

# FINANCIAL SECTOR BLUEPRINT

## Introduction

### Structure of the Blueprint

The Blueprint comprises a long-term development strategy and a sector development plan. The long-term strategy is based on key lessons drawn from the experiences of financial sector development and reform in other countries, and it guides the sector development plan.

Each sector development plan consists of a development goal, intermediate reform agenda, and illustrative policy measures in each phase. The development goal describes the sector strategy to achieve visions in each sector over three phases: 2001-2004, 2005-2007, and 2008-2010.

The intermediate reform agenda is selected to help (i) identify specific policy measures to achieve the goals that have been set, and (ii) sequence and pace these policy measures. In other words, the intermediate reform agenda in a specific phase describes *tactics* to achieve the set goals. At the same time, a series of reforms over three phases suggest sequencing tactics for development efforts in a specific subsector. The reform agenda, however, includes built-in flexibility because it enables policymakers to add or refine the agenda to reflect the progress made in each sector and

each phase along with changing financial market conditions. This is inevitable because each intermediate reform agenda is interwoven, vertically and/or horizontally, with those in the other sectors. In case some actions are not implemented, the actions that would have followed them become infeasible. Policy measures under each intermediate reform agenda are *illustrative and indicative*. Thus, when implementing the sector development plan, policymakers may need to further refine policy actions.

The sector development plan is a *think panel* to assist policy makers and stakeholders in sequencing and coordinating development efforts. The panel considers the interrelation of (i) human and institutional capacity building, (ii) the development of related infrastructure, (iii) the establishment of a legal and regulatory framework, (iv) the emergence of relevant financial markets, and (v) the availability of technology.

The sector development plan addresses necessary standards, laws, and regulations as well as the preparation of necessary human resources and the institutional capacity for implementation. Because the mere establishment of laws and standards does not mean that financial sector development goals have been met, the Blueprint also focuses on the institutional and human capacity building needed to implement measures that address financial sector weaknesses.

The sector development strategy is a rolling plan that needs continuous updating to reflect the Government's achievements and the changing socioeconomic environment. If the Government accomplishes a certain development goal set in the plan earlier than planned, the policies that follow need to be adjusted accordingly.

## Long-term Development Strategy

A long-term development strategy is developed to implement the financial sector vision, which has been derived from the following factors: (i) key lessons drawn from other economies' experiences with financial sector development, (ii) the current situation in Cambodian financial markets, and (iii) the progress in governance reforms under implementation.

The experiences in financial sector reform in Asian and other economies in recent decades have been well documented by numerous studies. Sound financial sector development requires that emphasis be put on (i) a sound and sustainable macroeconomic environment; (ii) sound governance, including legal and accounting infrastructure; (iii) effective market discipline; (iv) adequate institutional and human resource capacity; and (v) the ability to take advantage of modern technology.

In particular, the development of the banking system builds on an adequate body of laws that underpin the financial system and transactions, covering contracts, bankruptcy, collateral, and loan recovery. Supporting the body of laws must be ethical and professional lawyers and judges and an efficient court system whose decisions are enforceable. In addition, financial reporting must be based on common accounting and auditing standards so that

investors and supervisors can assess the financial condition of the banks, and banks can monitor the health of the institutions to which they lend. Accurate financial data require a professional body of accountants and auditors.

The initial stages of the Blueprint focus on building sound governance through developing the legal and accounting infrastructure, and building institutional and human capacity. An early focus is given to banking sector development, as this has proven to be the fastest means of mobilizing financing for private sector growth in developing economies. Next, to lay the foundation for capital market development and contractual savings, the Government must develop proper legal and supervisory frameworks.

Experiences from financial sector development and reforms in Asian economies and other transition economies offer many lessons for consideration in financial sector development in Cambodia. In drawing a long-term strategy for the Blueprint, the following 10 key lessons 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 the 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 an 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, credit information system, and regulatory framework.

- (v) Sound competition in financial markets is a key driving force that leads 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 supports 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 factor that adversely affects financial development and the allocational efficiency of investment funds.
- (ix) Lax entry requirements under a weak supervisory system results in an excessive number of poorly managed banks.
- (x) For sustainable financial sector development, it is crucial to build up market-oriented management, a sound system of operations, and improvements in technical competence, commensurate with the desired change in the financial structure.

Based on the above lessons, the key elements of a long-term strategy for financial sector development are as follows:

- (i) maintaining sound fiscal and monetary policies to ensure macroeconomic stability;
- (ii) systematically establishing a sound legal framework to protect property rights and enforce contracts;
- (iii) establishing the rule of law through legal/judicial reform and law enforcement to underpin financial and commercial activities;
- (iv) sequencing efforts to develop financial infrastructure, particularly the payment/clearing system, accounting and auditing 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 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 allocational efficiency and financial deepening;
- (ix) developing an efficient exit mechanism for troubled institutions to

foster continuous reorganization in the financial system without incurring social costs; and

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

- (iii) restructuring the banking sector,

- (iv) establishing a framework for the payment system, and

- (v) establishing a capacity-building mechanism.

## The Banking Sector

The Blueprint for the banking sector consists of three phases. The first phase aims at laying the foundation for the banking system by establishing basic policy and an 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 the 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 the efficiency and quality of banking services in the rural areas.

### Phase I: Lay the Foundation for Banking Sector Development

To achieve the goal in Phase I, five intermediate reform agendas are set:

- (i) establishing a basic framework for monetary policy,
- (ii) establishing a framework for supervision,

**Establishing a Basic Framework for Monetary Policy.** It is imperative that monetary policy be normalized to safeguard macroeconomic stability. Considering the rampant dollarization in the economy, a full-fledged monetary policy is not expected to be in place until Phase III. However, the basic preparatory work to establish monetary policy framework should be initiated in Phase I. The following steps should be considered: (i) streamlining reserve requirements to reduce idle bank reserves and reduce commercial banks' operating costs, (ii) phasing out the guarantee deposit or capital reserve required for bank licensing, and (iii) considering reducing the reserve requirement ratio on riel-denominated deposits. A lower reserve requirement for riel-denominated deposits would help increase the attractiveness of riel deposits and encourage riel-based operations among commercial banks.<sup>12</sup> Second, the Government should consider issuing government securities, notably T-Bills. The provision of riel-denominated securities will stimulate demand for the riel and develop banking activity in the local currency. Furthermore, the auction of T-Bills will provide benchmark interest rates on riel-denominated financial instruments. This measure will be the first step in developing an instrument to control riel liquidity.<sup>13</sup> Finally, the Government should adopt a plan to implement rediscount/refinance facilities.

<sup>12</sup> Cardona, Michel and Luca Papi. 1997. Cambodia: *Financial Sector Issues*. World Bank.

<sup>13</sup> *ibid.*

**Establishing a Framework for Supervision.** In continuation of the current efforts, NBC needs to establish the framework for effective bank supervision. Key policy actions considered include:

- (i) establishing a complete body of prudential regulations by reconciling old regulations with new regulations and issuing clarifying guidance to commercial banks;
- (ii) adopting surveillance and inspection procedures, including standardization of the reports submitted by commercial banks;
- (iii) improving the application of the CAMEL system for evaluating bank performance;
- (iv) adopting new prudential regulations on lending to connected or related parties, risk management, and internal control;
- (v) establishing a fully staffed on-site inspection unit;
- (vi) adopting a uniform chart of bank accounts and disclosure rules consistent with IAS/ISA;
- (vii) adopting a prompt corrective action (PCA) system; and
- (viii) adopting an antimoney-laundering regulation.

**Restructuring the Banking Sector.** NBC needs to complete the bank relicensing program under the IMF program. To this end, the following actions need to be taken: First, NBC needs to establish procedures to ensure the orderly resolution and liquidation of problem banks. Second, NBC needs to make

an effort to appoint liquidators for all delicensed banks as soon as possible. Third, NBC must have a contingency plan to address circumstances wherein some conditionally licensed banks are unable to achieve the conditions imposed in their memoranda of understanding to increase capital to the minimum level required under the regulations by the end of 2001. NBC should also complete restructuring and privatization of FTB in the first phase. FTB restructuring/privatization calls for many challenging tasks. First, FTB needs to adopt and implement a privatization plan. Second, the FTB board needs to adopt a business plan for the medium term to reorganize FTB as a commercial bank. Third, FTB needs to adopt a comprehensive training program to instill commercial orientation, including accounting, risk management, asset/liability management, and management information systems.

**Establishing a Framework for the Payment System.** Despite NBC's active efforts, the current payment system calls for further refinements. The following actions should be taken: (i) improve operational procedures for both the riel and dollar clearing systems, considering the compliance capability of commercial banks; (ii) adopt a payment law to underpin the payment system; and (iii) improve the backup system for smooth operation of the payment system. In addition, NBC and the Bankers Association should adopt a protocol for an on-line banking system to facilitate the integration of individual banks' systems in the future. Some commercial banks have already adopted different systems in their automated teller machines and other services; this may incur unnecessary costs to the banking sector in establishing an integrated interbank on-line system in the near future.

**Establishing a Capacity-Building Mechanism.** The first step in capacity building is to establish and strengthen training

institutions for both the private and the public sectors. Important activities in the private sector include (i) creation of an inclusive bankers association recognized by NBC, and (ii) establishment of a banking institute for the professional training of commercial bankers. NBC needs to strengthen its capacity-building mechanism through the following actions:

- (i) appointing full-time CBS instructors under a competitive compensation scheme;
- (ii) establishing a central banking course for NBC professional staff in CBS;
- (iii) adopting a comprehensive retraining program for NBC staff with noncollege-level education in the form of a NBC personnel regulation;
- (iv) adopting a mandatory training program for entry-level professional staff in CBS; and
- (v) adopting a competitive, merit-based compensation scheme.

## Phase II: Enhance Intermediation through Competition

The second phase of banking sector development aims at enhancing intermediation through competition. Competition will increase the diversification of banking services as well as the expansion of service areas, leading to increased outreach to the poor and to rural areas. This development goal in the second phase can be achieved through the following intermediate reform agenda:

- (i) improving monetary policy instruments,

- (ii) improving the enforcement of prudential regulations,
- (iii) enhancing banking services through diversification,
- (iv) improving the efficiency of the payment system through investments in IT,
- (v) promoting outreach to rural areas by encouraging the establishment of branches, and
- (vi) strengthening NBC organizational structure.

**Improving Monetary Policy Instruments.** Building on the achievements of the first phase, NBC needs to further improve the monetary policy framework. NBC may need to adopt a phased plan for further reduction of the reserve requirements. NBC also needs to prepare a detailed plan to implement rediscount/refinance facilities, because the Government is expected to regularize the issuance of T-Bills and to improve the trading system by developing primary dealerships in Phase II.

**Improving the Enforcement of Prudential Regulations.** Following the efforts to set up a basic supervision framework, NBC needs to improve the enforcement of prudential regulations and to continue updating regulations to reflect changes in banking businesses. The main emphasis should be on the following areas: First, NBC needs to strengthen the implementation of PCA to encourage sound management and operations. Second, NBC needs to begin full on-site inspection with NBC staff. Third, in line with strengthening PCA, NBC needs to establish a transparent exit mechanism and streamline exit procedures to allow the swift and orderly exit

of nonviable banks. To do this, NBC should pursue the following:

- (i) revising laws that cover insolvency and liquidation of banks to eliminate inconsistencies, and
- (ii) establishing procedures for mergers and acquisitions and purchase and assumption for problem banks.

Finally, NBC should establish legal protection for supervisors against lawsuits for actions taken in fulfilling their official duties. Such legal protection will be the basis for proactive supervisory activities.

**Enhancing Banking Services through Diversification.** The Government should further enhance intermediation through the diversification of banking services. This will be achieved, in part, by allowing banks to expand their scope of business into nonbanking areas. Meanwhile, the Government needs to allow banks to set up nonbanking subsidiaries by establishing proper regulatory guidelines. To do this, NBC needs to establish a regulatory framework for credit card services, housing/mortgage finance, installment finance, etc.

**Improving the Efficiency of the Payment System through Investments in IT.** As financial transactions increase and become more diverse, the banking system needs increased investment in IT to improve the efficiency of the payment system. Key areas to be addressed include (i) establishment of a central bank wire system, (ii) automation of the clearinghouse, and (iii) establishment of an on-line banking system in individual banks. NBC and the Bankers Association should make concerted efforts toward the success of these tasks.

**Promoting Outreach to Rural Areas by Encouraging the Establishment of**

**Branches.** This can be done through expansion of the formal banking sector to rural areas. This process will be facilitated by the Government's proactive effort, such as the introduction of an explicit incentive system for banks that are active in branching out to rural areas.

**Strengthening NBC Organizational Structure.** Although the key capacity-building activities for the central bank identified in Phase I will continue in the second phase, NBC must strengthen its organizational structure to undertake its increasing role and responsibilities in the financial sector. The reorganization of NBC must address a proper division of responsibilities among departments to carry out central bank functions with the evolution of the financial sector. This includes (i) defining the necessary skill mix, (ii) refining job descriptions for senior officials and professional staff, and (iii) identifying additional capacity-building requirements. The task will be initiated by a diagnostic review of the current organization and by drafting a reorganization plan. The reorganization plan should also address (i) the establishment of an effective recruitment system to attract competent staff into the central bank, and (ii) the introduction of a performance-based compensation and promotion system to retain and develop qualified staff. Reorganization requires the strong commitment and support of executive management and consensus among staff.

## Phase III: Promote Efficiency through Integration and Reorganization

Phase III aims to promote efficiency within the banking system through the reorganization of the banking industry and further integration of the banking system. Such a goal will be achieved through six areas of intermediate reform:

- (i) developing a market-based monetary policy framework,
- (ii) upgrading prudential regulations,
- (iii) facilitating bank reorganization through incentives and a reinforced supervision system,
- (iv) establishing an integrated on-line interbank system,
- (v) strengthening outreach to rural areas through competition, and
- (vi) enhancing central bank independence.

**Developing a Market-Based Monetary Policy Framework.** In Phase III, the environment for monetary policy will improve with the deepening of the money markets and the increased efficiency of the payment system. NBC can consider introducing an open-market operation system based on available government securities. To accomplish this, NBC must develop a detailed framework for open-market operations. NBC and MEF will also need to further deepen government securities market.

**Upgrading Prudential Regulations.** The supervisory role of NBC must be upgraded in line with the diversification of the banking industry. For this, NBC needs to upgrade the prudential norms in accordance with the Bank for International Settlement (BIS) guidelines. Special emphasis must be placed on strengthening risk management regulations covering banks engaged in diverse nonbanking businesses.

**Facilitating Bank Reorganization through Incentives and a Reinforced Supervision System.** The main task of bank supervision in Phase III is to promote the

reorganization of the banking sector. To this end, NBC first needs to strengthen the enforcement of PCA. Second, NBC should strengthen the incentive system by expanding the scope of nonbanking business for commercial banks that initiate voluntary mergers and acquisitions. Third, NBC needs to further refine the minimum capital requirement reflecting the increased size and scope of business. NBC might consider adopting multi-tier minimum capital requirements, depending on the business scope of the commercial banks.

**Establishing an Integrated On-Line Interbank System.** Automation of banking operations will continue in the third phase. The target of the third phase is to establish an on-line interbank system that integrates the central bank wire system and individual banks' on-line banking networks. With the establishment of intrabank and interbank on-line systems, the scope of banking services will be further expanded.

**Strengthening Outreach Rural Areas Through Competition.** The Government should promote the expansion of the formal banking sector by promoting the establishment of community-based savings institutions such as credit unions and cooperatives. To do this, the Government must establish legal and regulatory frameworks for credit unions and cooperatives with appropriate incentive systems. Together with the integrated on-line banking and interbank system, community-based savings institutions will create competition in the rural banking sector, thus leading to further integration of the banking system, and will improve the quality of banking services in rural areas.

**Enhancing Central Bank Independence.** Building on the reform efforts in the second phase, NBC will be ready to undertake the modernization of its function as an independent central bank. The Central

Banking Law and the Banking Law need to be revised to step up NBC's responsibilities in monetary policy and financial sector development. The independence of the central bank is essential in Cambodia, as an independent central bank will be able to safeguard the stability of the banking system and continue banking sector development in the changing sociopolitical conditions.

## Rural Finance

The need for institutional development in the nascent and fragile financial sector is pervasive, and the magnitude of required support is enormous. A defined focus on the poor, especially women, the disabled, and other excluded sections is critical for creating financial and social capital in Cambodia. Access to financial services, limited as it is, has enabled the poor to participate in economic activities at the community/village levels. The Rural Credit Policy, accordingly, aims to enhance the outreach of sustainable finance through private sector participation, community-based approaches, and linkages among institutions based on competitive advantages.

The aim of the long-term development strategy is to enhance outreach to the poor, to low-income households, and to their microenterprises through appropriately managed institutions. Measures in Phase I aim primarily to implement the ADB-funded Rural Savings and Credit Project and TA for Rural Financial Services to provide the foundation for a sustainable rural financial system. During Phases II and III, the emphasis will be on enhancing the impact and outreach of poverty reduction. These interventions should also be sequenced with other reform agenda in the Blueprint.

## Phase I: Implement a Basic Policy and Institutional Framework for the Rural Finance Sector

To achieve the goal of Phase I, the ongoing ADB-funded Rural Savings and Credit Project and the TA will continue its support to (i) implementing the policy actions specified in the Rural Credit Policy; (ii) strengthening supervision and regulation; (iii) facilitating institutional transformation, linkages, and service delivery; and (iv) building sustainable institutions. In addition, the agenda will include capacity building for optimal utilization of financial services.

**Implementing Policy Actions in the Rural Credit Policy.** The Government and NBC have already initiated actions pursuant to the adoption of the Rural Credit Policy. The application of the Banking Law with specific reference to licensing of MFIs needs to be broadened, as the establishment of the policy forum to facilitate stakeholder consultation needs to be expedited.

**Strengthening Supervision and Regulation.** The key variable in the orderly and systematic development of rural finance is effective supervision and regulation. Consistent with efforts in this regard for the banking sector, MSD of NBC needs to enhance its supervisory and regulatory capacity, ideally ahead of the licensing of NGOs as licensed MFIs. In its supervisory and regulatory role, NBC needs to provide flexibility and room for innovation for licensed MFIs.

**Facilitating Institutional Transformation, Linkages, and Service Delivery.** Transformation of the six identified NGOs<sup>14</sup> into licensed MFIs will enable them to provide a range of services and access refinance assistance from RDB. The framework of delivery of microfinance services in Cambodia is through community groups. Funding agencies and the Government need to assist these groups to become effective intermediaries and be able to establish linkages with MFIs. Promotion of savings through MFIs will be a first step to address the demand from the poor for saving services.

**Building Sustainable Institutions.** To start, there is need to strengthen RDB to enable it to effectively function as a sustainable apex institution. Building the institutional capacity of the NGOs that have become licensed MFIs is critical for their sustainability. Although NBC needs capacity on many fronts, its supervisory and regulatory capacity with reference to the rural financial system is a priority. The immediate capacity-building need will be accommodated by the existing facilities of CBS, but there may be a need to set up specialized rural and microfinance training institutions and resource centers. Possibilities for these will be explored during Phase I.

**Capacity Building for Optimal Utilization of Financial Services.** Demand for microfinance services for the poor is accompanied by the need for social mobilization and capacity building. These needs are more acute for those in resource-poor areas because they remain unserved or underserved due to risk-return considerations, although the social returns to reaching these clients may be high. Support is therefore

required to meet the intermediation and capacity-building costs of the poor in order to build social capital. The Government will have to coordinate with planned aid initiatives and continue directing resources towards the social sector to enhance the effectiveness of microfinance.

## Phase II: Increase the Impact of Poverty-Reduction Measures

To reach the goal, the agenda for Phase II includes (i) policy coordination, (ii) improving in the application of prudential regulations, (iii) establishing a range of service providers, (iv) expanding the institutional network, (v) enhancing effective intermediation, (vi) promoting innovative microfinance pilot projects, and (vii) introducing safety nets to reduce vulnerability.

**Policy Coordination.** It would be worthwhile to review the Rural Credit Policy to provide improved synergy with the basic financial sector building blocks that have taken shape during Phase I. To enhance the developmental impact, the Rural Credit Policy will have to be closely coordinated with investments in agriculture and rural development such as rural infrastructure, irrigation, agricultural research, and extension. The Government will need to maintain public investment priorities in the rural sector and continue nondiscriminatory agricultural pricing policies.

**Improving Application of Prudential Regulations.** Measures taken in this regard during Phase I will have to be effectively applied with the increase in the number of licensed MFIs. NBC will need to strengthen MSD.

<sup>14</sup> By Loan CAM 30237: Rural Credit and Savings Project: ACLEDA, Hattha Kaksekar, Ennatién Moulethan Tchonnebat, village banks organized by Catholic Relief Services, Cambodia Community Building, and Action Nord Sud. The first two are already functioning as licensed MFIs.

**Establishing a Range of Service Providers.** Commercial agriculture and agriculture-related enterprises, including leasing services, will be introduced in the rural sector. Legal provisions for these will be created to support the establishment of venture capital funds and equity funds, which could facilitate the emergence of sustainable institutions by assisting NGOs to become licensed MFIs and enable restructured commercial banks to raise resources for possible incorporation as licensed MFIs.

**Expanding the Institutional Network.** The involvement of commercial banks in rural finance is essential to expand outreach and establish an integrated financial system. In their current financial situation, commercial banks cannot become active players in rural finance. Subsequent to their relicensing, restructuring, and possible relocation, selected commercial banks could be either designated as licensed MFIs or assisted to provide rural financial services, particularly term loans for agriculture and agriculture-related enterprises. Considering the narrow institutional base, it would be necessary to take the initiative to intervene. This could be done through the creation of new licensed MFIs, primarily in the private sector with active aid agency participation, to meet the demand for rural financial services in remote areas. During Phase II, the capacity of community groups and linkages with licensed MFIs and commercial banks will continue.

**Enhancing Effective Intermediation.** Building the capacity of restructured commercial banks to downscale their operations for banking with the poor and extending agricultural credit is required if these are to become active and effective participants. Similarly, intensive capacity-building support will be required for licensed MFIs for institutional and financial sustainability. Specialized training institutions and/or

programs therefore will have to be established to provide affordable capacity-building services for (i) social organization, (ii) cost-effective targeting, (iii) products and services development, (iv) management information and accounting systems, (v) governance, (vi) cost-reduction technologies, and (vii) appraisal and management of term financing for agriculture.

**Promoting Innovative Pilot Microfinance Projects.** The Government will consider initiating innovative programs and developing financial technology and services that contribute to breaking the barriers to accessibility through pilot projects for disadvantaged groups and those living in the resource-poor areas.

**Introducing Safety Nets to Reduce Risks and Vulnerability.** The disadvantages of poor households include lack of access to financial services, unfair terms of participation in the local economy, and vulnerability to economic and physical downturns. As a result, poor households forgo potentially viable new technologies, production choices, and income opportunities because of risk aversion. A risk-mitigation facility that effectively targets the poor is not available. Insurance services will be extended to the poor during Phase II to mitigate some of the risks.

## Phase III: Enhance Sustainable Outreach

The agenda for Phase III includes (i) reviewing and coordinating policy; (ii) introducing self-regulating mechanisms; (iii) updating and upgrading skills; (iv) establishing a comprehensive institutional network; and (v) enhancing outreach to special microfinance groups.

**Reviewing and Coordinating Policy.** Phase II activities will continue.

**Introducing Self-Regulating Mechanisms.** It is neither feasible nor cost effective for NBC to monitor the performance of a multitude of NGOs as their number grow. Self-regulation accompanied by performance standards is better suited for monitoring small NGOs that would neither qualify immediately nor choose to become licensed MFIs. This function can be undertaken by a coalition of NGOs, by RDB, or by rating agencies as the sector grows in size and sophistication. Self-regulation could be based on historical performance standards, disclosures, and transparency. NBC should eventually confine itself to licensed institutions.

**Updating and Upgrading Skills.** The specialized training/resource centers established during Phase II will need to develop linkages with regional institutions and continually update their capacities and the quality of their courses. In addition, activities initiated during Phase II will continue.

**Establishing a Comprehensive Institutional Network.** To extend the institutional network, small farmer or community-owned institutions will be provided with a legal framework to enable them to integrate with the financial sector and upscale their operations. Depending on the size of the institutional network, NBC will review the equity threshold and other criteria for licensing MFIs.

**Enhancing Outreach to Special Microfinance Groups.** Successful pilots in Phase II will be replicated during Phase III to cover those disabled during conflict or by land mines. Correspondingly, the coverage of safety nets will be enlarged.

## The Insurance Sector and Pension System

The development of the insurance sector will also go through three phases. To tackle the weak legal infrastructure and supervisory capacity, the first phase aims at establishing the foundation of the insurance business and building capacity for the sector. With a solid foundation in place, the insurance sector will develop in size and diversity. The focus of the second phase will be to promote the insurance market through private sector development, to increase outreach to the poor and to 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 diverse insurance products. In response to the growing sophistication and volume of insurance business, an independent insurance supervisor will be needed. As the insurance sector further expands, the independent insurance supervisor will also upgrade prudential regulations in the third phase.

During the first phase of pension system development, the feasibility and design for establishing a multi-pillar pension system will be completed. In Phase II, the legal, regulatory, and supervisory frameworks will be established for the pension system. In addition, capacity-building mechanisms will be needed to ensure that staff of the regulatory and supervisory body are properly trained. During Phase III, the legal framework will be implemented 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.

## Phase I: Establish a Foundation for the Insurance Sector and Determine the Feasibility of a Pension System.

Five intermediate agendas are identified to establish the foundation for the insurance sector and determine the feasibility of a multi-pillar pension system:

- (i) establishing a regulatory and supervisory framework for insurance,
- (ii) establishing a framework for compulsory insurance,
- (iii) establishing a basis for private sector development,
- (iv) building the capacity of insurance regulators and supervisors, and
- (v) conducting a feasibility study to establish a multi-pillar pension system.

### **Establishing a Regulatory and Supervisory Framework for Insurance.**

With the promulgation of the new insurance law, the Government needs to establish a framework for insurance regulation and supervision. The following policy actions need to be done:

- (i) establishing an insurance supervisory unit within MEF;
- (ii) adopting a subdecree to implement the insurance law; and
- (iii) establishing a complete body of prudential regulations, including a uniform chart of accounts consistent with IAS and PCA system.

**Establishing a Framework for Compulsory Insurance.** The Government has introduced compulsory insurance in the new Insurance Law and has committed to develop compulsory insurance framework. To establish an efficient enforcement and monitoring mechanism, coordination and cooperation among concerned ministries are crucial. Thus, the Government needs to establish an interministerial working group to set up an enforcement and monitoring framework for compulsory insurance. In addition, an official plan should be adopted to coordinate the efforts of related ministries toward formulating a legal framework and enforcement mechanisms for compulsory insurance. The preparatory works may also include promulgation or revision of the related supporting laws.

### **Establishing a Basis for Private Sector Development.**

The market orientation of the insurance sector will be enhanced by the privatization of CAMINCO through a joint venture with a private company. Although it is expected that an increased minimum capital requirement will lead to the consolidation of the industry, it is also necessary to keep the insurance sector exposed to sound competitive forces. In fact, given the relatively high level of minimum capital requirement with regard to the market size, the oligopolistic structure remain intact in the medium term. Thus, the Government must create a transparent entry mechanism to encourage private sector participation in the market. Furthermore, the Government should consider adopting regulations to encourage the use of domestic insurance companies.

### **Building the Capacity of Insurance Regulators and Supervisors.**

To ensure effective supervision and regulation, intensive capacity building must be conducted for supervisors and regulators. Initial capacity-building efforts require assistance from aid

agencies and foreign insurance training institutes. The Government must actively seek technical and financial assistance from aid agencies. To do this, the Insurance Office of MEF must develop a training plan which identifies training needs and resource requirements. The plan should include a training program for related Government agencies that will be involved in the enforcement and monitoring of compulsory insurance. The capacity-building mechanism for compulsory insurance must be addressed in the official plan for compulsory insurance development.

**Conducting a Feasibility Study to Establish a Multi-pillar Pension System.** A feasibility study must be conducted to determine the appropriate design and timing for a multi-pillar pension system, consisting of a mandatory public pension program, a mandatory privately managed funded pension program, and voluntary retirement savings programs. The feasibility study should include demographic projections, determination of the most appropriate institutions to administer and manage the different components of the pension system, appropriate legal framework, supervisory and regulatory arrangements, and funding mechanisms.

## **Phase II: Promote an Insurance Market through Private Sector Development and Establish a Foundation for the Pension System.**

The key policy goal in the second phase is to enlarge and expand the insurance sector through private sector development, and to establish a foundation for the pension system. To achieve this goal, nine intermediate reform actions are needed:

- (i) strengthening the insurance regulation and supervisory framework,
- (ii) implementing compulsory insurance,
- (iii) promoting a competitive private sector insurance market,
- (iv) increasing outreach to rural areas,
- (v) establishing a training institution for the insurance sector,
- (vi) developing an actuarial professional body,
- (vii) establishing a legal framework for pension system;
- (viii) establishing a regulatory and supervisory framework for pension system, and
- (ix) building the capacity of pension regulators and supervisors.

### **Strengthening the Insurance Regulation and Supervisory Framework.**

As the insurance sector expands, the insurance regulatory and supervisory framework will need to be strengthened by refining existing regulations and adopting new regulations to address the increased diversity of insurance products. In addition, the Government should allocate more resources to reinforce the regulatory and supervisory body and the enforcement mechanism. The insurance division needs to attract additional qualified staff.

**Implementing Compulsory Insurance.** With the establishment of the enforcement/ monitoring framework and other preparatory work accomplished during Phase I, the Government will be ready to implement compulsory insurance. It is essential at this

stage that the Government make continued efforts to further refine and improve the enforcement/ monitoring mechanism to build policyholder confidence in the compulsory insurance system.

**Promoting a Competitive Private Sector Insurance Market.** To develop a private competitive insurance sector, the Government must institute policies that will encourage additional private insurance companies to enter the market. To this end, the following areas need to be addressed: (i) the Government should further streamline procedures to encourage foreign insurance companies to participate in the Cambodian insurance market; (ii) the Government needs to develop reinsurance institutions through public-private partnership; and (iii) the Government must take lead in promoting private sector development by divesting its shareholdings in insurance companies to avoid conflicts of interest.

**Increasing Outreach to Rural Areas.** Increased outreach of the insurance sector will have a direct poverty-reduction impact on the rural areas. Competition among private insurance companies will eventually drive them to expand their business into rural areas. Although improvement in the payment system and other banking services will also create a synergic impact on the capacity of the insurance sector, the Government may need to adopt an incentive system to further encourage the voluntary expansion of private companies' business into rural areas. Such an incentive system should encourage the insurance sector to develop products and distribution channels for providing insurance services in rural areas. New products could include crop insurance and other types of natural disaster insurance.

**Establishing a Training Institution for the Insurance Sector.** The Government

needs to establish a comprehensive insurance training institution in the second phase. As the sector size increases and products diversify, so will the demand for a comprehensive training institution grow. Private and public sector partnerships will be essential in pooling resources to create an effective and financially sustainable institution that will play an essential role in capacity building in the sector by attracting international assistance and best practices to Cambodia.

**Developing an Actuarial Professional Body.** As the insurance sector grows, the Government should develop an actuarial professional body and adopt a relevant legal and regulatory framework, including a code of ethics and professional standards. The actuarial professional body will also be a center for capacity building for actuaries.

**Establishing a Legal Framework for Pension System.** The pension system design formulated during Phase I will determine the necessary laws that need to be adopted. The pension law(s) must cover the three pillars of the pension system: a mandatory public pension program, a mandatory privately managed funded pension program, and a voluntary retirement savings program. The Government also needs to identify the appropriate implementing, administration, regulatory, and supervisory body for each component.

**Establishing a Regulatory and Supervisory Framework for Pension System.** Given the development stage of Cambodia, a comprehensive regulatory and supervisory regime must be established based on the specific components of the pension system as well as the sequence of their implementation. The regulatory and supervisory regime for the mandatory public pension program should receive first priority.

Rules concerning eligibility, calculation of benefits, and funding mechanisms must be considered.

**Building the Capacity of Pension Regulators and Supervisors.** To ensure effective supervision and regulation, intensive capacity building must be provided for supervisors and regulators. Initial capacity-building efforts will need assistance from donor agencies and foreign training institutes.

### Phase III: Strengthen the Insurance Sector and initiate the Establishment of a Pension System.

In this phase, further strengthening of the insurance sector and development of a pension system are accomplished through the following five intermediate reform agendas:

- (i) upgrading prudential regulations for the insurance sector;
- (ii) implementing a legal framework for pension system;
- (iii) implementing a mandatory public pension program;
- (iv) strengthening the regulatory and supervisory capacity for the pension system; and
- (v) establishing a capacity-building institution for pension sector.

**Upgrading Prudential Regulations for the Insurance Sector.** With the expansion of the sector, the Government may decide to establish an independent insurance supervisory body. An independent supervisor will undertake two fundamental functions toward

the development of the insurance sector: (i) attract qualified insurance specialists through a competitive compensation scheme, and (ii) enhance supervisory capacity and the prudential regulations in accordance with the Core Principles of the International Association of Insurance Supervisors. Enhanced supervisory capacity would bolster public confidence and thus facilitate the development of the insurance sector.

**Implementing a Legal Framework for the Pension System.** To become operational, the pension law needs implementing sub-decrees. Therefore, the Government must adopt sub-decrees that provide operational guidance to the appropriate ministries to implement the pension law. The sub-decree pertaining to the mandatory public pension program should receive first priority.

**Implementing a Mandatory Public Pension Program.** The mandatory public pension program should be implemented based on the adoption and establishment of the law and sub-decrees and the institutional development accomplished during Phases II and the early part of Phase III.

**Strengthening the Regulatory and Supervisory Capacity for the Pension System.** As the mandatory public pension program is launched, the relevant prudential regulations should be refined and enhanced in preparation for the implementation of the next pillar of the pension system – the mandatory privately managed funded pension program. In addition, the pension supervisory body must be strengthened by enlarging the staff with qualified personnel.

**Establishing a Capacity-Building Institution for the Pension System.** The Government needs to establish a comprehensive pension-training institution during Phase III. In anticipation of the

introduction of the mandatory privately managed funded pension program, a training institution must be established as a cost-effective and efficient means of preparing staff for both private sector and public sector needs. The establishment of private and public sector partnerships that can pool resources will be essential in creating an effective and financially sustainable pension- training institution. The training institute will play a key role in capacity building for the pension system by attracting international assistance and best practices to Cambodia.

## Nonbank Financial Institutions

The development of NBFIs begins in the second phase. The 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 legal and regulatory foundation 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 (DFIs). These institutions will support the development of money and capital markets.

### Phase II: Lay the Foundation for NBFIs

To achieve the goal in Phase II, three intermediate development actions are set:

- (i) developing the leasing business,
- (ii) developing money market intermediaries, and

- (iii) developing capital market intermediaries.

#### **Developing the Leasing Business.**

Lease financing is an attractive alternative financial product for banks in an environment with an inefficient infrastructure to offer term finance on capital equipment. Leasing readily provides the equivalent of term loans for capital equipment to SMEs. Therefore, the Government must address the development of the leasing business geared to NBFIs. This should include adoption of specific leasing laws and regulations. Under the current Banking Law, banks are allowed to undertake leasing business, but due to the lack of implementing regulations, no banks are actually initiating leasing. Thus, NBC should first establish basic procedures for banks to undertake leasing business. The Government must also consider the framework for encouraging FDI in leasing companies with an appropriate fiscal and financial incentive system.

#### **Developing Money Market Intermediaries.**

With the expansion of money markets, the Government needs to establish a legal and regulatory framework for finance companies, investment companies, and money market broker/dealers. Finance companies and other NBFIs will begin to emerge as competition among commercial banks increases. From the second phase, the banking sector will undergo reorganization as a result of competition among banks. Some banks may decide to establish a finance company subsidiary, whereas others might want to convert themselves into finance companies and specialize in a relatively narrow business.

#### **Developing Capital Market Intermediaries.**

While the Government is preparing all the legal, regulatory, and institutional groundwork for capital markets, it must consider the development of capital market intermediaries. First, the Government

needs to establish regulations on securities brokers/dealers, targeting the first candidate group of financial institutions. Since the Banking Law also allows commercial banks to undertake a wide range of securities businesses, they will likely become the first securities brokers/dealers. Thus, along with the establishment of the securities exchange, the Government should also establish a legal and regulatory framework for (i) securities companies/subsidiaries, investment advisory companies, and securities finance companies; and (ii) banks to establish securities subsidiaries. If commercial banks become securities brokers/dealers, the capital market supervisor must coordinate with NBC regarding the division of supervision responsibilities.

### Phase III: Promote Diversification of NBFIs

In the third phase, the Government needs to make an effort to establish a balanced financial system. To achieve this goal, the following intermediate reforms are proposed:

- (i) developing institutional investors for capital markets, and
- (ii) establishing DFIs to promote medium and long-term lending.

**Developing Institutional Investors for Capital Markets.** For sound development of capital markets, diverse institutional investors need to be developed such as the trust business in banks, investment/management trust companies, mutual funds, venture capital companies, and the like. Thus, the Government needs to establish a proper legal and regulatory framework for these institutional investors.

**Establishing DFIs to Promote Medium and Long-term Lending.** The Government also needs to establish DFIs to supplement the

capital markets by intermediating long-term capital at home and abroad and therefore facilitating growth-oriented investments. Thus, in the third phase, the Government should provide a legal and regulatory framework for medium- and long-term export-import credit institutions (such as the US Export-Import Bank) and other DFIs.

## Interbank/Money Markets

The sequencing and pacing in money market development need to be aligned with development of the banking and nonbanking sectors. The development plan targets three strategic goals. The first phase aims to establish the foundation for short term unsecured interbank markets and to provide a base for interbank/money markets through the issuance of T-Bills and the promulgation of a negotiable instruments law. The second phase will strengthen interbank markets, establish regulations for diversified money market instruments such as negotiable certificates of deposit and repurchase agreements, and develop a primary dealer system and regularize the issuance of T-Bills. The third phase aims to broaden the interbank/ money markets with a regulatory framework for nonfinancial issuers of money market instruments such as commercial paper.

### Phase I: Establish a Foundation for Interbank/Money Markets

To achieve the goal of the first phase, three intermediate reforms are desired:

- (i) establishing interbank market arrangements for the banking sector,

- (ii) creating an enabling environment for money market development, and
- (iii) creating an enabling environment for T-Bills.

**Establishing Interbank Market Arrangements for the Banking Sector.** The first step in establishing interbank markets should be initiated by commercial banks. The establishment of an inclusive bankers association, acting on behalf of all bank members, will allow it to play a catalytic role in the formation of the interbank markets. The arrangement must be self-regulated by banks with the endorsement of NBC. The first interbank service can be short-term unsecured interbank lending (overnight call loan and money).

**Creating an Enabling Environment for Money Market Development.** In the first phase, the Government must put in place legal and regulatory frameworks for the development of money markets. The first task is to adopt a negotiable instruments law. The scope of the law should be comprehensive enough to include all types of instruments from simple payment instruments to credit instruments. Second, NBC should set up a regulatory framework for the interbank market activities of commercial banks. The focus of the framework, however, must be as a central bank supervisor and a 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.

**Creating an Enabling Environment for T-Bills.** A key element for money market development is government securities. Thus, the Government should proactively consider the issuance of T-Bills through competitive auction. To this end, the Government needs to

further scrutinize the legal/regulatory framework for the issuance of T-Bills. Furthermore, the Government also needs to adopt a medium-term plan to develop a T-Bill market, which must be geared to rationalization of fiscal management. The development of a T-Bills market should go hand in hand with necessary capacity-building activities for key staff of the National Treasury and NBC who are involved in T-Bill issuance and management.

## Phase II: Strengthen the Interbank/Money Markets

From the second phase, the money markets will develop to the fullest extent with strengthening of market microstructure, introduction of diverse instruments, and increased participation of financial institutions, including NBFIs. Phase II targets three intermediate reforms:

- (i) expanding the scope of interbank markets,
- (ii) establishing regulations governing financial institutions' instruments, and
- (iii) developing T-Bill markets.

**Expanding the Scope of Interbank Markets.** With the availability of T-Bills and other government securities from the second phase, the money markets will be able to accommodate small banks and NBFIs by providing an interbank repurchase arrangement based on T-Bills and other government securities. To facilitate the expansion of the scope of the interbank market, NBC and the Bankers Association need to work together to develop a standardized contract for repurchase agreements and supporting regulations, based on international best practices.

**Establishing Regulations Governing Financial Institutions' Instruments.** NBC needs to establish detailed regulations to enable the development of key money market instruments such as negotiable certificates of deposit (CDs) and repurchase agreements (RPs). However, the role of the central bank must be minimized in the regulation of these instruments in the context of monetary policy and consumer protection. To expedite the development of money markets and monetary policy instruments, NBC may also consider issuing central bank securities (for example, central bank certificates of deposit) in line with the development of government securities.

**Developing T-Bill Markets.** The development of T-Bill markets will play an instrumental role in developing money markets because the market interest rate of T-Bills will set the benchmark for other money market instruments, and the T-Bills themselves will be used as key money market instruments. To further develop the T-Bill market, building on the preparatory work in the first phase, the Government needs to undertake two key policy actions. First, it must introduce a primary dealer system for government securities. Second, it must regularize the issuance of T-Bills. This measure should be carefully coordinated with rationalization of the function of the National Treasury.

## Phase III: Increase the Depth of the Interbank/Money Markets

The reform efforts in the second phase will continue in the third phase with the expansion of the scope of both participants and instruments, thereby deepening the money markets. The reform agenda in the third phase includes:

- (i) establishing integrated interbank markets, and

- (ii) establishing regulations governing nonfinancial institutions' instruments.

**Establishing Integrated Interbank Markets.** The emergence of diverse financial institutions and an increase in financial transactions call for an even wider scope of interbank markets than before. Thus, the Government should aim to develop integrated interbank/money markets in the third phase. Since the lack of mutual confidence among various types of financial institutions – in particular, between seasoned institutions (such as commercial banks) and new institutions – might hamper the expansion of the interbank markets outside of seasoned institutions, the Government needs to scrutinize the regulatory framework to enhance confidence in the interbank/money markets.

**Establishing Regulations Governing Nonfinancial Institutions' Instruments.** The Government will also need to establish a regulatory framework for money market instruments issued by nonfinancial institutions such as commercial papers and trade bills. The introduction of money market instruments needs to be synchronized with the development of private bond markets as well as the emergence of diverse money market intermediaries such as investment companies and finance companies.

## Capital Markets

The capital market development plan consists of three sequenced development goals. During Phase I, the Government is expected to accomplish the necessary preparatory work to create an enabling environment for capital markets. In the second phase, it is envisaged to establish the foundation for capital markets by establishing a securities exchange and the necessary infrastructure related to securities trading, as well as by adopting detailed

regulations and procedures. Building on the preparatory work up to the second phase, it is expected that the Government will make systematic efforts to develop capital markets in Phase III.

## Phase I: Create an Enabling Environment for Capital Markets

Capital market development cannot take place without a specific legal and institutional environment. To achieve this goal, three intermediate reforms are desired:

- (i) establishing a key legal/regulatory framework,
- (ii) creating an enabling environment for public bond markets, and
- (iii) building capacity for future capital market participants.

**Establishing a Key Legal/Regulatory Framework.** In line with the establishment of the legal infrastructure envisaged in Phase I (see Section H. Financial Market Infrastructure), the Government needs to establish a legal/regulatory framework to underpin the capital markets. In the first phase of capital market development, the following actions need to be taken. First, the Government needs to strengthen the capital market development unit with full-time staff to undertake the preparatory work for capital market development. The enlarged staff of the unit will be the basis for the future capital market supervisor, as well as an institutional basis to retain the knowledge transferred from externally funded TA. Second, the Government should develop a master plan for creating a functional capital market framework. Policy actions in the master plan needs to be synchronized with the progress in

key legal and accounting reform. Third, the Government must conduct a feasibility study to assess the existence of a critical mass of potential securities issuers. The feasibility study should be a realistic assessment of the number of public companies (defined in the forthcoming Law on Commercial Enterprises) that would be willingly subjected to higher standards of corporate governance in accordance with new IAS/ISA. Fourth, the Government needs to draft a securities and exchange law, reflecting recent progress in legal reform. Finally, in line with drafting the securities and exchange law, and based on the feasibility study, the Government should determine the basic structure of exchange regulations such as listing requirements, auction rules for trading, corporate disclosure, and exchange membership.

**Creating an Enabling Environment for Public Bond Markets.** Along with the issuance of T-Bills, the Government should exert effort to develop diverse public bonds markets. The development of public bonds markets will be of strategic importance in the context of Cambodian economic and financial development. First, the issuance of diverse riel-denominated public bonds will contribute to de-dollarization along with macroeconomic stability. Second, the issuance of public bonds will contribute to the development of monetary policy and money markets by providing necessary instruments to establish the refinance/rediscount facility of NBC. Third, the issuance of public bonds will expedite the development of financial institutions by providing diverse investment assets. The benefit would be most pronounced in the insurance sector. In the initial stage of the development of fixed-income securities markets, priority should be given to government and other public entity bonds. Government bonds should include both marketable types (such as Treasury notes and

bonds) and nonmarketable types (for example, like US Savings Bonds). The Government should also encourage public entities such as large state-owned infrastructure enterprises to issue bonds.

**Building Capacity for Future Capital Market Participants.** Since the notion of capital markets is new in Cambodia, it is necessary to conduct capacity-building activities for a wider group of stakeholders of capital markets. The first and urgent group to train through international cooperation is the future regulators and players in capital markets. In addition, the Government needs to conduct comprehensive public awareness activities for capital markets.

## Phase II: Establish the Foundation for Capital Markets

Building on the preparatory work and achievements in the first phase, the Government can establish a securities market in the second phase. To facilitate the establishment of a securities exchange, the Government should address the following reform agenda:

- (i) establishing a capital market surveillance framework,
- (ii) establishing a securities exchange,
- (iii) promoting the issuance of public bonds, and
- (iv) strengthening capacity building for the public.

**Establishing a Capital Market Surveillance Framework.** With the adoption of the securities and exchange law and its implementing regulations, the Government should establish a securities market supervision

and surveillance body. The decision on the institutional modality of the capital market surveillance body must consider the availability of a critical mass of issuers, that will enable a financially independent capital market supervisor. In the initial stage of capital market development, the Government can consider two options for the supervisor: (i) a capital market surveillance unit under the related line ministry, or (ii) a full-fledged SEC. Without a sufficient number of listed companies, it would be academic to set up a full-fledged independent SEC because it could not finance its own budget. Without fiscal autonomy, the independence of a SEC can be notional. In this case, a capital market surveillance unit under the related line ministry is a realistic option in the initial stage of capital market development as the unit can benefit from full budget and administrative support.

### **Establishing a Securities Exchange.**

The Government must develop a detailed action plan to establish a securities exchange. The plan should include the design of the management structure of the securities exchange, membership and board of directors, trading system, and surveillance mechanism. Cambodia needs to establish a computerized exchange trading system, taking advantage of new technology as a latecomer. In addition, the ownership of the securities exchange is a critical issue to be decided in this phase. The Government must also develop a plan to establish a trading infrastructure such as a securities depository system and a clearing system. Since the capital market infrastructure requires substantial fiscal and technical resources, the capital market supervisor needs to secure international cooperation.

**Promoting the Issuance of Public Bonds.** To facilitate the issuance of diverse public bonds, the Government needs to establish or refine the related legal and regulatory frameworks. Creating a proper

demand base for the public bonds market is also crucial in the early stages. Thus, the Government must consider an incentive system to create a demand for public bonds.

**Strengthening Capacity Building for the Public.** The Government should continue to conduct comprehensive public awareness activities. In this phase, the Government may need to publish a detailed master plan to create a securities exchange and provide general guidelines for listing requirements.

## Phase III: Develop Capital Markets

With the opening of the securities exchange, one of the most critical issues in the third phase is to promote participation of both issuers and investors. To accomplish this goal, four intermediate actions are needed:

- (i) strengthening capital market supervision and surveillance,
- (ii) promoting capital market participation,
- (iii) developing private bonds markets, and
- (iv) strengthening capacity building activities for capital market participants.

**Strengthening Capital Market Supervision and Surveillance.** Capital market supervision and surveillance calls for extensive technical capability on the part of the supervisor. In the third phase, the Government may establish a long-term plan to build the capacity of supervisory staff. With the establishment of a securities exchange and the development of the capital market industry, the capital market supervisor will soon have to face

competition from the private sector in attracting competent staff. Unless the capital market supervisor provides strong pecuniary and nonpecuniary incentives to potential staff, it will be difficult to attract competent new recruits. With the strengthening of the capital market supervisor, the Government will need to begin upgrading prudential regulations in accordance with IOSCO principles.

**Promoting Capital Market Participation.** A critical challenge in the initial stage of capital market development is to attract a sufficient number of listing companies. The Government needs to adopt carefully designed incentives to encourage firms to go public, while bearing in mind the potential adverse selection problem. The Government should also promote sound governance principles for listing companies to promote investor confidence. Thus, with the expansion of listing firms, the capital market supervisor should design a policy framework to promote sound corporate governance. This can be done by adopting corporate governance principles and enforce them through listing requirements.

**Developing Private Bonds Markets.** To accommodate the diverse financing needs of firms, the Government needs to adopt a comprehensive plan to develop corporate debt markets. The Government should provide a legal and regulatory framework for the large commercial banks and DFIs to issue bonds. In addition, The Government also needs to support the development of a trading system for fixed-income securities.

**Strengthening Capacity Building Activities for Capital Market Participants.** In the third phase, the Government should further strengthen capacity building activities for capital market participants. Thus, it may consider establishing a capital market training institution. In addition, it should promote the establishment of a securities brokers and

dealers association as a capital market self-regulatory organization. The association can also assume the role of professional capacity-building institution.

## Financial Market Infrastructure

### Develop Legal Infrastructure

The development of legal infrastructure targets three reform agendas as follows:

- (i) Phase I: creating the legal infrastructure to underpin financial sector development,
- (ii) Phase II: strengthening law enforcement, and
- (iii) Phase III: enhancing the legal infrastructure for private sector development.

**Creating the Legal Infrastructure to Support Financial Sector Development.** In the first phase, the Government is expected to establish key laws underpinning financial sector and private sector development. These include civil code, company law, bankruptcy law, secured transactions law, commercial contract law, and commercial arbitration procedure. The Government should also initiate comprehensive judicial reform supported by ADB and World Bank. First, the Government needs to adopt and implement a master plan for judicial reform. Second, it should adopt the Law on the Organization and Function of the Court. The draft should include the establishment of a commercial chamber to undertake commercial cases.

### **Strengthening Law Enforcement.**

Building on the reform efforts in the first phase, the Government should make an effort to strengthen law enforcement in the second phase. This includes (i) continuing judiciary reform, (ii) establishing a commercial chamber in the court system, (iii) developing and adequate compensation scheme and capacity for commercial court jurists, and (iv) establishing a public registry for secured transactions.

**Enhancing the Legal Infrastructure for Private Sector Development.** The Government's effort to reform the judiciary system to support private sector development will be completed in the third phase, during which the Government needs to allocate more resources to improve and enlarge the legal infrastructure to underpin commercial activities. For example, following the establishment of a public registry for real estate in the second phase, the Government needs to adopt a legal/regulatory framework for a public registry for movables. Since the registration system for movables may require the participation and cooperation of multiple line ministries, the Government may need to establish an interministerial committee.

### Develop an Accounting and Auditing System

Development of accounting and auditing system consists of a three-phase reform agenda over 10 years as follows:

- (i) Phase I: establishing accounting and auditing standards and an enforcement system,
- (ii) Phase II: strengthening enforcement of accounting and auditing standards, and

- (iii) Phase III: enhancing the enforcement of accounting standards.

**Establishing Accounting and Auditing Standards and an Enforcement System.** In the first phase, the Government will complete the establishment of a basic accounting and auditing system. This includes (i) promulgation of the Law on Corporate Accounts, their Audit, and the Accounting Profession; (ii) application of IAS/ISA to all companies incorporated in Cambodia; (iii) establishment of a national accounting council; (iv) adoption of a code of ethics; and (v) establishment of an association of accountants and auditors.

**Strengthening Enforcement of Accounting and Auditing Standards.** In the second phase, the Government will strengthen the enforcement of accounting and auditing standards. This will be accomplished by promoting competition in the local accounting industry to encourage new entries in order to reduce the accounting and auditing and compliance costs of the private sector.

**Enhancing the Enforcement of Accounting and Auditing Standards.** In the second phase, the Government will further expand the scope of application of IAS/ISA into private companies. Efforts toward improvement in the enforcement of accounting and auditing standards will continue in the third phase.

## Develop Financial Information Infrastructure

Developing a financial information system is crucial to cultivate the credit and repayment culture from the early stage of financial development. These efforts include three strategic reform agendas over the next 10 years as follows:

- (i) Phase I: creating a financial market information system,
- (ii) Phase II: expanding the scope of the arrangements for sharing information among members of the Bankers Association, and
- (iii) Phase III: diversifying and upgrading the market information system.

**Creating a Financial Market Information System.** The Government needs to establish arrangements for sharing information among members of the Bankers Association to support the banks' credit operations. Establishment of such arrangements requires the collaboration of NBC and the Bankers Association. NBC must provide a regulatory framework governing integration of credit information from commercial banks. The Bankers Association must establish a detailed procedure to establish and maintain the credit reference database with the lowest compliance costs of member banks. The Bankers Association needs to mobilize the necessary resources to set up the hardware/software system for these arrangements.

**Expanding the Scope of the Arrangements for Sharing Credit Information.** In the second phase, the arrangements for sharing credit information should allow the participation of other financial institutions upon their emergence and the diversification of financial services. The expanding scope of participating institutions will require an amendment of the regulations and the establishment of a cost-sharing mechanism.

**Diversifying and Upgrading the Market Information System.** The Government needs to further develop financial information systems by introducing diverse

information infrastructure. This includes the development of a financial sector database industry and a credit rating agency to support debt markets. In addition, the Bankers Association will need to upgrade the capacity and accessibility of the arrangements for sharing credit information through increased investment in IT.

## Develop a Financial Sector Safety Net

Financial safety is required to enhance public confidence in the financial system. In the early stage of financial sector development, the systemic risk may be minimal because of underdevelopment. However, as the financial system expands, so does the systemic risk. Therefore, the Government needs to address financial safety nets with the development of the financial system. This includes a two-stage reform agenda:

- (i) Phase II: enhancing the banking sector safety nets; and
- (ii) Phase III: expanding the financial sector safety nets.

**Enhancing the Banking Sector Safety Net.** The Government first needs to establish the banking sector safety nets, which includes (i) introduction of a deposit insurance system for the banking sector, and (ii) adoption of corporate governance guidelines for banks. Establishment of a deposit insurance system

needs to be coordinated with the reform in reserve requirements for commercial banks. For example, NBC might amend the regulations regarding capital reserves, or guarantee deposits, and allow those funds to be invested as seed money for the deposit insurance system. This can be done in two ways. First, NBC can separate the capital reserve from the NBC account and, with the endorsement of commercial banks, invest those funds in the deposit insurance system. The second option is to maintain the capital reserve but to allow the banks to fund the deposit insurance scheme. At the early stage of development of a deposit insurance system, the central bank can take responsibility for this system.

**Expanding the Scope of the Deposit Insurance System into the Nonbanking Sector.** As the nonbanking sector develops, it will also provide deposit-type debts, which need to be included under the deposit insurance system. Thus, the Government may need to adopt a revised legal framework for an expanded deposit insurance system to accommodate other credit institutions. In addition, the Government may need to change the governance structure of the deposit insurance system. That is, the Government may need to establish a separate deposit insurance corporation, independent from the central bank, to avoid conflict of interest. With the expansion of the scope in the deposit insurance system, it will be necessary to adopt corporate governance guidelines for nonbanking institutions.