KEY ISSUES IN THE FINANCIAL SECTOR

Overview

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: bank loans and deposits account for approximately 8 percent and 12 percent of gross domestic product (GDP), respectively.

Cambodia had a monobanking system when the National Bank of Cambodia (NBC) operated through its provincial branches. Structural reforms were initiated in 1989 through a Government decree to establish a two-tier banking system by separating the function of commercial banks from NBC. This decree allowed the formation of private commercial banks as limited liability companies. In 1990, treasury operations were transferred to the Ministry of Economy and Finance (MEF), and NBC was designated as a ministry and largely used to finance budget deficits. In 1991, the first private commercial bank was established as a joint venture between NBC and the Siam Commercial Bank of Thailand. Commercial banks operated under the framework of a law on the supervision of financial institutions, which was enacted in August 1992, and the subdecree on the supervision of commercial banks approved in November 1992. In 1996, NBC was established as the central bank as the result of the promulgation of the Law on the Organization and Conduct of the National Bank of Cambodia (the Central Banking Law).

The period of political stability has allowed steady progress in the Government's efforts toward financial sector development. Following the reestablishment 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. The Banking Law introduced more appropriate definitions for banking activities and a refined legal framework for banks. It also allowed microfinance institutions (MFIs) to undertake financial operations under the supervision of NBC. Furthermore, in 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.

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

Weak financial infrastructure hampers the further development of the financial sector. Cambodia has yet to develop or strengthen laws pertaining to accounting, insurance, negotiable instruments, secured transactions, commercial enterprises, bankruptcy, contracts, commercial credit, and the like. In addition, public confidence in the judicial system is very low. The lack of the rule of law prevents the development of a formal, contract-based credit culture and has thus been a primary impediment to private sector development. Cambodia has yet to adopt common accounting and auditing standards. Few companies produce financial statements, and those that do use different standards. Lack of common accounting standards and an enforcement system has not only increased the risk and cost of banking operations but has also deterred the development of financial markets.

The Banking Sector

Background

To strengthen the banking system, NBC recently conducted a bank relicensing program based on increased capital requirements and the CAMELS rating system. In November 2000, just before the first phase of NBC's bank relicensing program, the commercial banking system consisted of 31 banks, including two Government-owned banks, 22 locally incorporated banks, and 7 foreign bank branches. In December 2000, NBC revoked the licenses of 12 banks classified as nonviable, and placed 16 banks under conditional licenses, entering into memoranda of understanding that required compliance with restructuring measures and prudential regulations (for example, minimum capital requirements) by the end of 2001.

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, make up 93 percent of total banking deposits. The US dollar is the primary medium of exchange, with the Cambodia riel (KR) used primarily in rural areas. The formal banking sector is concentrated in Phnom Penh, although 90 percent of the population resides in rural areas.

As of December 2000, the total assets of the banking system stood at KR2,517 billion - the equivalent of $644 million, or 20 percent of GDP. This represented 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 occurred predominantly in the manufacturing and service sectors.

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 reported to be substantial and growing. The lack of both accounting standards and a uniform chart of bank accounts compounds concern about the accuracy of the reported nonperforming loans.

Table 1: Loans and Deposits in the Banking Sector as of December 2000

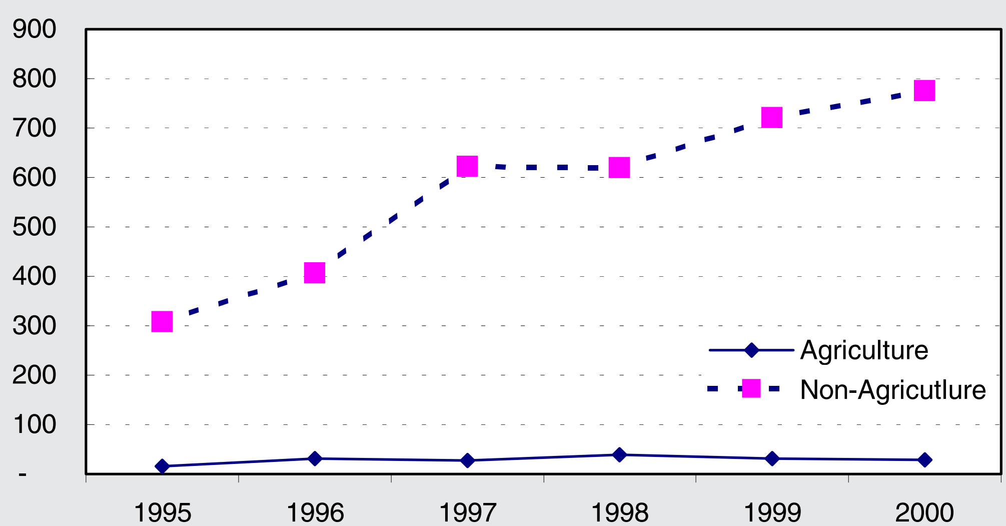
Item	Amount/Equivalent As KR million	Amount/Equivalent As $ million	Percentage of GDP
Loans	972,747	249	7.60%
Deposits in KR	103,969	27	0.8%
Deposits in Foreign Currency	1,386,985	355	10.9%
Total Deposits	1,490,954	382	11.7%

Source: National Bank of Cambodia.

In addition, the banking sector maintains excess liquidity with the percentage of cash to total assets at about 19 percent. Roughly 33 percent of total assets are non-earning. The banking system provides a narrow range of financial products, usually limited to demand, savings, and time deposits on the liability side. Loan portfolios tend to be confined to better-known firms.

The high risk and operating costs associated with bank lending are reflected in a high interest rate spread and the prevalence of short-term lending. The spread between loan and deposit interest rates is estimated at around 13 percentage points, as loan interest rates are around 20 percent per annum or more. Typical loan maturity is 3-6 months, because banks are reluctant to provide loans with longer terms. Term finance is unavailable, and the usual practice is to continue rolling over short-term loans. This practice generates maturity mismatches and increases overall risk in the banking system.

Figure 1. Bank Loan by Sector (KR Billion)



Source: National Bank of Cambodia.

Constraints and Issues

A number of factors contributing to the low level of intermediation, poor asset quality, and high operating costs for banks all lead to low public confidence and limited deposit mobilization. As a result, the bulk of money in the economy is held outside of the banking system.

Uncertainties regarding the enforceability of security interests impede bank lending and contribute to poor asset quality. The present collateral registration system is unreliable because of the absence of a legal basis for secured transactions and an inadequate public registration system that specifies lenders' positions and priority rankings in secured property. The current collateral registration system is cumbersome and requires banks to go through several steps to identify, confirm, and register a secured interest. In addition, lack of a proper collateral valuation system also inhibits sound lending.

Lack of reliable borrower information impedes bank lending and leads to poor asset quality. Cambodia lacks a credit bureau or arrangements for sharing information among financial institutions that can be accessed by all banks. Further, few firms produce financial statements, and no common accounting standards are enforced. Thus, banks are unable to lend based on cash-flow analysis, as they lack clients' financial information. Consequently, banks are compelled to lend against collateral as the primary source of repayment, which is further compromised by a lack of infrastructure for secured transactions.

The lack of liquidity management mechanisms resulting from underdeveloped financial markets incurs substantial opportunity costs to banks. The banking sector maintains an abnormally high level of liquidity because of the lack of interbank markets to effectively manage liquidity. In addition, although the Central Banking Law provides the legal basis for rediscount facilities,[2] NBC is unable to provide liquidity service to commercial banks to meet temporary liquidity shortages, because all eligible negotiable instruments (bills of exchange, promissory notes, etc.) are unavailable because of the lack of necessary legal infrastructure (i.e., a negotiable instruments law).

The weak supervisory capacity and regulatory framework impede early identification of problem banks and their timely and orderly resolution. The basic framework and the capacity for on-site inspection and off-site surveillance, as well as a prompt corrective action system, are not yet 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. Bank regulations and the capacity of the Bank Supervision Department of NBC both need strengthening. In addition, lack of a uniform chart of bank accounts and disclosure rules hampers effective bank supervision and prudential regulations. Like their borrowers, commercial banks adopt varying accounting standards. Furthermore, a review of sample financial statements of commercial banks revealed that the quality of the audits performed by international firms is inconsistent, partially as a result of the lack of common accounting and auditing standards within Cambodia.

Finally, the banking system suffers from a

[2] "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 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, Central Banking Law.

lack of human resource capacity. The early market opening policy has enabled Cambodia to attract many experienced foreign commercial bankers into the banking sector. As a result, most senior managers are experienced and competent bankers. However, most banks have difficulty finding qualified working-level staff because of the country's legacy of long-standing domestic turmoil 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.

Rural Finance

Background

The rudimentary banking system cannot address the nature of demand from the poor for microfinance to smoothen consumption, build assets, and develop microenterprises. Furthermore, it is not 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 such as rice milling and dairy.

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

Currently, about 90 NGOs supported by funding agencies such as Kreditanstalt fur Wiederaufbau, Gesellschaft fur Technische Zusammenarbeit of Germany, United Nations Children's Fund, International Fund for Agricultural Development, United States Agency for International Development provide microfinance to nearly 420,000 poor households, or 15 percent of the total, with most of the borrowers being women. In 2000, the estimated aggregate outstanding microcredit was $30 million, and savings mobilized was $1.4 million. Service delivery is through "village banks" consisting of 100-200 members and managed by a village credit committee. Members are organized into groups and are provided with some basic training; they are given individual credit with group liability. Loans varying from $20 to $300 are provided for 3-12 months with equated installments and incentives for timely repayment. Interest rates on loans range from 3 to 5 percent per month. Repayment rates are 80-95 percent. The balance of microfinance is supplied by informal sources, either based on reciprocity and social obligations or from moneylenders and input suppliers.

Cognizant of the issues, the Government has adopted the Rural Credit Policy to develop an effective rural financial system, and has initiated the Rural Credit and Savings Project[3] and TA for Capacity Building for Rural Financial Services,[4] the policy measures under which include (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 (MSD) within NBC to undertake off-site and on-site inspection of licensed MFIs, and specialized 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 to

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

[4] TA CAM 3270: Capacity Building for Rural Financial Services, for $1.45 million, approved on 10 October 1999.

MFIs; and (iv) enhancing collaboration among the Government, NBC, and NGOs for the promotion of sustainable rural finance. The Government intends to actively encourage the entry of commercial banks into rural finance, strengthen NBC's capacity to ensure orderly development of the sector, and make RDB a sustainable apex institution. Agent Francais de Development also provided technical and financial assistance to build up the supervisory capacity of NBC with regard to the supervision of MFIs with a view to ensure their sustainable development.

Constraints and Issues

Although many factors contribute to poverty, its most obvious manifestations are insufficient household income, lack of productive assets, and inaccessibility of affordable financial services. In response, the Government has prioritized the development of a policy and institutional framework for rural finance. Nevertheless, rural finance faces a number of constraints in expanding outreach and attaining sustainability.

The demand-supply gap for institutional rural finance, even at the current level of economic activities, is significant. The majority of rural households, including the poor, have no access to institutional finance at affordable terms. Although the collective outreach of the informal sector (that is, friends, relatives, money lenders, input suppliers, etc.) is large, the terms and conditions limit the ability of rural households to participate actively in and benefit from the development process.

The demand for savings, although not quantified, is significant and largely unmet because of (i) the absence of secure and reliable savings facilities, (ii) the lack of appropriate products, (iii) the high cost of service delivery, (iv) inaccessibility, and (v) the 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 the agriculture and rural sector is seriously constrained by the lack of institutions capable of delivering and managing term credit and by the lack of long-term funds. This undermines efforts to diversify agriculture and promote exports. 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.

The majority of NGOs, the sole as well as de facto suppliers of microfinance in rural areas, exhibit (i) weak systems and procedures, (ii) reliance on Government or external assistance, (iii) lack of commitment to sustainability, and (iv) inadequate realization of the need to specialize for efficient delivery of financial services.

The Insurance Sector

Background

The insurance sector consists of a Government-owned insurance entity, CAMINCO, which acted as both regulator and underwriter, and four private insurance companies that are performing as agents for CAMINCO. As part of the current restructuring and corporatization program, CAMINCO will be transformed into a private company through a joint venture with a private insurance company. The Government is expected to sign a joint venture agreement with the candidate company soon, in which the company will have 49 percent of the shares and MEF will hold 51 percent.

Most of the 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 arrangements for reinsurance facilities with markets in the region and European countries. Other products expected in the future include livestock, crop, and life insurance.

In 1992, the Law on the Establishment of the Insurance Business in Cambodia was adopted. During 1992-1996, subdecrees, circulars, and declarations were issued to address the management of the insurance business, the scope of business, and the establishment of private insurance companies.

The year 2000 was a watershed period in the development of the insurance sector. The National Assembly adopted the Insurance Law, and the Government moved forward with the privatization of the state-owned insurance company. The new Insurance Law covers property insurance, life, and personal insurance; compulsory third party liability motor vehicle insurance; construction insurance and insurance for passenger transport; insurance company and state control; insurance agents and brokers; and legal penalties. The Government is drafting a subdecree to implement the new law. The first draft has been submitted to the Council of Ministers for approval and is expected to be effective this year.

In anticipation of the privatization of CAMINCO, its regulatory responsibility was transferred to the Insurance Office that was established under the Financial Industry Department of MEF in January 2001. Key staff in the Insurance Office came from CAMINCO. On 4 January 2001, the Government also nominated the former President of CAMINCO as the Insurance Commissioner.

Constraints and Issues

First, the insurance sector has been constrained by a weak supervisory and regulatory framework and capacity, low levels of income in the country, and lack of public awareness of the sector. Although the Government adopted the new Insurance Law in 2000, it has yet to adopt implementing subdecrees and basic prudential regulations, such as uniform chart of accounts and solvency requirements.

Second, an effective enforcement and monitoring mechanism to implement compulsory insurance needs to be established. Although the new Insurance Law is a framework law for the insurance business, compulsory insurance cannot be fully implemented by such a framework law alone but needs supporting legislation to establish an enforcement and monitoring system. This in turn requires significant interministerial effort and coordination.

Third, the framework for private sector development in the insurance sector needs to be strengthened. The introduction of compulsory insurance would create a policy-driven demand for insurance. Without a competitive framework for the private insurance business, it would be difficult to implement and develop compulsory insurance. The Government has already taken an important initiative toward private sector development by adopting a privatization policy for CAMINCO. However, two issues still need to be addressed to facilitate private sector development: The Government should make an effort to divest its ownership in the insurance sector. Although MEF is now responsible for insurance supervision, the Government's share in the largest insurance company poses a conflict of interests in supervision and will affect competition in the insurance market. Thus, the partial privatization of CAMINCO through a joint venture should ultimately lead to divestiture of the Government shares in the joint venture over the medium term. In addition, the Government needs to develop a transparent entry mechanism to foster competition by creating a level playing field for both state-owned and private companies.

Finally, the new insurance supervisor needs substantial capacity building. MEF has successfully retained experienced regulators from CAMINCO, but additional staffing and substantial capacity building are still needed to help CAMINCO to discharge its responsibilities anticipated under the new Insurance Law as well as to undertake a development role for the insurance sector. In the initial stage of insurance development, the insurance supervisor is expected to play the role of facilitator as well as regulator of the sector. Recently, authorities have been seeking cooperation with institutions such as the Malaysia Insurance Institute to train current supervisory staff and to establish 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 who will be involved in the enforcement and monitoring of compulsory insurance.

Pension System

Background

Cambodia's pension system consists of two public programs. A pension program for military personnel was established by law in 1994, and provides basic retirement and disability benefits based on years of service and other special criteria including hazardous duty. A civil servant pension program was established by sub-decree in 1997 and provides basic retirement and disability benefits based on years of service. Currently, there is no mandatory pension program for the private sector. Each private company or organization determines its own pension scheme, if any. The government has already submitted to the legislative bodies a draft Law on Social Security, which also covers public pension scheme.

Under the civil servant pension program, civil servants receive a retirement pension equivalent to 80 percent of their net salary, after they have accomplished at least 30 service years. Eligible civil servants with at least 20 years of service receive a retirement pension equal to 60 percent of their respective net salary. Those who have more than 20 years of service also receive a proportional annual supplementary pension of 2 percent of their net salary.

According to MEF, the benefits paid under the current civil servant pension system are financed from the budget. Under the civil servant pension sub-decree, all ministries and institutions submit an annual budget and statistics of civil servants about to reach retirement and those about to be placed on disability to the Ministry of Social Affairs, Labor Vocational Training and Youth Rehabilitation and MEF. Based on these data, part of the budget is reserved to cover the retirement and disability benefits. The Ministry of Social Affairs, Labor Vocational Training and Youth Rehabilitation is also responsible for the management and monthly payment of retirement and disability benefits. A scheme for the establishment of a pension fund for the civil servant has been under discussion in MEF.

Constraints and Issues

The current pension system in Cambodia covers only civil servants and military personnel. Because pension benefits are based on a large percentage of the retirees' previous wages, the civil servant pension system suffers from a weak financial base because little or nothing is withheld from wages to cover pension benefit payments. Therefore, transfers from the Government budget are used to meet the current pension obligations.

Income security for retirees and old persons represents an important component of overall poverty reduction in Cambodia. Cambodia faces a number of challenges in creating a system that will ensure income security for retirees and old persons. According to the estimate of the Ministry of Planning, roughly 4 percent of Cambodia's population is over 60 years old. This figure is expected to be 6.6 percent by 2021, when the population grows from 11.4 million to more than 20 million. This increase will create increasing demand for resources to provide income security for retirees and old persons.

Nonbank Financial Institutions

Background

Nonbank financial institutions (NBFIs) offering lease financing, consumer credit, and housing finance have yet to be developed in Cambodia. Some commercial banks conduct limited credit card transactions and services, and hotels and some restaurants accept credit cards. However, the general public does not have access to credit cards or consumer financing from banks.

Under the Banking Law, banks are allowed to conduct universal banking, including lease financing. However, the law has yet to define the basic nature and scope of leasing, and the authorities have to develop detailed procedures and prudential norms to conduct the leasing business. Housing finance is unavailable because of the underdeveloped legal framework and uncertainties regarding title to land and buildings. The current title system is neither adequately organized nor reliable.

Constraints and Issues

Most impediments in the banking sector apply to the nonbanking sector. To create an enabling environment for the development of NBFIs, the Government first needs to establish a legal and regulatory framework. Since the current Banking Law adopts a universal banking orientation, the Government should start developing the nonbanking sector in the context of banking sector development. Thus, the Government may start with establishing a regulatory framework for banks to undertake nonbanking business either in the form of in-house operations or through subsidiaries.

Special consideration must be given to linking the development of the nonbanking sector with small and medium-sized enterprise (SME) development. Lease financing could be an attractive alternative product for banks in an environment with inefficient infrastructure for protecting credit providers. Leasing would readily provide the functional equivalent of loans for capital equipment to SMEs. Thus, the Government may consider the leasing business as a priority in developing the nonbanking sector.

Other than peripheral businesses in the banking sector, development of the nonbanking sector relies critically on relevant financial markets and infrastructure. Thus, the

Government needs to carefully sequence and synchronize its efforts with the development of financial markets and infrastructure.

Payment System

Background

In the mid-1990s, NBC established a riel-based settlement system based on an early version of the Central Banking Law (1992). The latest Central Banking Law (1996) charges NBC with overseeing the payment system, clearing, and interbank markets.[5]

Annual clearings have increased from 692 checks valued at KR88,577 million in 1997 to 1,234 checks valued at KR163,284 million in 2000. To date, the clearinghouse operates clearing sessions that extend into the next day. Efforts are under way to achieve same-day clearing despite concerns over banks' ability to conform to it.

With IMF TA, NBC has improved the rules for clearinghouse operations and has made substantial progress toward creating and regulating clearings in US dollar-denominated checks.[6] Considering the dominant use of US dollars in the economy, banks are expected to actively participate in US dollar-denominated clearings. This change will facilitate payment operations and shorten availability time. However, the effectiveness of the new regulations will depend on the compliance capacity of commercial banks and the establishment of safeguard measures for addressing emergency cases. A recent Prakas establishes a working group for addressing clearing, settlement, and payment system issues.

Constraints and Issues

Despite recent improvements, the payment system still needs further refinement to safeguard it against settlement failure. The Prakas absolves NBC from responsibility or liability for payment failures.[7] The mechanisms have not been implemented to enable NBC to extend emergency liquidity to a bank that is experiencing a temporary delay in the receipt of large payments. This should warrant a further review of how, in the event of a large payment failure, the banking system could be assured there will not be an interruption in bank operations and solvency, and that preventive measures will be in place to avert a liquidity crisis.

The current payment system is built on weak legal underpinnings. There is no penalty for dishonored checks, and existing laws do not address criminal charges for check fraud. There should be a minimum legal basis for the payment system through drafting a payment law that will formalize current regulations.[8] The present situation creates payment uncertainties at the bank level, particularly in terms of determining the legality of checking deposit signatures, endorsements, and assignments. Moreover, promulgation of a negotiable instruments law should receive priority that goes beyond checks and covers bills of exchange, promissory notes, and other money market-type instruments.

5 "The Central Bank may establish a clearing house for the prompt clearing and settlement of interbank payments" (Title VIII, Article 40).

6 See Prakas on US Dollars Net Settlement Clearing House, Number B-5.00-150.P.K., November 14, 2000.

7 See Prakas on US Dollars Net Settlement Clearing House, Number B-5.00-150.P.K., November 14, 2000, Article 18 and 19.

8 IMF is considering TA to draft a payment law.

Interbank/Money Markets

Background

There is no recognized interbank/money market operating in Cambodia other than an occasional exchange of deposits among a few banks that trust one another. The lack of an interbank market hampers banking operations and increases operating costs. Since there is no way to manage liquidity, most banks are forced to maintain high levels 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 non-earning.

Constraints and Issues

Two factors hinder the establishment of interbank/money markets in Cambodia. First, the lack of mutual confidence among commercial banks hinders interbank market services. There must be a forum to build mutual confidence among banks and to discuss common policy agenda. Thus, the commercial banks first need to work together to establish an inclusive bankers association and obtain official recognition from the authorities. Second, the lack of a legal basis for money market instruments hinders the development of interbank markets. To improve the current situation, establishment of the legal basis for negotiable instruments must be a prime consideration in legislation.

Capital Markets

Background

Under the Prime Minister's initiative, the Government has made considerable efforts toward capital market development. The Government drafted a Capital Market Law in 1995; unfortunately, this initiative was interrupted as a result of the political disturbance in 1997. Even after 1997, only limited progress has been made because of delays in the development of related financial and legal infrastructure.

With the progress in governance reform assisted by ADB and the World Bank, the Government is now renewing its efforts toward capital market development. For instance, it 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. The main functions of the supervisory body would include (i) implementing relevant regulations, including the making of administrative rulings; (ii) supervising and safeguarding securities operations in settling and trading; and (iii) licensing and registering all entities (broker-dealers, registrars, investment companies, management companies, depositories, custodians) engaged in securities markets activities.

However, the Central Banking Law (1996) assigns NBC the responsibility for establishing and overseeing financial markets. According to this law, NBC has duties and functions to participate in the formation and supervision of 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). These powers would have to be delegated by NBC to a securities and exchange commission (SEC) once it is created.

Constraints and Issues

Capital markets cannot be established and operational until accounting, legal, and other financial infrastructure is in place and the legal and accounting professions are organized and operational. Not only is it necessary to draft and pass key laws, but the implementing institutions must also be formed and developed. Furthermore, potential listing companies must be willing to accept higher standards of corporate governance and be 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.

Legal Infrastructure

Background

Financial sector development depends on an adequate body of laws that covers 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.

The civil code and procedures are being drafted with assistance from the 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 the rules governing the transfer of those rights. Because these laws are yet to be put in place in Cambodia, specific legislation can supplement this deficiency.

The Ministry of Commerce (MOC) has submitted a draft Law on Commercial Enterprises to the Council of Ministers which is being debated and is expected to be adopted by the National Assembly 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 with IMF assistance.

The Government is moving forward with judiciary reform as an integral part of governance reform. It 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 Court System that includes establishment of a commercial chamber and four other chambers in the district court. The draft is under review by the Council of Ministers.

Constraints and Issues

Although adoption of a legal framework is a key step toward development of the private sector and the financial sector, there must be concerted efforts to prioritize adoption of the necessary laws, and by doing so, the Government can expedite the legislation process. With regard to the financial sector development, laws pertaining to commercial transactions, including accounting, negotiable instruments, secured transactions, commercial enterprises, bankruptcy, and contracts, must be given the first priority. The Accounting and Auditing Law and the Law on Commercial Enterprises must be promulgated to enable capital market development. Afterwards, the Government may proceed to adopt a securities and exchange law (or redraft the Capital Market Law).[9] In line with the adoption of the Law on Commercial Enterprises, the Bankruptcy Law must be adopted, to bolster the liquidation of delicensed banks on 8 December 2000. And in line with the adoption of the civil code and procedures, a secured transactions law and negotiable instruments law must be established to underpin commercial activities and financial transactions.

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

Accounting and Auditing System

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 the International Accounting Standards (IAS) and International Standards on Auditing (ISA) as core principles of accounting and has submitted a draft Accounting and Auditing Law to the Council of Ministers for reconsideration.

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 approximately 125 staff and serve about 400 clients, of which 30-40 percent are private companies. Many of the private companies are the local affiliates of international companies, and the audited information is sent to the home office for inclusion in the consolidated accounts.

At present, most senior accountants and all of 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 because the training courses are located 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.

NBC has a broad legal mandate to regulate nearly all issues related to the accounting and auditing of banks. This goes beyond the usual prudential regulations to include establishment of the rules for measurement, recognition, and disclosure in the financial statements, and consolidation of accounts. The Central Banking Law also permits NBC to establish accounting standards for the banking sector that are 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

[9] This 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, Francis B., and Ted Gordon. 2000. *Financial Management and Governance Issues in Cambodia: Diagnostic Study of Accounting and Auditing*. Manila: Asian Development Bank.

Preparation and Development of Financial Statements," published in July 1989. However, there are some substantive changes, so the resulting financial statements will not be in accordance with IAS.

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.[10] Although the Government has already committed to adopting IAS/ISA in their entirety, it should carefully work out an implementation plan to phase in IAS/ISA, considering the limited capacity of and compliance cost to the private sector.

The Government should play a pivotal role in establishing an enforcement system for accounting and auditing standards. Upon adopting the Accounting and Auditing Law, the Government should establish an accounting standards authority and a professional association of accountants and auditors. An association serves 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 also can communicate best practices to members and thus help to reduce the cost of providing training to 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 includes provisions for creating the 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 the division of responsibilities is determined, there is an urgent need for the establishment of such an association.

Human Resource

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

A number of institutions and organizations play a role in the development of human resources for the financial sector in Cambodia. These include universities and business schools, commercial banks, the Bankers Association, the Centre for Banking Studies (CBS) of NBC, and MEF.

Each commercial bank operating in Cambodia assumes individual responsibility for its internal training program. The commitment of resources to training differs by bank. Foreign commercial banks normally send their employees for training overseas.

[10] The rationale for adopting international standards is as follows: 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 adopting IAS.

Constraints and Issues

Although CBS has contributed to filling the initial capacity gap in the early stage of banking development, the scope and quality of training services are insufficient to meet the needs of the private sector, and so CBS remains as a training school for entry-level NBC employees. At this time, all CBS instructors are part-time, and salary payments still based largely on academic degrees rather than teaching ability. CBS instructors receive considerably less than those paid by the business universities. Therefore, CBS has been unable to attract a sufficient number of qualified instructors.

Commercial banks will continue to send their employees outside of Cambodia at high cost until adequate training is available inside the country. Many commercial banks have indicated the need for a professional training program in Phnom Penh. However, the commercial banks will send their employees to training only if it is practical and relevant and taught by experienced bankers. One reason for the absence of professional training is the difficulty in 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 asset/liability management.

A bankers association is the logical home for a professional training program for bankers. By pooling 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 an inclusive bankers association, it should first establish such a professional training program. The training program should also be open to staff of MFIs.