FINANCIAL SECTOR VISION FOR 2010: "PREPARATION FOR TAKE-OFF"

Prospect for Economic Development under Governance Reform

The development of both the financial sector and the private sector depends on governance reform. Good governance is emerging as a key element to sustain social and economic development. Governance is defined as the manner in which power is exercised in the management of a country's economic and social resources for development. One critical challenge facing Cambodia in the area of governance is to strengthen the accountability of institutions in the public sector. The necessary reforms include (i) judiciary and legal reform, (ii) public administration reform, and (iii) public finance reform.

An ADB study[11] on the development impact of comprehensive governance reform suggests that the Cambodian economy will be able to sustain an average annual economic growth rate of 7 percent over the medium term if the governance reform programs are fully implemented. The reform scenario in the study assumes that the Government will implement full governance reform. Specifically, the reform scenario assumes the implementation of the three reforms mentioned above and a continuous flow of official development assistance.

Judiciary/Legal Reform and the Development of Private Sector Framework. Judicial/legal reforms provide an environment favorable to long-term and large-scale investment and create a level playing field for domestic and foreign investors. They also ensure the protection of creditors and investors and generate confidence in the future prospects of Cambodia's economy and public policy. This enables the Government to develop financial markets and help to integrate the country with the regional and world economies to improve its prospects as an industrial base for exports targeting the region and the rest of the world.

Public Administration Reform. Public administration reform consists of three components: (i) the demobilization of soldiers and security officers, (ii) the rationalization of civil administration, and (iii) an increase in the average monthly salaries of public officials.

Public Finance Reform. In public finance reform, revenue-enhancing measures increase the efficiency of tax collection. This enables the Government to increase revenues from direct taxes, indirect taxes, and customs duties. Forestry sector reform increases the Government's managerial capacity to control the volume of logging. This enables the forestry

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

Figure 2. Expansion of the Economy

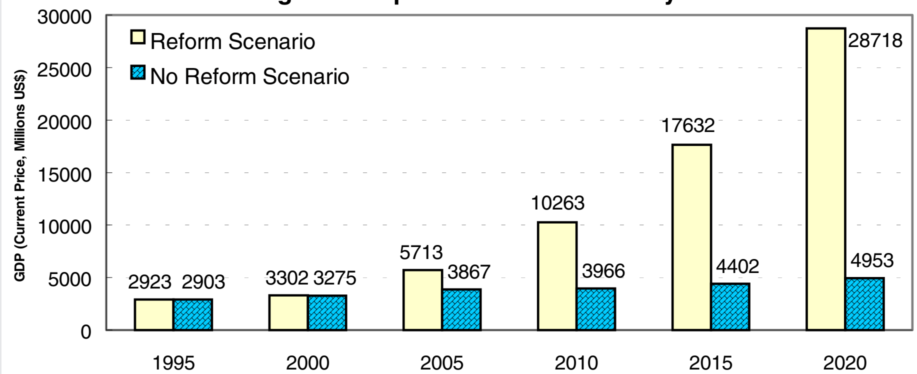


Figure 3. Per Capita GDP

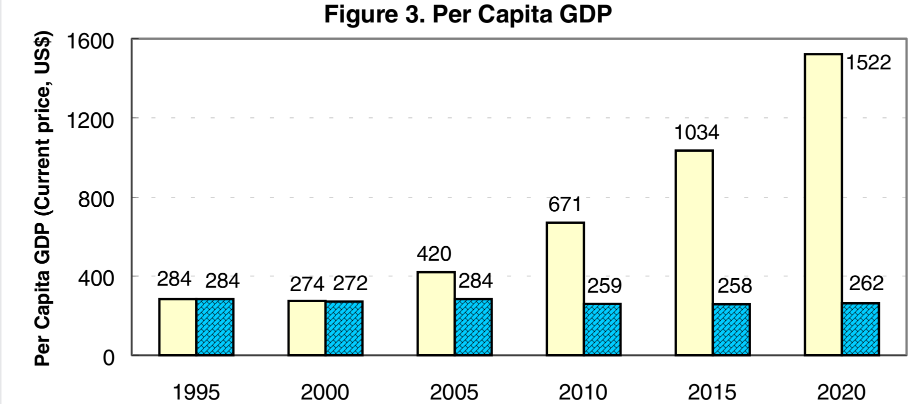


Figure 4. Exports

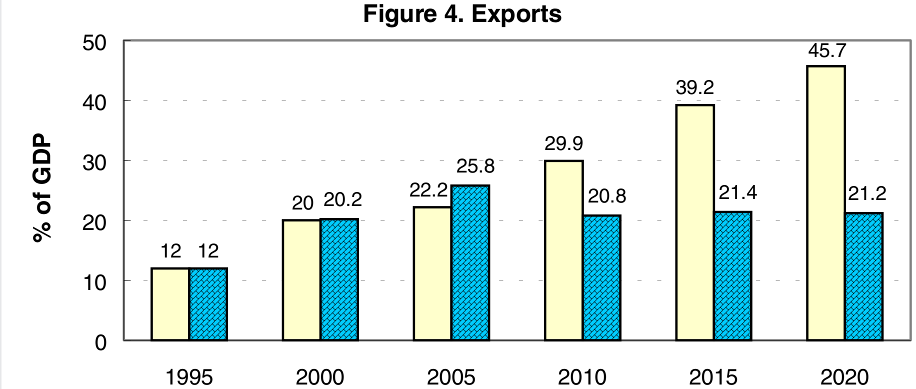
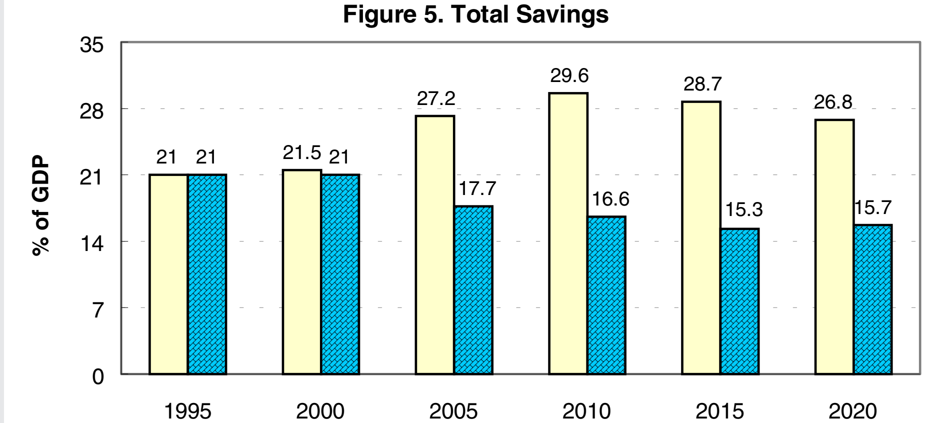


Figure 5. Total Savings



sector to be sustainable and to contribute long-term revenues to the National Treasury.

Continuous Flow of Official Development Assistance. The Government's strong commitment to reforms sends positive signals to aid agencies. This enables Cambodia to have access to grants and loans, which are necessary to carry out various reforms and development programs.

The "reform scenario" in the ADB study optimistically predicts that if the governance reforms are implemented on a full scale, a high level of sustainable economic growth will be achievable in the coming two decades. Major predictions under the "reform scenario" are summarized as follows:

(i) The real GDP growth rate will accelerate from 5 percent in 2000 to 7.7 percent in 2005, and will be maintained around the average annual rate of 7-8 percent from 2005 to 2020.

(ii) The GDP will triple from $3,302 million in 2000 to $10,263 million in 2010, and per capita income will increase by about two times in 10 years, from $274 in 2000 to between $500 to $650 in 2010.

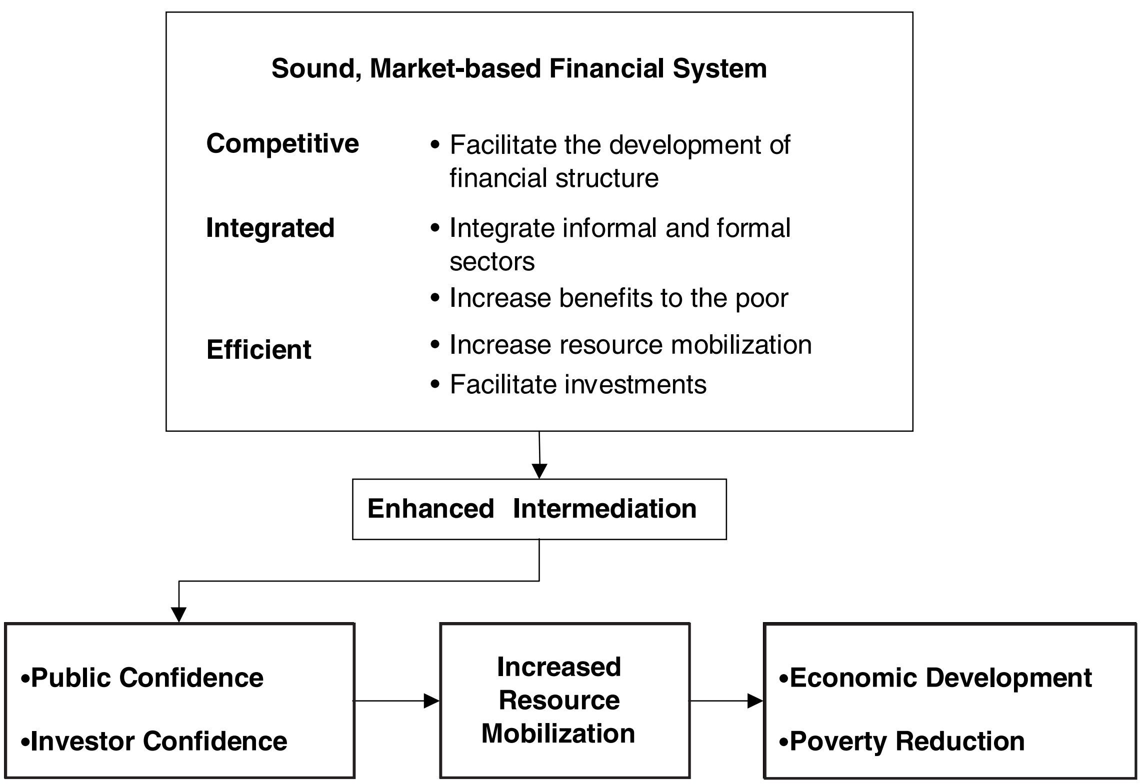
(iii) Total savings and exports as percentages of GDP will increase by about 10 percentage points.

Financial Sector Vision for 2010

Overview

With successful progress in governance reform, especially in the judicial/legal system, and the development of the private sector

Figure 6: Financial Sector Vision for 2010



framework, a sound, market-oriented financial system will be in place in 10 years. A sound, market-oriented financial system is characterized as a competitive, integrated, and efficient system. Competitiveness, supported by a transparent regulatory system and the financial policy, will be the primary driving force for the development of financial system in Cambodia. An integrated financial system offers a breadth of savings and credit products that will extend economic benefits to Cambodians in lower economic strata. In turn, a competitive and integrated financial system will facilitate domestic resource mobilization and growth-oriented investments.

The empirical relationship between financial asset growth and economic growth shows that financial assets grow faster than per capita GDP. Moreover, the speed of financial assets growth is much faster when per capita GDP is below $1,000 (Box 1). The ratio of financial assets to GDP in Cambodia should at least triple as GDP triples and per capita GDP doubles over the next 10 years.

The spread between loan and deposit rates will narrow as intermediation becomes more efficient. Similar to the experience of other economies (Box 2), several factors will contribute to this trend in Cambodia and determine the speed of reduction in spread. The major contributing factors include (i) sustained macroeconomic stability, (ii) reduced uncertainties resulting from improved legal and financial infrastructure, and (iii) increased competition among banks.

The banking sector will be the prime area of growth in financial assets, followed by the insurance sector. This projection is based on factors such as (i) the current structure in which banks are predominant, (ii) enhanced intermediation capacity following a comprehensive bank restructuring under the IMF Poverty Reduction and Growth Facility program, and (iii) improved financial infrastructure. Universal banking orientation under the Banking Law will further strengthen the leading role of banks over the medium term. In fact, the banking sector has demonstrated its capacity to increase the loan portfolio by more than 30 percent over the last two years with the increased demand from the real sector. With the successful restructuring assisted by IMF, the banking sector will step up its capital base. Further, the banking sector will increase intermediation capacity once related infrastructure is developed.

Development of Financial Institutions

Expansion of the Banking Sector. Competition between banks will facilitate reorganization of the banking industry, resulting in economies of scale and scope as some of the best performing banks acquire or merge with other banks. Some weaker and perhaps smaller banks may voluntarily decide to sell to or merge with stronger performing banks. The strategy of being acquired or merging with stronger banks will improve the efficiency of the banking system through better utilization of bank capital and human resources, as well as sharing common resources across a broader product line.

As competition among commercial banks increases, banks will become less dominant, as a more balanced and integrated financial structure with diverse nonbank financial activities gradually emerges. Competition may drive banks to adopt different strategies for expanding into the nonbank financial business. Given a universal banking system, some of the best performing banks will expand the scope of their businesses into nonbank areas as they increase their capital bases and assets through mergers and acquisitions. Others will decide to specialize in either commercial banking or

Box 1: Financial Interrelation Ratio

The financial interrelation ratio (FIR) is the ratio of the total value of all financial assets to the national wealth, which can be approximated by gross domestic product (GDP). Low FIR normally characterizes an early stage of financial development.

Figure B1.1. FIR: 1965-90

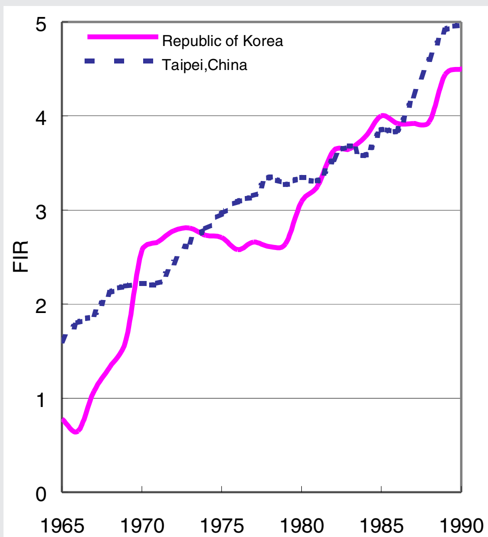
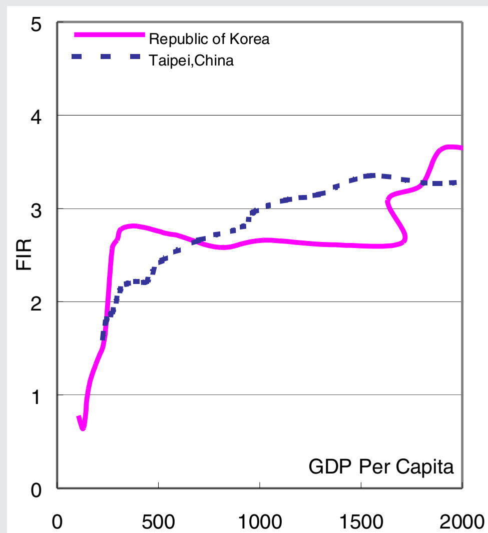


Figure B1.2. FIR vs. GDP Per Capita



Source: FIR data from "The Financial Development of Japan, Korea, and Taiwan: Growth, Repression and Liberalization," edited by H. T. Patrick & Y. C. Park, Oxford University Press, 1994.

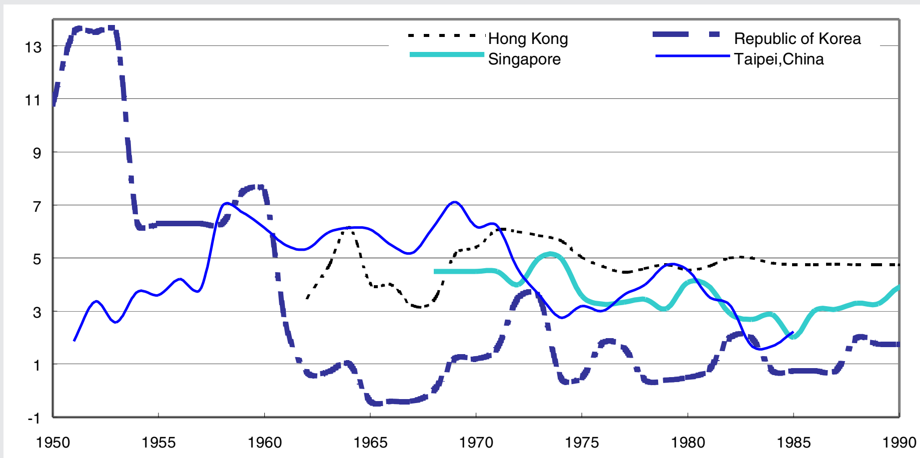
The figures show that financial assets grow faster than per capita GDP in the course of economic development. Furthermore, the speed of growth of financial assets is much faster when per capita GDP is below $1,000. Once the economy attains a certain stage of development, the FIR ratio tends to level off.

In the case of the Republic of Korea, when GDP tripled from $3 billion to $9.73 billion and per capita GDP tripled from $105 to $296 during 1965-1971, FIR jumped from 0.78 to 2.66, meaning that the total financial assets become more than 11 times those at the beginning of the period. The number for Taipei,China is less dramatic but still very significant. During 1966 and 1973, its GDP also tripled from $3.13 billion to $10.77 billion and the per capita GDP doubled from $242 to $700, with financial assets increasing more than fivefold as FIR increased from 1.8 to 2.66.

Box 2: Interest Rate Spread

The historical data of the four Asian Tigers illustrate the relationship between interest rate spreads and depth of financial system.

Figure B2.1. Spread of Loan and Deposit Interest Rates



Spreads consist of operating costs and a risk premium. Operating costs include treasury costs, salaries, and other administrative expenses of the banks, while risk premiums cover legal, regulatory, and other uncertainties.

The right environment is the key for developing the financial system and for reducing interest rate spreads. With the deepening of the financial system, the competition among financial institutions will increase the financial intermediation efficiency and in turn bring down spreads.

The data show that interest spreads tightened over the observed period, reflecting increased intermediation efficiency. Taipei,China's case differs in the early years, when the government controlled the interest rates. After relaxation of interest rate control, the spread also followed the generally declining trend. The Republic of Korea's spread was above 13 percent during the Korean War period, and a speedy reduction in spread followed thereafter. With the liberalization of interest rates, strong competition among banks resulted in negative spreads for about three years during the mid-1960s.

The current interest rate spread in Cambodia is above 13 percent per annum, reflecting the lack of liquidity management instruments, lack of law and contract enforcement mechanisms, and heavy adverse selection on the borrowers' side. Once these issues are resolved, Cambodia can expect a decline in interest rate spreads. First, efficient interbank markets will substantially reduce the operating costs of banks. Second, with introduction of the rule of law and a contract enforcement mechanism, the costs related to legal uncertainties will decline. Third, with the development of accounting and auditing standards and monitoring systems, the uncertainty with regard to borrowers will be minimized and thus reduce adverse selection.

non-bank finance, which will separate banking and nonbanking activities. As the number of banks that adopt specialized financial services increases, so will the diversity of nonbank financial institutions.

As banking efficiency improves, the scope of bank products will expand to include diverse maturity profiles and interest rate structures. In the short term, reduced uncertainties in the legal environment will enable banks to increase the average maturity of loan products and to reduce loan-deposit interest rate spreads. Furthermore, the improvement in the payment system and the availability of diverse negotiable instruments will permit the banking sector to further expand payment services. Competition between banks will lead to increased investments in information technology (IT) and attract new customers. An improved IT environment will expedite the development of credit cards and other consumer finance services.

With the Government's proactive privatization efforts and market-oriented reform, the banking sector will be dominated by privately owned banks. The universal banking orientation in the Banking Law will limit state ownership in the banking system because the private banking system is expected to undertake the major role of development financing.

The non-agriculture sector will remain the dominant borrower in the banking system. The service and manufacturing industries will lead the growth of bank loan portfolios. The banking sector will become a major financing source for the working capital of SMEs and microenterprises. With improvement in transparency, a growing number of banks will lend based on cash flow analysis rather than on the availability of collateral, which will thereby improve the quality of loan portfolios.

Regional deposit bases will expand as banks compete to establish branch networks outside urban areas. Improvement in the banking sector will create competitive pressures in the informal financial sector. This will lead to a reduction in loan margins and overhead costs for financial products and services for the rural areas and therefore facilitate integration of the formal and informal financial sectors.

With the promotion of the financial service outreach as well as the development of financial infrastructure, a variety of community-based savings institutions such as cooperatives, credit unions, and postal savings offices will emerge. These second-layer savings institutions will supplement the banking system because they will provide additional rural lending and diversify channels for banking and payment services among the lower income classes and the rural areas.

Rural Finance. The development and reorganization of the banking industry will enable expansion of the banking network in rural areas. This will enhance the access of farmers and rural businesses to financial services and serve to integrate the rural and urban financial markets. The agriculture sector, in particular, will be able to access long-term resources. With the policy, legal, and institutional measures initiated for microfinance development, an array of MFIs is likely to emerge to provide a range of financial services to the poor. NGOs with substantive long-term interest in microfinance will graduate to licensed MFIs. Strengthening of regulatory and supervisory systems, information systems, and accounting and auditing standards will improve the capacity of MFIs and enable them to leverage funds in the market and provide competition.

Emergence of NBFIs. Given the current bank-dominant structure, it is probable that NBFIs will emerge as subsidiaries of banks.

Leasing companies and consumer finance companies will be the first possible candidates for NBFIs in the form of subsidiaries of commercial banks. In the initial stage, the securities trading business also will be undertaken by the commercial banks directly or on behalf of clients. As business expands in the securities market, risk management concerns will facilitate the separation of the banking and securities businesses.

The improved legal framework and the development of money markets will facilitate the emergence of money market intermediaries such as finance and investment companies. The development of capital markets will also bring diverse capital market intermediaries and institutional investors such as securities companies, investment and trust companies, and venture capital companies.

Development of the Insurance Sector and Pension System. With the strengthened efforts to privatization, the insurance sector will be soon transformed into a market-oriented system where the private sector dominates. Given the weak demand, the current oligopolistic structure will be sustained over the medium term. In the initial stage, nonlife insurance companies will dominate the insurance market to meet the increasing demand from the business sector. Implementation of compulsory insurance policies will give impetus to the development of the nonlife insurance business by creating policy-driven demand. Further, with the promulgation of supporting laws and the development of enforcement/monitoring mechanisms, compulsory insurance will create a broader demand base for the insurance business. Third-party liability motor insurance will first emerge after the appropriate legislation and enforcement. With the expansion of commercial activities and the increased awareness of insurance in the business sector, the insurance sector will further diversify its products to include, for example, credit insurance, livestock insurance, and crop insurance. As per capita income grows, the demand for life insurance will gradually emerge. However, life insurance will be developed on a limited scale because of the relatively low level of per capita income over the next 10 years.

An enabling environment will be created for developing a multi-pillar pension system with the expansion of financial services, the strengthening of banking and insurance sectors, and the development of sound supervisory and regulatory frameworks. The current civil servant and military pension systems will be sustained over the next ten years as the foundation is established for a mandatory public pension program. At the same time, the legal and regulatory frameworks will be developed for a mandatory privately managed funded pension program and voluntary retirement savings programs.

With the expansion of the industry base and the diversity of products, the insurance sector will be a major contributor to domestic resource mobilization, and the domestic insurance sector will reverse the flow of premiums from overseas to the local market.

Development of Financial Markets and Instruments

With the enhancement of public confidence and competition, financial institutions will diversify financial instruments to meet the diverse needs of savers and investors. In the initial stage, the average maturity of bank assets will increase and deposit products will be further diversified. Contributing factors include (i) development of the legal and financial infrastructure, (ii) enhanced efficiency of the payment system, (iii) strengthening of law and contract enforcement,

(iv) enhanced public confidence in the banking system, (v) enhanced mutual confidence between financial institutions, (vi) availability of an efficient interbank markets, and (vii) competition between financial institutions.

Interbank/Money Markets. Development of interbank markets will enable financial institutions to manage liquidity more efficiently and reduce operating costs. With a gradual build-up of confidence among commercial banks, unsecured overnight interbank borrowing among a small number of large banks will emerge first. With the availability of Treasury Bills (T-Bills) and other government securities, repurchase agreements will further expand the scope of interbank markets. Under the guidance of the central bank, the Bankers Association will play a catalytic role in developing and deepening interbank markets' architecture and services.

With the increased sophistication of fiscal management, the Government will issue T-Bills and further diversify the maturity structure of its securities. Interest rates on government securities will play a key role in setting benchmark interest rates for pricing marketable financial instruments. Thus, the development and deepening of government securities market will create a positive environment for diverse money market instruments as well as a market-based monetary policy through open market operations.

In the early stages of money market development, commercial banks will take the lead in issuing money market products such as negotiable certificates of deposits and will play the role of intermediary as well. With the development of the export-import industry, trade bills will also emerge. The introduction of commercial papers and corporate bonds may come at a much later stage.

With the strengthening of the legal infrastructure, especially the adoption of a negotiable instruments law, basic negotiable instruments such as commercial bills, bills of exchange, and promissory notes will emerge. Increased commercial activities and enhanced financial intermediation will facilitate the use of negotiable instruments issued by financial institutions, which in turn will reduce transaction costs in the economy as a whole.

Capital Markets. The foundation for capital markets will be in place within the next 10 years. Public confidence in the financial and corporate sectors will improve substantially. Successful reform in the judiciary system and enforcement of key laws such as the company law, contract law, and bankruptcy procedure will enhance the rule of law. The promulgation of the Accounting and Auditing Law and the implementation of IAS/ISA as common accounting and auditing standards will strengthen public confidence in the corporate sector. Continued macroeconomic stability and the Government's de-dollarization policy will boost public confidence in riel-denominated assets. Together with improved transparency in the corporate sector, these measures will build a solid demand base for corporate securities. A critical mass of issuers will emerge as economic growth gains momentum under improved transparency.

Until an SEC is established and the related securities market infrastructure is in place, corporate securities will be initially traded on the over-the-counter market. With the development of government securities, fixed income securities of large public corporations may emerge on the over-the-counter market. As the number of qualified issuers increases, a securities exchange will be established.

The commercial banks will play the role of intermediary in the early stage of capital market development. When the securities exchange market is formally operating, securities companies will emerge as subsidiaries of larger and more active commercial banks. Foreign securities companies may also show interest and open branches in Cambodia.

Some contributing factors include (i) macroeconomic stability, (ii) the Government's de-dollarization policy, (iii) a gradual recovery of public confidence, (iv) development of the legal and financial infrastructure (such as promulgation of a company law and a bankruptcy law), (v) emergence of a critical mass of issuers, (vi) buildup of an investor base and income level, (vii) institutional capacity of a regulatory body, and (viii) availability of human resources.

Regulatory/Supervisory System and Financial Safety Net

Regulatory and Supervisory Structure

The regulatory and supervisory system will be developed to encourage competition among the financial institutions while safeguarding the integrity of the financial system. Continuous modernization of prudential regulations based on international best practices will improve transparency and predictability and thus reduce the compliance cost of financial institutions while instilling market discipline.

NBC will pursue a medium-term reorganization plan to establish itself as an independent regulator with full-fledged supervisory capacity. It will be able to allocate adequate resources for staffing, training, and compensation to attract and retain qualified staff. Its supervisory functions will improve with the development of prudential norms, improvement in the accounting infrastructure, and enhancement of human capacity. As banking activities increase and diversify, NBC will continue to increase supervisory resources and improve supervision skills, so BSD will be a major functional body in the central bank over the next 10 years.

NBC will also maintain its functional independence when conducting monetary policy. With the development of money markets and the availability of diverse financial instruments, monetary policy function will be enhanced, thus strengthening NBC's role as the lender of last resort.

MEF will become a key policy initiator of the financial system as it will establish the regulatory system in nonbanking areas, including insurance. MEF also will be responsible for the laws related to the financial infrastructure. In the first phase, insurance supervision will be strengthened through further enhancement of the capacity of the Insurance Office of MEF. As the insurance sector expands in respect of institutions and products, an independent insurance supervisory authority will be established.

With the promulgation of a securities and exchange law, an SEC will be established as the primary supervisor of capital market activities. In the initial stage of capital market development, NBC will oversee the securities business of commercial banks, which will be major players in securities trading on the OTC market.

With the establishment of sector-specific supervisors, coordination among supervisors will become critical to maintain consistency and to avoid conflicts. Therefore, the coordination role of MEF will become more significant. The Government may decide to establish a coordination committee to maintain the integrity and consistency of supervisory policies while honoring the independent activities of supervisors.

Financial Market Safety Net

As each supervisory authority puts in place a prompt corrective mechanism for each sector based on international best practices, the financial market safety nets will improve. As financial activities expand, explicit financial market safety nets will also be established in the form of a sector-wide deposit insurance system. A deposit insurance system will be first introduced in the banking sector. The safety nets will be designed to avoid the moral hazard problem and will target especially the protection of small depositors. Equally important is the financial sustainability of the safety nets, which will be achieved partly through an equitable share of burdens among participants.

Financial Market Infrastructure

Legal Infrastructure

The basic legal infrastructure that will underpin the financial system and commercial activities will be in place. The ultimate goal of legal/judiciary reform will target (i) well-defined property rights; (ii) enforceable contracts; (iii) ability to pledge and seize collateral; and (iv) fiduciary responsibilities and liabilities of financial agents, stakeholders, and managers of financial institutions. For this, a comprehensive civil code, following commercial contract law and procedures, will be in place. In addition, a complete commercial code will be implemented after the adoption of the Law on Commercial Enterprises, a bankruptcy law, etc.

With successful judiciary reform, law enforcement will be strengthened. In particular, a commercial chamber of the court will play a key role in reestablishing public confidence in the judiciary and law enforcement systems.

A secured transactions law and a public registry system will be in place, which will reduce transaction costs by alleviating uncertainties about secured transactions and collateral registration. With the promulgation of the supporting laws, a public registry for movables will be in place.

The development of the legal infrastructure and improved public confidence will reduce uncertainties regarding contract enforcement, which will facilitate private sector development by revitalizing commercial activities and financial transactions. More important, reduced uncertainties of contract enforcement will substantially reduce the transaction and operating costs of the financial institutions and thus facilitate intermediation.

Accounting and Auditing System

With the Government's proactive policy, the accounting and auditing system will be developed based on international standards. Financial and nonfinancial public corporations will take the lead in adopting IAS/ISA, which will be followed by private companies.

The establishment of an association of accountants and auditors will improve the enforcement of accounting and auditing standards. The association will play a key role in developing the accounting industry, as well as in capacity building, by providing professional training in accounting and auditing.

Improved transparency resulting from strengthened enforcement of auditing and disclosure standards will enhance public confidence in financial institutions. The banking sector will be the first group of beneficiaries when improved transparency in the corporate sector will reduce information costs. Improved transparency will also facilitate the development of the nonbanking sector and capital markets.

Financial Market Information System

An efficient and reliable credit bureau or arrangements for sharing credit information will allow financial institutions to timely access to credit information. This will be complemented by improved transparency in the corporate sector because of strengthened enforcement of accounting and auditing standards. Furthermore, a credit rating agency will emerge as the issuance of corporate securities and commercial papers increases. Improved quality of the financial information infrastructure will reduce the information costs of financial institutions.

Payment System

An efficient payment system will be established to settle funds between customers and banks, and among financial institutions. An increased investment in IT by both the private and public sectors will enhance the efficiency and quality of the payment system. Integration of computer networks and adoption of on-line banking systems will further improve the payment system; diversify payment instruments for prompt noncash fund transfers; and facilitate integration of the formal and informal sectors, thus increasing the viability of financial institutions in the rural area.

Capacity-Building Mechanism

The capacity-building institutions, in both the private and public sectors, will be in place to meet the multifaceted demands of the financial system. The Bankers Association will take the lead in major capacity-building activities in the private sector. The collective efforts of commercial bankers under the Bankers Association will provide professional training through international cooperation and the establishment of a bankers' training institute. Capacity building in the public sector will be accomplished through the establishment of self-funded training institutions and the continuous reorganization of key regulatory institutions.