning assets.

48. **Constraints and Issues.** Several factors hinder the establishment of interbank/money markets in Cambodia. First, lack of mutual confidence among commercial banks hinders interbank market service. There must be a forum to build mutual confidence among banks and to discuss a common policy agenda. To begin with, commercial banks need to work together to establish an inclusive bankers association and obtain official recognition from the authorities. Second, lack of a legal basis for money market instruments also hinders the development of

interbank markets. To improve the current situation, establishing a legal basis for negotiable instruments must be a prime consideration in legislation.

6. Capital Markets

49. **Background.** Under the Prime Minister's initiative, the Government has made considerable efforts to lay the foundation for capital market development. The Government drafted a capital market law in 1995; unfortunately, this initiative was interrupted due to the political disturbance in 1997. Even after 1997, little progress was made owing to the delay in developing the requisite financial and legal infrastructure.

50. With progress in the governance reform assisted by ADB and World Bank, the Government is now renewing its efforts for capital market development. For instance, the Government has established a capital market unit in MEF. The Government is also drafting a subdecree to create an independent securities supervisory body responsible for attending to all of the functions of capital markets and bringing about its full operation.

51. On the other hand, the Central Banking Law (1996) assigns to NBC the responsibility for establishing and overseeing financial markets. According to the law, NBC has duties and functions in forming and supervising the money and financial markets. In addition, the Central Banking Law empowers NBC to conduct securities operations to facilitate the registration, distribution and trade of securities issued by the Government (Title VI, Article 23). NBC will have to delegate these powers to the Securities and Exchange Commission (SEC) once the latter is created.

52. **Constraints and Issues.** Capital markets cannot go forward until proper accounting, legal, and other financial infrastructure are in place and the legal and accounting professions are organized and operational. Not only is it necessary to draft and pass the key laws currently under preparation; the implementing institutions must be formed and developed. More importantly, there must be a critical mass of potential listing companies who are willing to accept higher standards of corporate governance and capable of producing audited financial statements. Thus, the Government needs to conduct a feasibility study to assess a critical mass of issuers in line with the promulgation of the law on commercial enterprises.

7. Legal Infrastructure

53. **Background.** Financial sector development depends on an adequate body of laws that include such things as contracts, bankruptcy, collateral, and loan recovery. To enforce these laws, a body of ethical and professional lawyers and judges, and a reliable and efficient court system whose decisions are enforceable must be in place.

54. A civil code and procedures are currently being drafted with assistance from Japan International Cooperation Agency. These laws will provide a legal basis from which stakeholders in the financial sector will obtain their rights and liabilities and their causes of action. The civil code should be drafted to ensure certainty in basic contract law principles, including rights attached to securities and rules governing the transfer of those rights. Because these laws are yet to be in place in Cambodia, specific legislation can supplement the deficiency.

55. The Ministry of Commerce (MOC) has submitted to the Council of Ministers a draft law on commercial enterprises that is being debated and is expected to be submitted to the National

Assembly this year. It is expected that the National Assembly will adopt the law by mid-2002. In May 2000, Cambodia ratified adherence to the New York Convention on commercial arbitration, and is now drafting a commercial arbitration procedure. MOC is also drafting a bankruptcy law and a secured transactions law.

56. The Government is moving forward with judiciary reform as an integral part of governance reform. The Government has adopted the Governance Action Plan, which underscores the importance of human resource development, court inspection, and infrastructure. Moreover, the Ministry of Justice has drafted a law on the organization and function of a court system, which includes establishing a commercial chamber and four other chambers in the district court. The Council of Ministers is currently reviewing the draft.

57. **Constraints and Issues.** The Government needs to exert efforts to prioritize the adoption of necessary laws that it can expedite the legislation process. With regard to financial sector development, laws pertaining to commercial transactions including accounting, negotiable instruments, secured transactions, commercial enterprises, bankruptcy, and contracts must have first priority. The law on corporate accounts, their audit, and the accounting profession (accounting and auditing law) and law on commercial enterprises must be established to lay the foundation for capital market development. Afterwards the Government may proceed to adopt a securities and exchange law (or redraft the capital market law).[14] In line with the adoption of the law on commercial enterprises, a bankruptcy law must be adopted, particularly to bolster the liquidation of banks delicensed on 8 December 2000. In addition, a secured transactions law and negotiable instruments law must be established to underpin banking and commercial activities.

58. The establishment of a law enforcement mechanism should also be addressed in a systematic way. Most importantly, the Government should move forward with the judicial reform addressed in the Governance Action Plan. With regard to financial sector development, the Government should also draft a plan to establish a public registration system for secured transactions and make efforts to maintain public confidence in such an enforcement mechanism.

8. Accounting and Auditing System

59. **Background.** Cambodia has yet to adopt common accounting and auditing standards and to establish an enforcement mechanism. MEF's Commission for Accounting Reform has endorsed the adoption of International Accounting Standards (IAS)/International Standards on Auditing (ISA) as core principles of accounting standards, and has submitted a draft accounting and auditing law to the Council of Ministers for consideration.

60. Currently, the local offices of two international accounting firms and several local firms undertake most of the auditing services in Cambodia. The international firms together employ a staff of approximately 125 and serve about 400 clients, of which 30-40 percent are private sector companies. Many private sector companies are the local affiliates of international

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[14] Such recommendation on the sequence of legislation is also supported by a previous ADB study on Cambodia's financial management and governance issues. The study suggests that "The current draft Capital Market Law and the draft Law on Commercial Enterprises be reviewed and replaced by a comprehensive Law on companies and, at the appropriate time, a further law be drafted regarding the establishment of a Securities and Exchange Commission and a Stock Exchange." See Narayan, F. B., and T. Gordon, 2000. *Financial Management and Governance Issues in Cambodia: Diagnostic Study of Accounting and Auditing*. Manila: Asian Development Bank.

companies and the audited information is sent to the home office for inclusion in the consolidated accounts. At present most senior accountants and all the managers are expatriates. Both international firms have looked into certification of Cambodian staff using programs from the Association of Chartered Certified Accountants. Although the inspections may be taken locally, this program is very expensive as the training courses are offered in Viet Nam. The demand for trained auditors is expanding rapidly and will increase dramatically once an accounting and auditing law and common standards are established.

61. NBC has a broad legal mandate to regulate nearly all issues related to accounting and auditing of banks. This goes beyond the usual prudential regulations to include establishing the rules for measurement, recognition, and disclosure in the financial statements and consolidation of accounts. The Central Banking Law also permits NBC to establish the banking sector accounting standards separate from the tax regulations. NBC has drafted a uniform chart of accounts for banks. Most of the accounting policies are taken verbatim from the “Framework for the Preparation and Development of Financial Statements” published in July 1989. However, there are some substantive changes so that the resulting financial statements will not be in accordance with IAS.

62. **Constraints and Issues.** Given the importance of the accounting and auditing system in Cambodia, the Government needs to expedite the promulgation of the accounting and auditing law and the adoption of common accounting and auditing standards.[15] While the Government has already committed to adopt IAS/ISA in their entirety, it should carefully work out an implementation plan to phase in IAS/ISA, considering the limited capacity and compliance cost of the private sector.

63. The Government should play a pivotal role in establishing an enforcement system for accounting and auditing standards. Upon adoption of the accounting and auditing law, the Government should establish an accounting standards authority as well as a professional association of accountants and auditors. An association serves a number of important regulatory functions in the public interest. In the early stages of development, an association can provide a forum for practitioners to communicate with the Government and educational institutions. An association can also play a role in communicating best practices to members and thus help to reduce the cost of training staff members by combining the resources of member firms. A more mature association can assume regulatory functions, including certification of new auditors and enforcement of a code of ethics, and may offer continuing education programs. The draft accounting and auditing law included provisions for creating a national accounting council and an institute of Khmer auditors and accountants under the aegis of MEF. The international best practice for such organizations is that they be private sector entities. However, regardless of how responsibilities are divided, there is an urgent need for establishing such an association.

9. Human Resource Development

64. **Background.** Lack of human resource capacity is a major impediment to financial sector development in Cambodia. There is great need for formal training in core skills (e.g., banking,

[15] The rationale for adoption of international standards is that, first, it is time-consuming and expensive to develop national standards; second, it is also time-consuming for users to learn national standards in addition to IAS. Even the largest economies today are moving toward adoption of IAS.

accounting, statistical analysis, and general management) and specialized competencies for the effective operation of a market-driven economy in both public and private sectors.

65. A number of institutions and organizations play a role in developing of human resources for the financial sector in Cambodia. They include universities and business schools, commercial banks, bankers associations, the Centre for Banking Studies (CBS) under NBC, and MEF. Each commercial bank operating in Cambodia assumes individual responsibility for its internal training program. The commitment of resources to training differs from bank to bank. Foreign commercial banks normally send their employees for training overseas. Capacity building activities for NBC are primarily undertaken by CBS. CBS was established in 1995 for NBC staff; since 1996, it has been transformed into a broader training facility for both NBC and outsiders (high school graduates). CBS currently offers a 2.5 years (5 semesters) associate's degree program, recognized by the Ministry of Education. As of July 2000, CBS has graduated 443.

66. **Constraints and Issues.** While CBS has contributed initially to filling the capacity gap in the early stage of banking development, the scope and quality of training services are not enough to meet the needs of the private sector and so it remains a training school for entry-level NBC employees. At this time, all CBS instructors are working part-time and salary payments are still largely based on academic degrees rather than teaching ability. CBS instructors receive hourly compensation, considerably less than that typically paid by the business universities. Therefore, CBS has been unable to attract a sufficient number of qualified instructors.

67. Commercial banks will continue to send their employees outside of Cambodia at high cost until adequate training is available in the country. Many commercial banks have indicated the need for a professional training program in Phnom Penh; they further indicated, however, that they will only send their employees to training that is practical and relevant, and taught by experienced bankers. One reason for the absence of professional training is the difficulty of hiring qualified instructors with the practical commercial banking experience necessary to teach courses such as credit analysis, letters of credit, foreign exchange, bank operations, and assets/liabilities management.

68. A bankers association is the logical home for a professional training program for bankers. By pooling their resources and using experienced commercial bankers to teach training programs, a bankers association can be an effective means for providing training to the commercial banking sector. Upon creation of a comprehensive bankers association, the association should first establish a professional training program. The training program should also be open to staff of MFIs.

B. Government Objectives and Strategy

69. ADB has supported the Government in developing its long-term vision and development strategy and plan for the financial sector. The objective of the long-term development plan is to develop a sound, market-based financial system that is competitive, integrated, and efficient. The long-term vision is that the financial sector will double in size relative to GDP in 10 years. The vision will be achieved by ensuring the following:

(i) a competitive, safe, and sound banking system that is well regulated and supervised and effectively mobilizes savings to provide financing to support the growth of the private sector;

(ii) the establishment and development of nonbank financial institutions that increase the depth of the financial sector by providing a broad array of diversified services including leasing and consumer finance;

(iii) an insurance sector that protects businesses and individuals from catastrophic events and a pension system that provides a secure retirement, both of which provide capital for long-term investment in the real sector;

(iv) a safe and reliable system for the transfer of funds between customers and banks and the settlement of payments between banks;

(v) money markets that facilitate interbank markets that provide banks, companies, and individuals with the means for effectively managing liquidity;

(vi) efficient and transparent capital markets with a critical mass of issuers that mobilizes funds for long-term investment;

(vii) a legal system that promotes and enforces the rule of law in commercial and financial transactions and that supports good governance by promoting transparency, accountability, participation, and predictability;

(viii) an accounting and auditing system based on international standards that supports good governance by promoting transparency, accountability, participation, and predictability; and

(ix) human resource development based on performance-based compensation and promotion, and the availability of a broad range of professional programs that retrain existing staff and provide ongoing training.

70. To achieve the long-term vision, the Government has adopted a long-term strategy for the financial sector to

(i) maintain sound fiscal and monetary policies to ensure macroeconomic stability;

(ii) establish systematically a sound legal framework to protect property rights and enforce contracts;

(iii) establish the rule of law through legal/judicial reform and law enforcement to underpin financial and commercial activities;

(iv) sequence efforts to develop financial infrastructure, particularly a payment/clearing system, accounting and auditing system, credit information system, and regulatory framework;

(v) structure the regulatory and policy framework to foster competition in the financial markets and to encourage financial institutions to realize economies of scale and scope;

(vi) establish a regulatory and institutional framework to promote sound governance principles and to allow market discipline to work in the management and operations of financial institutions;

(vii) establish a sound framework for private sector development in the financial system by phasing out state ownership and state intervention in the system;

(viii) develop a transparent entry framework to encourage allocation efficiency and financial deepening;

(ix) develop an efficient exit mechanism for troubled institutions (such as liquidation, merger and acquisition) to foster continuous reorganization in the financial system without incurring social costs; and

(x) develop human and institutional capacity in both private and public sectors through a public-private sector partnership.

71. Under the long-term strategy, the Government has adopted the long-term financial sector development plan, or the Financial Sector Development Blueprint as its official financial sector development plan. The FSPL is a critical component to support the Government's implementation of Phase I of the Blueprint.

C. External Assistance to the Sector

72. In addition to ADB, IMF has been a major contributor to Cambodia's financial sector development. Since 1994, IMF has provided support to develop Cambodia's monetary policy and central bank operations. In October 1999, IMF approved the Poverty Reduction and Growth Facility (PRGF) for Cambodia for SDR58.5 million (equivalent to $81.6 million) to support the Government's economic program for 1999-2002. The reform agenda under the PRGF includes

(i) avoiding central bank financing of the budget (1999-2002);

(ii) completing on-site inspection for all private banks (1999);

(iii) improving supervision capacity, including strengthening staff capacity and setting supervision guidelines (1999-2002);

(iv) strengthening the legal framework by adopting a new law on commercial banks and financial institutions (November 1999);

(v) relicensing all existing commercial banks under the new Banking Law and close down those that do not comply with the law (2000-2002); and

(vi) restructuring the FTB (1999-2001).

73. IMF's recent review mission noted Cambodia's "strong" performance reflected in "a resumption of growth, low inflation, and significant progress in major areas of structure reform," and supported the tranche release of the PRGF.[16] In banking reform, it noted NBC's action in closing nonviable banks, and emphasized the importance of closely monitoring the conditionally viable banks, which are under restructuring MOU. It also urged the Government's "timely action when those MOU banks do not meet the requirements."

[16] IMF. 2001. *Cambodia: Second Review Under the Poverty Reduction and Growth Facility*.

74. The World Bank has been assisting in drafting an accounting and auditing law. Together with ADB,[17] the World Bank also assists the Government in adopting IAS/ISA and establishing enforcement mechanisms such as an accounting and auditing standard board and an accounting professional association. In addition, based on ADB's seminal work in governance reform,[18] the World Bank joined ADB and the United Nations Development Programme to help the Government in adopting the Governance Action Plan.

75. The International Finance Corporation (IFC) is assisting Cambodia in financial sector development through TA and the Mekong Project Development Facility (MPDF). One TA was launched in February 2001 to help the Government formulate the restructuring and privatization plan for FTB. The TA focuses on advising the Government on the approach to restructuring and privatization without getting involved in the actual process. Another TA under consideration intends to assist in training future capital market regulators in anticipation of the establishment of a SEC and securities exchange in the near future. MPDF, an IFC facility, is to assist and accelerate the development of productive, self-sustaining small- and medium-sized enterprises (SME) in Cambodia, Lao People's Democratic Republic (Lao PDR), and Viet Nam. MPDF is also charged with improving the enabling environment for SME development. The principal activities of MPDF cover two areas: investment evaluation and preparation, and in-country development program. Specifically, it facilitates bank lending to SMEs through bank training, developing the bankers association, and a TA to one of the leading local commercial banks. In addition, MPDF aims at developing new forms of financing, such as trade financing facilities, leasing, and venture capital.

D. ADB's Operations and Strategy in the Sector

76. ADB's country operational strategy specifies three priority areas: (i) support for pro-poor, sustainable economic growth through interventions to relieve key constraints to broad-based agricultural growth; (ii) a focus on human resource development; and (iii) development of an enabling environment for the private sector through selected interventions in transportation, finance, and energy.

77. ADB's assistance to the finance and industry sector consists of four advisory TA (ADTAs) and one project preparatory TA (PPTA): (i) Cambodia Development Bank ($31,000), approved in January 1973; (ii) Institutional Strengthening of the CBS and State-Owned Banks' Staff Training ($340,000), approved in May 1995; (iii) Strengthening Capacity in the Trade and Industry Sectors ($600,000), approved in May 1996; (iv) Enhancing Banking Skills ($400,000), approved in May 1997; and (v) PPTA for the FSPL ($800,000), approved in July 2000. In the rural finance sector, a PPTA on Rural Credit & Savings ($600,000) was approved in June 1997. ADB launched a $20 million Rural Credit and Savings Project Loan in April 2000. For SME development, ADB is supporting MPDF under a regional TA for Small- and Medium-Sized Enterprises Growth and Development in the Mekong Region ($750,000), approved in November 2000; and approved an equity investment of $5 million in the Mekong Enterprises Fund in August 2000.

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[17] ADB has provided a comprehensive diagnostic study of accounting and auditing to help develop an accounting and auditing standards and enforcement mechanism consistent with international standards. See Narayan, F. B., and T. Gordon, 2000. *Financial Management and Governance Issues in Cambodia: Diagnostic Study of Accounting and Auditing*. Manila: Asian Development Bank.

[18] Kato, T., J. A. Kaplan, Chan Sophal, and Real Sopheap. 2000. *Cambodia: Enhancing Governance for Sustainable Development*. Manila: Asian Development Bank.

78. ADB undertook a financial sector strategy study in 1999 that produced a preliminary road map for financial sector development over the next 20 years. Based on the preliminary road map, ADB provided a PPTA for preparing a financial sector development program, completed the in-depth diagnostic review of constraints to the financial sector, and produced a long-term financial sector vision and three-stage sector development plan, or the Financial Sector Blueprint for 2001-2010.

79. The Blueprint comprises a long-term development strategy and subsector development plan. The long-term strategy is developed based on key lessons from the experiences of financial sector development and reform in Asia and other transition economies. The long-term objective is to guide the subsector development strategy. Each subsector development plan consists of a development goal, intermediate reform agenda, and illustrative policy measures in each phase. The development goal describes the subsector strategy to achieve visions in each subsector over three phases: 2001-2004, 2005-2007, and 2008-2010. The intermediate agendas are selected to help (i) identify specific policy measures to achieve the set goals, and (ii) sequence and pace such policy measures. At the same time, a series of reforms over three phases suggest sequencing tactics for development efforts in a specific subsector. These reform agendas, however, include built in flexibility, to enable policymakers to add or refine the agenda to reflect development progress in each subsector and each phase in concert with changing financial market conditions.

E. Lessons Learned

80. Experiences from financial sector development and reforms in Asian economies and other transition economies (for example, Viet Nam and Lao PDR) are well-documented in various studies and by ADB and other aid agencies' project experiences, and offer valuable lessons to consider for financial sector development in Cambodia. In developing a long-term strategy and program loan for financial sector development, the following are noteworthy:

(i) A sound fiscal policy and price stability are the preconditions for a well-functioning financial system.

(ii) The financial sector will not develop without public confidence in protection and security of property rights and contract enforcement.

(iii) A sound financial sector cannot be created without establishing the rule of law, supported by appropriate legal/judiciary system and law enforcement.

(iv) For efficient financial intermediation, it is necessary to develop the financial market infrastructure, particularly an accounting and auditing system, a credit information system, and a regulatory framework.

(v) Sound competition in financial markets is one of the key driving forces that lead to financial deepening by encouraging financial institutions to achieve economies of scale and scope.

(vi) A sound financial system builds on sound governance principles and strong market discipline, which support a strong credit culture.

(vii) State ownership of financial institutions and state intervention in the allocation of financial resources hinder the development of a market-based financial sector.

(viii) Strict entry regulation in financial industries is one of the factors that adversely affect financial development and the allocational efficiency of investment funds.

(ix) Lax entry requirements under a weak supervisory system result in an excessive number of poorly managed banks.

(x) For sustainable financial sector development, it is crucial to build up market-oriented management and a sound system of operations and improvements in technical competence**,** commensurate with the desired change in the financial structure.

81. ADB's experience in program lending in the financial sector also offers, among others, the following valuable lessons in designing a program:

(i) A program loan should focus on establishing the process of reform rather than quantitative outcomes and single, static events (process design over blueprint; being clear on where we are going as well as on how to get there).

(ii) Policy conditions should be front-loaded rather than back-loaded.

(iii) The program should build in flexibility to accommodate a dynamic environment in which reforms must be made (cluster program modality, periodic review, and recalibration of targets).

(iv) If passage of legislation is critical, then it should be an up-front condition.

V. THE PROGRAM

A. Rationale

82. A sound, efficient, and integrated financial system is fundamental to achieve broad-based, sustainable economic growth, and help meet the country's social and economic development objectives, particularly poverty reduction. Numerous constraints have hampered financial intermediation: (i) uncertainties regarding law and contract enforcement due to lack of an adequate body of laws and a deficient judicial system, (ii) high operating costs due to the absence of liquidity management mechanism and other market infrastructure, (iii) high information costs due to lack of common accounting and auditing standards and other infrastructure for borrower information, and (iv) weak supervisory system and capacity. A sound and efficient financial system will give impetus to broad-based economic growth and poverty reduction by enlarging job opportunities and enhancing the outreach of the formal financial sector to the poor and rural areas.

83. An efficient financial system will be the first step to lay the foundation for the private sector development. In a survey of SMEs by IFC,[19] difficulties in access to credit and other

[19] Webster, L., and D. Boring. 2000. *The Private Manufacturing Sector in Cambodia: A Survey of 63 Firms*. Mekong Project Development Facility, and International Finance Corporation.

financial services were cited as one of the major impediments to the development of SMEs and the private sector as a whole. Thus, a sound and efficient banking system providing credit and financial service is crucial.

84. A sound and efficient financial system is also essential for attracting foreign direct investment, which has been the pillar of industrial development in Cambodia. Foreign investors invest in countries with sound governance that fosters transparency, accountability, predictability, and participation by the private sector in the formulation of laws and regulations. A sound and efficient financial sector is an important indicator of good governance.

85. A robust financial sector will protect the economic system from exogenous shocks that are becoming more common with the continued globalization of the economy and financial markets. Those countries in Asia with the strongest legal and bank supervisory frameworks had stronger resistance to the negative impact of the Asian financial crisis than the countries with weak legal and bank supervisory frameworks.

B. Objectives and Scope

86. The primary goal of the FSPL is to promote the development of a sound, market-based financial system to support enhanced resource mobilization and sustainable economic growth by establishing the foundation for banking and insurance sectors as well as financial markets. The FSPL will focus on the following activities:

- (i) enhancing banking intermediation and public confidence by establishing and strengthening banking supervision, developing key information infrastructure and safety nets, and building capacity in both public and private sectors by reinforcing capacity-building institutions;
- (ii) establishing legal and regulatory frameworks for insurance development by instituting a supervisory system and prudential regulations, fostering private sector development in the insurance business, and developing enforcement/monitoring mechanism for compulsory insurance;
- (iii) laying the foundation for the development of interbank/money markets through public-private sector partnership and establishing a basic legal framework; and
- (iv) developing financial market infrastructure by establishing common accounting standards and enforcement mechanism and promulgating laws to underpin commercial activities and financial markets.

C. Policy Framework and Actions

87. The FSPL is based on the Blueprint and ADB’s previous assistance in, among others, governance reform (footnote 18) and the development of an accounting and auditing system (Narayan and Gordon, footnote 14). The policy reform package of the FSPL focuses on strategic policy reforms identified in Phase I of the Blueprint. Limited capacity and weak governance structure in Cambodia call for flexibility as well as strong leverage in the program structure, to push forward with needed reforms. Thus, the FSPL proposes to adopt a program cluster approach with three back-to-back subprograms (Appendix 3).

1. Banking Sector Development

88. The FSPL will focus on key policy agenda for banking sector development identified in the Blueprint, which includes, among others, (i) strengthening bank supervision and prudential regulations, (ii) supporting bank restructuring under the IMF PRGF program, (iii) developing banking sector infrastructure and safety net, and (iv) strengthening capacity-building institutions.

a. Strengthen Bank Supervision and Prudential Regulations

89. While NBC has made substantial progress in establishing basic supervisory framework and prudential regulations with IMF assistance, many areas are to be addressed to strengthen supervision and prudential regulations. First, old and new prudential regulations need to be reconciled. Some old and new regulations address the same topics. Some regulations do not appear among the new regulations, but language used in the new prudential regulations does not explicitly cancel the old regulations.

90. Second, the BSD of NBC must continue to strengthen its organizational structure and capacity to effectively discharge supervisory responsibilities. BSD has yet to appoint adequate staff in the on-site inspection unit. BSD off-site surveillance staff have begun to be introduced to on-site inspection procedures with the help of an IMF TA and with the aid of an IMF-prepared on-site inspection handbook. However, BSD needs to adopt comprehensive formal inspection and surveillance procedures to guide its staff. BSD also needs to further develop prudential regulations to effectively deal with problem banks at an early stage of the problem.

91. NBC should institutionalize an anti-money-laundering policy to safeguard the banking system against money laundering and bolster public confidence. While the authorities recognized the importance of safeguarding the banking system against criminal activities as they included an explicit clause in the Banking Law addressing anti-money-laundering activities, a regulation against money laundering has not been fully instituted due in part to lack of a sense of urgency. It is time for the authorities to adopt regulations against money laundering, such as the compulsory reporting to NBC and other law enforcement authorities of suspicious cash transactions, especially large cash transactions above some minimum threshold.

92. To address this policy agenda, the FSPL will support the strengthening of banking supervision through the following measures: (i) reconciling old prudential regulations with new regulations and issuing clarifying guidance to commercial banks, (ii) fully staffing the on-site inspection division of BSD, (iii) adopting surveillance and inspection procedures including standardization of reports submitted by commercial banks, (iv) adopting a prompt corrective action system, and (v) adopting an anti-money-laundering regulation.

93. Policy components regarding bank supervision addressed above are applied to RDB and MFIs with or without minor adaptation (Appendix 3), so that the FSPL will complement the RSCP approved in April 2000. RCSP in fact builds in direct linkage with the FSPL in terms of supervision and prudential regulations, through which policy components in the FSPL will be directly applied to rural financial institutions such as RDB and MFIs. Under RCSP, RDB is required to comply with an audit and full compliance with recommendations in the audit, and bank regulations and the reporting requirements set by NBC on its financial performance. These are related to a uniform chart of bank accounts and disclosure rules and on- and off-site

supervision procedures under the FSPL. In addition, MFIs are also required to maintain full compliance with NBC's regulations for licensing, circulars, and reporting requirements.[20]

b. Support Bank Restructuring

94. The FSPL will support the completion of the bank restructuring program under IMF PRGF. To complete bank restructuring, the Government needs to address two important areas. First, the Government needs to expedite liquidation of closed banks and to prepare itself to deal with conditionally viable banks, that do not meet the conditions specified in the bank restructuring MOU. Second, the Government should exert systematic efforts to instill commercial orientation in the state-owned FTB that was recently separated from NBC and will be privatized by 2001 under the IMF program. To facilitate bank restructuring, the FSPL supports a comprehensive training program for FTB, including accounting, risk management, asset/liability management, and a management information system.

c. Develop Banking Sector Infrastructure and Safety Net

95. Lack of borrowers' information and uncertainties regarding law and contract enforcement hamper the banking operation and undermine public confidence in the banking system. To alleviate information asymmetry and uncertainties in the credit markets, the FSPL supports the development of key banking sector infrastructure and safety net in a phased way.

96. First, the FSPL will assist the Government in developing information infrastructure. Along with the adoption of common accounting standards consistent with IAS/ISA, the FSPL will support the adoption of a uniform chart of bank accounts and disclosure rules for commercial banks, consistent with IAS. The uniform chart of bank accounts and disclosure rules will lay the foundation of effective banking supervision, and will instill market discipline in bank operations. The FSPL will also assist NBC in establishing arrangements for sharing credit information in close cooperation with a bankers association. Desirably, the arrangements need to be operated by the bankers association under the general guidance of the supervisory authority. Thus, the FSPL will first support the establishment of an inclusive bankers association with articles of association approved by NBC, and will ensure that the approved articles of association include a mandate to establish and operate an arrangement for banks sharing of credit information.

97. Second, the FSPL will support the establishment of a secured transactions system to enable the enforcement of secured interest. The FSPL adopts a step-by-step approach to develop the system. It will support the adoption of a secured transactions law and development of a plan to establish a public registry, and then the establishment of the registry. While the establishment of a secured transactions system will be an important step to facilitate banking operation, the system will not function fully unless the public gains confidence in the judicial system and law enforcement. Thus, the Government should push forward with the governance reforms envisaged in the Governance Action Plan.

98. Third, along with the establishment of basic infrastructure, the FSPL will initiate the development of a banking sector safety net to bolster public confidence in the banking system. The bank relicensing program aims at enhancing the soundness of the banking system by facilitating the exit of nonviable banks, and thus eventually boosts public confidence in the system. However, at least in the short term, depositor confidence in the banking system has

[20] Loan 1741-CAM: *Rural Credit and Savings Project*, for $20 million, approved on 20 April 2000.

suffered due to bank closures and delays in the liquidation process. Thus, after the relicensing program is completed, with appropriate recapitalization and restructuring, the Government should consider introducing a small-depositor protection system. To support the authorities' effort, the FSPL includes developing a plan to establish a deposit insurance system to safeguard small depositors of commercial banks.

99. Weak contract enforcement and uncertainties have been major impediments to the development of rural finance. Strengthening contract enforcement by developing a secured transactions system will facilitate rural finance. The FSPL also explicitly supports the application of a uniform chart of bank accounts and disclosure rules (based on IAS) to RDB, other specialized banks, and licensed MFIs. Considering the limited capacity of MFIs compared with commercial banks, the FSPL envisages the application of a uniform chart of accounts and disclosure rules to RDB, other specialized banks, and MFIs under Subprogram III (Appendix 3).

d. Strengthen Capacity-Building Institutions

100. The FSPL will support the strengthening of the existing capacity-building institutions as well as the establishment of new institutions. It will first target strengthening the existing CBS by separating it from NBC and establishing it as a subsidiary of NBC with separate management and accounts. An independent CBS will not only facilitate hiring full-time instructors and competent managers with a competitive salary scheme different from that of NBC; it will also promote mobilization of external assistance with sound financial management. CBS can then be developed into a prime training institution for the central bank and other government agencies. To support the process, the FSPL will assist CBS to establish a central banking course for NBC professional staff and a mandatory course for professional staff at entry level.

101. The FSPL will also support the establishment of a comprehensive banking institute for private bank staff to meet the increasing demand for professional training in the commercial banking sector and ensure that the approved articles of association of the bankers association include a mandate to promote education, research, and training in all aspects of banking. The banking institute, together with CBS, will undertake formal training in core skills (e.g., banking, accounting, statistical analysis, and general management), as well as specialized competencies necessary for the effective operation of financial institutions in a market-based economy. The banking institute should be open to staff of MFIs, so that it can accommodate training demands for rural finance (Appendix 3).

2. Insurance Sector Development

102. To support the implementation of the policy reform agenda identified in the Blueprint, the FSPL will focus on the following strategic areas: (i) establishing and strengthening a supervisory/regulatory framework, (ii) establishing an enforcement mechanism for compulsory insurance, and (iii) promoting private sector development.

a. Establish and Strengthen Supervisory/Regulatory Framework

103. As the first step toward the development of the insurance sector, the FSPL will support the establishment of supervisory and regulatory system in a phased manner: (i) establish an insurance supervisory unit under MEF, (ii) adopt a subdecree to implement the new Insurance Law, and (iii) adopt a regulation to apply IAS/ISA to the insurance sector.

b. Establish an Enforcement Mechanism for Compulsory Insurance

104. The Government introduced compulsory insurance in the new Insurance Law in July 2000, and committed itself to develop compulsory insurance on par with that in member countries of the Association of South East Asian Nations. Implementing compulsory insurance, however, calls for an effective enforcement and monitoring mechanism that involves related government agencies, as well as supporting laws and regulations. To organize the efforts of multiple line ministries toward the establishment of an enforcement mechanism, the Government should first adopt an official working plan for the development of a compulsory insurance system by creating an interministerial working group. The plan should include, among others, a timetable for adopting supporting laws and organizational structure, and division of responsibilities in enforcement and monitoring.

c. Promote Private Sector Development

105. Given the underdeveloped insurance markets and the weak basis for private sector development, insurance sector development hinges on increased participation of the private sector insurance companies and a competitive market environment. In particular, the success of the newly introduced compulsory insurance critically depends on the active marketing role of the private insurance companies who are suppliers of insurance policy. As the first step to foster private sector development, the FSPL will support a joint venture between the state-owned CAMINCO and a private company, a plan to divest the Government's share in the joint venture to avoid conflict of interests, and the establishment of a transparent entry mechanism. The joint venture will instill commercial orientation into the state-owned company and thus expedite the development of insurance products.

3. Development of Interbank/Money Markets

106. Development of interbank/money markets is critical to reduce the operating costs of banks and other financial institutions in Cambodia. To develop interbank/money markets, the FSPL focuses on two reforms: creating self-regulated interbank market arrangements, and establishing a legal and regulatory framework for money markets.

a. Create Interbank Markets

107. The first step in establishing interbank markets should be initiated by the commercial banks under the guidance of NBC. With the establishment of an inclusive bankers association, acting on behalf of all bank members, the association must play a catalytic role in forming interbank markets. Interbank market arrangements should be self-regulated by banks under the general guideline of NBC. The first interbank service can be short-term, unsecured interbank lending (overnight call loan and money). The FSPL supports (i) the establishment of an inclusive bankers association with the mandate of establishing interbank market arrangements included in the articles of association, which will be subject to NBC's approval; and (ii) the creation of a working group, consisting of representatives from NBC and the bankers association, when formed, that undertakes the task of establishing interbank market arrangements.

b. Establish a Legal and Regulatory Framework for Money Markets

108. The FSPL supports the development of a legal and regulatory framework for money markets. The first task is to adopt a comprehensive negotiable instruments law that includes all types of instruments – from simple payment instruments to credit instruments. Second, NBC

should set up the regulatory framework for the interbank market activities. The framework should focus on the role of a central bank as a supervisor and monitor of the liquidity positions of the banks as well as the overall decision-making authority for monetary policy. Third, NBC should provide detailed procedures for issuing interbank/money market instruments. Among these tasks, the FSPL supports the adoption of a negotiable instruments law as the legal basis for the money market instruments.

109. Key impediments facing MFIs include heavy dependence on Government and funding agency assistance for resources, and high transaction and operating costs. The development of interbank/money markets is expected to lessen these impediments. The emergence of interbank markets will provide a mechanism by which RDB and MFIs can manage short-term liquidity and thus reduce their operating costs. Furthermore, the interbank markets will facilitate the integration of RDB and MFIs into the whole banking system and provide a channel through which financial resources in urban and rural areas can be pooled and allocated by a common market mechanism. Thus, the development of and the participation of RDB and licensed MFIs in interbank markets will enhance the outreach of the financial system into the rural areas. Availability of interbank markets will also partly relieve difficulties regarding funding uncertainties stemming from intermittent financing from funding agencies.

4. Development of Accounting and Legal Infrastructure

a. Establish an of Accounting and Auditing System

110. Establishing accounting and auditing standards and their enforcement system is an essential thrust of the FSPL. The Government has already committed itself to adopt IAS/ISA in their entirety. However, given its limited capacity, the Government will phase in IAS/ISA starting with 15 standards of IAS and 10 standards of ISA. The FSPL will support the Government's efforts in the following key areas: (i) promulgating of an accounting and auditing law; (ii) adopting of a subdecree to apply IAS/ISA to all companies incorporated in Cambodia; (iii) establishing a national accounting council, which will be in charge of setting and interpreting standards; (iv) adopting IAS and ISA; (v) establishing an association of accountants and auditors; (vi) adopting a code of ethics that complies with the requirements of the International Federation of Accountants; and (vii) establishing committees on education and ethics within the association.

b. Develop Legal Infrastructure

111. To facilitate financial sector development, the Government is expected to complete key legislation such as a civil code, law on commercial enterprises, bankruptcy law, secured transactions law, commercial arbitration procedure, etc. It is also expected to initiate comprehensive judicial reforms, supported by ADB and World Bank, to strengthen law enforcement. In this reform agenda, the FSPL will specifically support the adoption of the law on commercial enterprises.

c. Establish a Regulatory Framework for Corporate Financing Activities

112. In line with the adoption of a law on commercial enterprises, the Government needs to establish a basic law governing corporate financing, or the securities and exchange law. A securities supervisory authority is necessary in implementing the forthcoming law on commercial enterprises and accounting and auditing law, as the two laws envisage the

securities supervisory authority (whether the MEF or an independent regulator) will be the main regulatory body to implement the laws. The securities and exchange law will provide a legal basis for securities supervisory authorities. Second, once the Government puts in place a law on commercial enterprises, nonexchange-based, grassroot capital market transactions will occur due to companies' financing activities. Shares of certain good firms will be traded. Equity participation of foreign investors will increase. Certain good firms may also issue debt instruments. This implies that even before the Government establishes exchange-based capital markets, it would need a legal basis to regulate securities transactions over the counter and to protect investors and traders – in particular, foreign direct investors.

D. Social and Environmental Issues

113. The FSPL is expected to have an impact on facilitating resource mobilization through the banking and insurance system and capital markets. It will increase the efficiency of resource allocation, thereby facilitating economic growth and job creation and benefiting all elements of society including the poor and near poor. Appendix 4 presents the poverty impact assessment for the FSPL. By developing the banking system and capital markets, the FSPL is expected to have a beneficial impact on growth and employment by reducing intermediation costs and, in turn, reducing the cost of capital for businesses. It will also encourage direct private participation in economic activities. The development of interbank markets will facilitate the use of monetary instruments and improve the liquidity management of banks. The improved performance of the insurance system will enhance savings and the availability of productive resources to enhance investments.

114. The FSPL is classified as category C under ADB's environmental classification system. Its environmental impact is expected to be minimal. It addresses the development of a legal and regulatory system and market infrastructure to lay the foundation for broad-based economic growth. Most of the policy components are concerned with such things as developing a supervisory and regulatory framework, basic market infrastructure, and capacity-building mechanisms, but does not include investment projects.

VI. THE PROPOSED LOAN

A. Amount of Loan and Source of Funds

115. The FSPL adopts a program cluster approach with three back-to-back subprograms totaling $30 million. The program cluster approach will not only allow flexibility, but also provide safeguard against inherent risks perceived in Cambodia (paras. 141-146) and strong leverage to push forward with needed reforms.

116. Each subprogram loan will be for $10 million and will be processed sequentially upon the completion of the previous subprogram (Appendix 3). The program cluster is front-loaded, with the first two subprograms carrying the most weighty policy reforms. Subprogram I has two tranches and will be completed within 12 months after loan effectiveness. Subprogram II will be presented for Board consideration and approval based on progress in implementing Subprogram I, the status of proposed policy reform actions, and the readiness of the Government to undertake the proposed reforms. The conditions for Subprogram II are expected to be implemented within 12 months after the effectiveness of the loan agreement. However, the Government is encouraged to undertake policy conditions specified in Subprogram II up-front, even before the loan effectiveness of Subprogram II, whenever feasible. Thus, before presenting the Subprogram II loan agreement for approval, ADB will further refine the proposed

policy reform actions to reflect the Government's achievements and changing policy environment. Subprogram III will be processed in a similar manner. The conditions for Subprogram III are expected to be implemented within 12 months after the effectiveness of the loan agreement for Subprogram III.

117. The processing and financial implication of the program cluster are the same as in the traditional single program to the Government because the approval of subsequent programs is integrated into the loan review process of the previous programs, except that the structure requires a separate loan agreement for each subprogram. The Government welcomed and strongly supported the subprogram cluster approach.

118. The total loan amount for the FSPL and individual loan amounts for the subprograms are determined on the basis of the strategic significance of financial sector development and the costs of structural reforms under the FSPL. The pecuniary components of the latter are estimated at $80 million-$90 million equivalent, as shown in the table.

Estimated Adjustment Costs for Key Policy Reforms of the FSPL
($ million equivalent)

Item	**Estimated Cost**
Adopting and enforcing the International Accounting Standards and International Standards on Auditing	37
Establishing banking sector infrastructure and safety net including public registry of secured transactions, credit information exchange arrangement, and deposit insurance system	18
Strengthening bank prudential regulations and bank restructuring	16
Developing interbank and money markets and laying the foundation for capital market development	6
Developing capacity-building institutions in both private and public sectors	7
Developing a legal and regulatory framework for the financial sector	6
Total	**90**

119. Given Cambodia's situation with a shortage of human and social capital, the policy changes envisaged in the FSPL involve three types of adjustment cost components, both pecuniary and nonpecuniary. The first kind is the cost to the private and public sectors of compliance with the new legal and regulatory systems and standards that the FSPL will introduce. As described in the previous section, the FSPL supports the introduction of many new laws, as well as regulations and standards such as accounting and auditing standards, uniform chart of bank accounts and disclosure rules, new prudential regulations, on- and off-site supervision procedures, a prompt corrective action system, an anti-money-laundering regulation, and compulsory insurance. The compliance costs are incurred partly because the previously unregulated areas of financial and commercial activities are now subject to regulations and standards, and partly because the old regulations and standards must be replaced with new ones. The compliance costs can be pecuniary and nonpecuniary. While nonpecuniary costs and some pecuniary costs are substantial, it would be difficult to estimate them because the absence of relevant markets makes the key cost components unavailable.

120. The second type of adjustment costs will be the capacity-building cost. Given the limited human and social capital in Cambodia, almost all sectors need substantial capacity building. The capacity-building costs will be incurred in the early stage of program implementation and

thus precede the compliance costs. The pecuniary components of capacity-building costs include, for instance, costs for training managerial and working-level staff in both private and public sectors or hiring skilled staff or experts.

121. The third type relates to the enforcement costs for the authorities and self-regulated organizations, which mirrors the compliance cost for the regulated parties. The enforcement costs include mostly institution building, which has direct budget implications as well as nonpecuniary cost implications. Examples include the establishment of an on-site inspection unit, insurance supervisory unit, bankers association, bank training institutions in both private and public sectors, interbank market arrangements, arrangements for sharing credit information, public registry for secured transactions, and deposit insurance system. Like the capacity-building cost components, the enforcement cost components tend to occur at the early stage of program implementation, as the authorities need to start substantial preparatory works before implementation.

122. Given the nature of the adjustment cost components, the time profile of those costs for the FSPL generally corresponds to that of the implementation of the three subprograms. Since the FSPL aims at process-oriented financial sector development and the impact of policy changes under the FSPL extends into medium- to long-term periods, the compliance cost components are spread over the time after program implementation, although some cost components will be incurred at the time of policy changes. Moreover, the program cluster is designed to introduce policy changes commensurate with the gradual building up of capacity and enforcement mechanisms to ensure smooth implementation, and each subprogram is designed in such way that the preceding subprogram serves as a preparatory stage for or to provide inputs for the following subprogram. Thus, the capacity-building and enforcement cost components tend to be incurred before or at the time of policy actions of each subprogram. Considering the different time profiles of the three cost components, the combined weight of individual policy action in terms of adjustment costs will follow an increasing pattern over time when each subprogram is implemented sequentially. To balance the overall weights of adjustment costs across subprograms, the policy conditions in the whole program cluster are front-loaded, as the first and second subprograms carry most of the difficult policy conditions.

B. Interest, Maturity, and Utilization Period

123. For the loan under Subprogram I of FSPL, the Borrower will be the Kingdom of Cambodia, and the Asian Development Fund (ADF) loan will have a repayment period of 24 years, including a grace period of 8 years, and will carry an interest rate of 1.0 percent per annum during the grace period and 1.5 percent per annum thereafter.

124. The loan will be utilized within 18 months from the date of loan effectiveness. The loan proceeds may be used to finance eligible imports incurred within 180 days before the date of effectiveness.

C. Implementation Arrangements

1. Executing Agency

125. NBC will be the Executing Agency for the FSPL, and will have overall responsibility for program implementation, including administering and preparing semiannual progress reports on program implementation. Implementing agencies will be MEF, MOC, NBC, and the bankers association when formed.

2. Steering Committee

126. A financial sector steering committee (FSSC) will be established to oversee implementation. The FSSC will be chaired by the governor of NBC and will include senior representatives from MEF, MOC, NBC, and the Council for the Development of Cambodia (CDC). The FSCC will meet at least once every three months to ensure that the proposed reforms are undertaken in accordance with the agreed-upon timetable, all as set forth in the list of actions to be taken during the FSPL. A working group will also be established under the FSSC to assist in and oversee day-to-day program implementation. The working group will consist of representatives from MEF, MOC, NBC, and CDC, and will be joined by a representative of the bankers association when this is formed and recognized by NBC. Another working group, called the interbank markets working group, comprising representatives from NBC and the bankers association will also be established to facilitate the establishment of interbank markets, a banking institute, and arrangements for sharing credit information among the members of the bankers association.

D. Procurement

127. In accordance with the simplified disbursement procedures and related requirements for program loans,[21] goods and services produced in and originating in ADB member countries will be procured, with due consideration to economy and efficiency, in accordance with standard public sector procedures in Cambodia and normal private sector commercial practices, acceptable to ADB. In the case of goods commonly traded on the international commodity markets, they will be procured in accordance with procedures appropriate to the trade and acceptable to ADB.

E. Disbursement

128. The proceeds of the FSPL will be disbursed for a broad range of imports, subject to a negative list of ineligible items (Appendix 5). Loan proceeds will be disbursed on the basis of a certification provided by the Borrower, confirming that in each year in which FSPL proceeds are expected to be disbursed, the value of total imports minus (i) imports from nonmember countries, (ii) ineligible imports, and (iii) imports financed under other official development assistance, is equal to or greater than the amount expected to be disbursed during the year. The Government will open an account (the deposit account) at NBC into which the proceeds of the loans will be deposited and from which all withdrawals will be made. Monthly statements of the deposit account will be attached to the semiannual report of the FSPL.

F. Counterpart Funds

129. The policy framework for the FSPL includes specific components that bear distinct costs of structural adjustments. The counterpart funds to be generated from the loan proceeds will be used to finance the structural adjustment costs under the FSPL. Any counterpart funds not required will be used for general development purposes.

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[21] R50-98: *Simplification of Disbursement Procedures and Related Requirements for Program Loans,* 16 April 1998.

G. Monitoring and Tranching

1. Subprogram I

130. The loan for Subprogram I is to be released in two tranches: (i) $5 million upon loan effectiveness, and (ii) $5 million within 12 months subject to the fulfillment of specified second tranche release conditions. ADB will review with the Government progress in implementing specified policy actions set out in the policy matrix, about three months prior to the scheduled tranche release. The conditions for the first and second tranche releases follow.

a. Conditions for First Tranche Release

131. The Government has complied with the up-front policy actions and the first tranche can be released as soon as the loan agreement becomes effective. These actions follow:

(i) NBC to reconcile old prudential regulations with new regulations and issue clarifying guidance to commercial banks.

(ii) NBC to fully staff the on-site inspection division of Banking Supervision Department, acceptable to ADB.

(iii) MEF to establish an insurance supervisory unit within MEF.

(iv) MEF to adopt a subdecree to implement the Insurance Law.

(v) NBC to recognize the bankers association as a self-regulatory organization. The approved articles of association must include provisions for the establishment of interbank market arrangements, arrangements for sharing credit information among the members of the bankers association, and a banking institute for private bank staff. NBC and the bankers association to establish a working group to establish interbank market arrangements, a banking institute, and arrangements for sharing credit information among the members of the bankers association.

(vi) NBC to adopt a formal procedure for soliciting comments from the private sector on proposed, or revisions to, laws, regulations, procedures, and policies affecting the banking sector.

b. Conditions for Second Tranche Release

132. For the release of the second tranche, the following eight conditions must be complied with:

(i) NBC to adopt surveillance and inspection procedures including standardization of the reports submitted by commercial banks. Unless specified otherwise in the NBC regulations, these procedures are also to be applied to licensed MFIs.

(ii) NBC to adopt a prompt corrective action system for commercial banks, acceptable to ADB. A similar system is to be applied to licensed MFIs with modified capital adequacy standards.

(iii) NBC to adopt an anti-money-laundering regulation. Unless specified otherwise in the NBC regulations, this regulation is also to be applied to licensed MFIs.

(iv) NBC to establish CBS as a subsidiary of NBC, with separate management and accounts.

(v) NBC to ensure that FTB management adopts a comprehensive training program for FTB staff, including accounting, risk management, asset/liability management, and management information system.

(vi) MOC to submit to the National Assembly a draft law on commercial enterprises.

(vii) MEF to submit to the National Assembly a draft law on corporate accounts, their audit and the accounting profession.

(viii) MEF to adopt IAS and ISA, which will be applied upon the adoption of the law on corporate accounts, their audit and the accounting profession.

2. Subprogram II

133. The proposed loan for Subprogram II of the FSPL will be $10 million from ADF. Tranching is still to be determined. Policy actions for Subprogram II are subject to revision and refinement following ADB's reassessment of the macroeconomic environment, lessons learned in Subprogram I, and the status of implementation and readiness of the Government to undertake the proposed policy reform actions in connection with related reforms specified in the Blueprint. The conditions for Subprogram II are envisaged to be implemented within 12 months of the effectiveness of the loan agreement for Subprogram II. Proposed conditions for Subprogram II are as follows:

(i) Adoption of a law on corporate accounts, their audit and the accounting profession.

(ii) Adoption of a law on commercial enterprises.

(iii) NBC to adopt a uniform chart of bank accounts and disclosure rules for the commercial banks, consistent with IAS.

(iv) NBC to adopt a guideline for the arrangements for sharing credit information among the members of the bankers association, and NBC and the Bankers association to establish such arrangements.

(v) MOC to submit to the National Assembly a draft secured transactions law.

(vi) MOC to adopt a plan to establish a public registry for secured transactions, acceptable to ADB.

(vii) NBC to ensure that CBS establish a central banking course for NBC professional staff, including mandatory training program for professional staff at entry level.

(viii) MEF to establish a joint venture between the state-owned insurance company and a private insurance company.

(ix) MEF to adopt a plan for the development of compulsory insurance.

(x) MEF to adopt a regulation to apply accounting standards consistent with IAS/ISA to insurance companies.

(xi) MOC to submit to the National Assembly a draft negotiable instruments law.

(xii) MEF to submit to the National Assembly a draft securities and exchange law.

(xiii) MEF to adopt a subdecree to apply IAS/ISA to all companies incorporated in Cambodia, and to establish a national accounting council to set and interpret standards, etc.

134. Among the conditions, (i) and (ii) will be included as the Board consideration of conditions for Subprogram II.

3. Subprogram III

135. The proposed loan for Subprogram III of the FSPL will be $10 million from ADF. Tranching and the revision of policy conditions for Subprogram III will be determined as they are for Subprogram II. The conditions for Subprogram III are envisaged to be implemented in 12 months after the effectiveness of the loan agreement for Subprogram III. The Proposed conditions for Subprogram III are as follows:

(i) NBC to apply the uniform chart of bank accounts and disclosure rules for the commercial banks consistent with IAS to RDB, other specialized banks, and licensed MFIs.

(ii) NBC to adopt a plan to establish a deposit insurance system for commercial banks.

(iii) Adoption of a secured transactions law.

(iv) MOC to establish a public registry for secured transactions.

(v) NBC to ensure that the bankers association establish a banking institute for private bank staff under the bankers association, pursuant to its approved articles of association, and establish a professional training course for private bank staff. The banking institute should be open to staff of MFIs.

(vi) MEF to adopt a plan to divest MEF's share in the joint-venture insurance company.

(vii) Adoption of a negotiable instruments law.

(viii) Adoption of a securities and exchange law.

(ix) MEF to establish an association of accountants and auditors, to adopt a code of ethics that complies with the requirements of the International Federation of Accountants, and to establish committees on education and ethics within the association.

136. Among the conditions, (iii), (vii), and (viii) will be included as the Board consideration of conditions for Subprogram III.

4. Monitoring

137. ADB, in cooperation with NBC, MEF, MOC, and CDC, will carry out semiannual reviews of progress in program implementation, and will assess the program's impact on the financial and other sectors of the economy. The Government and ADB will continue to engage in active policy dialogue throughout FSPL implementation on issues that may affect financial sector development and additional reforms that may be necessary or desirable for the sustainable development of the financial sector (which may result in the revision of the Blueprint). The Government will keep ADB informed of outcomes of the policy discussions with the IMF and the World Bank Group and other multilateral and bilateral funding agencies that have implications for FSPL implementation.

138. The Government will submit to ADB semiannual reports on FSPL implementation, particularly on policy actions set out in the policy matrix, the development policy letter, and the Blueprint, as well as on the accomplishment of the FSPL objectives. In case the Government updates or revises the Blueprint, the semiannual reports will also include the rationale and contents of such revisions. Semiannual reports will be submitted in such form and in such detail and within such period as ADB may request, and will include (i) progress made and problems encountered during the six months under review, (ii) steps taken or proposed to be taken to remedy the problems encountered, and (iii) the proposed detailed activity for FSPL implementation and expected progress during the next six months. On completion of the FSPL, but in any event not later than six months, the Government will prepare and submit to ADB a comprehensive report on the overall impact of the policy reforms implemented. Monitoring indicators and mechanisms are given in the program framework (Appendix 6).

VII. PROGRAM BENEFITS AND RISKS

A. Benefits

139. Cambodia's underdeveloped financial system is potentially the most significant constraint to broad-based economic growth and achieving the Government's socioeconomic development objectives, particularly, poverty reduction. The beneficial impacts on poverty associated with the FSPL can be summarized as follows:

(i) Strengthening the prudential and supervisory framework for commercial banks is expected to promote the development of a sound and viable banking system and improve access of the more vulnerable and poorer segments of the population to financial service;

(ii) Strengthening the banking system will render banks more resilient and invulnerable to disruptions to the banking system from external shocks, which undermine growth prospects, wipe out savings, and lead to significant fiscal restructuring costs; and

(iii) A consolidated, restructured, and well-regulated banking system will (a) on the expenditure side, free up public sector resources to invest in productive activities such as infrastructure or social sectors (i.e., health and education), which may otherwise have been reallocated to bank restructuring or recapitalization; and (b) on the revenue side, relax credit constraints and strengthen credit to the private sector, expanding GDP growth and with it, the taxable revenue base to meet the social safety net and other social expenditure needs to minimize the vulnerability of the poor segment of the population.

140. The financial sector reforms under the FSPL are necessary to ensure a stable, viable, and competitive financial system based on improved asset quality in the banking system, and a more efficient banking intermediation process. Development of the insurance sector and interbank markets will create an enabling environment necessary to ensure domestic resource mobilization including long-term sources of investment funds to complement the lending channels intermediated through the banking system. The reforms under the FSPL are expected to have a positive impact on savings and investment in the economy.

B. Risks and Safeguards

141. The principal risk lies in unexpected political disturbance. The country has been enjoying a very high level of political unity and stability, and the comprehensive reform programs in place should lead to significant progress in economic growth. However, Cambodia will go into a political season up to early 2002, as the National Assembly and the Senate of Cambodia passed the Commune Election and Commune Administration Laws in January and February 2001, respectively.[22] At the moment, the commune elections could take place as early as January 2002 after final approval of the law by the Constitutional Council and the King, giving the National Election Committee less than a year to prepare for a major undertaking involving potentially thousands of candidates.

142. There may be risks associated with weak capacity at the institution level, the ability to recruit and retain qualified cadres and staff, and poor coordination between policy-making agencies. While risks associated with weak capacity are typical in policy reform programs, those factors need special attention in designing a program loan in Cambodia.

143. Another risk may be related to “law fatigue.” Given the deficient legal environment in Cambodia, the Government has been expediting a substantial volume of legislation in a relatively short period. However, there have been some cases where adopted laws are not fully implemented, despite all the efforts of the Government and aid agencies. This stems in part from lack of consultation with stakeholders including the private sector and aid agencies and in part from weak institutional capacity.

144. The FSPL includes safeguards in the design of the overall framework of assistance. First, the FSPL adopts the program cluster approach, with three back-to-back subprograms that contain doable sets of policy reforms in a relatively short period (e.g., one year). The program cluster approach introduces flexibility to accommodate various types of risks by allowing further refinement of policy conditions reflecting changing environments, while pursuing the original objectives of the program cluster concept, approved by the Board.

145. The FSPL will also be supported by an ADTA to reduce the downside risks from weak capacity. An ADTA will be processed to assist the Government in implementing policy reform measures.[23]

[22] National elections are likely to be held in 2003, thereby potentially prolonging the upcoming period of political instability.

[23] A capacity-building TA had been in the pipeline for 2001 and was supposed to be piggybacked to this program, but it was rescheduled to 2002 due to the scaling down of the TA budget early in 2001. However, on July 31, the French Government confirmed its funding for an ADTA for capacity building in banking and financial management.

146. Risks associated with “law fatigue” can be minimized by instituting procedures for broad and regular consultation with the private sector stakeholders. In this regard, the Government has already made substantial progress. On 25 January 2001, the Government adopted the Prime Minister’s Decision on the Formation of a Sectoral Working Group for Consultation Partnership with the Private Sector, which mandated the creation of procedures for private sector consultation in seven major areas including banking and financial service. While it is understood that the procedure can also be utilized as a private sector consultation procedure for legislation, the FSPL explicitly supports the adoption of a formal consultation procedure for legislation with the banking sector as one of the policy conditions of Subprogram I (Appendix 3).

VIII. ASSURANCES

147. The Government has given the following assurances in addition to the standard assurances, which have been incorporated in the legal documents:

(i) The policies adopted and actions taken prior to the date of the Loan Agreement, as described in the development policy letter, will continue in effect for the duration of the FSPL period.

(ii) The Government will undertake the policy actions included in the development policy letter and the Loan Agreement, and ensure that such policies and actions continue in effect for the duration of the program period.

(iii) The Government will regularly update and refine the Financial Sector Blueprint based on its achievements and will consult with ADB with respect to the refinements through regular policy dialogue.

IX. RECOMMENDATION

148. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve

(i) the program cluster concept of $30,000,000 for the Financial Sector Program to the Kingdom of Cambodia; and

(ii) the loan in various currencies equivalent to Special Drawing Rights 7,758,000 to the Kingdom of Cambodia for Subprogram I of the Financial Sector Program, with a term of 24 years, including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

Tadao Chino
President

17 October 2001

APPENDIXES

SUPPLEMENTARY APPENDIXES

(available on request)

FINANCIAL SECTOR BLUEPRINT FOR 2001-2010

I. The Banking Sector

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
	Lay the Foundation for the Banking Sector Development	**Enhance Intermediation through Competition**	**Promote Efficiency through Integration and Reorganization**
Monetary Policy	***Establish a basic framework for monetary policy*** • Streamline reserve requirements • Phase out the guarantee deposit or capital reserve required for bank licensing • Reduce the reserve requirement ratio on riel-denominated deposits • Implement rediscount and refinance facilities	***Improve monetary policy instruments*** • Phase out reserve requirements • Commence the operation of refinance/rediscount facilities	***Develop a market-based monetary policy framework*** • Introduce an open market operation system with the development of money markets
Supervision and Prudential Regulations	***Establish a framework for supervision*** • Establish a complete body of prudential regulations • Adopt surveillance and inspection procedures • Establish a fully staffed banking supervision department • Establish a uniform chart of bank accounts and disclosure rules consistent with International Accounting Standards (IAS) • Establish a prompt corrective action (PCA) system • Establish an anti-money-laundering regulation	***Improve the enforcement of prudential regulations*** • Strengthen PCA implementation • Commence full on-site inspection with the National Bank of Cambodia (NBC) staff • Establish a transparent exit mechanism and streamline exit procedures →Revise laws covering insolvency and liquidation of bank to eliminate inconsistencies →Establish legal and regulatory frameworks and procedures for bank merger and acquisition (M&A) and purchase and acquisition (P&A) • Establish legal protection for supervisors against lawsuits for actions taken in fulfilling official duties	***Upgrade prudential regulations*** • Upgrade prudential norms in accordance with the Bank for International Settlement guidelines • Strengthen risk management regulations with the expansion of nonbanking business by banks

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Bank Restructuring and Competition	***Restructure the banking industry*** • Complete bank relicensing and liquidation of problem banks • Establish a contingency plan for banks that do not comply with conditions in their restructuring memoranda of understanding • Restructure/privatize the Foreign Trade Bank	***Enhance banking services through diversifying the scope of banking business*** • Diversify the scope of business by allowing banks to expand their business into nonbanking areas • Allow banks to set up nonbank financial institution (NBFI) subsidiaries • Establish legal and regulatory frameworks for credit card services, housing/mortgage finance, installment finance, etc.	***Facilitate bank reorganization through incentives and a reinforced supervision system*** • Strengthen the enforcement of PCA to facilitate early and orderly exit of nonviable banks • Strengthen the incentive system for promoting voluntary bank M&A and P&A • Refine the minimum capital requirement for banks involved in diverse nonbanking businesses
Payments System	***Establish a framework for the payment system*** • Improve operational procedures for both the riel and dollar clearing systems, considering the compliance capability of commercial banks • Adopt a payment law to underpin the payment system • Improve the backup system for smooth operation of the payment system • NBC and the Bankers Association should adopt a protocol for an on-line banking system to facilitate future integration of an on-line banking network	***Improve the efficiency of the payment system through investments in information technology (IT)*** • Establish a central bank wire system • Automate the clearinghouse • Establish an on-line banking system in individual banks	***Establish an integrated on-line interbank system*** • Integrate individual bank on-line networks including the central bank wire system
Outreach to the Rural Areas		***Promote outreach to rural areas by encouraging the establishment of branches*** • Adopt an incentive system to encourage banks to expand branches into rural areas	***Strengthen outreach to rural areas through competition*** • Establish legal and regulatory frameworks for community-based savings institutions (e.g., credit unions, cooperatives) with appropriate incentive systems

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Capacity Building	***Establish a capacity building mechanism*** • Appoint full-time Centre for Banking Studies (CBS) instructors under a competitive salary scheme • Establish a central banking course for NBC professional staff in CBS • Adopt a comprehensive re-training program for NBC staff with non-college-level education • Adopt a mandatory training program for entry-level professional staff in CBS • Adopting a competitive, merit-based compensation scheme in NBC • Establish an inclusive bankers association • Establish a banking institute for professional training of commercial bankers	***Strengthen NBC organizational structure*** • Redesign the division of responsibilities among departments with new job descriptions • Establish an effective recruitment system to attract competent staff to NBC • Introduce a performance-based compensation and promotion system to retain and develop qualified staff	***Enhance central bank independence*** • Revise the Central Banking Law and the Banking Law to step up the independence of NBC

II. Rural Finance

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
	Implement a Policy and Institutional Framework for Rural Finance Sector	**Increase Poverty Reduction Impact**	**Enhance Outreach**
Implement and Enhance Rural Credit Policy	***Implement policy actions in Rural Credit Policy (RCP)*** • Make applicable the provisions of the Banking Law to develop the rural finance sector • Create forum for policy coordination	***Policy coordination*** • Review and, if required, amend RCP in the context of the ongoing financial sector development measures • Coordinate rural finance sector development with investments in poverty reduction, agriculture, rural infrastructure, irrigation, and agricultural research and extension	***Review and coordinate policies*** • Policy review and coordination to continue as in Phase II

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Strengthen Supervision and Regulation	***Strengthen supervision and regulation*** • Establish supervision system for licensed microfinance institutions (MFIs) consistent with the overall framework for the banking industry • Introduce appropriate prudential norms for licensed MFIs	***Improve application of prudential regulations*** • Strengthen MSD of NBC in its supervisory and regulatory capability	***Introduce self-regulating mechanisms*** • Enable the multisectoral nongovernment organizations (NGOs) to develop a self-regulatory mechanism for minimum service standards • Encourage emergence of rating agency for licensed MFIs
Building Rural Financial Infrastructure	***Facilitate institutional transformation linkages, and services delivery*** • Facilitate transformation of identified NGOs into licensed MFIs • Enhance access to resources of community-based groups through licensed MFIs • Promote deposit and microcredit through licensed MFIs	***Establish a range of service providers*** • Introduce leasing and crop insurance • Establish venture capital and equity funds for licensed MFIs ***Expand institutional network*** • Enhance flow of term finance for agriculture through resource support and enhanced presence of banks in rural areas • Adopt incentive systems for commercial banks to expand in rural areas • Provide support for establishment of licensed MFIs • Deepen and broaden linkages between community groups, licensed MFIs, and banks	***Establish a comprehensive institutional network*** • Establish a legal framework for small farmer- or community-owned institutions to integrate with the formal financial sector • Review equity threshold for licensed MFIs
Create Institutional Capacity	***Build sustainable institutions*** • Strengthen the Rural Development Bank • Comprehensive capacity building support for licensed MFIs • Strengthen NBC's capacity with reference to the rural financial system	***Enhance effective intermediation*** • Develop specialized training centers • Introduce rural finance specialization in restructured/reorganized banks • Facilitate downscaling of operations for banks intending to enhance microfinance operations	***Update and upgrade skills*** • Establish linkages with regional training centers and update their capacities and the quality of their courses

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Ensure Pro-Poor Orientation	***Build capacity for optimal utilization of financial services*** • Organize the poor into community groups for financial services • Enhance capacity of community groups to establish linkages with licensed MFIs • Support capacity building of the poor for management of income-generating activities	***Promote innovative microfinance pilot projects*** • Establish pilot projects in resource-poor areas • Bring innovations to address specific clients groups (e g , the disabled) ***Introduce safety nets to reduce vulnerability*** • Introduce risk mitigation tailored to the needs of the poor, including insurance services • Extend protection to the savings of the poor	***Enhance outreach to special microfinance groups*** • Replicate successful pilots • Enlarge coverage of safety nets

III. Insurance and Pension System

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
	Establish a Foundation for Insurance Sector and Determine Feasibility for Pension System	**Promote Insurance Market through Private Sector Development and Establish Foundation for Pension System**	**Strengthen Insurance Sector and Initiate Establishment of Pension System**
Insurance Sector Supervision and Regulations	***Establish a regulatory and supervisory framework for insurance*** • Establish an insurance supervisory unit within the Ministry of Economy and Finance (MEF) • Adopt a subdecree to implement the insurance law • Establish prudential regulations including uniform chart of accounts and disclosure rules consistent with IAS/ISA and a PCA system	***Strengthen the insurance regulation and supervisory framework*** • Strengthen the regulatory framework for insurance by refining prudential regulations to cover diverse insurance products • Reinforce the insurance supervisory unit by enlarging staff with qualified personnel	***Upgrade prudential regulations for insurance sector*** • Establish an independent insurance supervisor • Upgrade prudential regulations in accordance with the Insurance Core Principles of the International Association of Insurance Supervisors

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Compulsory Insurance	***Establish a framework for compulsory insurance*** • Adopt a plan and establish legal frameworks and enforcement mechanisms to implement compulsory insurance • Establish an interministerial working group to develop enforcement and monitoring system for compulsory insurance	***Implement compulsory insurance*** • Establish insurance monitoring and enforcement system	
Insurance Industry Organization	***Establish a basis for private sector development*** • Establish a joint venture between the state-owned insurance company and a private company • Develop a transparent entry mechanism • Adopt regulations to encourage the use of domestic insurance companies	***Promote a competitive private sector insurance market*** • Facilitate private insurance companies' entry into underwriting business • Encourage foreign companies' participation • Establish reinsurance institutions • Divest MEF shares in joint venture	
Outreach to the Rural Areas		***Increase outreach to rural areas*** • Introduce crop insurance, weather insurance, etc.	
Capacity Building	***Build capacity of insurance regulators and supervisors*** • Conduct intensive capacity-building activities for insurance regulators and supervisors • Establish a training program to build the enforcement and monitoring capacity in the related government agencies	***Establish a training institution for the insurance sector*** • Establish a comprehensive insurance training institution through international cooperation	
Insurance Infrastructure		***Develop an actuarial professional body*** • Adopt a legal and regulatory framework for a public actuarial system • Create an actuarial profession	

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Pension System			
Legal Framework	***Conduct feasibility study to establish a multipillar pension system*** • Conduct feasibility study to determine appropriate design and timing for a mandatory public pension program, mandatory privately managed funded pension program, and voluntary retirement savings programs	***Establish legal framework for pension system*** • Adopt a legal framework for mandatory public pension program • Adopt a legal framework for mandatory privately managed funded pension program • Adopt a legal framework for voluntary retirement savings programs	***Implement legal framework for pension system*** • Adopt a subdecree to implement legal framework for mandatory public pension program • Adopt a subdecree to implement legal framework for mandatory privately managed funded pension program • Adopt a subdecree to implement legal framework for voluntary retirement savings programs ***Implement mandatory public pension program*** • Introduce mandatory public pension program
Supervision and Regulation		***Establish regulatory and supervisory framework for pension system*** • Establish a supervisory and regulatory body for pensions • Establish basic prudential regulations	***Strengthen regulatory and supervisory capacity for pension system*** • Refine and complete a corpus of prudential regulations to cover expanded pension system • Reinforce pension supervisory body by enlarging staff with qualified personnel
Capacity Building		***Build capacity of pension regulators and supervisors*** • Conduct intensive capacity building activities for pension regulators and supervisors	***Establish capacity building institution for pension system*** • Establish comprehensive pension industry training institutions through international cooperation

IV. Nonbank Financial Institutions

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
		Establish the Foundation of NBFIs	**Promote Diversification of NBFIs**
Leasing Business		***Develop the leasing business*** • Adopt a leasing law • Adopt a leasing regulation for commercial banks to conduct leasing business and/or to establish leasing company subsidiaries • Adopt a policy framework for promoting joint venture leasing companies	
Money Market Intermediary		***Develop money market intermediaries*** • Establish a legal and regulatory framework for finance companies, investment companies, nonfinancial corporations, individuals, and money market broker/dealers	
Capital Market Intermediary and Institutional Investors		***Develop capital market intermediaries*** • Establish a legal and regulatory framework for securities companies/subsidiaries, investment advisory companies, and securities finance companies • Establish a regulatory framework for banks to establish securities subsidiaries	***Develop institutional investors for capital markets*** • Establish a legal and regulatory framework for trust business in banks, investment/management trust companies, mutual funds, venture capital companies, and the like
Development Finance Institutions			***Establish development finance institutions to promote medium- and long-term lending*** • Establish a legal and regulatory framework for medium- and long-term export-import credit institutions (e. g., EXIM Bank) and other development finance institutions (e.g., leveraged leasing companies/ subsidiaries)

V. Interbank/Money Markets

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
	Establish a Foundation for Interbank Markets	**Strengthen the Interbank Markets**	**Increase the Depth of Money Markets**
Interbank Market Arrangements and Scope	***Establish interbank market arrangements*** • Establish interbank market arrangements/ procedures for commercial banks	***Expand the scope of the interbank markets*** • Establish a framework for interbank markets to allow the participation of NBFIs • Develop a standardized interbank repurchase (RP) contract and supporting regulations	***Establish integrated interbank markets*** • Allow all financial institutions to participate in interbank/money markets
Money Market Instruments	***Create an enabling environment for money market development*** • Adopt a negotiable instruments law • Set up a regulatory framework for interbank/money market activities	***Establish regulations governing financial institutions' instruments*** • Adopt procedures and regulations for negotiable certificates of deposit (CDs), RP agreement, banker's acceptance, etc. • Issue central bank securities (e.g., central bank CDs)	***Establish regulations governing non-financial institutions' instruments*** • Adopt regulations for trade bills, and commercial papers
Treasury Bills	***Create an enabling environment for Treasury Bills*** • Adopt a regulatory framework for the issuance of Treasury Bills • Adopt a medium-term plan to develop Treasury Bill markets • Capacity building for staff in National Treasury and NBC who are involved in Treasury Bill issuance	***Develop Treasury Bills markets*** • Introduce a primary dealer system for government securities • Regularize the issuance of Treasury Bills	

VI. Capital Markets

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
	Create an Enabling Environment for Capital Markets	**Establish the Foundation for Capital Markets**	**Develop Capital Markets**
Legal and Regulatory Framework	***Establish a key legal/regulatory framework*** • Strengthen the capital market development unit • Develop a master plan for creating a functional capital market framework • Conduct a feasibility study to assess a critical mass of potential securities issuers • Draft a securities and exchange law • Determine the basic structure of exchange regulations (e.g., listing requirements auction rules for trading, corporate disclosure, membership)	***Establish a capital market surveillance framework*** • Establish an independent securities and exchange commission	***Strengthen capital market supervision and surveillance*** • Upgrade prudential regulations in accordance with IOSCO principles
Securities Exchange		***Establish a securities exchange*** • Create a securities exchange board • Set up a computerized trading system • Establish a trading infrastructure (e.g., a securities depository system, and a clearing system)	***Promote capital market participation*** • Adopt an incentive system to encourage firms to go public • Adopt corporate governance principles
Fixed-income Securities	***Create an enabling environment for public bond markets*** • Establish a regulatory framework for medium- and long-term government bond, and issue Treasury Bond and government savings bond • Establish a legal and regulatory framework for local government, public instrumentality, and small and medium enterprises to issue bonds and notes	***Promote the issuance of public bonds*** • Establish or refine related legal and regulatory frameworks • Establish an incentive system to create demand for government bonds	***Develop private bond markets*** • Adopt a plan to develop corporate debt markets • Establish a legal and regulatory framework for the issuance of bonds of large banks and development finance institutions • Develop a trading system for fixed income securities

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Capacity Building	***Build capacity for future capital market participants*** • Conduct intensive capacity building for capital market regulators through international cooperation • Adopt a training program for capital market participants	***Strengthen capacity building for the public*** • Develop a comprehensive program for public awareness activities • Publish a master plan to create a securities exchange to provide general guidelines for listing requirements	***Strengthen capacity building for capital market participants*** • Create an association of securities brokers and dealers • Establish a capital market training institution

VII. Financial Market Infrastructure

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
	Develop Key Legal, Accounting, and Information Infrastructure	**Strengthen Enforcement and Establish Safety Net**	**Enhance Financial Market Infrastructure and Safety Net**
Legal Framework for Commercial and Financial Transactions	***Create key legal infrastructure to underpin financial sector development*** • Adopt a company law, a bankruptcy law, a secured transactions law, etc. • Adopt a civil code and procedure • Implement the Governance Action Plan • Adopt a law on organization and function of the court including establishment of a commercial chamber	***Strengthen law enforcement*** • Continue judicial reform • Establish a commercial chamber in the court system • Develop an adequate compensation scheme for commercial jurist • Establish a public registry for secured transactions	***Enhance the legal infrastructure for private sector development*** • Establish a legal framework for a public registration system for movables
Accounting and Auditing Standards	***Establish accounting/auditing standards and enforcement system*** • Adopt a law on corporate accounts, their audit, and the accounting profession • Apply IAS/ISA to all companies in Cambodia • Establish an accounting standards board • Establish an association of accountants and auditors including committees on education and ethics • Adopt a code of ethics for auditors	***Strengthen enforcement of accounting/auditing standards*** • Promote competition in the local accounting industry to encourage new entries to reduce accounting and auditing compliance costs of the private sector	***Enhance the enforcement of accounting standards*** • Apply IAS/ISA to private companies • Improve the enforcement of accounting and auditing standards

	Phase I (2001-2004)	Phase II (2005-2007)	Phase III (2008-2010)
Financial Market Information Infrastructure	***Create financial market information system*** • Establish arrangements for sharing credit information among members of the bankers association	***Expand the scope of arrangements for credit information sharing*** • Formalize the membership of the arrangements for sharing credit information to include other credit institutions • Allow the participation of other financial institutions in the credit information sharing arrangements	***Diversify and upgrade the market information system*** • Introduce a credit rating database industry • Upgrade the capacity and accessibility of the arrangements for sharing credit information through increased investment in IT
Financial Market Safety Net		***Enhance the banking sector safety net*** • Introduce a deposit insurance system for the banking sector • Adopt corporate governance guidelines for banks	***Enhance financial sector safety net*** • Expand deposit insurance system into other credit institutions that participated in the payment system • Adopt corporate governance guidelines for nonbanking institutions

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ជាតិ សាសនា ព្រះមហាក្សត្រ

ក្រសួងសេដ្ឋកិច្ច និង ហិរញ្ញវត្ថុ
លេខ.............................. សហវ.......

Phnom Penh, 04 October 2001

H.E. Mr. Tadao Chino
President
Asian Development Bank

Subject: **DEVELOPMENT POLICY LETTER**
Long-Term Financial Sector Development Plan and Program Loan Cluster for Financial Sector Development Program

Your Excellency,

1. This letter refers to the request of the Royal Government of Cambodia (the Government) for assistance from the Asian Development Bank (ADB) for support of policy reform efforts under the proposed Financial Sector Development Program (FSDP). As its strong commitment to undertakings envisaged in FSDP, the Government is pleased to inform ADB that it has formally adopted the Financial Sector Blueprint for 2001-2010 (the Blueprint) prepared under ADB's recently completed technical assistance (TA3467-CAM: Preparing for the Financial Sector Development Program) as the Government's official financial sector development plan. This letter spells out the Government's long-term vision and strategy for financial sector development and key elements of the Blueprint, as well as objectives, scope, and main elements of the FSDP.

I. FINANCIAL SECTOR DEVELOPMENT ISSUES

2. Cambodia's financial sector is at a rudimentary stage, with limited financial intermediation and low public confidence. Cambodia has one of the lowest rates of banking intermediation in the world: bank loans and deposits account for approximately 8 percent and 12 percent of GDP, respectively.

3. Currently Cambodia has 20 commercial banks after National Bank of Cambodia (NBC)'s re-licensing program in 2000, which revoked the licenses of eleven non-viable banks. Other financial institutions operating in Cambodia include insurance companies, currency exchange bureaus, and microfinance institutions. In the rural area, banking activities are even scarcer, and microfinance operations of NGOs are the major providers of credit. There are no recognized interbank/money markets and capital markets in Cambodia.

4. A number of factors contribute to the low level of intermediation, poor asset quality, and high operating costs for financial institutions. All these factors hamper public confidence and hinder deposit mobilization, as the majority of money in the economy is held outside of the financial system.

ផ្ទះលេខ ៩២ សង្កាត់វត្តភ្នំ ខណ្ឌដូនពេញ រាជធានីភ្នំពេញ កម្ពុជា
St. 92, Sangkat Wat Phnom, Khan Daun Penh, Phnom Penh, CAMBODIA.
ទូរស័ព្ទ : ៨៥៥-២៣-៧២៤ ៦៦៤ ទូរសារ : ៨៥៥-២៣-៤២៧ ៧៩៨
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5. Weak financial infrastructure hampers the development of financial sector. Cambodia has yet to develop or strengthen laws pertaining to accounting, negotiable instruments, secured transactions, commercial enterprises, bankruptcy, contracts and commercial credit, etc. In addition, the public confidence in the judicial system is very low. Lack of the rule of law has hampered the development of contract-based credit culture and thus one of the primary impediments to the private sector development. Moreover, Cambodia has yet to adopt common accounting/audit standards. Not many companies produce audited financial statements, and companies produce financial statements using different standards. Lack of common accounting standards and enforcement has not only increased the risk and cost of banking operations, but also deters the development of capital markets.

6. Lack of financial information infrastructure impedes bank lending and leads to poor asset quality. Bankers are unable to lend based on cash-flow analysis due to lack of clients' financial information. As a result, they are compelled to lend against collateral as the primary source of repayment, which is further compromised by a lack of infrastructure for secured transactions. Furthermore, Cambodia lacks a credit bureau or other arrangements, by which credit information that can be accessed and shared by the members of the Bankers Association.

7. Lack of liquidity management mechanisms incurs opportunity costs to banks. The banking sector maintains abnormally high levels of liquidity due to the lack of interbank markets to effectively manage liquidity. Furthermore, NBC is unable to provide liquidity to commercial banks to meet temporary liquidity shortages. Although the Law on the Organization and Conduct of the National Bank of Cambodia provides the legal basis for rediscount facilities, all eligible negotiable instruments such as bills of exchange, promissory notes, etc., are not available due to the lack of a Negotiable Instruments Law and other necessary legal infrastructure.

8. Weak supervisory capacity and regulatory framework impedes early identification of banking problems, and the timely and orderly resolution of problem banks. The basic framework and capacity for on-site inspection and off-site surveillance have yet to be in place. There is no prompt corrective action system. In addition, weak capacity and shortcomings in the legal and regulatory framework for bank liquidation has hampered and delayed the early and orderly liquidation of delicensed banks. Both the existing bank regulations and the capacity of the supervisory department of NBC need strengthening. The framework for insurance supervision has yet to be developed.

9. Finally, the financial system lacks human resource capacity. Key regulatory bodies such as NBC and Ministry of Economy and Finance (MEF) need substantial capacity building to properly discharge supervisory and regulatory responsibilities. However, capacity building institutions are constrained by limited human and financial resources. Furthermore, most of commercial bank staff lack training in credit analysis, loan monitoring, and problem loan management, although many of the commercial banks have experienced and competent senior managers.

II. FINANCIAL SECTOR BLUEPRINT

10. Although the recent banking sector restructuring and other policy reforms under the IMF Poverty Reduction and Growth Facility have generally been moving in the right direction, it is the view of the Government that Cambodia needs to exert coherent and systematic efforts to develop a sound market-based financial system to support resource mobilization and a broad-based sustainable economic growth.

11. With these objectives in mind, the Government has formulated the long-term vision and development strategy for the financial sector with the technical assistance from ADB. The long-term vision and development strategy has been developed based on key lessons drawn from the experience of other Asian economies in financial sector development, as well as from the current situation in Cambodia.

A. Long-Term Vision and Development Strategy

12. Financial sector development crucially depends on governance reform. One of the critical challenges facing Cambodia in governance is to strengthen accountability of institutions in the public sector. The necessary reforms include, among others, (i) public administration reform, (ii) public finance reform, and (iii) legal and judiciary reform.

13. If the governance reform programs envisaged in Socio-Economic Development Plan II and the Governance Action Plan are fully implemented, it is expected that the Cambodian economy will be able to sustain an average annual economic growth rate of 6-7 percent over the medium-term.

14. Building on the development prospect to be achieved from successful governance reform, the Blueprint anticipates that the financial sector will at least double in terms of the ratio of financial assets to GDP in ten years. The spread between loan and deposit rates will narrow as intermediation becomes more efficient owing to macroeconomic stability, improved legal and financial infrastructure, and increased competition among banks and other financial institutions.

15. The vision will be achieved by ensuring the following:

(i) a competitive, safe, and sound banking system that is well regulated and supervised and effectively mobilizes savings to provide financing to support the growth of the private sector;

(ii) the establishment and development of non-bank financial institutions that increase the depth of financial sector by providing a broad array of diversified services such as leasing and consumer finance;

(iii) an insurance sector that protects businesses and individuals from catastrophic events and a pension system that provides a secure retirement, both of which provide capital for long-term investment in the real sector;

(iv) a safe and reliable system for the transfer of funds between customers and banks and the settlement of payments between banks;

(v) money/interbank markets that provide banks, companies, and individuals with the means for effective liquidity management;

(vi) efficient and transparent capital markets with a critical mass of issuers that mobilize funds for long-term investment;

(vii) a legal system that promotes and enforces the rule of law in commercial and financial transactions and that supports good governance by promoting transparency, accountability, participation, and predictability;

(viii) an accounting and audit system based on international standards that supports good governance by promoting transparency, accountability, participation, and predictability; and

(ix) human resource development based on performance based compensation and promotion and the availability of a broad range of professional programs that retrains existing staff and provides ongoing training.

16. The Government has adopted a long-term strategy for financial sector development in Cambodia, which comprises the following elements:

(i) maintaining sound fiscal and monetary policies to ensure macroeconomic stability;

(ii) establishing a sound legal framework to protect property rights and enforce contracts;

(iii) establishing the rule of law through legal/judicial reform to underpin financial and commercial activities;

(iv) sequencing efforts to develop financial infrastructure, particularly payment/clearing system, accounting/audit system, credit information system, and regulatory framework;

(v) structuring the regulatory and policy framework to foster competition in the financial markets and to encourage financial institutions to realize the economies of scale and scope;

(vi) establishing a regulatory and institutional framework to promote sound governance principles and to allow market discipline to work in the management and operations of financial institutions;

(vii) establishing a sound framework for private sector development in the financial system by phasing-out state-ownership and state intervention in the system;

(viii) developing a transparent entry framework to encourage efficiency and financial deepening;

(ix) developing efficient exit mechanisms for troubled institutions to foster continuous reorganization in the financial system without incurring social costs; and

(x) developing human and institutional capacity in both private and public sectors through public-private sector partnership.

B. Sector Development Plan

17. Under the guidance of the long-term strategy, the Blueprint details sector development strategy and policy reform agenda. The sector development plan explicitly considers the interrelation of (i) human and institutional capacity building, (ii) developments in related financial infrastructure, (iii) establishment of a legal and regulatory framework, (iv) emergence of relevant financial markets, and (v) availability of technology. The sector development strategy is a rolling

plan, which needs continuous updating to reflect the Government's achievements as well as the changing socio-economic environment. The Government is committed to implementing the sector development plans specified in the Blueprint, as well as to continuously updating the sector development plan to reflect the Government's achievements and the changing socio-economic environment, thus maximizing the development impact.

1. Banking Sector

18. The Blueprint for the banking sector consists of a strategic goal for each of the three phases. The first phase (2001 to 2004) aims at laying the foundation for the banking system by establishing basic policy and institutional framework. The second phase aims to enhance intermediation through competition. Building on the achievements in the first phase, the banking system should be developed into a more consolidated system through competition among banks, intermediation will be expanded and banking services will be extended to rural areas. The third phase aims to promote intermediation efficiency by facilitating the integration of the formal and informal financial sectors as well as the reorganization of the banking industry. An integrated banking sector will enhance efficiency and quality of banking services in the rural areas.

2. Insurance Sector and Pension System

19. The development of the insurance sector will also go through three phases. To improve the current weak legal infrastructure and supervisory capacity, the first phase aims at establishing the foundation and building capacity for the sector. With a solid foundation in place, the insurance sector will develop in terms of size and diversity. The focus of the second phase will be to promote the insurance market through private sector development, to increase the outreach to poor and rural areas, to implement compulsory insurance, and to enhance product variety. The implementation of compulsory insurance will create policy-driven demand, and the growing income will generate demand for a greater variety of insurance products. In response to the growing sophistication and volume of business in the insurance sector, an independent insurance supervisory and regulatory body will be established. As the insurance sector expands, the independent insurance supervisor will further upgrade prudential regulations in the third phase.

20. During the first phase of pension system development, the feasibility and design for establishing a multi-pillar pension system will be completed. During Phase II, the legal, regulatory, and supervisory frameworks will be established for the pension system. In addition, a capacity-building mechanism will be needed to ensure properly trained staff in the regulatory and supervisory body. During Phase III, the legal framework will be enhanced through the issuance of sub-decrees. The mandatory public pension program will be launched and the supervisory and regulatory framework will be further strengthened in anticipation of the implementation of the mandatory privately managed funded pension program that will be implemented after Phase III.

3. Non-Banking Financial Institutions

21. The development of non-banking financial institutions (NBFIs) begins in the second phase. The development goal is to provide a legal and regulatory framework for the NBFIs commensurate with the development of interbank/money markets and capital markets. Thus the goal of Phase II is to establish the foundation of laws and regulations for NBFIs such as leasing companies, finance companies, investment companies and money market broker/dealers. The

goal of Phase III is set to further develop the NBFI sector including trust companies, venture capital companies and longer-term development finance institutions. These institutions will support the development of money and capital markets.

4. Interbank/Money Markets

22. The sequencing and pacing of money markets development will match the development of the banking and non-banking sectors The development plan for interbank and money markets targets three strategic goals. The first phase aims to establish the foundation for a market in short-term unsecured interbank lending, and provide a base for money markets (including Treasury Bills), based on a Negotiable Instruments Law. The second phase will strengthen the interbank markets, by establishing regulations for diverse money market instruments such as negotiable CDs, repurchase agreements, etc., as well as by regularizing the issuance of Treasury Bills with the development of a primary dealer system. The third phase is to broaden money markets with a regulatory framework for non-financial issuers of money market instruments such as commercial papers.

5. Capital Markets

23. The Government has taken initial actions in developing capital markets, and this process will continue. During the first phase, necessary preparatory work is expected to create an enabling environment for capital markets. In the second phase, it is envisaged to establish the foundation for capital markets by developing necessary infrastructure related to securities trading, as well as adopting detailed regulations and procedures. Building on the preparatory work, it is expected that the Government will make a systematic effort to develop capital markets in the third phase.

6. Financial Market Infrastructure

a. Development of Legal Infrastructure

24. The development of the legal infrastructure for financial markets also targets three reform agenda over the next ten years. The goal in Phase I is to introduce key laws pertaining to commercial activities to underpin financial sector development. In Phase II, law enforcement will be strengthened with the progress in court reforms and capacity building. Phase III will focus on enhancing legal infrastructure for private sector development; during the period, a legal framework for public registration system for movables will be established.

b. Development of the Accounting/Audit System

25. The accounting/audit system is the base for financial sector development and demands urgent attention. The goal in Phase I is to establish accounting/audit standards and a system for their enforcement through promulgation of a Law on Corporate Accounts, their Audit and the Accounting Profession, adoption of IAS/ISA standards, and establishment of an accounting professional body and an Accounting/Audit Standards Board. In Phase II, the accounting association will strengthen the enforcement of accounting/audit standards, and promote competition in accounting industry to reduce accounting/audit compliance costs of the private sector. In Phase III, enforcement of accounting standards and expansion of IAS to more firms will occur.

c. Development of Financial Information Infrastructure

26. For efficient financial intermediation, development of a financial information system is crucial to cultivate credit and repayment culture in the early stage of financial development. In Phase I, the Government will create the financial market information system via banker-led arrangements for sharing credit information. During Phase II, the Government will expand the scope of the arrangements to non-bank institutions. In Phase III, financial market information system will be further diversified by including a credit rating industry.

d. Development of a Financial Sector Safety Net

27. A financial safety net will be developed to bolster public confidence in the financial system. As the financial system expands, so do the systemic risks. The development of the financial safety net includes a two-stage reform agenda starting from Phase II. The goal of Phase II is to develop a banking sector safety net with the establishment of deposit insurance and corporate governance guidelines. Phase III will expand deposit insurance to the non-banking sector participants who join the payment system.

III. FINANCIAL SECTOR DEVELOPMENT PROGRAM

28. Although necessary, the implementation of the long-term policy reform envisaged under the Blueprint is challenging to the Government due to the limited social capital and capacity. Thus, the Government is in need of, and thus requests, systematic and concerted financial assistance and policy advice from international institutions. As the first step of such assistance, the Government requests for ADB's proposed Financial Sector Development Program.

29. The Government is committed to achieve the following goals of the FSDP, as an effort to implement the reform agenda in the Blueprint:

(i) enhancing banking intermediation and public confidence in the banking system and building capacity in both public and private sectors,

(ii) establishing legal and regulatory framework for insurance sector development,

(iii) laying the foundation for the development of interbank/money markets, and

(iv) developing financial market infrastructure by establishing common accounting standards and enforcement mechanisms as well as introducing key legislation.

1. Banking Sector Development

30. Under the FSDP, the Government will focus on key policy agenda to address key impediments identified in the Blueprint, which include, among others, (i) strengthening bank supervision and prudential regulations, (ii) completion of bank restructuring under the IMF PRGF program, (iii) developing banking sector infrastructure and safety net, and (iv) establishment and strengthening of capacity building institutions.

31. First, to **strengthen bank supervision and prudential regulations**, the Government will (i) reconcile old prudential regulations with new regulations and issue clarifying guidance to commercial banks, (ii) fully staff the on-site inspection division of Banking Supervision Department, (iii) adopt surveillance and inspection procedures including standardization of the

reports submitted by commercial banks, (iv) adopt a prompt corrective action system acceptable to ADB, and (v) adopt and implement an anti-money laundering regulation.

32. Second, the Government will **complete bank restructuring**, which has been undertaken under the IMF PRGF. In particular, the Government will make efforts to expedite liquidation of closed banks and prepare itself to deal with conditionally viable banks, which do not comply with the conditions specified in the bank restructuring MOU signed between those banks and NBC. Under FSDP, the Government will adopt a comprehensive training program for FTB including accounting, risk management, asset/liabilities management, MIS, etc.

33. Third, the Government will **develop banking sector infrastructure and safety net**. Along with the adoption of common accounting standards consistent with IAS/ISA, the Government will adopt a uniform chart of bank accounts and a disclosure rule consistent with IAS for the commercial banks. The Government will also establish arrangements for sharing credit information among the members of the Bankers Association and secured transactions system. In addition, the Government will initiate the development of banking sector safety net to bolster the public confidence in the banking system. That is, the Government will work out an official plan to develop a deposit insurance system to safeguard small depositors in the commercial banks.

34. Fourth, the Government will **strengthen capacity building institutions**. The Government will first strengthen the existing Center for Banking Studies (CBS) by separating it from NBC, and establish as a subsidiary of NBC with separate management and accounts. To develop CBS as a prime training institution for central bank and other government agencies, the Government will establish a central banking course for NBC professional staff and a mandatory course for the entry-level professional staff in CBS. The Government will also support the establishment of a comprehensive banking institute for private bank staff under the bankers association to meet an increasing demand for professional training in the banking sector.

2. Insurance Sector Development

35. The Government is committed to insurance sector development envisaged under FSDP, focussing on the following strategic areas: (i) establishing and strengthening of supervisory/regulatory framework, (ii) establishing regulatory framework for compulsory insurance, (iii) promoting private sector development, and (iv) capacity building in the insurance sector.

36. First, the Government will **establish and strengthen supervisory/regulatory framework for insurance** by establishing an insurance supervisory unit under MEF, adopting sub-decree to implement the new Insurance Law, and adopting regulations to apply IAS/ISA to the insurance sector.

37. Second, the Government will make concerted efforts with the related line ministries to **establish a regulatory framework for compulsory insurance**. The Government will set up an inter-ministerial working group to draft an official plan for compulsory insurance development. The plan will include, among others, adoption of supporting laws and establishment of enforcement and monitoring mechanism.

38. Third, the Government will **promote private sector development in the insurance sector**. As the first step for the private sector development, the Government will complete the establishment of joint venture between the state-owned CAMINCO and a private company, and

adopt a plan to divest the Government's share in the joint venture to avoid conflict of interests, along with the establishment of a transparent entry mechanism for the private sector.

39. Fourth, the Government will also exert efforts to **build capacity in the insurance sector**. Due to the short history of the sector, initial capacity building efforts will need assistance from donor agencies and foreign insurance training institutes. The Government will establish a training program for capacity building in related Government agencies, which will be involved in the enforcement and monitoring of compulsory insurance. The capacity building will be an integral part of the official plan for compulsory insurance. As the sector size increases and products diversify, the Government will also consider the establishment of a comprehensive insurance training institute.

3. Development of Interbank/Money Markets

40. Development of interbank/money market is critical to help reduce operating costs of banks and other financial institutions in Cambodia. The Government will play a pivotal role in establishing interbank/money markets. For this, the Government will fully support the establishment of an inclusive bankers association. The Government will also adopt a comprehensive Negotiable Instruments Law, which covers all types of instruments from simple payment instruments to credit instruments. In addition, the Government will set up the regulatory framework for the interbank market activities, and provide detailed procedures for issuing interbank/money market instruments.

41. The Government will continue to make efforts to create an enabling environment for capital market development. To begin with, the Government will adopt a Securities and Exchange Law following the promulgation of Law on Commercial Enterprises and Law on Corporate Accounts, their Audit and the Accounting Profession.

4. Development of Accounting and Legal Infrastructure

42. In recognition of the importance of the market infrastructure development, the Government will put substantial emphasis on the development of market infrastructure to underpin the financial market. The Government will put the first priority in the establishment of accounting standards and enforcement system, which includes (i) promulgation of Law on Corporate Accounts, their Audit and the Accounting Profession; (ii) adoption of a sub-decree to apply IAS/ISA to all companies incorporated in Cambodia; (iii) establishment of a National Accounting Council which will be in charge of setting and interpreting standards, etc.; (iv) adoption of official translation of IAS/ISA; (v) establishment of an association of accountants and auditors; (vi) adoption of a code of ethics that complies with the requirements of the International Federation of Accountants; and (vii) establish committees on education and ethics within the association.

43. The Government will complete key legislation to underpin the financial sector and private sector development, which includes Civil Code, Law on Commercial Enterprises, Bankruptcy Law, Secured Transactions Law, etc. The Government will also initiate a comprehensive judicial reform supported by ADB and World Bank to enhance enforcement of the law. Among these reform agenda, the Government is committed to adopt a Law on Commercial Enterprises and a Securities and Exchange Law.

IV. THE GOVERNMENT'S COMMITMENT AND REQUEST

44. The Government with ADB assistance has established a long-term vision and development strategy for its nascent financial sector. The Government believes that the Blueprint and FSDP will move the country's financial sector forward and will provide the basis for the development of Cambodia's financial sector with all the associated benefits for private sector growth and long-term poverty reduction.

45. The Blueprint has the highest commitment of the Government, as attested by the Government's adoption of the Blueprint as its official financial sector development plan. Furthermore, the Government is fully committed to carry out FSDP as the core policy reform envisaged in the Blueprint. In addition, the Government has established the Financial Sector Steering Committee and Working Group representing Ministry of Economy and Finance, Ministry of Commerce, National Bank of Cambodia, and Council for the Development of Cambodia.

46. Nevertheless, the Government is fully aware that this undertaking, although clearly needed, is fraught with difficulties and will be undertaken with limited social capital and human resources. It is crucial that ADB's assistance to help implement the policy reform of FSDP be provided in a timely manner. With the assistance of ADB and other development partners, the Government is prepared to forge ahead.

47. Consequently, we trust that ADB will consider favorably the Government's request for approval of the program loan cluster of $30 million and a loan of $10 million for Program I of the FSDP. We strongly urge ADB to provide further loans of $10 million each to continue policy reforms in Program II and III of the FSDP.

Yours sincerely,

Keat Chhon
Senior Minister of Economy and Finance
Ministry of Economy and Finance

Chea Chanto
Governor
National Bank of Cambodia

POLICY MATRIX OF FINANCIAL SECTOR PROGRAM

OBJECTIVES	SUBPROGRAM I		SUBPROGRAM II	SUBPROGRAM III
	1ST TRANCHE	2ND TRANCHE		
I. Development of the Banking Sector				
Establishing Bank Supervision/ Prudential Regulations	1. National Bank of Cambodia (NBC) to reconcile old prudential regulations with new regulations and issue clarifying guidance to commercial banks 2. NBC to fully staff the on-site inspection division of Banking Supervision Department, acceptable to ADB 3. NBC to adopt a formal procedure for soliciting comments from the private sector on proposed, or revisions to, laws, regulations, procedures, and policies affecting the banking sector	1. NBC to adopt surveillance and inspection procedures including standardization of the reports submitted by commercial banks. Unless specified otherwise in the NBC regulations, these procedures are also to be applied to licensed microfinance institutions (MFIs) 2. NBC to adopt a prompt corrective action system for commercial banks, acceptable to ADB. A similar system is to be applied to licensed MFIs with modified capital adequacy standards 3. NBC is to adopt an anti-money-laundering regulation. Unless specified otherwise in the NBC regulations, this regulation is also to be applied to licensed MFIs		

OBJECTIVES	SUBPROGRAM I		SUBPROGRAM II	SUBPROGRAM III
	1ST TRANCHE	2ND TRANCHE		
Development of Banking Sector Infrastructure and Safety Net			1. NBC to adopt a guideline for the arrangements for sharing credit information among the members of the bankers association, and NBC and the bankers association to establish such arrangements	1. NBC to apply the uniform chart of bank accounts and disclosure rules for the commercial banks consistent with IAS to the Rural Development Bank, other specialized banks, and licensed MFIs
			2. NBC to adopt a uniform chart of bank accounts and disclosure rules for the commercial banks consistent with IAS 3. Ministry of Commerce (MOC) to submit to the National Assembly a draft secured transactions law 4. MOC to adopt a plan to establish a public registry for secured transactions, acceptable to ADB	2. NBC to adopt a plan to establish a deposit insurance system for commercial banks 3. Adoption of a secured transactions law 4. MOC to establish a public registry for secured transactions

OBJECTIVES	SUBPROGRAM I		SUBPROGRAM II	SUBPROGRAM III
	1ST TRANCHE	2ND TRANCHE		
Strengthening Capacity Building in the Banking Sector		4. NBC to establish the Centre for Banking Studies (CBS) as a subsidiary of NBC with separate management and accounts 5. NBC to ensure that Foreign Trade Bank (FTB) management adopts a comprehensive training program for FTB staff, including accounting, risk management, asset/liability management, and management information system	5. NBC to ensure that CBS establish a central banking course for NBC professional staff, including a mandatory training program for entry-level professional staff	5. NBC to ensure that the bankers association establish a banking institute for private bank staff under the bankers association, pursuant to its approved articles of association • Establish a professional training course for private bank staff. The banking institute should be open to staff of MFIs
II. Development of the Insurance Sector				
Establishing a Supervisory/ Regulatory Framework for Insurance Development	4. Ministry of Economy and Finance (MEF) to establish an insurance supervisory unit within MEF 5. MEF to ensure issuance of a subdecree to implement the Insurance Law		6. MEF to adopt a regulation to apply accounting standards consistent with IAS/ISA to insurance companies	
Establishing a Framework for Compulsory Insurance			7. MEF to adopt a plan for the development of compulsory insurance	
Promoting Private Sector Development			8. MEF to establish a joint venture between the state-owned insurance company and a private insurance company	6. MEF to adopt a plan to divest MEF's share in the joint venture insurance company

OBJECTIVES	SUBPROGRAM I		SUBPROGRAM II	SUBPROGRAM III
	1ST TRANCHE	2ND TRANCHE		
III. Development of Interbank and Money Markets				
Creating an Interbank Market Arrangements	6. NBC to recognize the bankers association as a self-regulatory organization • Approved articles of association must include provisions for the establishment of interbank market arrangements, arrangements for sharing credit information among the members of the bankers association, and a banking institute for private bank staff • NBC and bankers association to establish a working group to establish interbank market arrangements, arrangements for sharing credit information among the members of the bankers association, and a banking institute			
Establishing Legal Framework for Money Market Development			9. MOC to submit to the National Assembly a draft negotiable instruments law	7. Adoption of a negotiable instruments law

OBJECTIVES	SUBPROGRAM I		SUBPROGRAM II	SUBPROGRAM III
	1ST TRANCHE	2ND TRANCHE		
IV. Development of Accounting/Auditing and Legal Infrastructure				
Establishing Accounting/ Auditing System		6. MEF to submit to the National Assembly a draft law on corporate accounts, their audit, and the accounting profession 7. MEF to adopt IAS and ISA, which will be applied upon the adoption of the law on corporate accounts, their audit, and the accounting profession	10. Adoption of a law on corporate accounts, their audit and the accounting profession 11. MEF to adopt a sub-decree to apply IAS/ISA to all companies incorporated in Cambodia • MEF to establish a national accounting council to set and interpret standards, etc.	8. MEF to establish an association of accountants and auditors, including • Adopting a code of ethics that complies with the requirements of the International Federation of Accountants • Establishing committees on education and ethics within the Association
Development of Legal Infrastructure		8. MOC to submit to the National Assembly a draft law on commercial enterprises	12. Adoption of a law on commercial enterprises 13. MEF to submit to the National Assembly a draft securities and exchange law	9. Adoption of a securities and exchange law

POVERTY IMPACT ASSESSMENT

A. Introduction

1. The primary goal of the Financial Sector Program Loan (FSPL) is to promote the development of a sound, market-based financial system to support enhanced resource mobilization and sustainable economic growth by establishing the foundation for banking and the insurance sector as well as financial market development. This appendix analyzes Cambodia's poverty profile, describes the strategy of the Government of Cambodia fighting poverty, and examines the impact of the FSPL on poverty reduction in Cambodia.

B. Poverty Profile

2. As of 1999, Cambodia had 11.4 million people, about 84 percent of whom were in the rural areas. The prolonged domestic strife has caused negative population growth rate during the Khmer Rouge period, but the population grew at an estimated 2.5 percent per year in the 1990s. This resulted in a low average age, as children under 14 accounted for 43 percent of the population.

3. With per capita gross domestic product (GDP) lingering around $260 in the 1990s, Cambodia had an estimated poverty ratio of 36 percent as of 1999,[1] and almost 90 percent of the poor were in the rural areas.[2] The rapidly growing population added burdens to the poor, and poorer households tended to have a larger share of children. The poverty rate also rose with household heads' age; the rate peaked at those households with the heads in the 36-40 years group. In urban areas, the unemployment rate was higher, and households with female heads were at a disadvantage compared with those with male heads.

4. The financial sector in Cambodia offers limited services in urban areas. The financial services are confined to a small group of better-known firms and are out of the reach of most of the poor population. The rural population relies on microfinance and moneylenders charging interest rates as high as 10-30 percent per month.[3] Even so, there exists a substantial gap in rural credit as the estimated rural credit demand stands at $120 million per year. The limited size, location, and products of the financial institutions restrict the sector's ability to generate employment. By the end of 2000, the total employees of the financial sector is around 3,300, of which 1,078 people in commercial banks, 150 in insurance companies, and around 2,100 are employed in approximately 120 rural credit nongovernment organizations around the country.[4]

C. Government Strategy in Poverty Reduction

5. Poverty reduction in Cambodia is a daunting challenge and has been a top priority target of the policy measures. The Government recognizes that economic growth and programs targeting the poor are the two major driving forces for poverty reduction. In addition to macroeconomic stability, sustainable economic growth critically depends on efficient resource mobilization and allocation, which builds on governance reform, private sector development,

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[1] The poverty line is defined, in monetary terms, as KR54,050 ($14) per person per month, or about $0.50 per day.

[2] The Ministry of Planning, Cambodia. 2000. *A Poverty Profile of Cambodia, 1999 (draft).*

[3] The Ministry of Planning, Cambodia. 2001. First Draft of *the Second Five-Year Socioeconomic Development Plan, 2001-2005.*

[4] Data provided by the National Bank of Cambodia.

and human resource capacity building.[5] The Government has made efforts to increase the poor's access to credit,[6] as well as reduce income fluctuation through insurance and other programs.

D. Impact Assessment

1. Development of the Banking Sector

6. Cambodia's banking sector features limited products and outreach, and a wide interest rate spread. The high spread results mainly from uncertainties regarding law/contract enforcement (e.g., difficulties and uncertainties in registering secured interest) and borrowers' creditworthiness. More than 80 percent of businesses have no access to credit, according to an International Finance Corporation (IFC) survey.[7] The survey also reveals that access to capital is the primary concern of SME managers, and that lack of access to credit has become a major impediment for the private sector, especially SMEs. To improve the situation, the FSPL supports strengthening banking supervision; establishing interbank/money markets; developing legal, judiciary, and accounting and auditing systems and key information infrastructure; and reinforcing capacity-building institutions. All these efforts will reduce uncertainties and risks in financial transactions, and promote public confidence (Table A4.1).

7. Along with governance reforms, the successful implementation of the FSPL will reduce the interest rate spread, mainly by relieving uncertainties and risks stemming from lack of legal and financial infrastructure. Specifically, adopting a secured transactions law and establishing a public registration system will reduce uncertainties related to collateral value and security. The establishment of common accounting and auditing standards and enforcement mechanisms will reduce uncertainties related to borrower's performance and creditworthiness. In addition, the development of financial information infrastructure including arrangements for sharing credit information will reduce information costs of banks. The establishment of interbank/money markets will also reduce the operating costs of banks as liquidity management will enable them to reduce nonearning assets. On the other hand, together with successful bank restructuring programs, strengthening the prudential regulations and supervisory capacity will enhance public confidence in the banking system. This will increase deposit mobilization and further bring down the bank's funding cost, and thus the interest spread. A decreased interest rate spread directly benefits the poor in two ways. First, reduced uncertainties and risks will substantially tighten interest rate spread, which prevents most of the population from accessing financial services. With lower interest rates, the poor (who are currently excluded from banking services) will be able to access bank loans and other services. This impact of poverty reduction will be strengthened as the reduced interest rate of banks will put downward pressure on the interest rate of microfinance providers. Second, a lower interest spread is important to the private sector, especially SMEs and microenterprises, as it gives many of them to access working capital. Lower funding cost will enable them to cut operational cost and expand business opportunities. The expansion of SMEs and microenterprises will reduce poverty as most of the industries are at the nascent stage and are labor-intensive.

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[5] Government of Cambodia. 1994. *National Program to Rehabilitate and Develop Cambodia*; 1998. *Royal Government Platform for the Second Term 1998-2003*; and the Ministry of Planning, Cambodia. 2001. First Draft of *the Second Five-Year Socioeconomic Development Plan, 2001-2005*.

[6] ADB approved Loan 1741–CAM: *Rural Credit and Savings Project*, for $20 million, in April 2000.

[7] Webster, L., and D. Boring. 2000. *The Private Manufacturing Sector in Cambodia: A Survey of 63 Firms*. Mekong Project Development Facility, and International Finance Corporation.

Table A4.1: Poverty Impact of Developing the Banking Sector

Item	Direct Effect	Indirect Effect	Macro	Mitigation Measures
Labor		Private sector, especially small- and medium-sized enterprise (SME), development will expand employment opportunities for the poor.	Increased soundness and reduced intermediation cost of the banking sector will promote growth-oriented investment and increase employment.	
Prices	Reduced uncertainties and risks will tighten interest rate spread, which will enable most of the poor who were excluded from banking services to have access to bank lending and other services.	Enhanced through the integration of the formal and informal sectors will fill the gap in interest rate spreads between rural and urban areas. Lower funding cost and increased credit availability will facilitate the development of SMEs and micro-enterprises.	Increased intermediation will bring down the general price level, and contribute macroeconomic stability.	
Access for Poor	Reduced uncertainties and risks will facilitate collateral and cash flow-based bank lending, and thus allow the increased access of the poor public and SMEs to bank lending and other financial services.			
Transfer	Establishment of a secured transactions system will reduce uncertainties regarding secured interest, and promote collateral-based lending. Establishment of common accounting and auditing standards and enforcement mechanisms will reduce uncertainties related to borrower's information, and promote cash flow-based lending. Establishment of credit information sharing arrangements will reduce information cost.			
Assumptions	Full-scale governance reforms, especially legal and judicial reform and corporate governance reform, will reduce uncertainties related to contract enforcement. Completion of the banking restructuring program strengthened banking supervision, will strengthen public confidence.			
Total Net Effect	Positive.			

2. Development of the Insurance Sector

8. The insurance sector in Cambodia offers only a few nonlife insurance policies, and most of the public is outside the reach of the sector due to high premiums and limited services. Most of the policy purchasers are foreign companies and international organizations. Part of the reason is that the supervisory system failed to convince the public that the supervisory authorities oversight insurance companies. Such lack of confidence resulted in limited demand for insurance products. Furthermore, a weak legal framework and supervision capacity undermines the supply of insurance products to cover diverse commercial activities. Thus, most businesses, especially SMEs, are exposed to catastrophic events. Most of the poor public and SMEs cannot afford to pay the currently high premiums, which are out of line with market equilibrium level. In fact, no one will purchase an insurance policy unless one has to. The catastrophic events are particularly costly to the poor public and SMEs as Cambodia does not have a social safety net.

Table A4.2: Poverty Impact of the Insurance Sector Development

Item	Direct Effect	Indirect Effect	Macro	Mitigation Measures
Labor		The private sector, especially small- and medium-sized enterprises (SMEs), development will be enhanced, and thus will generate more employment and income.	Development of the insurance sector will lead to a more balanced and competitive financial structure, and reduce the income fluctuation of individuals and businesses, thus contributing to macroeconomic stability.	
Prices	Market-based insurance premiums will reflect the demand and supply conditions, and allow the poor public and SMEs who were previously unable to access insurance products.	Lower insurance premiums will reduce the expenses of individuals as well as the operational cost of the private sector, including SMEs. The new insurance products will enable SMEs to enlarge domestic and international business opportunities.		
Access for Poor	The availability of insurance products and diversified services will reduce the cost of catastrophic events to poor and SMEs.			
Transfers	Establishment of an insurance supervisory framework will promote public confidence and awareness of insurance and thus increase the demand for insurance. Enhanced private sector participation with a level playing field will unleash competition, resulting in market-based premiums. Establishment of a legal framework for compulsory insurance will facilitate the introduction of compulsory insurance products.			
Assumptions	Full-scale governance reforms, including legal and judicial reform, and corporate governance reform. Enforcement/monitoring mechanism for compulsory insurance will be in place with supporting laws.			
Total Net Effect	Positive.			

9. The FSPL targets the establishment of the basic regulatory and supervisory framework to build public confidence in and awareness of insurance. It also supports the development of an enforcement mechanism for compulsory insurance (Table A4.2). In addition, by privatizing the state-owned insurance company and offering equal opportunities, the program will support private sector development. Through these policy measures, the FSPL directly supports the development of the insurance market by enlarging the supply capacity of the insurance business on one hand and by creating policy-driven demand for insurance on the other hand.

10. The establishment of the basic supervisory framework will promote public confidence and awareness of insurance. Once the public gains confidence in the soundness of insurance companies and the enforcement of insurance policies, the demand for insurance products will increase and more diversified products will be supplied. In turn, more businesses including SMEs will have access to insurance products needed to protect and expand their commercial activities. Moreover, the establishment of a legal framework for compulsory insurance will lay the foundation for the emergence of compulsory insurance products.

11. With equal opportunities and active private sector participation, the insurance sector will unleash competition to bring the premium close to a market-based level (which will reflect

demand and supply conditions). The competition will also encourage the insurance companies to diversify their products to meet the demands of individuals as well as businesses including SMEs. For example, the provision of export/import insurance will allow the expansion and protection of the private sector especially SMEs. The diversified products and reduced premium will increase the demand for insurance products, which will help the insurance companies to expand in terms of scale and outreach. On the macro level, the expanded scale and outreach of insurance companies will facilitate a more balanced and competitive financial structure, and support broad-based sustainable economic growth.

3. Development of Interbank/Money Markets

Table A4.3: Poverty Impact of Development of Interbank/Money Markets

Item	Direct Effect	Indirect Effect	Macro	Mitigation Measures
Labor		Development of private sector especially small- and medium-sized enterprises will generate more employment opportunities.	Reduced transaction cost of financial institutions and funding cost of the real sector will reduce and stabilize the general price level, which will contribute to macroeconomic stability and sustainable economic growth.	
Prices	Reduced operating cost of financial institutions due to the development of interbank/money markets will help tighten the interest rate spread. Moreover, integration of formal and informal sectors through interbank markets will further tighten the gap in interest spreads between urban and rural areas. As a result, the funding cost of the private sector, especially SMEs, will be cut down.	Reduced financial intermediation cost and the real sector's funding cost will help to stabilize general price level.		
Access for Poor	The poor's access to credit and asset accumulation will be improved.			
Transfers	The establishment of interbank/money markets will enable liquidity management, reduce a bank's nonearning assets, and thus operating costs. Interbank markets will facilitate the integration of formal and informal sectors, and thus spread the benefit of reduced operating costs into the rural areas.			
Assumptions	National Bank of Cambodia will develop payment and interbank clearing systems, and a regulatory framework to monitor and facilitate interbank/money markets activities.			
Total Net Effect	Positive			

12. Currently, Cambodia's financial sector offers only short-term bank loans at high rates. High funding cost can be attributed to the high operating cost of financial institutions. Lack of interbank/money markets prevents liquidity management by financial institutions, and leads to excessive nonearning assets (e.g., cash) and high operating cost. Without interbank/money markets, high funding cost and limited funding sources are expected to continue in the future, which will further widen the financing gap in both urban and rural areas. The FSPL supports the establishment of these markets by establishing a bankers association to lay down the institutional basis for interbank/money markets and establishing the legal framework by adopting a negotiable instruments law. The impact of the development of interbank/money markets on poverty is given in Table A4.3

13. The establishment and development of interbank/money markets will reduce financial institutions' costs related to liquidity management. The spread of lending and deposit rates in banks in urban areas will tighten in the short term, and the impact will increase and expand over time. The development of interbank/money markets will lead to gradual integration of the formal and informal financial markets in both urban and rural areas, because financial institutions in rural areas can also participate in the interbank markets to borrow or lend to manage their liquidity. The integration of the formal and informal financial markets will allow the benefits of enhanced banking services and reduced interest rate spread to be disseminated to borrowers in the rural areas as well.

4. Establishment of Financial Infrastructure and Safety Net

Table A4.4: Poverty Impact of Establishing Financial Infrastructure and Safety Net

Item	Direct Effect	Indirect Effect	Macro	Mitigation Measures
Labor		Economic growth will increase potential employment from private sector, especially small- and medium-sized enterprises (SMEs).	Establishment of financial infrastructure will promote confidence in the financial system, and in turn promote resource mobilization.	
Prices	Establishment of common accounting and auditing standards and their enforcement system will reduce uncertainties in lending (and thus risk premium), and tighten interest rate spread. This means lower funding cost for the private sector, especially SMEs.	Reduced funding cost of the real sectors will bring down the general price level.	Reduced funding cost and increased fund availability will promote real sector development, increase employment, stabilize price level, and thus contribute to sustainable macroeconomic growth.	
Access for Poor	The poor's access to financial services will improve.	Increased savings and compensation on savings will promote growth of family assets.		
Transfers	Establishment of a secured transactions system will reduce uncertainties related to the value and security of collateral, and promote collateral-based lending. Establishment of common accounting and auditing standards and their enforcement system will reduce uncertainties related to borrower's performance, and promote cash flow-based lending. Establishment of deposit insurance system will promote public confidence in the financial system and enhance resource mobilization.			
Assumptions	Full-scale governance reform including legal and judicial reform will reduce uncertainty regarding law/contract enforcement and adverse selection cost. Rule of law and transparency and establishment of a safety net will promote public confidence in the financial system. Government's strong commitment, sufficient human resource, and financial support.			
Total Net Effect	Positive.			

14. The current lack of or weak financial infrastructure and safety net is the major reason for the wide interest rate spread and nonexistence of many types of financial services. In Cambodia, many key laws to underpin commercial activities are yet to be in place, and law

enforcement is yet to be strengthened. For example, lack of an enterprises law and a securities and exchange law precludes debt and equity financing. The situation is further compromised by lack of common accounting standards and enforcement mechanisms. Moreover, lack of a deposit insurance system further reduced public confidence in the fragile banking system.

15. The establishment of financial infrastructure – accounting and auditing standards, the enforcement mechanisms, and key information infrastructure – will reduce uncertainties (and thus interest spread) and increase credit availability to the private sector, especially SMEs (Table A4.4). The establishment of a legal infrastructure, notably, the adoption of an enterprises law and a securities and exchange law along with an accounting and auditing law will provide the legal basis for various funding sources. An enterprises law and a securities and exchange law will lay the foundation for companies to issue different types of corporate securities. With the support of the accounting and auditing system reform and other corporate governance reforms, Cambodia can expect the emergence of capital markets, which will provide more funding at lower cost. A deposit insurance system protects small depositors from loss in the case of bank failure. It can promote public confidence in the banking system and, in turn, its resource mobilization capacity. More deposit means increased funding sources and fund availability to the private sector, especially SMEs.

E. Conclusion

16. The overall benefits of the FSPL for poverty reduction can be summarized as follows:

(i) A well-functioning financial sector, including banks and insurance companies, will provide resources for real economic activity, especially for private sector development, including SMEs that will create employment opportunities.

(ii) A well-diversified financial sector will increase the outreach of financial services to rural and poor areas.

(iii) A well-regulated financial system will enhance public confidence in banking and, capacity for resource mobilization. A sound and efficient financial system will facilitate resource allocation, a prerequisite for private sector development. This will support broad-based economic growth and the poverty reduction target set in the Government's Socioeconomic Development Plan for 2001-2005.

INELIGIBLE ITEMS

1. The proceeds of the loan will be utilized to finance the foreign currency expenditures for the reasonable cost of imported goods (excluding any duties or taxes) required during implementation of the Financial Sector Program. All imported goods financed from the proposed loan must be produced in, and procured from, member countries of the Asian Development Bank (ADB).

2. Notwithstanding the provision in para. 1, no withdrawals will be made for

(i) expenditures for goods included in the following groups or subgroups of the United Nations Standards International Trade Classification, Revision 3, or further revisions as designated by ADB by notice to the Borrower:

Group	Subgroup	Description of Items
112	—	Alcoholic beverages
121	—	Tobacco, unmanufactured tobacco refuse
122	—	Tobacco, manufactured (whether or not containing tobacco substitutes)
525	—	Radioactive and associated materials
667	—	Pearls; precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
897	897.3	Jewelry of gold, silver, or platinum group metals (except watches and watch cases); goldsmiths' or silversmiths' wares (including set gems)
971	—	Gold, nonmonetary (excluding gold ores and concentrates)

(ii) expenditures for goods intended for military and paramilitary purposes or for luxury consumption; and

(iii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a or 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification.

PROGRAM FRAMEWORK—FINANCIAL SECTOR PROGRAM

Design Summary	Targets/Measurable Indicators	Monitoring Mechanisms	Risks and Assumptions
Goal Develop a sound, market-based financial system to support resource mobilization and sustainable economic growth	• Increased M2/gross domestic product (GDP) • Increased ratio of financial assets to GDP • Increased capital adequacy and bank profitability • Reduced level of nonperforming assets • Tightened interest rate spread • Diversified financial services • Enhance financial services into rural area • Diversified insurance products • Increased interbank market activities • Established legal basis for capital market development	• Economic reports, official statistics • Asian Development Bank (ADB) review missions	• The Government's financial sector strategy is implemented. • Macroeconomic stability • Full-scale implementation of governance reform • Political commitment to undertake the reforms
Purpose 1. Enhance banking intermediation, public confidence, and capacity building 2. Establish legal and regulatory framework for insurance development 3. Lay foundation for the development of interbank/money markets 4. Create an enabling environment for capital market development 5. Develop financial infrastructure	• Strengthened banking supervision • Development of core information infrastructure and safety net • Strengthened human capacity in both public and private sectors • Strengthened insurance supervisory system and prudential regulations • Private sector development in the insurance sector • Development of compulsory insurance enforcement/monitoring mechanism • Establishment of basic legal framework for interbank/money markets • Establishment of legal system • Establishment of accounting and auditing standards and enforcement mechanism	• Official copies of laws, decrees, regulations, etc. from the National Bank of Cambodia (NBC) and the Ministry of Economy and Finance (MEF) • Reports of various financial institutions • ADB review missions	• Commitment of NBC, MEF, the Ministry of Commerce (MOC), and all stakeholders. • Human capacity to under-take the reforms • Full-scale implementation of governance reform as specified in Governance Action Plan
Subprograms **A. Subprogram I** **1. Banking Sector** a. Strengthening Bank Supervision/ Prudential Regulations	• NBC to reconcile old prudential regulations with new regulations and issue clarifying guidance to commercial banks • NBC to fully staff the on-site inspection division of Banking Supervision Department (BSD), acceptable to ADB • NBC to adopt a formal procedure for soliciting comments from the private sector on proposed or revisions to laws, regulations, procedures, and policies affecting the banking sector • NBC to adopt surveillance and inspection procedures including standardization of the reports submitted by commercial banks. Unless specified otherwise in the NBC regulations, these procedures are also to be applied to licensed MFIs	• Official copies of effective prudential regulations and the clarifying guidance • Official copies of organizational chart of BSD, job description, and NBC decision regarding the staff appointment • Official copy of the procedure for soliciting comments from the private sector • Official copy of the surveillance and inspection procedures	• NBC's commitment to the reform • NBC's willingness to communicate with the private sector

Design Summary	Targets/Measurable Indicators	Monitoring Mechanisms	Risks and Assumptions
	• NBC to adopt a prompt corrective action system for commercial banks, acceptable to ADB. A similar system is to be applied to licensed MFIs with modified capital adequacy standards • NBC to adopt an anti-money-laundering regulation. Unless specified otherwise in the NBC regulations, this regulation is also to be applied to licensed MFIs	• Official copy of NBC regulations on prompt corrective action system • Official copy of the anti-money-laundering regulation	
b. Capacity Building	• NBC to establish the Centre for Banking Studies (CBS) as a subsidiary of NBC with separate management and accounts • NBC to ensure that Foreign Trade Bank (FTB) management adopts a comprehensive training program for FTB staff, including accounting, risk management, asset/liability management, and a management information system	• Official copy of the NBC decision to establish CBS as a subsidiary • Confirmation letter from FTB management with official copy of the training program and budget approved by FTB Board	• Commitment of NBC and FTB management
2. Insurance Sector Establishing Supervisory/ Regulatory Framework for Insurance Development	• MEF to establish an insurance supervisory unit within MEF • MEF to ensure issuance of a sub-decree to implement the Insurance Law	• Official copy of the MEF regulation to establish the insurance supervisory unit • Official copy of personnel announcement • Official copy of the sub-decree	• MEF's commitment • Capacity building in the Insurance Supervisory Unit
3. Money/Interbank Markets Creating Interbank Market Arrangements	• NBC to recognize bankers association as a self-regulatory organization - Approved articles of association must include provisions for the establishment of interbank market arrangements, arrangements for sharing credit information among the members of the bankers association, and a banking institute for private bank staff - NBC and bankers association to establish a working group to establish interbank market arrangements, arrangements for sharing credit information among the members of the bankers association, and a banking institute	• Official copy of the articles of association approved by NBC • Confirmation letter from NBC with official copy of the document establishing the interbank markets working group	• Commitment of NBC and commercial banks • Collaboration of NBC and commercial banks
4. Accounting and auditing and Legal infrastructure	• MEF to submit to the National Assembly a draft law on corporate accounts, their audit and the accounting profession • MEF to adopt IAS and ISA, which will be applied upon the adoption of the law on corporate accounts, their audit and the accounting profession • MOC to submit to the National Assembly a draft law on commercial enterprises	• Official copy of the draft law on corporate accounts, their audit and the accounting profession submitted to the National Assembly • Confirmation letter from MEF to adopt IAS/ISA • Copy of the draft law on commercial enterprises submitted to the National Assembly	• The Government's commitment to establish and enforce the accounting standards • The Government's commitment to the reform

Design Summary	Targets/Measurable Indicators	Monitoring Mechanisms	Risks and Assumptions
B. Subprogram II			
1. Banking Sector			
a. Developing Banking Sector Infrastructure and Safety Net	• NBC to adopt a guideline for the arrangements for sharing credit information among the members of the bankers association, and NBC and the bankers association to establish such arrangements • NBC to adopt a uniform chart of bank accounts and disclosure rules for the commercial banks consistent with IAS • MOC to submit to the National Assembly a draft secured transactions law • MOC to adopt a plan to establish a public registry for secured transactions, acceptable to ADB	• Official copy of the guideline • Official copy of a uniform chart of accounts and disclosure rules for banks • Official copy of the draft secured transactions law submitted to the National Assembly • Confirmation letter of adoption of the plan from MOC, and official copy of plan to establish a public registry	• Commitment of NBC • Compliance costs
b. Capacity Building	• NBC to ensure that CBS establish a central banking course for NBC professional staff, including a mandatory training program for entry-level professional staff	• Confirmation letter from NBC, and official copy of the CBS curriculum	• NBC's commitment for systematic capacity building
2. Insurance Sector			
a. Establishing Supervisory/ Regulatory Framework	• MEF to adopt a regulation to apply accounting standards consistent with IAS/ISA to insurance companies	• Official copy of the regulation for adopting IAS/ISA to insurance companies	• MEF's commitment to the insurance sector reform
b. Establishing Framework for Compulsory Insurance	• MEF to adopt a plan for the development of compulsory insurance	• Confirmation letter from MEF, and official copy of the compulsory insurance development plan	• Capacity building in the Insurance Supervisory Unit
c. Promoting Private Sector Development	• MEF to establish a joint venture between the state-owned insurance company and a private insurance company	• Official copy of the joint venture agreement and Articles of Incorporation	
3. Interbank/Money Markets	• MOC to submit to the National Assembly a draft negotiable instruments law	• Official copy of the draft negotiable instruments law submitted to the National Assembly	• MOC's commitment
4. Accounting and Auditing System and Legal Infrastructure	• Adoption of a law on corporate accounts, their audit and the accounting profession • MEF to adopt a subdecree to apply IAS/ISA to all companies incorporated in Cambodia - MEF to establish a national accounting council to set and interpret standards • Adoption of a law on commercial enterprises • MEF to submit to the National Assembly a draft securities and exchange law	• Official copy of law on corporate accounts, their audit and the accounting profession, and official copy of the official gazette announcing the adoption • Official copy of the sub-decree • Copy of the law on commercial enterprises, and copy of the official gazette announcing the adoption • Official copy of the draft law submitted to the National Assembly	• MEF's capacity to enforce IAS/ISA • Compliance cost of the private sector • MOC's commitment to the reform • MEF's commitment and capacity

Design Summary	Targets/Measurable Indicators	Monitoring Mechanisms	Risks and Assumptions
C. Subprogram III			
1. Banking Sector			
a. Establishing Banking Sector Infrastructure and Safety Net	• NBC to adopt a plan to establish a deposit insurance system for commercial banks	• NBC confirmation letter to adopt the plan for deposit insurance system	• NBC's commitment
	• NBC to apply the uniform chart of bank accounts and disclosure rules for the commercial banks, consistent with IAS, to the Rural Development Bank, other specialized banks, and licensed MFIs	• Official copy of the clarifying regulation to apply the uniform chart of bank accounts and disclosure rules for the commercial banks to RDB, other specialized banks, and licensed MFIs	• Compliance costs of applying IAS/ISA
	• Adoption of a secured transactions law • MOC to establish a public registry for secured transactions	• Official copy of a secured transactions law, and official copy of the official gazette announcing the adoption of the law • Administrative circular to establish a public registry	
b. Capacity Building	• NBC to ensure that the bankers association establishes a banking institute for private bank staff under the bankers association, pursuant to its approved articles of association - Establish a professional training course for private bank staff. The banking institute should be open to staff of MFIs	• Bankers association's announcement to establish a banking institute • Copy of the banking institute's curriculum	• Support of NBC • Leadership of the bankers association
2. Insurance Sector	• MEF to adopt a plan to divest MEF's share in the joint-venture insurance company	• Confirmation letter from MEF, and official copy of the divestiture plan	• MEF's commitment to the reform
3. Money/Interbank Markets	• Adoption of a negotiable instruments law	• Official copy of a negotiable instruments law, and copy of the official gazette announcing the adoption of the law	• The Government's commitment to the reform
4. Accounting and Auditing and Legal Infrastructure			
a. Establishing Accounting and auditing System	• MEF to establish an association of accountants and auditors including: - Adopting a code of ethics that complies with the requirements of the International Federation of Accountants - Establishing committees on education and ethics within the association	• Official copy of the articles of association for the association of accountants and auditors • Official copy of code of ethics • Official copy of appointment documentation	• MEF's commitment to the reform
b. Developing of Legal infrastructure	• Adoption of a securities and exchange law	• Official copy of securities and exchange law, and copy of the official gazette announcing the adoption of the law	• The Government's commitment to the reform • MEF's capacity