



# Report and Recommendation of the President to the Board of Directors

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Project Number: 34389  
November 2008

## Proposed Loan for Subprogram 2 Kingdom of Cambodia: Financial Sector Program II Cluster

## CURRENCY EQUIVALENTS

(as of 9 October 2008)

Currency Unit	–	riel (KR)
KR1.00	=	\$0.0002418
\$1.00	=	KR4,135

## ABBREVIATIONS

ADB	–	Asian Development Bank
AML	–	anti-money laundering
AUSTRAC	–	Australian Transaction Reports and Analysis Centre
CBS	–	Center for Banking Studies
CFT	–	combating the financing of terrorism
CIS	–	credit information sharing system
FIU	–	Financial Intelligence Unit
FSDS	–	Financial Sector Development Strategy
FSP	–	Financial Sector Program
FSP II	–	Second Financial Sector Program Cluster
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MEF	–	Ministry of Economy and Finance
MFI	–	microfinance institution
MOC	–	Ministry of Commerce
NBC	–	National Bank of Cambodia
PCSS	–	payments, clearance, and settlement system
PPU	–	Payments Policy Unit
RTGS	–	real-time gross settlement
SDR	–	special drawing rights
SME	–	small or medium enterprise
TA	–	technical assistance

## NOTE

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

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## LOAN AND PROGRAM SUMMARY

<b>Borrower</b>	Kingdom of Cambodia
<b>The Proposal</b>	<p>The proposal comprises (i) a loan equivalent to \$10.3 million for Subprogram 2 of the Financial Sector Program II Cluster and (ii) a technical assistance (TA) grant for \$300,000 for the implementation of key policy triggers of Subprogram 3. The FSP II, approved on 6 December 2007, takes a cluster approach and consists of four back-to-back subprograms. Each succeeding subprogram is to be processed sequentially upon completion of the preceding subprogram.</p>
<b>Classification</b>	<p>Targeting classification: General intervention Sector: Finance Subsector: Finance sector development Themes: Sustainable economic growth, governance Subthemes: Promoting economic efficiency and enabling markets, financial and economic governance</p>
<b>Environment Assessment</b>	Category C
<b>Social Sector Assessment</b>	<p>Involuntary resettlement: Category C. Impact on indigenous people: Category C. No involuntary resettlement or impact on indigenous people is expected from program implementation.</p>
<b>The Program Rationale</b>	<p>With a rapidly growing commercial economy that requires a sound financial system to sustain its rate of growth, the Government, if it is to achieve long-term sustainable economic growth and poverty reduction, needs to develop the financial sector by mobilizing financial resources, channeling them to productive investments, and managing the inherent risks. The Asian financial crisis provided many examples of the devastating impact that financial crises can have on countries, wiping out several years of growth within a very short time. Thus, to promote economic growth, reduce poverty, and help countries avoid financial crises, the Asian Development Bank (ADB) plays an important role in supporting financial sector development in its client countries, including Cambodia.</p> <p>The program loan cluster will support the Government's continued efforts to strengthen the financial sector by supporting a combination of legal and regulatory reforms, targeted capacity building, improved disclosure standards and financial transparency, and establishment of key financial infrastructure. A sound, efficient, and integrated financial system is crucial for achieving broad-based sustainable economic growth. It will help reduce poverty by increasing job opportunities, lowering transaction costs of economic activities, and extending the outreach of the formal financial sector to poor and rural areas. An efficient financial system will promote private sector development and foreign direct investment. A robust</p>

financial sector will protect the economy from unfavorable exogenous shocks that are becoming more common in increasingly global financial markets.

### **Objective and Scope**

FSP II aims to promote the development of a sound, market-based financial system to support resource mobilization and sustainable economic growth. With a growing, resilient, and more efficient financial system as the expected outcome, Subprogram 2 will continue the following reform activities:

- (i) Improve financial intermediation by upgrading the payments, clearance, and settlement system to support growing financial services; enhance market confidence by improving public financial disclosure and establishing a credit information bureau; support market development by establishing an interbank market and tradable government securities; and improving the outreach of microfinance institutions (MFIs) in a sustainable manner.
- (ii) Enhance resilience of the financial sector by revising and updating the law on banking and financial institutions, and by introducing supportive regulations to strengthen financial activities; tighten prudential supervision and regulations of banks and microfinance institutions; and build on the legal and regulatory foundation by drafting a new law on commercial contracts that includes specific sections on agencies and franchising.
- (iii) Promote good governance by implementing international initiatives on anti-money laundering and combating the financing of terrorism; by enhancing corporate governance and transparency in the insurance industry; by establishing commercial dispute resolution mechanisms; and by improving the capability and increasing the number of qualified national accountants and auditors.
- (iv) Enhance efficiency by computerizing the management information system of the National Bank of Cambodia (NBC), as well as by upgrading the skills and capacity of microfinance agencies' staff.

**Loan Amount and Terms** A loan of \$10,300,000 equivalent will be provided from ADB's Special Funds resources for Subprogram 2. The loan will have a 24-year term, including a grace period of 8 years. The interest rate will be 1.0% per annum during the grace period and 1.5% per annum thereafter.

### **Program Period and Tranching**

The implementation period for Subprogram 2 is January–December 2008. The loan will be released in a single tranche upon completion of specific tranche conditions and following loan effectiveness.

### **Executing Agency**

NBC will be the Executing Agency, and the Ministry of Economy and Finance (MEF) and Ministry of Commerce (MOC) will be the implementing agencies. The financial sector steering committee, chaired by the governor of NBC and comprising senior officers from

MEF, MOC, and NBC, will meet as required to review progress reports from the technical working group, consider pending issues, and propose concrete actions to resolve issues. A senior NBC officer has been appointed as program director to assist NBC, MEF, and MOC in coordinating day-to-day program implementation. The program director will submit quarterly progress reports to ADB on program implementation.

## **Procurement**

The loan proceeds will be used to finance the full foreign exchange costs (excluding local duties and taxes) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources. All procurement of goods and services produced in, and originating from, ADB member countries will be made with due consideration to economy and efficiency, in accordance with standard public procedures in Cambodia and normal private sector commercial practices acceptable to ADB. In accordance with the provisions of ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans* (1998), the loan proceeds will be disbursed to the Kingdom of Cambodia as the Borrower.

## **Risks and Safeguards**

Program implementation could face a number of risks, for which mitigation measures have been put in place, as appropriate.

(i) **Challenges to sustaining economic growth.** Cambodia's economic prospects must be viewed against a number of adverse developments in the external environment. The immediate impact of the financial crisis in the US and Europe, and the drying up there of liquidity in the commercial paper and related money and interbank markets pose limited if no direct—or indirect—financial sector risks to Cambodia's economy, either through balance sheets or liquidity factors, as Cambodia's banks do not have significant exposure to borrowing from international banks and capital markets do not as yet exist. However, the slowdown in the global economy resulting from the fall in the US and European growth rates has impacted on Cambodia's growth rate, initially through reduced expansion of exports following reduced demand for Cambodia's garments. The recent unexpected surge in international energy and food prices has fueled higher domestic inflation in 2008 with potential knock-on effects for consumption and poverty, growth, and financial sector stability. In addition to foreign direct investment inflows, the rapid credit expansion is adding to growth in real estate investment and to rising property prices, and it is causing the assets of some banks to be increasingly vulnerable to real estate risks. The Government has introduced a combination of fiscal and monetary measures that have helped to moderate inflation and slow lending. Throughout Subprogram 2, the Government and ADB have undertaken periodic reviews of macroeconomic and financial developments to assess potential risks to the financial sector. These reviews will continue through the program period for Subprogram 3. Budget assistance through a series of program loans in 2008, including through this

program, is being provided to bolster the economy's resilience. The impact on poverty of food price increases is being mitigated through emergency assistance approved for this purpose.

(ii) **Unexpected political disturbance.** Cambodia has been enjoying very high political unity and stability for several years. A national election was conducted peacefully on 27 July 2008, as was the swearing-in ceremony for the new Government on 25 September 2008. In anticipation of any delays in forming the new Government, Subprogram 2 was designed to ensure that most of the legal drafting that closely involves midlevel officials would be done prior to formation of the Government so that draft laws and sub-decrees would be ready for submission to the Council of Ministers once the new Government was sworn in.

(iii) **Weak governance and corruption in the sector.** Weak governance and incidents of corruption could erode investor confidence and prevent the attainment of expected sector outcomes. The Government's National Strategic Development Plan 2006–2010 views corruption as a threat to sustained growth and development of the country in general. Backed by an active development community, the Government is increasingly taking a tougher stance against corruption. The general consensus is that good governance and measures to address corruption are needed for a successful partnership between the Government and the development community. This was considered during design of the program cluster, and there will be continuous pursuit of improvements to the institutional governance structure, accounting disclosure standards, financial transparency, complementary legislation, regulatory updates and enforcement, supervision, and surveillance of the financial sector.

(iv) **Weak institutional and human capacity.** Some of the financial sector risks are associated with weak institutional and human capacity. The same applies to the implementation and enforcement of new laws and regulations. To mitigate those risks, training programs have been initiated at various training institutions established during FSP I. Subprogram 2 provides financial support to the institutions to help update their curricula. The proposed advisory TA will help reduce the risks arising from weak capacity, especially in the implementation of all prudential regulations. With these design safeguards, the integrated benefits and impacts are expected to far outweigh any costs.

#### **Technical Assistance**

ADB will provide TA in the amount of \$300,000 from its TA funding program to support NBC, MEF, and MOC in implementing some of the reform triggers for Subprogram 3, as well as to provide the Government with timely policy advice as needed. The main activities of the TA will be to (i) further strengthen the on-site supervision and surveillance of the banking system (4 person-months), (ii) help strengthen the off-site and on-site supervision of MFIs (3 person-

months), and (iii) strengthen the supervision and surveillance of the insurance industry (4 person-months). One national consultant will be engaged, an insurance expert (6 person-months), to assist the international insurance expert. A total of 17 person-months of consulting inputs, comprising 11 international and 6 national person-months, are required. The consultants will be engaged by ADB on an individual basis to implement TA activities in accordance with ADB's *Guidelines on the Use of Consultants* (2007, as amended from time to time), using the competitive selection method. NBC will be the Executing Agency, and MEF and MOC the implementing agencies. The TA is scheduled to commence in February 2009 and be completed by January 2010.



## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to the Kingdom of Cambodia for Subprogram 2 of the Financial Sector Program II Cluster. The report also describes proposed technical assistance (TA) for the Implementation of Key Policy Triggers of Subprogram 3, and if the Board approves the proposed subprogram loan, I, acting under the authority delegated to me by the Board, will approve the TA.

## II. BACKGROUND

2. The Asian Development Bank (ADB) has supported reforms in Cambodia's financial sector since 1999, beginning with a diagnostic assessment of the financial sector and formulation of the Financial Sector Development Blueprint 2001–2010. The blueprint, updated as the Financial Sector Development Strategy (FSDS) 2006–2015, was adopted by the Government in February 2007. FSDS provides the long-term objectives and development framework to guide and shape medium-term policy design and implementation. The Government has, since 2001, been able to implement important reforms in the financial sector with ADB assistance under the first Financial Sector Program<sup>1</sup> (FSP I) that concluded in August 2007 and with complementary assistance from the International Monetary Fund (IMF) poverty reduction and growth facility that ended in 2003. Since implementation of the blueprint, there have been some notable achievements as well as lessons learned from both domestic and international experience. Those experiences, coupled with the need to support continuing development of the financial sector to meet the new challenges, prompted the Government to request further support from ADB to enable continuing reforms in the sector. This led to design and approval of the Second Financial Sector Program (FSP II) Cluster<sup>2</sup> on 6 December 2007.

3. FSP II comprises a series of four single-tranche subprograms, to be implemented from September 2006 to December 2010, within a well-defined medium-term framework involving fundamental reforms to be completed prior to Board consideration of each subprogram. Subprograms are linked by key actions (triggers) that are deemed essential for the success of the medium-term program. The overall goal of FSP II is to promote the development of a sound, market-based financial system to enhance resource mobilization and support sustainable economic growth. The expected outcome is a growing, resilient, and efficient financial system. (The design and monitoring framework for the program is in Appendix 1. The policy matrix and medium-term program are in Appendix 2).

4. Subprogram 1 with 14 key reform actions was approved together with the FSP II cluster concept on 6 December 2007. All 14 policy actions were completed prior to Board circulation in November 2007 and the loan agreement for Subprogram 1 (footnote 2) was signed on 18 February 2008. The loan was declared effective on 10 April 2008, following which the total loan equivalent of SDR6,381,000 was disbursed on 24 April 2008. To allow for loan disbursement in April, the loan closing date was extended from March to May 2008. ADB

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<sup>1</sup> ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Loan Cluster to the Kingdom of Cambodia for the Financial Sector Program*. Manila (Loan 1859-CAM); ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Cambodia for Subprogram II of the Financial Sector Program*. Manila (Loan 1951-CAM); ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Kingdom of Cambodia for Subprogram III of the Financial Sector Program*. Manila (Loan 2185-CAM).

<sup>2</sup> ADB. 2007. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Loan and Technical Assistance Grant to the Kingdom of Cambodia for the Second Financial Sector Program Cluster (Subprogram 1)*. Manila (Loan 2378-CAM).

provided a TA grant of \$1.7 million<sup>3</sup> to support the implementation of triggers and expected milestones for Subprogram 2 and part of Subprogram 3.

### III. THE MACROECONOMIC CONTEXT

5. **Sustained High Economic Growth and Recent Escalation of Inflation.** Cambodia has recorded double-digit economic growth averaging 11% over the last 4 years. Indications are that the incidence of overall poverty declined from 47% in 1994 to around 35% in 2004 (refer to key country economic indicators in Table 1). The economy is expected to grow at a more modest rate of 6.5% in 2008, reflecting an anticipated slowdown in garment exports and the dampening effects on domestic demand of the significantly higher inflation. Growth has been narrowly based and concentrated in garments, tourism, and construction, thus leaving the economy vulnerable to external shocks. Reflecting rapid economic growth, domestic liquidity has been rising rapidly, from a small base, partly fueled by the surge in capital inflows from foreign direct investments and the rapid growth of credit to the private sector. Inflation, which had been subdued until 2007, was sparked by supply-side shocks and surged from an annual rate of 10.8% in December 2007 to peak at 25.1% in June 2008, then slipped to 20.7% in September 2008. Domestic excess liquidity is being mopped up to avoid fueling an inflationary spiral.

6. **Balance of Payments Strengthened but Challenges Remain.** While exports (dominated by garments) grew by 11% in 2007, imports rose by over 14% (reflecting growing domestic inflationary pressures). That led to a widening of the trade deficit to 15.5% of gross domestic product (GDP). The resulting current account deficit (excluding transfers) was lower, at 7.8% of GDP, thanks to rising tourism receipts. The current account deficit was more than offset by rising capital inflows from foreign direct investment and aid. As a result of the very substantial capital inflows, as reflected in rising international reserves and a policy of maintaining a stable exchange rate, the overall balance of payments was in surplus and gross international reserves amounted to \$1.6 billion at the end of 2007 (equivalent to about 3.8 months of import cover) and rose further to about \$2.0 billion by mid-2008. Dampened demand for garment exports can be expected in 2008 due to the downturn in the United States, and greater competition can be expected from the People's Republic of China and Viet Nam in 2009 with the termination of safeguards imposed by the United States on garment imports. It is expected that slower growth of the garment trade will be at least partially offset by accelerating growth in tourism, facilitated by foreign direct investments in constructing new hotels and other service facilities (notably at Siem Reap where the historical ruins of Angkor Wat are located and at Sihanoukville where the popular beaches can be easily accessed).

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<sup>3</sup> ADB. 2007. *Technical Assistance to the Kingdom of Cambodia for Financial Sector Program II Implementation*. Manila (TA 4999-CAM). Attached to ADB. 2007. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Loan and Technical Assistance Grant to the Kingdom of Cambodia for the Second Financial Sector Program Cluster (Subprogram 1)*. Manila (Loan 2378-CAM).

**Table 1: Country Economic Indicators, 2004–2008**

Item	2004	2005	2006	2007	2008
<b>A. Income and Growth</b>					
1. GDP per Capita (\$, current)	393.7	454.6	513.2	596.3	—
2. GDP Growth (% , constant prices)	10.0	13.3	10.8	10.2	6.5 <sup>a</sup>
a. Agriculture	(0.9)	15.7	5.5	5.0	4.5 <sup>a</sup>
b. Industry	16.6	12.7	18.3	8.4	4.0 <sup>a</sup>
c. Services	13.2	13.1	10.1	10.1	7.0 <sup>a</sup>
<b>B. Saving and Investment</b> (current market prices, % of GDP)					
1. Gross Domestic Investment	16.2	18.5	20.6	20.8	—
2. Gross National Saving	8.5	14.2	19.5	17.9	—
<b>C. Money and Inflation</b> (annual % change)					
1. Consumer Price Index	5.6	6.7	2.8	10.8	20.7 <sup>b</sup>
2. Total Liquidity (M2)	30.0	16.1	38.2	63.0	31.4 <sup>c</sup>
<b>D. Government Finance</b> (% of GDP)					
1. Revenue excluding grants	10.4	10.6	11.4	12.1	11.9 <sup>d</sup>
2. Expenditure and Onlending	14.2	13.2	14.7	14.9	12.3 <sup>d</sup>
3. Overall Fiscal Surplus (Deficit)	(3.8)	(2.7)	(3.3)	(2.8)	(0.4) <sup>d</sup>
<b>E. Balance of Payments</b>					
1. Merchandise Trade Balance (% of GDP)	(12.8)	(16.2)	(14.5)	(15.5)	(15.4) <sup>a</sup>
2. Current Account Balance (% of GDP)	(8.2)	(9.4)	(7.2)	(7.8)	(8.1) <sup>a</sup>
3. Merchandise Exports (\$) (annual % change)	24.1	12.4	26.9	10.7	21.1 <sup>e</sup>
4. Merchandise Imports (\$) (annual % change)	22.5	20.2	20.9	14.2	23.1 <sup>e</sup>
<b>F. External Payments Indicators</b>					
1. Gross Official Reserves (including gold, \$ million in weeks of current imports of goods)	12.8	12.1	12.1	15.5	18.8 <sup>a</sup>
2. External Debt Service (% of exports of goods and services)	1.5	1.3	1.1	0.8	0.8
3. Total External Debt (% of GDP)	38.3	33.6	30.8	29.2	28.2
<b>G. Memorandum Items</b>					
1. GDP (current prices, KR billion)	21,438	25,754	29,849	35,039	44,780 <sup>a</sup>
2. Exchange Rate (KR/\$, average)	4,019	4,097	4,107	4,060	4,136 <sup>a</sup>
3. Population (million)	13.5	13.8	14.2	14.5	—

<sup>a</sup> Staff projections.

<sup>b</sup> End-September 2008 (year-on-year basis) based on old index.

<sup>c</sup> End-August 2008.

<sup>d</sup> Data through June 2008; annualized.

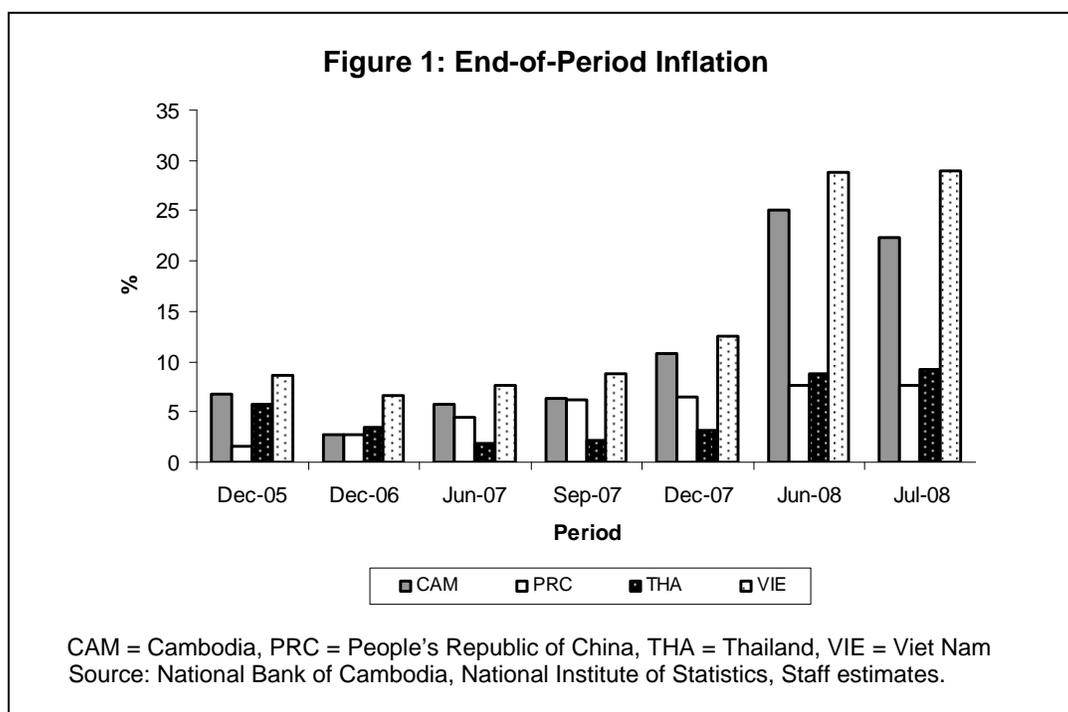
<sup>e</sup> Data through June 2008.

Sources: Ministry of Economy and Finance (MEF); National Institute of Statistics; National Bank of Cambodia (NBC); and IMF.

7. **Fiscal Policy Generally Prudent.** Given its importance to macroeconomic management, fiscal policy has been key to the pro-growth investment environment prevailing in Cambodia. The 2007 budgetary results have not varied substantially from the past budgetary record, as revenue collections were on target and expenditures were contained close to budgetary levels. The budget's current account balance showed a healthy surplus while the overall deficit, incorporating investment outlays, amounted to about 2.8% of GDP, continuing the trend from the last few years. Fiscal prudence appears to have been maintained in 2008, and the part of the budget funded from domestic sources continued to be contractionary. Government deposits in the banking system continued to increase through mid-2008. While the macroeconomic variables of economic growth, budget, and balance of payments were still clearly robust in 2007

and through mid-2008, the outlook for 2008 and beyond remains a concern unless inflation is brought fully under control.

8. **Inflation Accelerated.** After remaining in single digits in recent years, inflation has accelerated rapidly since September 2007. Published figures indicate that on an end-of-period basis, annual consumer price inflation accelerated from 6.4% at end-September 2007 to 10.8% at end-December 2007 and further to 25.1% at end-June 2008 before receding to 20.7% in September 2008 (Figure 1). Between February and August 2008, official inflation data was not released pending an ongoing interministerial technical discussion relating to the change in coverage and methodology of the consumer price index.<sup>4</sup> In September 2008, the Government decided to retain the old methodology and resumed publication of the inflation data. Despite a generally sound macroeconomic framework, Cambodia now faces a strongly inflationary situation that has been ignited by sharply higher prices for petroleum and food and has been further fueled by rapid credit expansion to the private sector. Following the increase in minimum reserve requirements to 16% of total deposits at the end of July 2008, the banking system is still in a position of excess unrestricted liquidity, equivalent to almost 22% of total deposits. Though real economic growth has averaged 11% over the past 4 years and monetization has been increasing because of rising confidence in the banking system, excess liquidity has been creating demand pressures that are reflected in the accelerating inflation.



9. **Government's Measures to Reduce Inflation.** In a bid to help absorb excess liquidity and ease inflationary pressure, the National Bank of Cambodia (NBC) (i) introduced a 15% ceiling on commercial bank credit for real estate trading, effective 26 June 2008; (ii) doubled the

<sup>4</sup> In January 2008, consideration was given to extending coverage of the consumer price index to four urban towns in addition to the capital, Phnom Penh; rebasing the index (to 2006); and reweighting based upon income surveys. The weight of food in the index was to increase from 42% to 58%. Following rapid food price increases, the revised index showed a higher inflation rate than did the old one. Among some other technical issues being reexamined by an interdepartmental technical group is the increased weight for food in the reference consumer basket.

minimum reserve requirement for commercial banks to 16%, effective end-July 2008; and (iii) relaxed capital controls by allowing commercial banks, upon verification, to invest their surplus deposits abroad where they can earn higher returns.<sup>5</sup> While the liquidity positions of a few small banks have been temporarily affected, this provided the NBC and the Bankers Association with the opportunity to initiate an interbank market. For its part, the Ministry of Economy and Finance (MEF) has also announced a series of measures that are designed to partially offset the reduction in the standard of living of civil servants (e.g., increasing the base wage by 20%, spouse and child allowances by 100%, and teacher allowances by 10%) and other affected groups (e.g., increasing subsidies to offset higher fuel and electricity costs), and to address some of the domestic food supply-related causes of inflation over the longer term (e.g., special financing for rice millers to increase rice stocks and internal distribution systems and reduced taxation on imports of agricultural machinery). With these measures in place, the Government reported that monetary growth had declined from 60% in December 2007 to 31.4% in August 2008 and credit growth had slowed. The inflation pressure has moderated, and inflation is expected to drop below 20% by December 2008. The Government will continue to monitor the situation closely.

10. **Macroeconomic Stability Crucial.** Cambodia's economy is vulnerable to a number of adverse developments in the external environment. The sharp slowdown in the US economy and turbulence in its financial markets will indirectly affect growth conditions by cutting demand for garments. Maintaining macroeconomic stability, including by further reducing inflation, is a necessary condition for the economy's continued expansion and diversification. Equally important is to limit the adverse impact of rising prices for basic necessities from supply-related shocks for the vulnerable segments of society. Cambodia has reserves sufficient for more than 3 months of imports, and, while these are normally adequate against external shocks, in the current environment of uncertain oil and food prices, close monitoring of macroeconomic developments is needed. Beyond the near-term measures outlined above, complementary structural reforms will be required to address Cambodia's longer-term development challenges, especially in reducing poverty (particularly in rural areas) and narrowing urban-rural income disparities. As a financial sector contribution, NBC and MEF are considering to accelerate the adoption of market-based instruments to help absorb excess liquidity whenever required and to begin the development of a capital market. This is consistent with FSDS 2006–2015 objectives.

#### IV. LINK BETWEEN THE GOVERNMENT AND ADB STRATEGIES

11. Cambodia's 5-year National Strategic Development Plan 2006–2010 was prepared in the context of a falling, but still high, incidence of overall poverty and a growing urban-rural divide. The Plan aims to give effect to the Government's Rectangular Strategy (adopted in 2004) that sets out the Government's reform agenda as a series of four interlocking strategies with enhanced governance at its core. One of the four strategies focuses on the preconditions required to promote economic growth through agriculture, infrastructure, and private sector development while enhancing employment and human resource development.

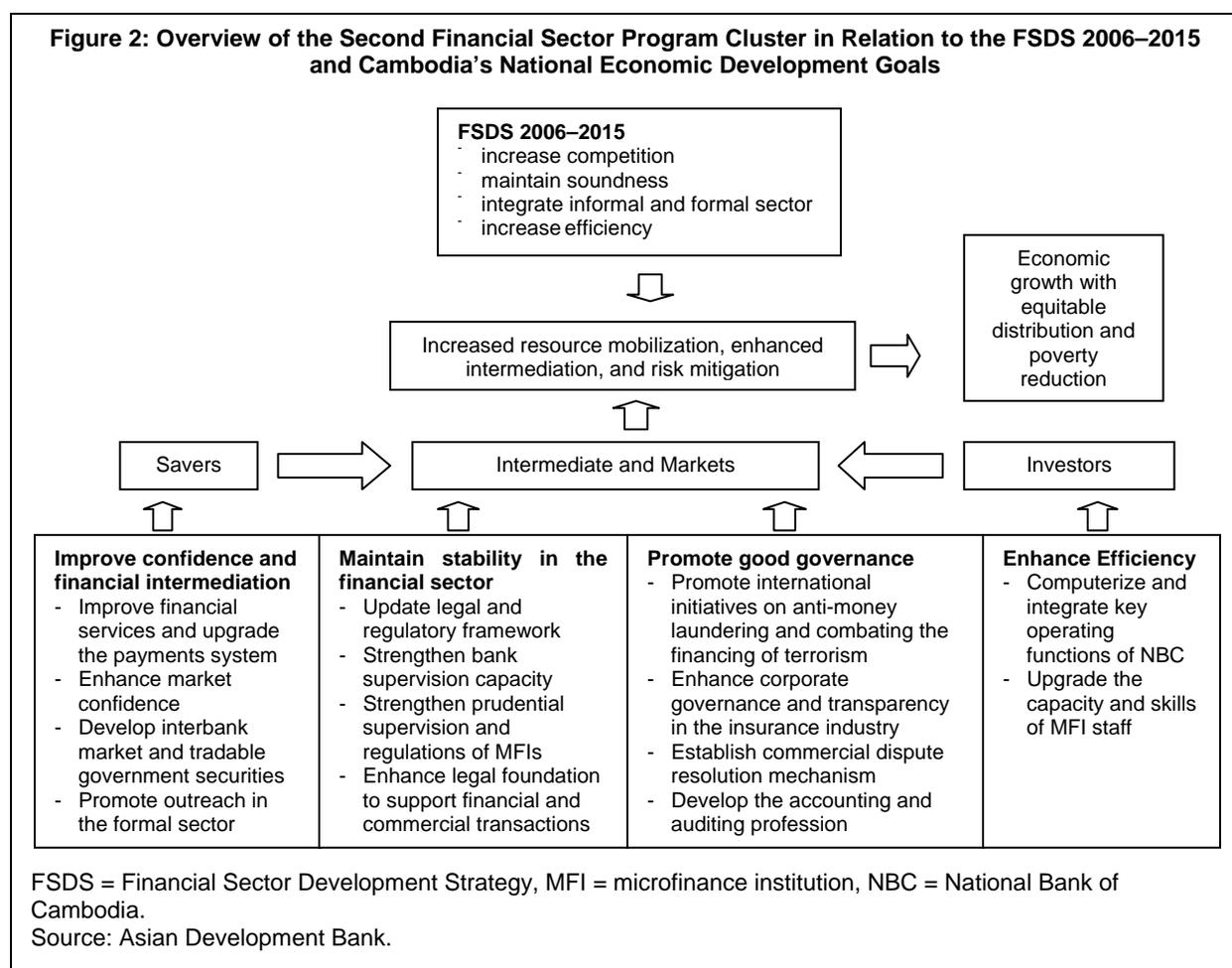
12. ADB's overarching goal in Cambodia is sustainable poverty reduction. In line with the priorities and strategies identified in the Government's Rectangular Strategy, ADB's country strategy and program<sup>6</sup> focuses on three strategic pillars: (i) broad-based economic growth

<sup>5</sup> Monetary policy is constrained by the high rate of dollarization in the economy and the lack of policy instruments.

<sup>6</sup> ADB. 2005. *Country Strategy and Program (2005–2009): Cambodia*. Manila.

through investments in physical infrastructure, development of the financial sector, support for greater regional integration, sustainable development of small and medium-sized enterprises, and investments in agriculture and irrigation; (ii) inclusive social development through basic education, empowerment of vulnerable groups such as women and ethnic minorities, control of communicable diseases, provision of rural water supply and sanitation facilities, and community-based sustainable management and conservation of natural resources in the Tonle Sap basin; and (iii) good governance through improvements in public financial management to enhance the development effectiveness of public expenditures and decentralization initiatives to strengthen local participation in government and improve public service delivery.

13. ADB's country strategy and program specifically states that ADB will continue its leading role in supporting financial sector development and that ADB's future involvement in the financial sector would depend on the successful update of the FSDS. The updated FSDS 2006–2015 states that financial sector development is not an end in itself; rather it is one aspect supporting the development and reduction of poverty in Cambodia (Figure 2). While much work is needed to achieve this difficult goal, accelerating and diversifying growth is generally accepted as the key. Financial sector development must support this objective. Reform and change are essential for growth. At the same time, expanding finance brings risks. Hence, the context in which financial development occurs must be carefully considered with a focus on prudential risk reduction, transparency, and uniform application of rules and regulations.

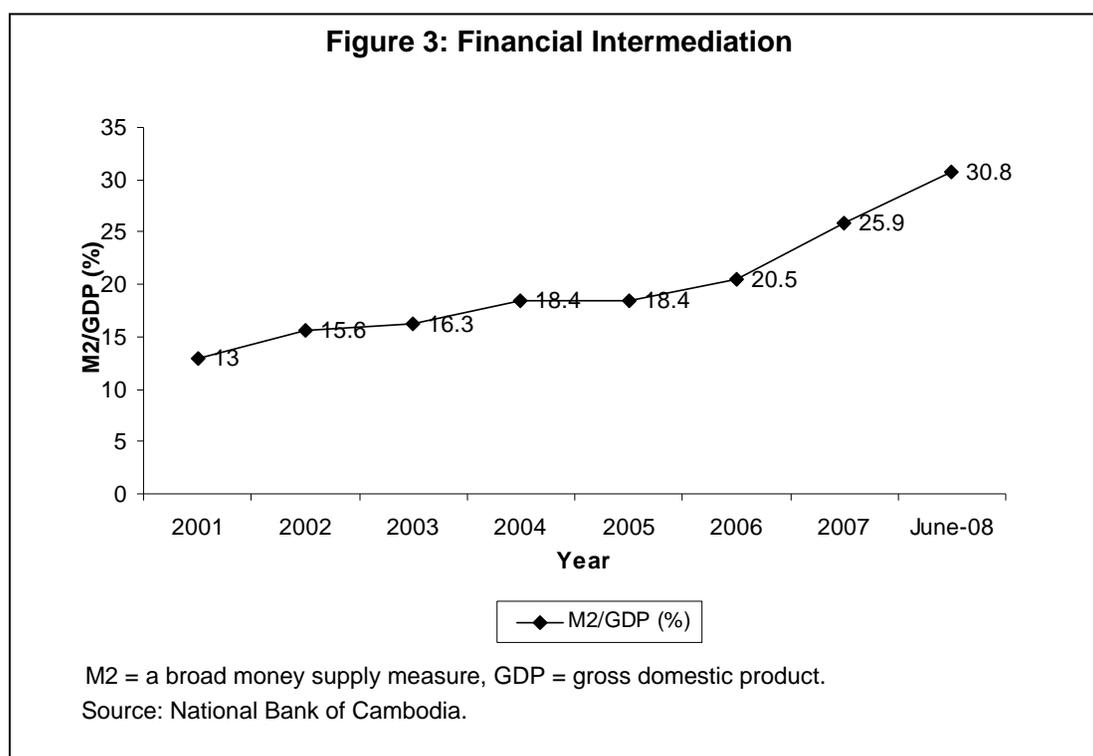


## V. THE FINANCIAL SECTOR

### A. Sector Description and Performance

14. Following the political instability and institutional destruction of the late 1970s and early 1980s, Cambodia's financial system has been undergoing rapid development based upon private sector participation. At the end of June 2008, the formal financial system comprised NBC, 20 private commercial banks, 5 specialized financial institutions, 2 representative offices of foreign-based banks, 16 licensed and 26 registered microfinance institutions (MFIs), and 6 insurance companies. Cambodia also has the objective of developing bond and securities markets within the medium term. The predominantly rural nature of the economy, high transaction costs, inability of the real sector to put together bankable projects, and low creditor confidence have been the main factors resulting in low formal intermediation and outreach within the financial sector. There has also been a slow development of nonbank financial institutions, with a limited range of products and services being offered. A sector analysis is provided in Appendix 3.

15. The performance of Cambodia's financial sector has been satisfactory, though challenging (refer to key financial data in Table 2). With a relatively strong banking subsector, financial deepening has accelerated with more financial services being promoted through the progressive reforms implemented under FSP I. The broad money supply (M2) to GDP rose from 12.8% of GDP in 2000 (before FSP I) to 30.8% in June 2008 (Figure 3). Credit to the private sector correspondingly rose from 6.5% of GDP in 2000 to an estimated 22.9% in June 2008. Total deposits to GDP grew from 9.2% in 2000 to about 25.8% in June 2008. Despite these positive developments, and as noted below, there are still policy gaps, implementation challenges, and capacity constraints needing to be addressed in each of the subsectors.



**Table 2: Key Financial Data**

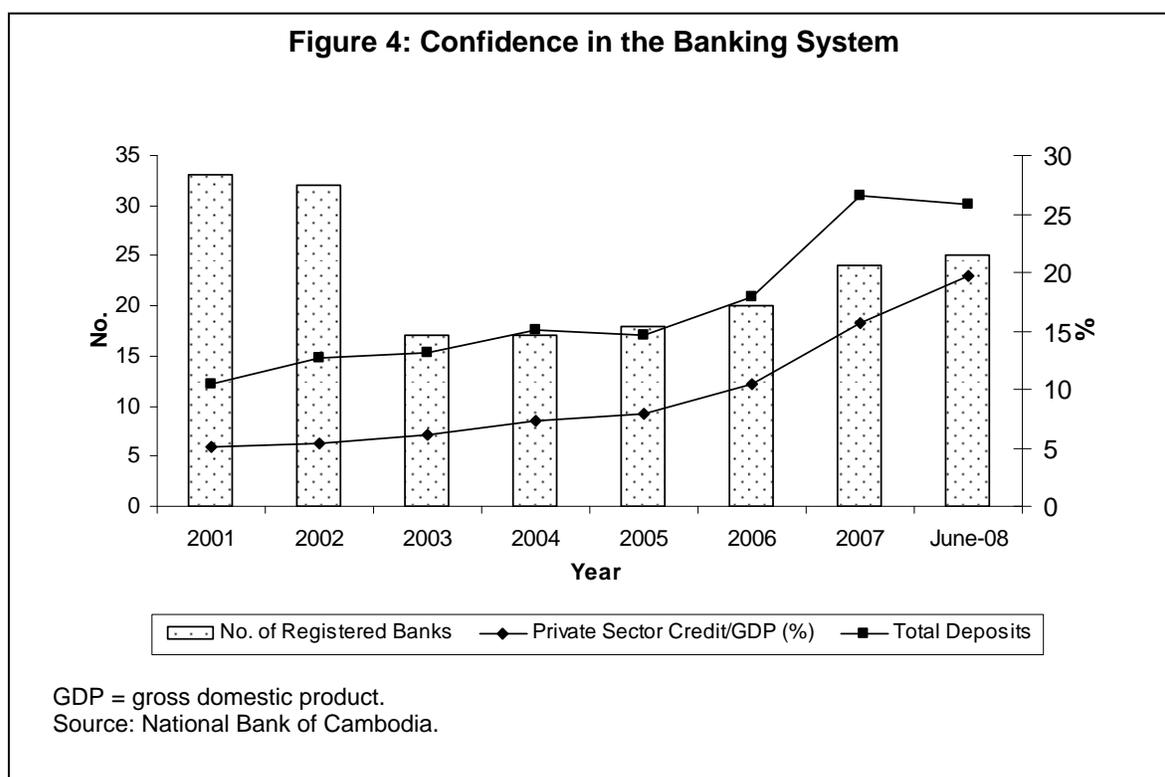
Indicators	2001	2002	2003	2004	2005	2006	2007	June 2008
M2/GDP (%)	13.0	15.6	16.3	18.4	18.4	20.5	25.9	30.8
Number of registered banks	33.0	32.0	17.0	17.0	18.0	20.0	24.0	25.0
Average CAR (%)	58.5	49.3	40.6	34.5	32.0	26.0	24.0	26.0
Private sector credit/GDP (%)	6.0	6.3	7.2	8.5	9.3	12.2	18.3	22.9
Number of loan accounts	68,167.0	86,757.0	105,347.0	123,937.0	145,161.0	164,931.0	197,337.0	209,053.0
<b>Total deposits/GDP (%)</b>	<b>10.4</b>	<b>12.7</b>	<b>13.1</b>	<b>15.1</b>	<b>14.6</b>	<b>17.9</b>	<b>26.6</b>	<b>25.8</b>
NPLs/total loans (%)	8.1	14.6	12.7	9.6	7.3	9.8	3.4	2.7
Average return on assets (%)	0.6	1.1	0.9	1.2	1.8	2.8	2.8	1.6
Average interest spread (%)	12.5	14.0	13.3	15.3	12.2	11.8	11.1	10.8
<b>Total assets of five largest banks/total assets (%)</b>	<b>62.7</b>	<b>70.3</b>	<b>68.6</b>	<b>66.6</b>	<b>63.3</b>	<b>66.3</b>	<b>70.0</b>	<b>69.1</b>
<b>Total deposits of five largest banks / total deposits (%)</b>	<b>80.8</b>	<b>83.6</b>	<b>80.9</b>	<b>78.3</b>	<b>71.0</b>	<b>70.0</b>	<b>73.0</b>	<b>61.6</b>
Number of licensed and registered MFIs	0.0	30.0	34.0	38.0	39.0	40.0	42.0	42.0
<b>Total number of MFI borrowers ('000)</b>	<b>410.0</b>	<b>328.0</b>	<b>265.0</b>	<b>322.0</b>	<b>368.0</b>	<b>471.0</b>	<b>624.1</b>	<b>689.2</b>
<b>Total amount of MFI loans (\$ million)</b>	<b>35.9</b>	<b>51.3</b>	<b>32.6</b>	<b>40.9</b>	<b>49.2</b>	<b>92.2</b>	<b>160.1</b>	<b>221.3</b>
<b>Total amount of MFI deposits (\$ million)</b>	<b>3.8</b>	<b>7.1</b>	<b>2.5</b>	<b>2.0</b>	<b>1.9</b>	<b>2.9</b>	<b>6.1</b>	<b>6.4</b>
<b>Total number of MFI depositors</b>	<b>158,627.0</b>	<b>107,150.0</b>	<b>88,474.0</b>	<b>122,984.0</b>	<b>137,624.0</b>	<b>113,277.0</b>	<b>147,966.0</b>	<b>154,599.0</b>
Number of insurance firms	1.0	1.0	4.0	3.0	3.0	3.0	5.0	5.0
<b>Total insurance premium (\$ million)</b>	<b>3.6</b>	<b>5.5</b>	<b>8.8</b>	<b>10.1</b>	<b>10.8</b>	<b>13.0</b>	<b>17.5</b>	<b>8.7</b>

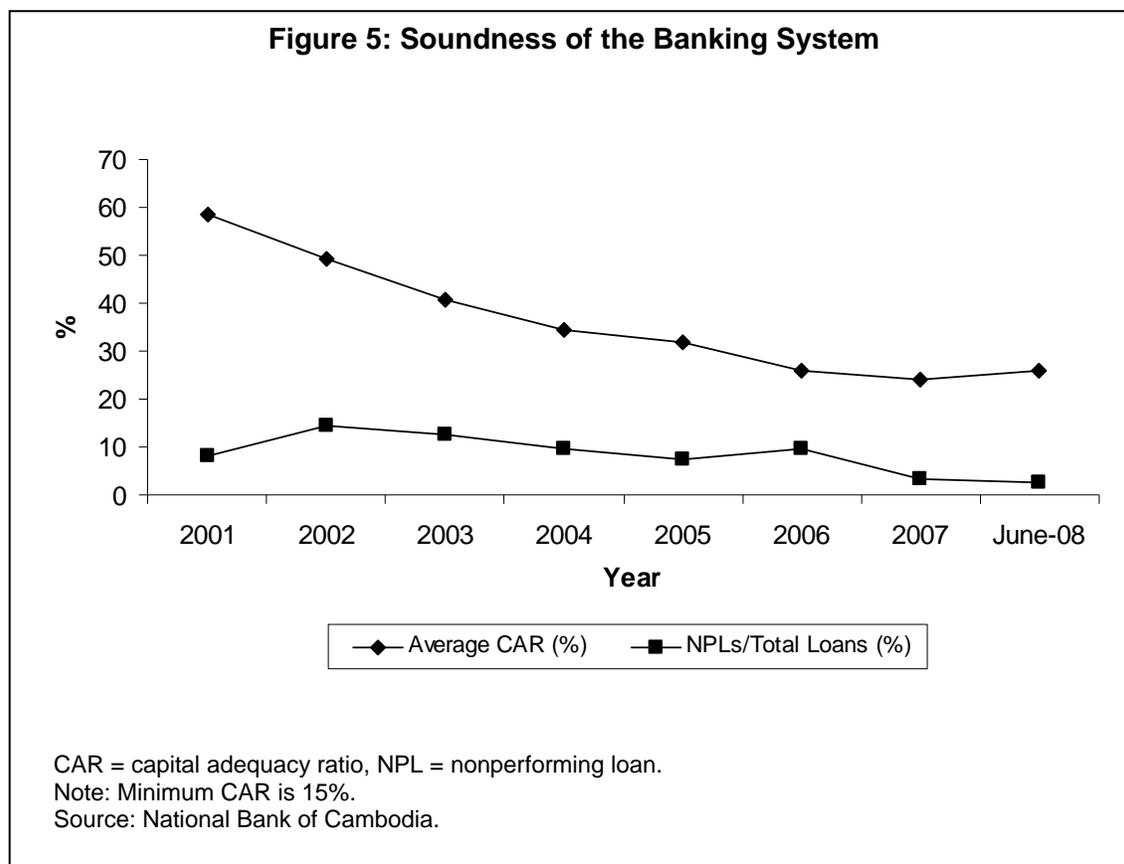
CAR = capital adequacy ratio, GDP = gross domestic product, M2 = a broad money supply measure, MFI = microfinance institution, NPL = nonperforming loan.

Sources: National Bank of Cambodia and Ministry of Economy and Finance.

16. **Banking.** At the end of June 2008 there were 20 private commercial banks, 5 specialized banks (including 1 state-owned bank, the Rural Development Bank), and 2 representative offices of foreign-based banks in Cambodia. All registered banks are adequately capitalized (Figures 4 and 5) following the relicensing process that set the capital requirement at \$13 million equivalent (2002) and the initial minimum capital adequacy ratio at

20%, which was then appropriately reduced to 15% in 2004. While banks are free to set their own interest rates (since 1995), the average annual interest rate spread tends to be high (around 11% in 2007, down from 15.3% in 2004) and most banks continue to maintain high liquidity. The number of active borrowers reached exceeded 209,000 (1.5% of the total population) at the end of June 2008, with potential for growth. Further work is required to address key governance structures of these banks, upgrade staff skills, encourage competition, increase the minimum capital requirement, and enhance their understanding of and compliance with new statutory requirements (e.g., regular provision of prudential reports, requirements for anti-money laundering and combating the financing of terrorism, a credit information sharing system, online filing registry for movable collaterals, new Cambodian Accounting Standards, publication of audited financial statements). While some progress has been made in the banking supervision area, further work is required to upgrade prudential requirements to international standards and best practices, upgrade the skills of NBC staff, and enhance proper surveillance (including the complementary role of external auditors) and uniform enforcement of regulations to maintain the safety of public deposits and the integrity of the banking system.

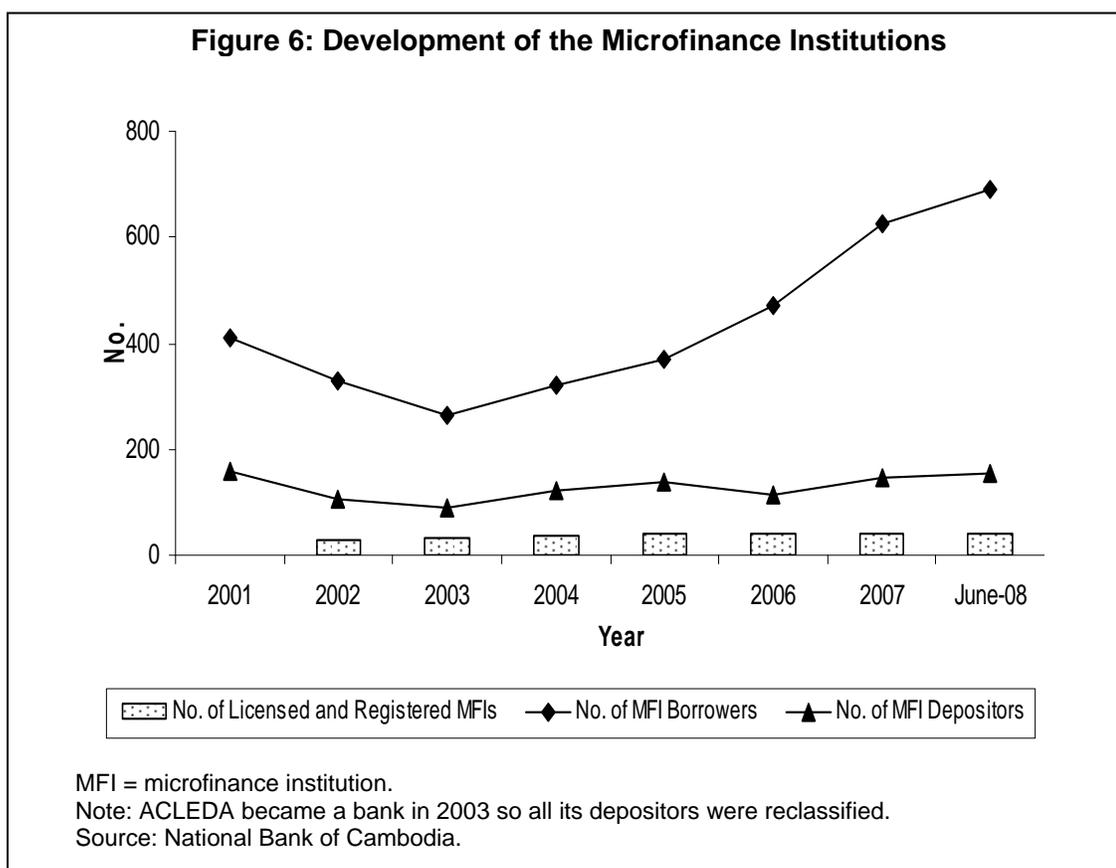




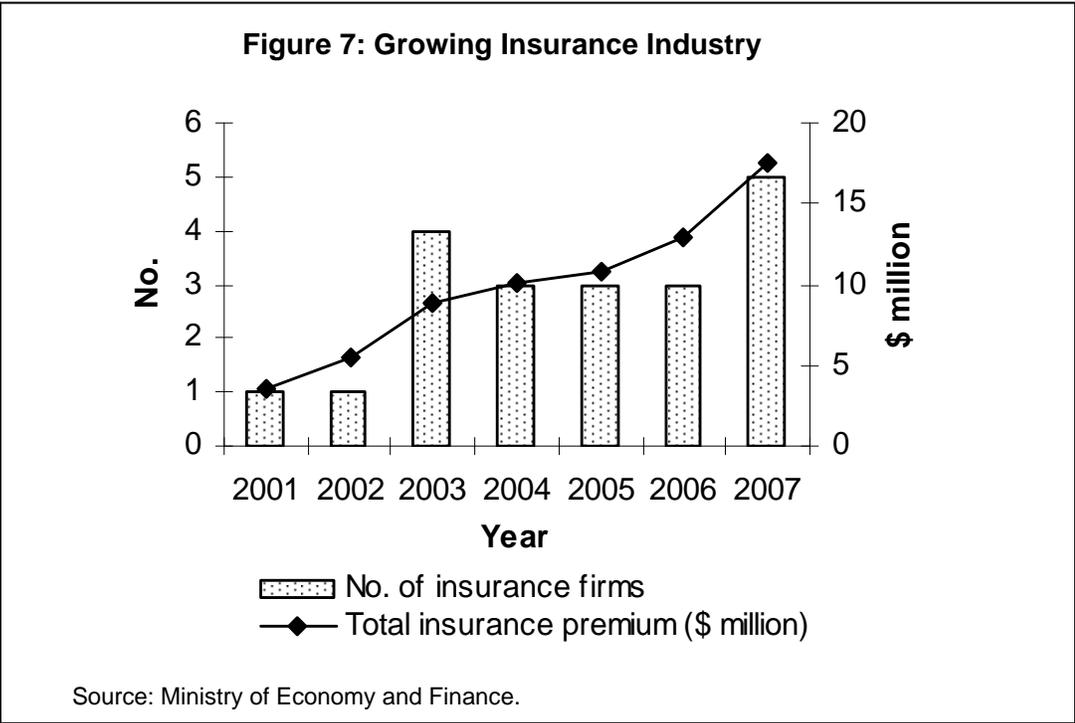
17. **Microfinance.** Microfinance has come a long way since licensing commenced in 2002, as there were new 16 licensed MFIs and 26 registered nongovernment-operated MFIs at the end of August 2008. The microfinance industry is expanding rapidly, providing a link from the formal financial sector to rural households and microenterprises (Figure 6). The number of active borrowers availing themselves of rural household credits, microbusiness loans, and small business loans exceeded 689,000 clients (4.9% of the total population) at the end of June 2008, with potential for further growth. Microfinance lending also grew from \$92.2 million in 2006 to \$221.3 million in June 2008, with reported nonperforming loans below 3%. Voluntary savings remain very small, and access to local finance by MFIs has been very limited. With technical assistance<sup>7</sup> from ADB, NBC issued a *prakas*<sup>8</sup> in December 2007 setting out the criteria for MFIs that are eligible to mobilize voluntary savings. A public campaign to promote MFI savings has commenced. The NBC supervision unit for MFIs regulates the operation of MFIs and further support will be required to enhance its off-site and on-site supervision capabilities.

<sup>7</sup> ADB. 2005. *Technical Assistance to the Kingdom of Cambodia for Developing Deposit Services in Rural Cambodia*. Manila (TA 4755-CAM).

<sup>8</sup> Khmer name for regulations or instructions issued by the NBC governor or a government minister.



18. **Insurance.** There are six operating insurance firms (one state-owned), including one locally registered reinsurer (80% state-owned). Shares in both state-owned firms are held by the MEF, which is also the regulator of insurance activities. Divesting government shares continues to be an important reform agenda item so as to allow the MEF to perform its regulatory functions equitably. Negotiation to sell 75% of state-owned Caminco's shares to a joint venture comprising an insurance firm from Thailand and a Cambodian investor is in its final stage. The insurance industry is very small, with a total premium income of \$17.5 million in 2007 (Figure 7). Growing the industry would require a more comprehensive legal and regulatory framework (comparable to those used in neighboring countries), accompanied by specifically tailored training and incentives. A risk-based capital framework is needed following amendments to the existing insurance law that MEF initiated. Some of the international standards have been adopted. Further work is required to upgrade the remaining insurance prudential regulations to international standards, including for insurance companies to adopt an appropriate reporting standard, to upgrade staff skills, to encourage competition on a level playing field, and to strengthen surveillance and ensure that regulations are fully enforced.



19. **Legal and Supporting Infrastructure.** Key pieces of legislation have been adopted since 2001. Those include laws on insurance, accounting, commercial enterprises, negotiable instruments and payment transactions, commercial arbitration, secured transactions, government and nongovernment securities, insolvency, as well as anti-money laundering and combating the financing of terrorism. Most of the enacted laws have been implemented, and training curricula have been introduced at selected legal faculties to train legal practitioners and judges on these new principles. The Government has requested ADB support under Subprogram 2 to revise and update the banking and financial institutions law, prepare implementing sub-decrees for the commercial arbitration law and secured transactions law, and complete the drafting of a new law on commercial contracts.

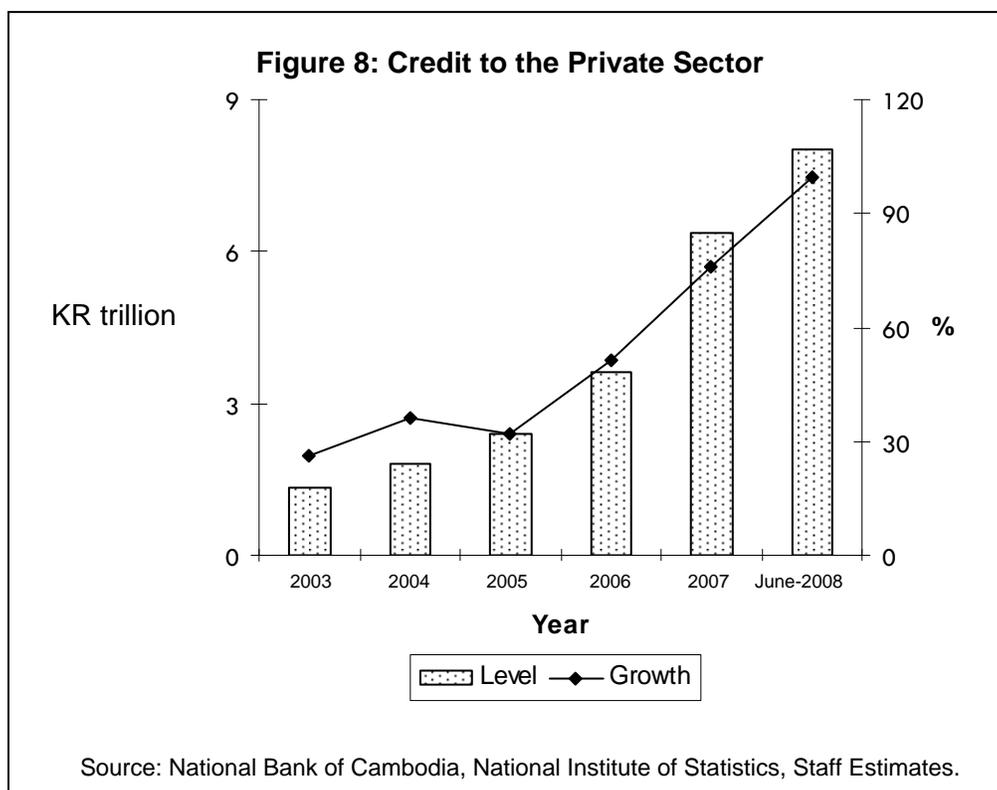
20. **Accounting Development.** Key accounting and auditing initiatives implemented so far include (i) adoption of a law on corporate accounts, their audit, and the accounting profession; (ii) establishment of a national accounting council to set and interpret standards; (iii) introduction of requirements that international accounting standards and international standards on auditing be applied to all companies incorporated in Cambodia; and (iv) establishment of an association of accountants and auditors (Kampuchea Institute of Certified Public Accountants and Auditors), its bylaws, a code of ethics that complies with the requirements of the International Federation of Accountants, and committees on education and ethics within the association. In 2005, only 10 locally qualified accountants were working in the system. To improve accounting and auditing capacity, the Government has been funding a scholarship scheme to assist at least 70 candidates annually to meet the required certified public accountant (CPA) accreditation. Subprogram 2 will continue to support this scholarship scheme.

## B. Emerging Challenges and Opportunities

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

22. **Emerging Risks and Anticorruption Initiatives.** Previous decades of conflict and isolation have resulted in weak governance and perceived high corruption. The transition from a centrally controlled to a market-led economy and the speedy implementation of changes creates new forms of risk and accompanying opportunities for corruption. The presence of international banks, the offer of more sophisticated services to depositors, and the increase in lending demonstrate investors' increasing confidence in Cambodia's financial system. Nevertheless, awareness of potential problems must be heightened within both the public and financial sectors and new ways pursued of mitigating risks.

23. **Rapid Expansion of Bank Lending.** Starting from a relatively small base, credit to the private sector has been expanding very rapidly, from an already high year-on-year rate of 46% at end-June 2007 to 76% at end-December 2007, and further to 102% by end-June 2008 (Figure 8). Total liquidity has also been fueled by increased capital inflows, resulting in the increase of net official international reserves from \$1.4 billion at end-September 2007 to \$1.6 billion at end-December 2007, and further to \$2.0 billion toward end-June 2008. Broad money grew at an annual rate of 60% to December 2007, then dropped to 31.4% in August 2008. The banking system is still in a position of excess unrestricted liquidity, equivalent to almost 22% of total deposits after July 2008. With real economic growth in the neighborhood of 8%, this excess liquidity has been creating demand pressures reflected in the acceleration of inflation. Along with foreign direct investment inflows, rapid credit expansion is adding to growth in real estate and construction investment that has been fueled by rising property prices. Credit, which is concentrated in a few banks, is almost entirely collateralized against the booming real estate market. Some banks' assets are increasingly vulnerable to real estate risks. NBC has issued guidelines to help improve banks' classification and reporting of exposure to housing, construction, and real estate loans. It also introduced a 15% ceiling on commercial bank credit to real estate trading with effect from June 2008. While reported system-wide nonperforming loans remain below 5%, there are concerns about the quality of asset classification. The rapid credit expansion reinforces the critical importance of strong banking supervision and enforcing compliance with prudential regulations while giving priority to assessing asset quality.



24. **Bank Supervision and Vulnerability to Shocks.** Regulatory standards have been gradually improved and relevant prudential regulations added to maintain NBC's primary objective of enhancing the banking system's soundness. Moreover, NBC's capacity for off-site supervision of banks has been upgraded and strengthened. All banks adopted a uniform chart of accounts in 2004 and commenced publishing their annual audited financial reports in 2005. At the end of 2006, NBC's Bank Supervision Department published its second annual report providing a very detailed and comprehensive assessment of the banking system. NBC has asked external auditors of each bank to undertake a comprehensive review of loan portfolios to June 2008 and provide their opinions on the quality of those portfolios and the application of prudential regulations by end-September 2008. In an effort to further strengthen and consolidate the banking system, NBC issued a directive in September 2008 requiring commercial banks that are owned by nonbank entities or individuals to increase their minimum capital to the equivalent of \$36.5 million by 2010. These developments are evidence that NBC is serious about bank soundness and has made significant progress to promote market transparency and establish a sound regulatory and efficient supervisory regime to enhance the banking system's integrity. Although enforcement of prudential regulations is improving, compliance with those regulations remains uneven. NBC aims, however, to enforce full compliance during FSP II implementation.

### C. Lessons

25. Key lessons from FSP I, Subprogram 1 of FSP II, and the associated TA projects to the sector include the following:

- (i) **Long-term perspective.** Adoption of the medium-term blueprint for the financial sector meant that the Government had a set of long-term objectives to guide and shape medium-term policy design and implementation. Changes in the

underlying policy environment necessitated an update of the blueprint, and in February 2007 the updated blueprint, known as the FSDS for 2006–2015, was adopted. The close consultative process involving the Government, ADB, and other development partners strengthened the Government's ownership and increased the potential for funding agency buy-in.

- (ii) **Flexibility in design.** Financial sector reforms are complex and involve major changes to the legal and regulatory framework, institutional arrangements, financial infrastructure, and human capacity. Hence, sufficient time must be allocated to program implementation. Design flexibility is also a key consideration. The use of the program cluster approach under FSP I provided the opportunity to refine the proposed policy actions for succeeding subprograms to reflect the Government's achievements, changes in the policy environment, and lessons from the previous subprograms. FSP II has also adopted the cluster approach, with each of the four subprograms to be processed annually. This provides the flexibility to address new macroeconomic developments and emerging risks to the financial sector.
- (iii) **TA resources.** Under FSP I, the Government adopted legal, policy, and institutional measures, many of which were relatively new concepts and therefore required extensive coordination and consultation to ascertain stakeholders' understanding, acceptance, and likely adoption of the new measures. Substantial TA support was necessary to ensure that best practices were incorporated and then consolidated throughout implementation to achieve the intended results. FSP II has also identified a set of TA projects to help implement the medium-term program. Individual consultants have been selected not only on merit but also on their perceived ability to work well with local counterpart staff and sensitivity to the local culture. These criteria are considered essential for successful transfer of knowledge.
- (iv) **National and commune council elections.** Implementation of subprograms 2 and 3 of FSP I was delayed by elections. The commune and national elections affected the passage of the draft laws through the Council of Ministers and National Assembly and subsequently affected the achievement of targets in relation to those laws. This is a lesson for FSP II Subprogram 2 design, as the next national general election was held on 27 July 2008.
- (v) **Emerging risks.** The transition from a centrally controlled to a market-led economy creates new forms of risk. The presence of international banks, the offer of more sophisticated services to depositors (credit and debit cards for automatic teller machines and electronic funds transfer systems), and the increase in lending demonstrate increasing investor confidence in Cambodia's financial system. With these encouraging developments, however, come new risks and challenges—such as lack of discipline over the use of credit cards, lax application of credit underwriting and portfolio management policies, and inappropriate safety nets for users of electronic cards. Strengthening awareness of potential risks within both the public and the financial sectors is therefore important. Similarly, new ways for mitigating risks must be pursued.

## **VI. THE PROPOSED SUBPROGRAM**

26. **Links between Subprograms.** Following approval of the FSP II cluster and Subprogram 1 in December 2007, the momentum of implementing the policy reforms within the FSP II medium-term framework has been maintained. As a continuation of reforms initiated under Subprogram 1, Subprogram 2 has 14 key reform actions that the Government began implementing in January 2008. All have been completed prior to Board circulation. Disbursement will follow loan effectiveness. Subprogram 3 has been designed with 11 triggers and 11 milestones to continue the policy reforms initiated under subprograms 1 and 2 within the four broad objectives of the medium-term framework that are intended to (i) improve confidence and financial intermediation, (ii) maintain financial stability, (iii) promote good governance, and (iv) enhance efficiency of the financial sector. Implementation of Subprogram 3 will commence in January 2009 and will be processed for Board approval and disbursement in December 2009. Reform measures may be added to subprograms 3 and 4 as necessary within the medium-term framework after duly considering the Government's social and economic achievements and changes in the macro policy environment.

27. **Refined Policy Framework.** With recent developments in Cambodia's macroeconomic and financial sectors, and through extensive consultation between ADB and the Government, new policy triggers and milestone were added. To address the rising level of inflation, NBC has doubled the minimum reserve requirement imposed on banks from the current 8% to 16% with effect from July 2008 in a bid to absorb some of the excess liquidity. NBC has also relaxed some restrictions on capital outflows, by allowing, upon verification, commercial banks to invest a proportion of their surplus funds abroad where they can earn higher rates of return. Both have been added to the policy triggers for Subprogram 2. While the liquidity position of a few small banks may be temporarily affected by the increase in reserve requirement, NBC has encouraged the Bankers Association to initiate an interbank market. The NBC indicated that further measures would be considered if doubling the reserve requirement together with the relaxation of capital outflows was not sufficient to achieve the objective of moderating inflation.

### **A. Progress in the Implementation of Policy Actions under Subprograms 1 and 2**

#### **1. Improve Confidence and Financial Intermediation**

##### **a. 1.1: Improve Financial Services and the Payments, Clearance, and Settlement System**

28. A payment, clearance, and settlement system is necessary to achieve modern payment systems and service outreach; for development of money and interbank markets; and to support macroeconomic policy implementation. The vast majority of transactions in Cambodia are conducted in cash rather than by check, and cash transactions are reckoned to be mainly in dollars. Checks, mainly used by companies and a few individuals who maintain bank accounts, are manually cleared and settled through clearinghouses operated by NBC (in Phnom Penh, Siem Reap, and Sihanoukville, with no electronic link between them). Checks are presented each morning at 9:30, and dishonored checks flow back through the system at 3:00 p.m. Settlement from clearing operations is recorded in the NBC books at each branch office. In view of this current manual system, NBC places high priority on upgrading the payment and settlement system because it will help build confidence, enhance growth in financial intermediation and outreach, and encourage product and service innovation. Further, the rapidly growing economy is straining the current manual system; an upgraded system is required to support the larger, more complex financial transactions in the economy; and moving from the

cash-based to a check-based treasury accounts system would enhance public financial management capacities throughout government.

29. In 2005, Cambodia enacted the Law on Negotiable Instruments and Payment Transactions, which provides a legal basis for negotiable instruments such as checks, bills of exchange, and promissory notes, plus regulation of payment systems. The process for modernizing the national payments, clearance, and settlement system started in 2006 when NBC established the Payments Policy Unit (PPU). With technical support from ADB, NBC developed a road map for modernizing the payments, clearance, and settlement system. Staff of the PPU consulted with banks to obtain their input on the unit's initiatives and to garner support for implementing the proposed road map. Under Subprogram 1, NBC signed a memorandum of understanding with each commercial bank endorsing the road map to modernize the national payment, clearance, and settlement system.

30. NBC continues to implement key actions of phase I of the road map to modernize the payment, clearance, and settlement system under Subprogram 2. With a long-term payment expert funded by ADB, the PPU commenced discussions with banks on standardization of checks, on an interbank switch to handle retail electronic payments, and to identify practical solutions to enhance funds transfer and faster bank settlement. A prakas on check standardization was issued by NBC in September 2008 after it was reviewed by all banks. An interbank switch was launched on 28 August 2008 between four banks. The shared visa switch is a positive beginning and may develop into a more inclusive and beneficial system in the future. To enhance funds transfer and early settlement, the PPU has been evaluating a credit remittance payment instrument designed with suitable flexibility to be used as a direct funds transfer instrument; as a direct credit; and as a direct debit instrument for government salary payment, utility payments, and settlement between banks. Since Cambodia presently operates on a decentralized basis, with every bank maintaining both riel and US dollar settlement accounts at each provincial NBC, this interim solution is considered pragmatic. The external advice regarding the importance of a real-time gross settlement (RTGS) has not received parallel practical consideration because a core requirement of any RTGS is that bank settlement accounts are centralized so that the central RTGS has a total view, and total management, of the respective commercial bank's credit and liquidity exposure on a real-time basis. Centralization of commercial bank settlement accounts has not been considered by NBC, and it cannot be reasonably implemented until the new core banking system is implemented and rolled out to all branches sometime near the end of 2010.

#### **b. 1.2: Enhance Consumer Access to Credit and Market Confidence**

31. To improve the quality of credit underwriting and portfolio management, and to boost the confidence in the banking system, a credible credit information system and supporting regulations are needed. With close cooperation between NBC and the Bankers Association, a pilot online credit information sharing system (CIS) was established in August 2006 to support the credit appraisal processes of participating banks. Rules, regulations, procedures, and a governing structure are in place, but implementation has not met expectations. Participating banks have reported that since introduction of the CIS they have had difficulty uploading data and also accessing the information online. A number of actions have been taken under the Small-and Medium Enterprise Development Program<sup>9</sup> to improve the software system and build

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<sup>9</sup> ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Kingdom of Cambodia for the Small and Medium Enterprise Development Program*. Manila (Loan 2129-CAM).

steering committee capacity to work with the system. Several additions have been made to the system to allow “no cases to report” as a quick option for participating banks, which can then trigger a more focused follow-up by the CIS steering committee. Subprogram 1 helped familiarize stakeholders with the system while addressing important changes to the system and to the governing structure of the CIS to enhance its effectiveness. The NBC will continue to help eliminate the systematic issues while strengthening bank compliance and ensuring the usefulness of the system.

32. The orderly development and expansion of the financial market requires knowledgeable customers as well as financially sound providers of financial services. It requires customers to be able to make informed decisions on the services they need and what financial institutions they should be requesting to undertake their financial transactions. Since 2005, all banks have been required to publish their audited financial statements to allow the general public to make informed judgments regarding where to place their deposits and with which banks to transact. Several banks have published these annual audited financial reports on their own websites. Following recent high credit growth in the banking system, NBC had requested all bank auditors to undertake a comprehensive portfolio review as of end-December 2007. These audit reports were completed by the end of June 2008. Subprogram 2 supported NBC in its efforts to promote bank transparency by requiring all audited financial statements of banks as well as new prudential regulations to be published on the NBC website.

**c. 1.3: Develop Interbank Market and Tradable Government Securities**

33. The Law on Government Securities, enacted in January 2007, provides a framework for the efficient issuance and management of government securities. This market will in turn ensure that the Government’s financing needs and payment obligations are met at the lowest possible cost, and it will provide key information to financial sector participants through the development of a yield curve. NBC has been assigned the role of maintaining the registry function for the issuance of government securities. NBC has established the registry and trained the staff on its operation and procedures under Subprogram 2.

**d. 1.4: Promote Outreach in the Formal Sector**

34. Banking activities in rural areas, although not fully developed, are improving with MFIs providing most of the formal financial services. The formal microfinance industry has undergone a transition from the development model to a fully commercial model, although some funding is still channeled from aid organizations and their affiliates. Nevertheless, by some estimates, the informal sector still has a greater share by value and number of transactions undertaken within the economy (especially among the poor and remote rural population) than the formal sector, which comprises registered banks and both licensed and registered MFIs. At present, no reliable data is available on the actual size and scale of the informal financial sector. An understanding of the size and depth of the informal sector outside of the formal financial sector needs to be established to help determine the required policies, both macro and micro, and amount of assistance needed to develop this sector. A survey would be useful to gather information on nonlicensed MFIs and moneylenders outside the formal sector and their impact on the economy. It would include data on size, scale, and scope while covering products and services offered, transaction costs, and locations serviced. NBC (for licensing and supervision purposes) and MEF (policy formulation) have agreed to jointly undertake this survey under Subprogram 2. Two months’ technical support has been provided to assist both agencies. The report of the survey was discussed at a series of workshops in September 2008.

## **2. Maintain Stability in the Financial Sector**

### **a. 2.1: Update the Legal and Regulatory Framework for Banks**

35. As part of Cambodia's efforts to strengthen prudential supervision, update regulations, and ensure stability, NBC has issued regulations (i) on large exposures of banks and financial institutions, and (ii) to amend the prakas on licensing of commercial and specialized banks under Subprogram 1. Further, because the Law on Banking and Financial Institutions was enacted in 1999, a comprehensive review of this law is needed to effectively address the features of a changing domestic market and the reality of increasing international economic integration. The review, with technical assistance from ADB under Subprogram 2, will take into consideration consumer protection in connection with the use of debit and credit cards, bank secrecy provisions to support development of the CIS, procedures for administering distressed and insolvent banks, and protection or immunity of bank regulators. Based upon the findings of this review, a revised and updated law is to be submitted to the Council of Ministers and the National Assembly during FSP II.

### **b. 2.2: Strengthen Bank Supervision Capacity and Adopt Measures to Sustain Financial Stability**

36. Updating and upgrading skills is a priority area that must be an ongoing feature of development and the deepening of the financial system. New risks will emerge requiring that skills development and training be pursued in tandem with these developments. NBC will continue to strengthen and upgrade the capacity of its own supervision staff to be able to effectively manage these developments. At the same time, NBC recognizes that the financial sector is still in an early stage of development and thus will strengthen its surveillance mechanisms. The IMF has been providing a resident adviser to help develop the off-site capability of the bank supervision staff and will continue to provide support to 2010. With TA for \$1.7 million approved together with Subprogram 1, ADB has been providing technical support to help NBC undertake regular on-site examinations of banks. During Subprogram 2, NBC evaluated the progress on capacity building support to bank supervision and again emphasized the need for ADB support for bank on-site supervision. This is very important in view of the rapid increase in the number and size of loans and concern with the quality of information reported by these banks. ADB is proposing TA together with Subprogram 2 to ensure that this very important area of NBC's work is further strengthened.

37. NBC has formulated remedial measures, broadly anchored on the policy matrix and program policy framework, covering stronger sanctions to address potential vulnerabilities in the banking system. NBC will closely monitor progress with implementation of the remedial measures, and ADB will regularly review progress reports. Under Subprogram 1, NBC has (i) assessed and identified capacity building needs for banking supervision, and (ii) strengthened surveillance and undertaken prompt corrective measures for banks that are not conforming to the laws and prudential regulations. NBC continues to require nonconforming banks to provide progress reports and promptly undertake corrective measures, and these reports have been discussed with ADB missions. Further, NBC has reviewed its regulations to strengthen good corporate governance, including the requirement for fit and proper testing of key bank management covering specific banking qualifications and experience under Subprogram 2. The regulation on corporate governance including the requirements for fit and proper test of key bank management has been formally issued as a prakas in October 2008.

38. As a reflection of rapid economic growth, domestic liquidity has been rising rapidly, from a very small base, partly fueled by the surge in capital inflows from foreign direct investments and by the rapid growth of credit to the private sector. Inflation has been sparked by supply-side shocks and surged from an annual rate of 10.8% in December 2007 to 25.1% in June 2008. The domestic excess liquidity needs to be mopped up to avoid fueling an inflationary spiral. Under Subprogram 2, NBC doubled the reserve requirement from 8% to 16% in July 2008 to help return bank lending to sustainable levels, and favorably considered applications from commercial banks to place excess reserves abroad with prudentially approved counterparties. Prior to introducing the above measures, NBC consulted the IMF in March 2008 and the Bankers Association in April 2008, neither of which had any objection to the measures. NBC has also encouraged the Bankers Association to start interbank lending to finance any temporary liquidity requirements. NBC will continue to provide periodic macroeconomic and financial data for ADB to monitor the performance of the financial sector.

**c. 2.3: Strengthen Prudential Supervision and Regulations for Microfinance Institutions**

39. Appropriate financial regulation and supervision are essential to build resilience against financial crisis. Similarly, providing incentives and guidance to financial institutions could further enhance their operations. NBC made significant progress in building the regulatory framework for licensing and supervising registered MFIs. It established a division for prudential supervision of MFIs within the Banking Supervision Department and it issued several prudential regulations in the form of prakas. Division staff has had some training through technical support<sup>10</sup> from ADB to undertake off-site and, to a limited extent, on-site supervision. Under Subprogram 1, NBC has issued regulations to amend the prakas on the licensing of microfinance institutions. The accompanying TA for Subprogram 1 also provided technical support to help strengthen NBC's supervision of MFIs. NBC issued additional regulations covering MFIs that can mobilize voluntary savings and manage foreign exchange risks in December 2007 and early 2008, respectively. The accompanying TA for Subprogram 2 will continue ADB's support to strengthen off-site and on-site supervision of the growing MFI subsector.

**d. 2.4: Enhance Legal Foundation to Support Financial and Commercial Transactions**

40. For financial transactions to develop beyond basic, short-term, and mainly cash-based transactions, a legal framework for commerce and finance must be developed, updated, and implemented. Progress in preparing and enacting a number of components of the legal framework for financial and commercial transactions has been significant. This includes the insurance law, accounting and auditing law, commercial enterprises law, negotiable instruments and payment transactions law, commercial arbitration law, secured transactions law, government securities law, civil procedures code, law on anti-money laundering and combating the financing of terrorism, and insolvency law. Under Subprogram 1, MEF submitted the draft law on nongovernment securities to the National Assembly and on 12 September 2007 the National Assembly adopted the law. Most of the enacted laws have been implemented, and training curricula have been introduced at selected legal faculties to train legal practitioners and judges on these new principles.

<sup>10</sup> ADB. 2005. *Technical Assistance to the Kingdom of Cambodia for Financial Sector Program Implementation*. Manila (TA 4656-CAM). Attached to ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Kingdom of Cambodia for Subprogram III of the Financial Sector Program*. Manila (Loan 2185-CAM).

41. Laws that were recently enacted require the adoption of implementing sub-decrees under Subprogram 2. The Government has developed the sub-decree for the secured transactions law. ADB has also provided technical support to help the Ministry of Commerce (MOC) complete the drafting of a new law on commercial contracts. The new law would supplement the Civil Code provisions with regard to contract law and will include general provisions relating to agencies and franchising. The law will help increase reliance on and confidence in the use of written commercial contracts in Cambodia for a variety of business transactions. Subprogram 2 continued supporting the Government's efforts to review Cambodia's requirements for a detailed set of rules for commercial transactions, review relevant international models and approaches, and help draft a new harmonized law on commercial contracts. Submission of the draft law to the Council of Ministers and National Assembly is expected during subprograms 3 and 4, respectively.

### **3. Promote Good Governance**

#### **a. 3.1: Promote International Initiatives on Anti-Money Laundering and Combating the Financing of Terrorism**

42. Work to implement an anti-money laundering (AML) and combating the financing of terrorism (CFT) regime in Cambodia is supporting international deterrence efforts and promotes standard governance principles. This will help build market confidence and discipline. Throughout 2005 and 2006, NBC and the Australian Transaction Reports and Analysis Centre (AUSTRAC) conducted joint training workshops on AML and CFT in general, including procedures to assess suspicious transactions reports and the roles of compliance officers at banks and financial institutions. They also conducted an AML and CFT assessment. Subprogram 1 supported the Government in its successful efforts to adopt the law on AML and CFT in 2007. This was followed by adoption of sub-decrees to appoint the board of directors and secretary general to head the Financial Intelligence Unit (FIU) and to formally establish the FIU with 5 staff members during Subprogram 2. ADB, World Bank, AUSTRAC, Asia Pacific Group on Money Laundering, the Bank Negara Malaysia, and other development partners are providing technical assistance to help the Government implement the AML and CFT initiatives.

#### **b. 3.2: Enhance Corporate Governance and Transparency in the Insurance Industry**

43. Building consumer confidence in insurance as a service will first require public understanding of the insurance business and the services it can provide. Business must be conducted as transparently as possible to protect consumers and ensure that information provided to the general public and the regulator is accurate. The goal for all participants in the industry is to raise their operations to international standards. The reinsurer and regulator are responsible for reinforcing these standards. The Government and the insurance association can contribute to the insurance industry's development by increasing public awareness about insurance. The regulator can take a leadership role by ensuring transparency within the industry, as well as for the general public and other government ministries. Under Subprogram 1, MEF issued regulations on (i) premium rates for fire insurance, and (ii) licensing of general and life insurance companies. MEF also issued prakas covering corporate governance and solvency for insurance companies in early 2008. A prakas on accounting guidelines for general insurance was discussed with international accounting firms, the National Accounting Council, and the insurance firms, and this has been adopted under Subprogram 2.

**c. 3.3: Establish Commercial Dispute Resolution Mechanism**

44. To promote good governance and boost public confidence in the financial system, the Government enacted the law on commercial arbitration in 2006, and the draft sub-decree is being reviewed by the Council of Ministers. Work to establish a national arbitration center will begin after adoption of the sub-decree. The arbitration center will improve the effectiveness and efficiency of the commercial and financial systems, as well as provide the commercial community with a cost-effective non-judicial process for dispute resolution. With greater public awareness of the arbitration center's functioning, confidence in the financial sector should increase. Before the center can commence operation, however, members of the judiciary, legal profession, and management personnel will need to be trained. TA under Subprogram 2 will support MOC's efforts to establish a national arbitration center by adopting the implementing sub-decree along with appropriate rules and procedures for commercial arbitration.

**d. 3.4: Strengthen the Accounting Institutions and Professional Capacity of Members**

45. For efficient financial intermediation, financial market infrastructure needs to be developed—particularly accounting and auditing systems plus qualified personnel to implement them. In 2005, only 10 locally qualified accountants were working in Cambodia and the MEF introduced an initiative to improve accounting and auditing capacity through a Government-funded scholarship scheme to assist at least 70 candidates per year to acquire the qualification needed to become members of the Kampuchea Institute of Certified Public Accountants and Auditors. These scholarships were initially awarded to government civil servants only. A significant number of awardees dropped out for various reasons, and results were very poor. Through policy dialogue, this was opened to the general public and selection is now based on merit. The scholarships were opened to the public in 2006, and the results have greatly improved. Under Subprogram 2, MEF continued to support this public scholarship scheme.

**4. Enhance Efficiency in the Financial Sector**

**a. 4.1: Computerize and Integrate Key Operating Functions of NBC**

46. NBC's current information technology system is not well integrated across the bank, resulting in duplication and inefficiency. NBC would gain considerable benefits in terms of its ability to provide a more efficient service to the banking sector by implementing an integrated system that initially links the accounting department to the cash management functions in the issues department, the customer account management in the banking operations department, and the foreign exchange transactions in the exchange management department. Under Subprogram 1, NBC reviewed and adopted the information technology architecture model for a total estimated cost of \$4.0 million. MEF has allocated a \$4.0 million grant to NBC to finance the new system, including the required hardware, and ADB provided two international consultants to assist NBC in procuring, designing, and installing the system. Under Subprogram 2, NBC has reviewed its management information system and commenced the procurement process to acquire the software and hardware for an integrated accounting system.

47. Implementation by NBC will continue in subsequent subprograms with technical support from ADB. Benefits are foreseen, too, in providing improved application software for other parts of the bank, in particular departments that do not need to link to the core banking system in real time, such as banking supervision, personnel, and economic research and statistics. Eventually the system should also link the accounting department to the NBC branches, thus promoting

financial deepening and operating efficiency. A wide area network infrastructure will be established at NBC to facilitate real time clearing and settlement operations.

**b. 4.2: Upgrade the Capacity of Microfinance Institution Staff**

48. Finding adequately trained and skilled people to meet the needs of a growing microfinance industry is an ongoing challenge. Growth puts pressure on the delivery and customer sides of the business. Capacity development structures are needed within MFIs. In consultation with the association of MFIs, the Center for Banking Studies (CBS) will undertake a review of its curriculum with the objective of expanding the scope of training to include all aspects of MFI business and to increase management awareness of liquidity risk, interest rate risk, concentration of credit risk, and foreign exchange risk. Technical assistance under Subprogram 2 is helping to review and upgrade the CBS curriculum.

**B. Financing Plan**

49. The Government has requested a loan of \$10,300,000 equivalent from ADB's Special Funds resources for Subprogram 2. The loan will be disbursed in a single tranche upon satisfactory compliance with specific conditions indicated in the policy matrix. The loan will have a 24-year term, including an 8-year grace period. The interest rate will be 1.0% per annum during the grace period and 1.5% thereafter. The ADB funds are to support the reforms outlined in the development policy letter of 26 October 2007 and the policy matrix as updated.

**C. Implementation Arrangements**

**1. Program Management**

50. NBC will be the Executing Agency, and MEF and MOC will be the implementing agencies for Subprogram 2. The financial sector steering committee will continue to coordinate program implementation among government ministries and agencies concerned. To ensure timely program implementation, the committee, comprising senior officers from MEF, MOC, and NBC, will meet as required to review progress reports from the technical working group and consider pending issues. The committee will propose concrete actions to resolve those issues. A senior NBC officer has been appointed as program director to assist MEF, MOC, and NBC in coordinating day-to-day program implementation. The program director will be required to submit quarterly progress reports on Subprogram 2 implementation.

**2. Period of Implementation**

51. The implementation period for Subprogram 2 is from January to December 2008. The Government has implemented all policy actions for the release of the single tranche.

**3. Procurement and Disbursement**

52. The loan proceeds will be used to finance the full foreign exchange cost (excluding local duties and taxes) of items produced and procured in ADB member countries, excluding a negative list of ineligible items (Appendix 5) and imports financed by other bilateral and multilateral sources. All procurement of goods and services produced in, and originating from, ADB member countries will be made with due consideration to economy and efficiency, as well as in accordance with standard public sector procedures in Cambodia and normal private sector commercial practices acceptable to ADB. In accordance with provisions of ADB's *Simplification*

of *Disbursement Procedures and Related Requirements for Program Loans* (1998), the loan proceeds will be disbursed to the Government as the Borrower. The Government will certify that (i) the value of the country's eligible imports is equal to, or exceeds, the amount of ADB's projected disbursements under the loan in a given period; and (ii) the loan proceeds will be utilized in a manner satisfactory to ADB. The loan proceeds will be disbursed based on the certification provided by the Government, which confirms that the requirements for the loan have been met. ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the Borrower's certification. Subprogram 2 will provide for retroactive financing for expenditures incurred by the Government up to 180 days prior to loan effectiveness.

#### 4. Anticorruption and Fiduciary Issues

53. ADB's *Anticorruption Policy* (1998, as amended to date) and the *Policy on Combating Money Laundering* (2003) were explained to the Government. All relevant ADB guidelines and the loan regulations were specifically brought to the attention and notice of the Government. Consistent with its commitment to good governance, accountability, and transparency, ADB will require the Government to institute, maintain, and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism, and covenant with ADB to refrain from engaging in such activities. All contracts financed by ADB in connection with the Program shall include provisions specifying the right of ADB to audit and examine the records and accounts of the Executing Agency and all contractors, suppliers, and service providers as they relate to the Program.

54. An assessment of the country's public financial management systems was carried out to better understand the fiduciary risks and determine appropriate arrangements for the fiduciary arrangements of Subprogram 2. Discussions were held with the Government during formulation of Subprogram 2 on the funds flow from NBC to MEF and the contribution of the ongoing public financial management reform program to the administration of loan proceeds.<sup>11</sup> Very satisfactory progress has been noted in revenue collections, with greater use of the banking system to streamline revenue collection and payment processes. The redesign of an integrated chart of accounts and budget classification has been substantially completed to improve expenditure tracking and reporting. As part of efforts to improve governance and reduce corruption, the Government continues to place significant emphasis on strengthening the overall public financial management system, internal systems (including internal audit functions), and the functions of the National Audit Authority. The ongoing public financial management program, which started in 2004 and is supported by 10 development partners including ADB,<sup>12</sup> has helped lower the fiduciary risk of the system.

55. A core component of Subprogram 2 focuses on promoting good governance, deterring money laundering and financing of terrorism, and implementing measures that will help deter corruption in the overall economy (a good governance framework is in Supplementary Appendix A). Subprogram 2 includes measures to improve the management information system and reporting standards within NBC, banks, and MFIs; promote transparency of information released by banks and MFIs; improve compliance with and usefulness of the credit information sharing

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<sup>11</sup> Ministry of Economy and Finance. 2007. *External Advisory Panel Report on the Public Financial Management Reform Program*. Phnom Penh.

<sup>12</sup> ADB, Australia, Department for International Development of the United Kingdom, the European Community, French Cooperation, IMF, Japan International Cooperation Agency, Swedish International Development Agency, United Nations Development Programme, and the World Bank.

system; support implementation of AML regulations; and deter activities that could support the financing of terrorism. Increasing use of payment instruments other than cash will particularly help discourage corruption at central, provincial, and district treasuries. These reforms will help keep savers and investors informed, empower civil society to monitor the weaknesses in these financial institutions, and deter those who are vulnerable to corrupt activities.

## **5. Accounting, Auditing, and Reporting**

56. The Government will open or nominate an account with NBC to receive the loan proceeds for Subprogram 2. It will manage, operate, and liquidate the account in accordance with terms satisfactory to ADB. ADB will retain the right to audit any account and records relating to utilization of the loan proceeds.

## **6. Program Performance Monitoring and Review**

57. The program director (para. 50) will coordinate and submit quarterly progress reports on policy and institutional reform implementation to the financial sector steering committee and ADB. The reports will be submitted in such form and detail as ADB may request, and include (i) progress made and problems encountered during the review period, (ii) steps taken or proposed to remedy problems encountered, and (iii) proposed detailed activities planned for the next review period. The Government will inform ADB of outcomes of policy discussions with the IMF, World Bank Group, and bilateral funding agencies having implications for Subprogram 2 implementation.

58. ADB, in cooperation with NBC, MEF, and MOC, will conduct semiannual reviews of program implementation progress and assess macroeconomic developments and their impacts on the financial and related sectors of the economy. The Government and ADB will continue to engage in active policy dialogue throughout Subprogram 2 implementation on macroeconomic issues that may affect financial sector development and on additional reforms that may be necessary or desirable for sustainable development of the financial sector. Not later than 4 months after completion of Subprogram 2, the Government will prepare and submit to ADB a program completion report.

# **VII. SUBPROGRAM BENEFITS, IMPACTS, ASSUMPTIONS AND RISKS**

## **A. Benefits**

59. With a rapidly growing commercial economy that requires a sound financial system to sustain economic growth, the Government, if it is to achieve long-term sustainable economic growth and poverty reduction, needs to develop the financial sector by mobilizing financial resources, channeling them to productive investments, and managing inherent risks. The Asian financial crisis of the 1990s provided many examples of the devastating impact that financial crises can have on countries, wiping out several years of growth within a very short time. Thus, to promote economic growth, reduce poverty, and help Cambodia avoid financial crises, FSP II, Subprogram 2 will support the Government in its development agenda.

60. The policies supported by Financial Sector Program II Cluster—Subprogram 2 will help reduce information asymmetry, improve governance, enhance financial stability, and improve efficiency in the financial sector. These factors will contribute to a more conducive environment for continued financial market development. FSP II, Subprogram 2 is expected to help boost confidence among market participants and, with improvements to the payments, clearance, and

settlement system, financial intermediation will grow. That will result in a wider offering of products and services in urban and rural areas. A sound, more efficient, and diversified financial sector will support higher investments and productivity in the private sector. Together with broader economic reforms, the reforms in the financial sector will contribute to higher economic growth.

## **B. Social and Environmental Safeguards**

61. Subprogram 2 will not entail any involuntary resettlement or have a negative impact on indigenous people or the environment. It is classified as category C for involuntary resettlement, impact on indigenous people, and impact on the environment. Subprogram 2 is a general intervention aimed at supporting sustainable economic growth. In that respect, it is expected to have an indirect positive effect on poverty reduction. A summary poverty reduction and social strategy is in Appendix 6.

## **C. Assumptions and Risks**

62. Financial Sector Program II Cluster—Subprogram 2 assumes political stability in Cambodia and sustained implementation of sound macroeconomic policies by the Government. Given Cambodia's encouraging results in the past decade, both these assumptions are valid and defensible. Implementation of Subprogram 2 could face a number of risks, however, for which mitigation measures have been put in place.

- (i) **Challenges to sustaining economic growth.** Cambodia's economic prospects must be viewed against a number of adverse developments in the external environment. The immediate impact of the financial crisis in the US and Europe, and the drying up there of liquidity in the commercial paper and related money and interbank markets, pose limited or no direct—or indirect—financial sector risks to Cambodia's economy, either through balance sheets or liquidity factors, as Cambodia's banks do not have significant exposure to borrowing from international banks and capital markets do not as yet exist. However, the slowdown in the global economy resulting from the fall in US and European growth rates has impacted on Cambodia's growth rate, initially through reduced expansion of exports due to reduced demand for Cambodian garments. The recent unexpected surge in international energy and food prices has fueled higher domestic inflation in 2008, with potential knock-on effects for consumption and poverty, growth, and financial sector stability. In addition to foreign direct investment inflows, the rapid credit expansion is adding to growth in real estate investment and to rising property prices. This is causing the assets of some banks to be increasingly vulnerable to real estate risks. The Government has introduced a combination of fiscal and monetary measures that have helped to moderate inflation and slow lending. Throughout Subprogram 2, the Government and ADB have undertaken periodic reviews of macroeconomic and financial developments to assess potential risks to the financial sector. These reviews will continue through the program period for Subprogram 3. Budget assistance through a series of program loans in 2008, including via this program, is being provided to bolster the economy's resilience. The poverty impact of food price

increases is being mitigated through emergency assistance approved for this purpose.<sup>13</sup>

- (ii) **Unexpected political disturbance.** Cambodia has been enjoying very high political unity and stability for several years. The national election was conducted peacefully on 27 July 2008, as was the swearing-in ceremony of the new Government on 25 September 2008. In anticipation of any delays in forming the new Government, Subprogram 2 was designed to ensure that most of the legal drafting that closely involves midlevel officials would be done prior to formation of the Government so that draft laws and sub-decrees would be ready for submission to the Council of Ministers once the new Government was sworn in.
- (ii) **Weak governance and corruption in the sector.** Weak governance and incidents of corruption could erode investor confidence and prevent the attainment of expected sector outcomes. The Government's National Strategic Development Plan 2006–2010 views corruption as a threat to sustained growth and development of the country in general. Backed by an active development community, the Government is taking an increasingly tougher stance against corruption. The general consensus is that good governance and measures to address corruption are needed for a successful partnership between the Government and the development community. This was considered during design of the program cluster, and there will be continuous pursuit of improvements to the institutional governance structure, accounting disclosure standards, financial transparency, complementary legislation, regulatory updates and enforcement, supervision, and surveillance of the financial sector.
- (iv) **Weak institutional and human capacity.** Some of the financial sector risks are associated with weak institutional and human capacity. The same applies to the implementation and enforcement of new laws and regulations. To mitigate those risks, training programs have been initiated at various training institutions established during FSP I. Financial Sector Program II Cluster - Subprogram 2 provides financial support to the institutions to help update their curricula. The proposed advisory TA will help reduce the risks arising from weak capacity, especially in the implementation of all prudential regulations. With these design safeguards, the integrated benefits and impacts are expected to far outweigh any costs.

## VIII. TECHNICAL ASSISTANCE

63. A program of annual TA projects was identified to help implement the FSP II medium-term program. Implementing TA for \$1.7 million was approved with Subprogram 1 to support NBC, MEF, and MOC in implementing the policy and institutional reforms under Subprogram 2 and some of the reform triggers and milestones for Subprogram 3. In response to the Government's request, ADB has prepared a TA project to support NBC, MEF, and MOC in implementing key reform triggers for Subprogram 3. The TA is estimated to cost a total of \$375,000 equivalent. ADB will finance \$300,000 from its TA funding program and the Government will provide the remaining \$75,000 equivalent in the form of office space, counterpart staff, and other support facilities.

64. The main activities of the TA are to (i) further strengthen on-site supervision and surveillance of the banking system (4 person-months), (ii) help strengthen off-site and on-site

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<sup>13</sup> ADB. 2008. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Asian Development Fund Grant for the Emergency Food Assistance Project*. Manila.

supervision of MFIs (3 person-months), and (iii) strengthen the supervision and surveillance of the insurance industry (4 person-months). One national consultant will be engaged—an insurance expert (6 person-months)—to assist the international insurance expert. A total of 17 person-months of consulting inputs, comprising 11 international and 6 national person-months, are required. The consultants will be engaged by ADB on an individual basis to implement TA activities in accordance with ADB's *Guidelines on the Use of Consultants* (2007, as amended from time to time), using the competitive selection method. The TA's purpose, outputs, methodology, implementation arrangements, budget, and terms of references are in Appendix 7. NBC will be the Executing Agency, and MEF and MOC the implementing agencies. The TA is scheduled to commence in February 2009 and be completed by January 2010.

## IX. ASSURANCES

65. In addition to complying with and implementing the actions specified in the Subprogram 2 policy matrix and standard assurances, the Government has given the following specific assurances, which are incorporated in the Loan Agreement:

- (i) The Government will (a) implement the policy triggers and milestones in accordance with the schedule of policy reforms contained in the medium-term policy framework and as described in the development policy letter, and ensure sustainability of the reforms beyond the Subprogram 2 period; and (b) carry out all of its obligations as stipulated under the Loan Agreement in a timely manner.
- (ii) The Government will undertake all reasonable measures to implement the triggers (reform actions) set out in the medium-term policy framework, which are the prerequisites for processing Subprogram 3.
- (iii) The Government will keep ADB informed of, and will at least semiannually, and more frequently as requested, exchange views on the progress made in implementing Subprogram 2. Furthermore, the Government will continue timely policy dialogue on this same frequency with ADB on macroeconomic policies and constraints, will keep ADB informed of policy discussions with other multilateral and bilateral agencies that have implications for the implementation of Subprogram 2, the TA, and the overall program cluster, and will provide ADB with an opportunity to comment on any resulting policy proposals. The Government will take ADB's views into consideration before finalizing and implementing any such proposals.

## X. RECOMMENDATION

66. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan in various currencies equivalent to Special Drawing Rights 6,618,000 to the Kingdom of Cambodia for Subprogram 2 of the Financial Sector Program II Cluster from ADB's Special Funds resources with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

Haruhiko Kuroda  
President

11 November 2008

### DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
<p><b>Impact</b> A sound, market-based financial system that enhances resource mobilization and sustainable economic growth</p>	<p>Real GDP growth at 7%–9% by 2010</p> <p>Increased ratio of (i) M2/GDP 25.0% or above by 2010 from 20.5% in 2006</p> <p>(ii) total private sector credit of banks to GDP 16% or above by 2010 from 12.2% in 2006</p> <p>(iii) total bank deposits/GDP 23% or above by 2010 from 17.9% in 2006</p>	<p>National accounts, economic reports, and official statistics of the Government, and other international development agencies</p> <p>Annual reports, including audited financial reports of banks, insurance firms, and licensed MFIs</p> <p>Mission discussions and consultations with the Government; representatives of banks, insurance firms, MFIs, audit firms; and other stakeholders</p> <p>ADB staff assessments</p>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Continuing political stability</li> <li>• Overall macroeconomic stability</li> </ul> <p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• Regional financial shocks</li> </ul>
<p><b>Outcome</b> A growing, resilient, and efficient financial system</p>	<p>All banks, insurance firms, and MFIs meet minimum capital adequacy requirements set by regulatory authorities.</p> <p>Ratio of nonperforming/total loans maintained below 10%</p> <p>Regular on-site reviews of risky financial institutions and prompt follow-up actions</p> <p>New financial products and wider range of financial services</p> <p>Information technology system for core operating functions operational at NBC with payment and settlement systems enhanced by 2010</p> <p>Increased number of qualified Kampuchea Institute of Certified Public Accountants and Auditors members by 2010</p>	<p>Economic reports and statistics published by regulatory authorities and other international development agencies</p> <p>Published audited reports of banks, MFIs, and insurance firms</p> <p>ADB review missions, and consultants' assessments and final reports</p> <p>Reports from the Bankers Association of Cambodia</p> <p>NBC reports on information technology system progress and project manager's reports</p> <p>NBC letters on tendering of software</p> <p>Reports from the National Accounting Council and Kampuchea Institute of Certified Public Accountants and Auditors</p>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Government remains committed to reforms and implementing the FSDS 2006–2015</li> <li>• Economic growth is sustained.</li> <li>• Good coordination continues among government agencies.</li> <li>• Ability to implement governance-related reforms and capacity to undertake reform will be built to ensure sustained implementation.</li> <li>• Complementary support from other development partners will continue.</li> </ul> <p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• Will of concerned stakeholders to (i) enforce laws and regulations weakens, and (ii) sustain reform activities without further technical support weakens</li> </ul>
<p><b>Outputs</b></p>			
<p><b>1. Improved confidence and financial intermediation</b></p>			
<p>1.1 Modernized payment, clearance, and settlement system (PCSS)</p>	<p>PCSS upgraded, including standardized checks and a more efficient check-clearing system by 2010</p>	<p>Reports of NBC: coordinated payment system working group including banks</p> <p>Official copy of the memorandum of understanding signed by all parties endorsing a payments</p>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Relevant parties agree on road map, support changes and related charges</li> <li>• Larger commercial banks take the lead to</li> </ul>

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
<p>1.2 Consumer access to credit and market confidence enhanced</p> <p>1.3 Interbank market and tradable government securities developed</p> <p>1.4 Outreach in the formal sector promoted in a sustainable manner</p>	<p>A working CIS for banks and MFIs by 2010</p> <p>All audited financial statements of banks and the remaining prudential regulations published on the NBC website by 2008</p> <p>Functioning registry for tradable government securities by 2009</p> <p>Established interbank market by 2010</p> <p>Survey results identifying number, scale, and scope of MFIs outside formal sector by 2008</p> <p>NBC and MEF to facilitate the development of a private sector wholesale institution for local financing to MFIs by 2010</p>	<p>system road map</p> <p>Official copy of check standards with encoding</p> <p>Official copy of the enhanced check-clearing procedures and approved architectural design of the electronic payment system and budget</p> <p>Six-month reports on the information received</p> <p>NBC letter of confirmation that audited financial statements and remaining prudential regulations have been uploaded</p> <p>NBC confirmation letter on establishing the registry unit and staffing</p> <p>NBC regulation establishing interbank market and repurchase agreement of valuable papers</p> <p>NBC and MEF progress and final reports of the survey undertaken and its results</p> <p>NBC and MEF progress reports on policy development to aide MFIs' access to local finance</p>	<p>introduce systems to enhance the PCSS</p> <ul style="list-style-type: none"> <li>• NBC management information system will be developed and established prior to upgrade of the PCSS</li> </ul> <p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• Poor telecommunications and energy supply infrastructure restricts reach to provincial branches</li> <li>• MEF decides not to issue government securities in riel</li> </ul>
<b>2. Maintain stability in the financial sector</b>			
<p>2.1 Updated legal and regulatory framework for banks</p> <p>2.2 Strengthened bank supervision capacity and measures adopted to sustain financial stability</p>	<p>Revised law on banking and financial institutions and updated regulations to comply with international standards, and staff trained by 2010</p> <p>Trained staff to monitor implementation of Basel I requirements and undertake on-site supervision of banks by 2009</p> <p>Surveillance of banks strengthened and prompt corrective actions undertaken</p> <p>To absorb excess liquidity, NBC (a) raised the reserve</p>	<p>Diagnostic report identifying parts of the law, regulations, and international practices or standards to be revised</p> <p>Copy of redrafted law and new regulations</p> <p>NBC report on assessment of capacity building needs</p> <p>Progress report on capacity training programs and evaluation report at the conclusion of training program</p> <p>Copy of NBC circular to all banks covering the increase</p>	<p><b>Risks</b></p> <ul style="list-style-type: none"> <li>• The will of the bank supervisor to strengthen surveillance and implement prompt corrective actions weakens</li> </ul>

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
<p>2.3 Prudential supervision and regulations for MFIs strengthened</p> <p>2.4 Legal foundation to support financial and commercial transactions enhanced</p>	<p>requirement from 8% to 16% to return bank lending to sustainable levels, and (b) favorably considered applications from commercial banks to place reserves in excess of 16% abroad with prudentially approved counterparties in 2008.</p> <p>MFI regulations for new product approval process and foreign exchange risk management revised, and staff trained on their application by 2009</p> <p>Ratings capabilities for MFI supervisor and a code of conduct for registered moneychangers introduced by 2010</p> <p>Implementing sub-decree for secured transactions law approved by 2009</p> <p>Draft Commercial Contracts Law, including chapters on franchise and agency law, submitted to the Council of Ministers and National Assembly by 2010</p> <p>Implementing sub-decree for the new insolvency law approved by 2010</p>	<p>in required reserves and progress report on implementation of both policy measures</p> <p>NBC official copy of revised regulations for MFIs</p> <p>NBC manual for ratings process and initial ratings of all licensed MFIs</p> <p>Copy of the code of conduct</p> <p>Official copy of approved implementing sub-decree for suspicious transaction reports</p> <p>Copy of the Commercial Contracts Law and official document submitting it to Council of Ministers and National Assembly</p> <p>Copy of the approved implementing sub-decree for the insolvency law</p>	
<b>3. Promote good governance</b>			
<p>3.1 International initiatives on AML and CFT promoted</p> <p>3.2 Corporate governance and transparency in the insurance industry enhanced</p> <p>3.3 Commercial dispute resolution mechanism established</p>	<p>AML and CFT sub-decree and awareness campaign by 2008</p> <p>Functioning FIU and awareness campaign undertaken by 2009</p> <p>MEF instruction issued and insurance firms adopt basic financial reporting standards by 2009</p> <p>Sub-decree for the commercial arbitration law approved by 2008</p> <p>National arbitration center functioning by 2009</p>	<p>NBC report on implementation of awareness program</p> <p>Official copy of adopted AML sub-decree and decision to establish the FIU</p> <p>MEF official copy of instruction for financial reporting standards</p> <p>Official copy of adopted sub-decree</p> <p>MOC letter confirming the establishment of national arbitration center with a copy of rules and procedures</p>	

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
3.4 Accounting and auditing profession developed	70 scholarships awarded annually by MEF	MEF letter confirming competitive selection used, list of scholarship holders, and progress report at the end of each semester	
<b>4. Enhance efficiency in the financial sector</b>			
4.1 Key operating functions of NBC fully computerized and integrated	NBC operating an integrated management information system by 2010	Progress reports on procurement arrangements  Final report confirming successful installation, testing of software systems, training of staff on use of application	<b>Risks</b> • NBC management delays implementation by requesting software modifications before system fully operating
4.2 Capacity of MFI staff upgraded	CBS courses on foreign exchange risk management, good business practice, bank credit requirements, MFI loan appraisal procedures, record keeping, and good lending practice by 2009	CBS progress reports on programs and courses held for MFIs and copy of the course materials, timetable, and participants	
<b>Activities with Milestones for Subprogram 1 and 2</b>			<b>Inputs</b>
<b>1. Improve confidence and financial intermediation</b>			<ul style="list-style-type: none"> <li>• ADB Subprogram 1 loan of \$10 million</li> </ul>
<b>1.1 Modernize the payment and settlement system</b>			<ul style="list-style-type: none"> <li>• ADB TA of \$1.7 million (ADB TA resources of \$0.75 million, Republic of Korea e-Asia and Knowledge Partnership Fund of \$0.5 million, and Luxembourg Financial Sector Development Partnership Fund \$0.45 million)</li> </ul>
<ul style="list-style-type: none"> <li>• NBC to sign a memorandum of understanding with commercial banks to formally adopt the road map for modernizing the payment and settlement system (completed)</li> <li>• NBC to implement key actions of phase I of the payment and settlement system road map (completed)</li> </ul>			
<b>1.2 Enhance consumer access to credit and market confidence</b>			<ul style="list-style-type: none"> <li>• Government TA contribution \$0.3 million</li> </ul>
<ul style="list-style-type: none"> <li>• NBC to ensure compliance and usefulness of the online credit sharing information system for banks (completed)</li> <li>• NBC to provide periodic macroeconomic data for ADB to assess the performance of the financial sector (ongoing)</li> <li>• NBC to publish audited financial statements of banks, and the remaining prudential regulations on the NBC website (completed)</li> </ul>			<ul style="list-style-type: none"> <li>• ADB Subprogram 2 loan of \$10.3 million</li> </ul>
<b>1.3 Develop interbank market and tradable government securities</b>			<ul style="list-style-type: none"> <li>• ADB TA of \$0.3 million (ADB TA resources to implement Subprogram 3)</li> </ul>
<ul style="list-style-type: none"> <li>• NBC to establish a recording system for a registry of tradable government securities and train staff for its operations (completed)</li> <li>• NBC to promote interbank lending to meet temporary liquidity needs of smaller banks (ongoing)</li> </ul>			<ul style="list-style-type: none"> <li>• Government TA contribution \$75,000</li> </ul>
<b>1.4 Improve intermediation functions of MFIs in a sustainable manner</b>			
<ul style="list-style-type: none"> <li>• NBC and MEF to undertake a nationwide survey of MFIs outside the formal sector (completed)</li> </ul>			
<b>2. Maintain stability in the financial sector</b>			
<b>2.1 Update legal and regulatory framework for banking and financial institutions</b>			
<ul style="list-style-type: none"> <li>• NBC to issue regulations on large exposure of banks and financial institutions (completed)</li> <li>• NBC to issue regulations to amend regulation on licensing of commercial and specialized banks (completed)</li> <li>• NBC to undertake consultations with banks and other stakeholders regarding amendments to the Law on Banking and Financial Institutions, including banking insolvency procedures and administration of financially distressed banks, consumer protection, (bank secrecy provisions: use of debit and credit cards), and</li> </ul>			

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
<p>protection and/or immunity of government regulators (completed)</p> <p><b>2.2 Strengthen banking supervision capacity</b></p> <ul style="list-style-type: none"> <li>• NBC to assess and identify capacity building needs for banking supervision (completed)</li> <li>• NBC to strengthen surveillance and undertake prompt corrective measures on banks that are not conforming with the laws and prudential regulations (completed)</li> <li>• NBC (a) raised the reserve requirement from 8% to 16% to return bank lending to sustainable levels, and (b) favorably considered applications from commercial banks to place reserves in excess of 16% abroad with prudentially approved counterparties (completed)</li> <li>• NBC to evaluate progress of capacity building for banking supervision and report status (completed)</li> <li>• NBC to continue requiring nonconforming banks to (i) provide progress reports, and (ii) promptly undertake corrective measures (completed)</li> <li>• NBC to review its regulations to strengthen the requirement for fit and proper test of key bank management to include specific banking qualifications and experience (completed)</li> </ul> <p><b>2.3 Strengthen prudential supervision and regulations for MFIs</b></p> <ul style="list-style-type: none"> <li>• NBC to issue regulations covering licensing of MFIs (completed)</li> <li>• NBC to review and introduce regulations for MFIs to (i) implement new product approval process, and (ii) introduce foreign exchange risk management (completed)</li> </ul> <p><b>2.4 Enhance the legal foundation to support financial and commercial transactions</b></p> <ul style="list-style-type: none"> <li>• MEF to submit draft law on nongovernment securities to the National Assembly (completed)</li> <li>• MOC to prepare implementing sub-decree for secured transactions law and submit to Council of Ministers (ongoing)</li> <li>• MOC to prepare commercial contracts law including chapters on franchise and agency (completed)</li> </ul> <p><b>3. Promote good governance</b></p> <p><b>3.1 Implement an AML and CFT regime</b></p> <ul style="list-style-type: none"> <li>• National Assembly to adopt the law on AML and combating the financing of terrorism (completed)</li> <li>• NBC to arrange for adoption of the sub-decrees to implement the law on AML and CFT (completed)</li> </ul> <p><b>3.2 Enhance corporate governance and transparency in the insurance industry</b></p> <ul style="list-style-type: none"> <li>• MEF to issue regulations covering premium rates for fire insurance (completed)</li> <li>• MEF to issue regulations on licensing of general and life insurance companies (completed)</li> <li>• MEF to require adoption of appropriate financial reporting standards by insurance companies (completed)</li> </ul> <p><b>3.3 MOC establishes commercial dispute resolution mechanism</b></p> <ul style="list-style-type: none"> <li>• MOC to arrange for adoption of the implementing sub-decree for the commercial arbitration law (ongoing)</li> </ul> <p><b>3.4 Develop the accounting and auditing profession</b></p> <ul style="list-style-type: none"> <li>• MEF to issue regulation covering the criteria to determine enterprises that should be subject to external auditing (completed)</li> <li>• MEF to continue providing 70 scholarships annually to train accountants to meet the required CPA accreditation (completed)</li> </ul> <p><b>4. Enhance efficiency in the financial sector</b></p> <p><b>4.1 Information technology project for computerizing NBC core operations</b></p> <ul style="list-style-type: none"> <li>• NBC to review and adopt the information technology architecture model (completed)</li> <li>• NBC to (i) review best practice for its management information systems and</li> </ul>			

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
restructure its chart of accounts, and (ii) prepare the bidding documents for its enhanced information technology systems (completed) <ul style="list-style-type: none"> <li>• NBC to procure software and hardware for key NBC operating functions through a competitive bidding process (ongoing)</li> </ul> <b>4.2 Upgrade capacity of MFI staff</b> NBC to support the CBS to develop and provide best practice courses for MFIs (ongoing)			

ADB = Asian Development Bank, AML = anti-money laundering, CBS = Center for Banking Studies, CFT = combating the financing of terrorism, CIS = credit information sharing system, CPA = certified public accountant, FIU = Financial Intelligence Unit, FSDDS = Financial Sector Development Strategy, GDP = gross domestic product, M2 = broad money, MEF = Ministry of Economy and Finance, MFI = microfinance institution, MOC = Ministry of Commerce, NBC = National Bank of Cambodia, PCSS = payments, clearance, and settlement system, TA = technical assistance.

## POLICY MATRIX and Medium-Term Program

### Proposed Policy Actions for Subprogram 1 and 2, Triggers and Milestones for Subprograms 3 and 4, and Medium-Term Program

Output and Milestones	Subprogram 1 Policy Conditions (December 2007)	Subprogram 2 Policy Conditions (2008)	Triggers (in bold) and Milestones for Subprogram 3 (2009)	Triggers (in bold) and Milestones for Subprogram 4 (2010)	Medium-Term Program Direction/Goals
<b>1. Improve confidence and financial intermediation</b>					
1.1 Improved financial services and payments system	i. NBC to sign an MOU with the commercial banks endorsing a road map to modernize the payment and settlement system  Completed: November 2007	i. <b>NBC to implement key actions of phase I of the road map</b>	i. NBC in cooperation with the Bankers Association to coordinate a public awareness program covering developments in the payment system  ii. <b>NBC to implement key actions of phase II of the road map</b>	i. <b>NBC to evaluate progress on implementing the road map and pursue improvements to meet the demands of the growing economy</b>	A functioning, modern, and efficient payment, clearance, and settlement system; begin rollout to provincial branches
1.2 Consumer access to credit and market confidence enhanced	ii. NBC to ensure compliance and usefulness of the credit information sharing system for banks  Completed: November 2007  iii. NBC to provide periodic macro-economic data for ADB to assess financial sector performance  Completed: September 2007	ii. <b>NBC to publish audited financial statements of banks, and the remaining prudential regulations on the NBC website</b>	iii. NBC to (a) modify the threshold to allow MFIs into the credit information sharing system, and (b) require other sources of data to be included under the credit information sharing system	ii. NBC to explore possibility of corporatizing the credit information sharing system and include private ownership	Promotion of private sector monitoring of financial institutions through improved public financial disclosure and ratings of major financial institutions to enhance confidence  Established credit information bureau
1.3 Interbank market and tradable government securities developed		iii. <b>NBC to establish a recording system for a registry of tradable government securities and train staff for its</b>	iv. Short term bills to be studied by NBC and MEF to facilitate development of short-term money market	iii. <b>NBC to ensure banks sign a standardized repurchase agreement</b>	Developed interbank market and tradable government securities

Output and Milestones	Subprogram 1 Policy Conditions (December 2007)	Subprogram 2 Policy Conditions (2008)	Triggers (in bold) and Milestones for Subprogram 3 (2009)	Triggers (in bold) and Milestones for Subprogram 4 (2010)	Medium-Term Program Direction/Goals
		operations	v. For liquidity support, <b>NBC to issue a regulation covering interbank repurchase agreements for valuable papers</b>		
1.4 Outreach in the formal sector promoted in a sustainable manner		iv. <b>NBC and MEF to undertake a nationwide survey of MFIs outside the formal sector</b>	vi. <b>NBC and MEF to facilitate the development of a private sector wholesale institution for loan financing to MFIs, linked to commercial banking</b>	iv. <b>NBC and MEF to monitor progress on MFI access to finance from local sources for policy development</b>	Improved intermediation functions of MFIs
<b>2. Maintain stability in the financial sector</b>					
2.1 Updated legal and regulatory framework	iv. NBC to issue revised regulations on large exposures of banks and financial institutions  Completed: November 2006  v. NBC to issue regulations to amend the <i>prakas</i> <sup>a</sup> on Licensing of Commercial and Specialized Banks  Completed: September 2006	v. <b>NBC to undertake consultations with banks and other stakeholders regarding amendments to the Law on Banking and Financial Institutions, including banking insolvency procedures and administration of financially distressed banks, consumer protection, (bank secrecy provisions: use of debit and credit cards), and protection and/or immunity of government regulators</b>	vii. <b>NBC to submit the amendments to the Law on Banking and Financial Institutions to the National Assembly</b>  viii. <b>NBC to require banks to comply with applicable Basel I core principles for effective bank supervision</b>  ix. NBC to review and update corporate governance requirements, including conflict of interest rules for banks and MFIs	v. <b>NBC to adopt relevant implementing regulations for the revised Law on Banking and Financial Institutions</b>  vi. <b>NBC to update prudential regulations for banks to reflect legal changes and developments in international banking standards and good practices</b>	An updated and effective regulatory framework for banks implemented  Full compliance with Basel 1 core principles  Improved consumer protection within the financial sector
2.2 Strengthened bank supervision capacity and measures adopted to sustain financial stability	vi. NBC to assess and identify capacity building needs for banking supervision  Completed: November 2007	vi. <b>NBC to continue requiring nonconforming banks to (a) provide progress reports, and (b) promptly undertake corrective measures</b>  vii. <b>To absorb excess</b>	x. NBC to evaluate progress of capacity building for banking supervision and determine the nature of further capacity support  xi. NBC to assess the	vii. <b>NBC to evaluate progress of capacity building for banking supervision and determine the nature of further capacity support</b>	Improved banking supervision capability to maintain stability in the financial sector

Output and Milestones	Subprogram 1 Policy Conditions (December 2007)	Subprogram 2 Policy Conditions (2008)	Triggers (in bold) and Milestones for Subprogram 3 (2009)	Triggers (in bold) and Milestones for Subprogram 4 (2010)	Medium-Term Program Direction/Goals
	<p>vii. NBC to strengthen surveillance and undertake prompt corrective measures for banks not conforming with the laws and prudential regulations</p> <p>Completed: October 2007</p>	<p><b>liquidity, NBC has (a) raised the reserve requirement from 8% to 16% to return bank lending to sustainable levels, and (b) favorably considered applications from commercial banks to place reserves in excess of 16% abroad with prudentially approved counterparties.</b></p> <p><b>viii. NBC to review its regulations to strengthen the requirement for fit and proper test of key bank management to include specific banking qualifications and experience</b></p>	<p>feasibility of rating major banks</p>		
<p>2.3 Prudential supervision and regulations for MFIs strengthened</p>	<p>viii. NBC to issue regulations to amend prakas on Licensing of Microfinance Institutions</p> <p>Completed: September 2006</p>		<p>xii. <b>NBC to develop a code of conduct for registered moneychangers</b></p>	<p>viii. NBC to introduce ratings</p>	<p>Improved prudential supervision capability for MFIs</p>
<p>2.4 Legal foundation to support financial and commercial transactions enhanced</p>	<p>ix. MEF to submit the draft law on nongovernment securities to the National Assembly</p> <p>Completed: March 2007</p>	<p>ix. <b>MOC to prepare commercial contracts law including chapters on franchise and agency</b></p>	<p>xiii. MOC to prepare the implementing regulations for the new Insolvency Law</p> <p>xiv. <b>MOC to submit draft commercial contracts law to the Council of Ministers</b></p> <p>xv. MOC to promote public</p>	<p>ix. MOC to prepare the detailed draft Agency Law and detailed draft Franchise Law</p> <p>x. <b>MOC to submit draft commercial contracts law to the National Assembly</b></p>	<p>Functioning online secured transactions registry</p> <p>Complete implementation of commercial laws including contracts, franchise, and agency provisions</p>

Output and Milestones	Subprogram 1 Policy Conditions (December 2007)	Subprogram 2 Policy Conditions (2008)	Triggers (in bold) and Milestones for Subprogram 3 (2009)	Triggers (in bold) and Milestones for Subprogram 4 (2010)	Medium-Term Program Direction/Goals
			awareness of new commercial laws and evaluate progress of training provided by selected legal faculties for judges, lawyers, and legal clerks		
<b>3. Promote good governance</b>					
3.1 International initiatives on anti-money laundering promoted	x. Adoption by the National Assembly of Law on AML and CFT  Completed: June 2007		xvi. NBC to establish the FIU with appropriate budget allocation	xi. NBC to enhance the role of the FIU and coordination among supervisory authorities	Implementation of an effective anti-money laundering and combating the financing of terrorism regime and institutional capabilities
3.2 Corporate governance and transparency in the insurance industry enhanced	xi. MEF to issue regulations on premium rates for fire insurance  Completed: June 2007  xii. MEF to issue regulations on licensing of general and life insurance companies  Completed: January 2007	x. <b>MEF to require adoption of appropriate financial reporting standards by insurance companies</b>	xvii. MEF to liaise closely with the association of insurance companies to ensure smooth implementation of the reporting standards  xviii. <b>MEF to submit the draft revised insurance law to the Council of Ministers</b>	xii. MEF to require publication of audited financial statements of insurance companies	Appropriate reporting and disclosure standards for the insurance industry
3.3 Commercial dispute resolution mechanism established		xi. <b>MOC to arrange for adoption of the implementing sub-decree for the Commercial Arbitration Law</b>	xix. <b>MOC to establish the National Arbitration Center with appropriate rules and procedures and train its members</b>	xiii. MOC to undertake public awareness program of the roles, responsibilities, rules, and procedures of the National Arbitration Center	Functioning arbitration center for commercial disputes
3.4 Accounting and auditing profession developed	xiii. MEF to issue regulations covering the criteria that would qualify enterprises for	xii. <b>MEF to continue providing 70 scholarships annually to train accountants to meet the</b>	xx. <b>MEF to continue providing 70 scholarships annually</b>	xiv. Review the performance of the scholarship program	Improved capability and increased number of qualified national accountants

Output and Milestones	Subprogram 1 Policy Conditions (December 2007)	Subprogram 2 Policy Conditions (2008)	Triggers (in bold) and Milestones for Subprogram 3 (2009)	Triggers (in bold) and Milestones for Subprogram 4 (2010)	Medium-Term Program Direction/Goals
	external auditing Completed: July 2007	<b>required CPA accreditation</b>			
<b>4. Enhance efficiency</b>					
4.1 Key operating functions of NBC fully computerized and integrated	xiv. NBC to review and adopt the information technology architecture model  Completed: November 2007	<b>xiii. NBC to (a) review best practice for its management information systems and restructure its chart of accounts, and (b) prepare the bidding documents for its enhanced information technology systems</b>  xiv. NBC to procure software and hardware for key NBC operating functions through a competitive bidding process	<b>xxi. NBC to install enhanced computer systems for its key operating functions and undertake relevant training of staff</b>	<b>xv. NBC to continue upgrading its information technology system and training of staff</b>	A modern management information system for NBC
4.2 Capacity of MFI staff upgraded			xxii. NBC to evaluate progress of capacity building for MFIs supervision and determine the nature of additional capacity support	xvi. NBC to support CBS in upgrading course materials and add new courses as required by banks and MFIs	Improved skills of MFI staff

ADB = Asian Development Bank, AML = anti-money laundering, CBS = Center for Banking Studies, CFT = combating the financing of terrorism, CPA = certified public accountant, FIU = Financial Intelligence Unit, MEF = Ministry of Economy and Finance, MFI = microfinance institution, MOC = Ministry of Commerce, MOU = memorandum of understanding, NBC = National Bank of Cambodia.

Note: Subprogram 3 has 11 triggers and 11 milestones, subprogram 4 has 8 triggers and 8 milestones.

<sup>a</sup> Khmer name for regulations or instructions issued by the NBC governor or a government minister.

Sources: Asian Development Bank, Ministry of Commerce, Ministry of Economy and Finance, and National Bank of Cambodia.

## SECTOR ANALYSIS

1. The development path in the 1990s reflected the period of liberal entry of financial institutions at a time when regulation and supervisory capacity were weak. The era was marked by a rapid rise in the number of joint ventures, locally incorporated family-owned banks, branches of foreign banks, and state-owned financial institutions. This resulted in most financial institutions being poorly managed and almost half being considered technically insolvent. Supported by an International Monetary Fund poverty reduction and growth facility that was phased out in 2003, the banking system relicensing program (i) introduced a legal framework for banks and financial institutions, (ii) successfully closed all nonviable banks, (iii) relicensed the remaining banks under strengthened National Bank of Cambodia (NBC) supervision requirements, and (iv) initiated restructuring and privatization of the major state-owned foreign trade bank. Cambodia's financial sector remains shallow and fragile with limited financial intermediation and outreach.

2. At the end of June 2008, the formal financial system comprised NBC, 20 commercial banks, 5 specialized banks, and 2 representative offices of foreign-based banks; 16 licensed and 26 registered microfinance institutions (MFIs); and 6 insurance companies. Cambodia has yet to establish bond or securities markets. The predominantly rural nature of the economy, high transaction costs, inability of the real sector to put together bankable projects, and low creditor confidence have been the main factors causing the low formal intermediation and outreach within the sector, slow development in nonbank financial institutions, and limited range of products and services being offered.

3. The Government's vision for the financial sector is for a sound, market-based system that will enhance resource mobilization, ensure the effective allocation of financial resources, and contribute to broad-based sustainable economic growth as embodied in the Financial Sector Development Strategy (FSDS) 2006–2015. The FSDS recognizes that, for equitable growth to occur, a diversified, competitive, but prudentially sound financial system would play an important role in national development by ensuring efficient accumulation and effective allocation of financial resources. At the same time, expanding finance brings risks. Hence, when pursuing financial development, a focus on prudential risk management, transparency, and uniform application of rules and regulations is needed.

4. Dominated by the banking system, the financial sector has gone through major restructuring and reforms since the mid-1990s. In 1996, NBC was established as the central bank following promulgation of the Law on the Organization and Conduct of the National Bank of Cambodia. In 1999, the Government enacted the Law on Banking and Financial Institutions, enabling NBC to undertake a relicensing program that brought about the closure of 16 nonviable banks in 2002, raised capital requirements for the remaining banks to \$13 million equivalent, and set the minimum capital adequacy requirement at 20% of risk-weighted assets (which was then appropriately reduced to 15% in 2004). In an effort to further strengthen and consolidate the banking system, NBC issued a directive in September 2008 requiring commercial banks that are owned by nonbank entities or individuals to increase their minimum capital to the equivalent of \$36.5 million by 2010. The Financial Sector Development Blueprint,<sup>14</sup> formulated and adopted in 2001, provided a clear set of objectives and a sequenced program of reforms in the financial sector. The Asian Development Bank (ADB) has been the lead development partner in supporting the Government's efforts to implement the blueprint to improve financial soundness

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<sup>14</sup> ADB. 2001. *Cambodia Financial Sector Blueprint for 2001-2010*. Manila

and efficiency, restore confidence, attract a broader base of high-quality financial institutions, and broaden the sector's outreach within the blueprint framework.

5. The economy is largely cash-based and highly dollarized. Dollarization emerged in Cambodia because public confidence in the local currency eroded following a series of shocks during the conflict and financial mismanagement prior to 1989. In some instances, dollarization has assisted development of the financial sector, but, in other respects, dollarization limits the tools the Government can use in its monetary policies. With recent improvements in macroeconomic stability and measures taken by the authorities to restore confidence in institutions and in the banking system, public confidence is growing but slowly, and dollarization remains high. In the absence of reliable data, the amount of dollars and other foreign currencies circulating in Cambodia cannot be verified. Thai baht and Vietnamese dong banknotes are also widely used in some of the provinces bordering Thailand and Viet Nam. The cash nature of the economy means that even major transactions are settled in cash outside of the banking system and paper trails are minimal.

6. The private sector is characterized by a high degree of informality, and it is dominated by the informal sector. Enterprises that have enjoyed years of operating without established rule of law prefer to remain informal. The tax regime is still very open to negotiation and the majority of participants in the real sector, especially in rural areas, are reluctant to enter into any form of formal financial transactions for fear of being exposed to the tax authorities. Private enterprises are generally family owned with no separation between management and owners who usually do not maintain proper records, including financial reports, that can be considered reliable.

7. **Banking System.** No legal barriers are in place for the entry of foreign banks. At the end of June 2008, nine commercial banks had majority foreign ownership. The commercial banking subsector at the end of June 2008 consists of 20 commercial banks, 5 specialized banks, and 2 representative offices of foreign-based banks. Despite the increase in the number of banks, high transaction costs and markups remain. Nevertheless, competition is starting to pick up and there is some evidence of market segmentation emerging. With the exception of the Rural Development Bank, the banking system is almost entirely owned by the private sector. Most banks have established branches in other urban centers and are planning to open additional offices in those areas.

8. To date most branches are concentrated in large urban centers, but this is expected to change. ACLEDA bank, a former MFI, currently has branches in every province and a total of 212 sites provide banking services. Canadia bank has 17 branches outside Phnom Penh. Five other banks have more than 3 branches outside Phnom Penh, including ANZ Royal bank (12 branches) with automated teller machines at each of its branches. At the end of 2007, bank staff totaled more than 6,869, with one bank (ACLEDA) employing 4,401 and other banks employing between 20 and 250. Technical capacity is still weak and most banks provide their own in-house training to complement the training programs offered by the Bankers Association.

9. Commercial banking is relatively small but growing quickly. The more aggressive and progressive banks attained average year-on-year growth rates of 77% for credit and 74% for deposits at the end of 2007. The number of commercial bank loans increased by 127% from 2002 to total 209,053 at the end of June 2008. If these loans were all to individual borrowers, then it would be the equivalent of providing loans to 1.5% of Cambodia's population. Total banking assets represented about 38.75% of the estimated gross domestic product (GDP) in 2007. The banking system is fairly concentrated, with about 77.63% of deposits held by the six

largest commercial banks. These six also accounted for about 84.6% of total loans at the end of 2007.

10. Commercial banks mainly offer simple services to retail and corporate customers in urban areas (time and term deposits, savings accounts, basic loans, domestic and cross-border wire transfers, foreign exchange, letters of credit, etc.). Specialized banks are not allowed by law to accept deposits, and commercial banks had about 603,992 depositors (more than 4% of the total population) at the end of 2007. Most deposit products are short-term in nature and, as a consequence, loan terms are also short (average 3 years) with high interest rates. Banks continue to rely on physical collateral and personal guarantee as loan security. More advanced banking services are being introduced, such as electronic banking and private banking. As of the end of 2007, 177 ATMs had been installed throughout the urban areas. Several banks have indicated that they plan to increase this number.

11. The noncash payment system is very small and of limited sophistication. It is predominantly paper-based and manual. NBC runs the clearinghouse, which operates in both riels and dollars. The riel clearinghouse has 19 members (NBC, Ministry of Economy and Finance [MEF], and 17 banks) and the dollar clearinghouse has 22 members (NBC and 21 banks). Daily amounts passing through the clearinghouses average about \$36 million, of which riel clearances represent only around 3%. About 1,811 checks are cleared each day, of which around 94% are drawn in dollars. The first clearance is at 9:30 a.m., with a second clearance at 3:00 p.m. to handle returns. Banks bring their balances to the clearinghouse on flash drives. Interbank settlement is by check drawn on the banks' accounts with NBC. The enactment of the negotiable instruments and payment transactions law in late 2005 and the issuance of key regulations in December 2006 provided the legal framework for developing the payments system, introducing new negotiable instruments, and promoting the development of money and interbank markets.

12. NBC's principal mission is to formulate and implement monetary policy aimed at maintaining price stability and economic development. Its main functions are to (i) act as the monetary authority and conduct monetary policy (NBC has actively intervened in the riel foreign exchange market to deliver a stable exchange rate and ensure price stability in riels), (ii) act as the sole issuer of the national currency (as such NBC has increased the number of currency denominations and replaced worn and dirty bank notes), (iii) act as the supervisory authority of the banking and financial system, (iv) oversee the payments system in Cambodia, and (v) manage the international reserves of the country.

13. The banking supervision program and standards have greatly improved since 2001 and been extended to cover all banks, a move made possible with the addition of skilled staff. Prudential supervision was enhanced with the adoption of the uniform chart of accounts by all banks in 2004, and by the same banks making their annual audited financial statements publicly available since 2005. Several banks have published these annual audited financial statements on their own websites. In 2006, NBC enhanced its regulatory and supervisory system by implementing an off-site supervision system known as Cambodian Bank Reporting for Prompt Corrective Action. The system enables staff to perform a regular analysis of off-site reports, to identify risks faced by banks and infringements caused by banks, and then for the staff concerned to recommend immediate actions to NBC management. The development and implementation of the system has been supported by a resident advisor from the International Monetary Fund. NBC continues to undertake on-site inspection of each bank once a year.

14. Banking, along with other financial and commercial subsectors, continues to face high

transaction costs attributable to the lack of mechanisms to enforce contracts and absence of reliable information. The establishment of the credit information sharing system in 2006 should improve the situation, but some time will be required to build a sufficient database. Dispute settlement remains a major issue and, if unresolved, will continue to affect the degree of certainty associated with financial and commercial transactions. Financial sector stakeholders would undoubtedly welcome the operations of a commercial court and commercial arbitration center to provide a greater degree of certainty.

15. **Microfinance Subsector.** Microfinance is growing rapidly, with assets expanding generally at around 73% in 2007 and some institutions expanding at 146% per annum. The expansion is allowing microfinance to support and grow the economy, especially in its target market of the poor and remote rural population. The microfinance subsector now comprises 16 licensed MFIs, 26 registered rural credit operations, and around 60 nongovernment organizations operating unrestricted across the whole country. Registration and licensing commenced in 2002. A number have transitioned from aid-focused nongovernment organizations to commercial MFIs, and some were set up as commercial, profit-oriented MFIs from the outset. Most MFIs have plans to continue rapid expansion with the establishment of additional branches and increased lending activities at existing branches.

16. As of the end of June 2008, MFIs had around 689,200 clients (about 4.9% of the total population) and loans outstanding with an average size of \$250. The expansion in the net number of loans is currently around 32% per annum. Voluntary savings of MFIs are very small. Licensed MFIs have adopted a wide range of business models with good corporate governance and orderly market development to deliver their services and products. This was highlighted in 2007, when Cambodian MFIs won 4 of 20 financial transparency awards presented by the Consultative Group to Assist the Poor.

17. MFIs, while growing rapidly, have major challenges to expanding their services. Addressing these issues should assist them to continue to grow in a sound manner. MFIs face competition from informal operators in their markets. The scale of this competition is anecdotally said to exceed the size of the formal financial sector, but no reliable data is available to support this view. A number of costs and challenges are imposed on the industry, such as nonresident withholding tax, lack of a reliable method to track the use of certificates of title for collateral between institutions, and extremely limited access to domestic funding sources. Growth brings its own challenges, such as whether management is able to maintain control over business processes when the scale of operations begins to outstrip the capabilities of current systems and processes. Foreign borrowing does bring growth and benefits in terms of improved governance and transparency, but, at the same time, foreign borrowing brings growing foreign exchange risk as institutions increase their lending in the riel-based rural areas.

18. **Moneychangers.** In addition to banks, the Law on Foreign Exchange, 1997, allows individuals and legal entities to undertake currency exchange if they register with NBC. They are not allowed to undertake any other financial activity. As of the end of April 2008, the country had 649 registered moneychangers (34 in Phnom Penh and 615 in the provinces). Statistics on the transactions undertaken by moneychangers are not available.

19. **Insurance Subsector.** The Department of Financial Industry within MEF is responsible for prudential regulation and supervision of the insurance industry, which consists of one state-owned and four private nonlife insurance companies plus a reinsurance company that is 80% state-owned. Negotiation for the sale of 75% of Caminco's (the state-owned firm's) shares to a joint venture comprising an insurance firm from Thailand and a Cambodian investor is in its final

stage. The insurance industry is young and small. It has gone through a turbulent period, but with the introduction of regulations and the enforcement of those regulations, stability and growth have returned. The regulator requires the capital of each company to be distributed as follows: 10% deposited with NBC, 50% deposited in commercial banks, with the decision on how to invest the 40% balance left to the insurance company concerned. Insurance companies have indicated that they would like these ratios to be changed, and the 40% increased. A revision of the insurance law has been initiated by MEF.

20. Growth has been steady (averaging 11–15% in the last 3 years) from a limited range of insurance products. The total gross premiums were \$17.5 million at the end of 2007. The three nonlife categories of insurance products (commercial vehicles, construction sites, and passenger vehicle liabilities) underwritten in this market are compulsory by regulation. Growth has been steady since 2003, with commercial fire and miscellaneous policies making up 63% of the market and motor vehicle insurance 19%. Other products sold include hospital and surgical, personal and accident, marine cargo, and travelers insurance. The insurance companies operating in Cambodia are conservatively managed.

21. The insurance industry requires a number of specialist skills that are not required in other industries. As insurance is a fairly new concept in Cambodia, these specialist skills are not available and need to be acquired (e.g., the skills of underwriters, actuaries, loss adjustors, and fund managers). The framework for insurance supervision has been developed, but material deficiencies in terms of capacity for supervision remain.

22. **Capital Market.** Cambodia has no bond and securities markets. The Law on Government Securities was promulgated by the King in January 2007 and the Law on Issuance and Trading of nongovernment securities was subsequently adopted by the National Assembly in September 2007. The most recent short-term government securities were issued in 2005. The placement of government securities is jointly organized by NBC and the commercial banks. The Government has established a capital market unit in MEF, and in April 2007 it signed a memorandum of understanding with the stock exchange of the Korea International Cooperation Agency for \$1.8 million worth of technical assistance to help with the initial training and preparation for establishing a securities market in the near future.

23. **Accounting and Auditing Infrastructure.** The continuing growth of the commercial sector is creating significant challenges to improving the quality of accounting and auditing, as well as to producing sufficient numbers of qualified accountants. Cambodia has established a legal and regulatory framework for accounting and auditing, but inconsistencies between the various laws and regulations remain. Some aspects are difficult to interpret, and there is weakness in the overall framework. As of May 2008, 20 Cambodian accounting standards and 10 Cambodian auditing standards have been introduced based on international standards. A standards advisory body and a local institute of accountants have been established to oversee this.

24. The accounting profession is in its infancy. As of May 2008, the 19 public accounting and auditing firms employed 30 resident qualified accountants—10 of whom are locally qualified. Currently more than 12,000 companies are registered, and the rate of registration is growing. The public accounting firms have few, if any, local clients. To date more than 1,000 students have enrolled in the local accounting qualification course, but approximately 40% of those have either dropped out or been dismissed. Seventeen students, including those not employed in public accounting, are qualified certified public accountants, but the vast majority of students are experiencing difficulties in completing the early stages of the course.

25. **Legal Infrastructure.** An enabling legal framework for financial and commercial transactions could be achieved by continuing support for Cambodia's process of law reform, including for the adoption and implementation of core financial and commercial laws that are harmonized and aligned with the legal system. The law reform process in financial and commercial areas aims to create an enabling environment for the financial sector and for economic growth in general. The Government has taken important steps to prepare, adopt, and implement certain major laws. The second stage of development is for additions and refinements to be made to the legal framework.

26. The process for enacting a new law is subject to several documented steps. In a common situation, where an international legal expert has provided assistance and produced a draft document in English, the translation into Khmer would take a minimum of 2–3 weeks. Then the process of internal debate and consultation is held within the ministry responsible for introducing the new law. Following these steps, the procedures pertaining to passage of the law through the Council of Ministers and National Assembly are usually lengthy: approval by the Council of Ministers typically takes at least 6 months (but usually longer), and the process for submission to the National Assembly and the approval process within the Assembly itself are estimated to take approximately 1 year. Consequently, delay is always a risk at any given stage of the legislative process.

27. The current court process for the enforcement of collateral is seen as lengthy, uncertain, and subject to delays (including for the appeals process). The current situation calls for an urgent strengthening of Cambodia's dispute resolution system, as this is a critical element of the emerging financial and commercial legal framework. The introduction of commercial arbitration under the new Law on Commercial Arbitration will be a key mechanism to consistently enforce contracts and fairly resolve commercial disputes. A new commercial court law sponsored by the United Nations and other bilateral development partners, still in the planning stages, has the potential to improve transparency and finality under clearly established court procedures.

## DEVELOPMENT COORDINATION MATRIX

<b>Banking and Formal Credit</b> (including SME and judicial reforms)	<b>Capital Markets, Corporate Governance, and Public Financial Management</b>	<b>Rural and Microfinance</b>
<p><b>Asian Development Bank</b></p> <p>Financial Sector Program I</p> <ul style="list-style-type: none"> <li>Budget: \$30 million program loan</li> <li>Time frame: 2001–2007</li> </ul> <p>Legal and regulatory foundation for banking, insurance, and commercial development; established supervision and surveillance framework; foundation for developing interbank and money markets; key financial market infrastructure.</p> <p>Financial Sector Program I implementation</p> <ul style="list-style-type: none"> <li>Budget: \$500,000 TA grant</li> <li>Time frame: 2005–2007</li> </ul> <p>Financial Sector Program II</p> <ul style="list-style-type: none"> <li>Budget: \$40 million program loan</li> <li>Time frame: 2007–2010</li> </ul> <p>Financial Sector Program II implementation</p> <ul style="list-style-type: none"> <li>Budget: \$1.7 million TA grant</li> <li>Time frame: 2007–2009</li> </ul>	<p><b>Asian Development Bank</b></p> <p>Preparing the Financial Sector Program</p> <ul style="list-style-type: none"> <li>Budget: \$800,000 project preparatory TA grant</li> <li>Time frame: 2000–2007</li> </ul> <p>Improving Insurance Supervision</p> <ul style="list-style-type: none"> <li>Budget: \$400,000 TA grant</li> <li>Time frame: 2002–2006</li> </ul> <p>Capacity Building for Banking and Financial Management</p> <ul style="list-style-type: none"> <li>Budget: \$1,000,000 TA grant (Government of France)</li> <li>Time frame: 2001–2005</li> </ul> <p>Improving Legal Infrastructure in the Financial Sector</p> <ul style="list-style-type: none"> <li>Budget: \$800,000 TA grant</li> <li>Time frame: 2002–2006</li> </ul>	<p><b>Asian Development Bank</b></p> <p>Rural Credit and Savings Project</p> <ul style="list-style-type: none"> <li>Budget: \$20 million project loan</li> <li>Time frame: 2000–2006</li> </ul> <p>Credit Facility to Promote Rural and Microfinance Services</p> <p>Developing Deposit Services in Rural Cambodia</p> <ul style="list-style-type: none"> <li>Budget: \$600,000 TA grant</li> <li>Time frame: 2005–2007</li> </ul>
<p><b>International Monetary Fund</b></p> <p>Poverty Reduction and Growth Facility</p> <ul style="list-style-type: none"> <li>Budget: \$81.6 million</li> <li>Time frame: 1999–2003</li> </ul> <p>Macroeconomic, structural, and social policies to foster growth and reduce poverty.</p> <ul style="list-style-type: none"> <li>Long-term resident adviser on banking supervision at NBC.</li> <li>Technical assistance to NBC on monetary policy development, legal framework for the payments system, and on-site inspection of selected banks</li> </ul>	<p><b>Government of the Republic of Korea</b></p> <p>Development of the Capital Market</p> <ul style="list-style-type: none"> <li>Budget: \$1,800,000 TA grant</li> <li>Time frame: 2006–2009</li> </ul> <p>Training and initial preparation for the establishment of a Cambodian capital market.</p> <p><b>IFC/MPDF</b></p> <p>Technical support to draft a sub-decree on microinsurance.</p>	<p><b>IFC/MPDF</b></p> <p>Support the establishment of the Cambodian Microfinance Association and its ongoing activities.</p> <p>Public workshops to discuss good governance and best practices for microfinance institutions and the development of the national arbitration center.</p>
<p><b>AUSTRAC</b></p> <p>Public awareness workshops and initial preparatory work on anti-money laundering and prevention of financing of terrorism activities.</p>	<p><b>ADB, AusAID, CIDA, DFID, EC, IMF, JICA, SIDA, UNDP, World Bank</b></p> <p>Public Financial Management Reform Program</p>	<p><b>United Nations Development Programme</b></p> <p>Public awareness and annual summit to promote microfinance activities.</p>

<b>Banking and Formal Credit</b> (including SME and judicial reforms)	<b>Capital Markets, Corporate Governance, and Public Financial Management</b>	<b>Rural and Microfinance</b>
<p><b>UNODC, World Bank, Asia Pacific Group, and Bank Negara Malaysia</b></p> <p>Technical support through provision of resource persons to support NBC on AML and CFT initiatives including capacity development.</p>	<p>Multi-Donor Trust Fund</p> <ul style="list-style-type: none"> <li>• Budget: \$14 million</li> <li>• Time frame: 2005–2011</li> </ul>	<p>Inclusive Financial Services Support (Project is under preparation.)</p>
<p><b>United Nations Development Programme</b></p> <p>Technical support to help the Ministry of Commerce draft the legal framework for the establishment of a commercial court.</p>	<p><b>Asian Development Bank</b></p> <p>Strengthening Debt Management</p> <ul style="list-style-type: none"> <li>• Budget: \$600,000</li> <li>• Time frame: 2005–2007</li> </ul> <p>The overall vision is to install much higher standards of management and accountability in the mobilization of all government current and capital resources and to achieve greater effectiveness and efficiency in the use of resources in their application to the Government's National Poverty Reduction Strategy and other priority programs. The long-term objective is to adapt international best practices into the Government's public financial management system.</p>	
<p><b>Asian Development Bank</b></p> <p>SME Development Program</p> <ul style="list-style-type: none"> <li>• Budget: \$20 million (loan)</li> <li>• TA: \$1.8 million (grant)</li> <li>• Time frame: 2003–2007</li> </ul> <p>The program objective is to support the Government's efforts to create a legal and regulatory environment that is conducive to business development.</p> <p>The issues addressed include</p> <ul style="list-style-type: none"> <li>• establishing an SME development policy framework,</li> <li>• developing business registration and licensing reform, and</li> <li>• improving SME access to finance.</li> </ul>	<p><b>AusAID</b></p> <p>Model Court Project (Kandal Province)</p> <p><b>World Bank</b></p> <p>Support to development of the accounting profession (support to National Accounting Council and institutional capacity building to Kampuchea Institute of Certified Public Accountants and Auditors.).</p>	<p><b>Agence Française de Développement</b></p> <p>Guarantee support for MFIs to receive local currency loan from the NBC.</p>

ADB = Asian Development Bank, AML = anti-money laundering, AusAID = Australian Agency for International Development, AUSTRAC = Australian Transaction Reports and Analysis Centre, CFT = combating the financing of terrorism, CIDA = Canadian International Development Agency, DFID = Department for International Development of the United Kingdom, EC = European Community, IFC = International Finance Corporation, IMF = International Monetary Fund, JICA = Japan International Cooperation Agency, MFI = microfinance institution, MPDF = Mekong Project Development Finance, NBC = National Bank of Cambodia, SIDA = Swedish International Development Agency, SME = small or medium enterprise, TA = technical assistance, UNDP = United Nations Development Programme, UNODC = United Nations Office on Drugs and Crime.

Sources: Ministry of Economy and Finance, National Bank of Cambodia, and the Asian Development Bank.

### LIST OF INELIGIBLE ITEMS

1. Loan proceeds will finance the foreign currency expenditures for the reasonable cost of imported goods required during the second Financial Sector Program Cluster, Subprogram 2.
2. No withdrawals will be made for the following:
  - (i) expenditures for goods included in the following groups or sub-groups of the United Nations Standard International Trade Classification, Revision 3 (SITC, Rev. 3) or any successor groups or sub-groups under future revisions to the SITC, as designated by ADB by notice to the Borrower:

**Table A5: Ineligible Items**

Chapter	Heading	Description of Items
112		Alcoholic beverages
121		Tobacco, unmanufactured; tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitute)
525		Radioactive and associated materials
667		Pearls, precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
728	728.43	Tobacco processing machinery
897	897.3	Jewelry of gold, silver or platinum-group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
971		Gold, nonmonetary (excluding gold ore and concentrates)

Source: United Nations.

- (ii) expenditures in the currency of the Borrower or of goods supplied from the territory of the Borrower;
- (iii) expenditures for goods supplied under a contract that any national or international financing institution or agency will have financed or has agreed to finance, including any contract financed under any loan or grant from the ADB;
- (iv) expenditures for goods intended for a military or paramilitary purpose or for luxury consumption;
- (v) expenditures for narcotics; and
- (vi) expenditures for environmentally hazardous goods, the manufacture, use or import of which is prohibited under the laws of the Borrower or international agreements to which the Borrower is a party; and
- (vii) expenditures on account of any payment prohibited by the Borrower in compliance with a decision of the United Nations Security Council taken under Chapter VII of the Charter of the United Nations.

## SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

### A. Linkages to the Country Poverty Analysis

<b>Is the sector identified as a national priority in country poverty analysis?</b> <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<b>Is the sector identified as a national priority in country poverty partnership agreement?</b> <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<b>Contribution of the sector or subsector to reduce poverty in Cambodia:</b>  The Second Financial Sector Program (FSP II) will support the Government's continued efforts to strengthen the financial sector via a combination of legal and regulatory reforms, targeted capacity building, improved disclosure standards and financial transparency, and establishment of key financial infrastructure. By promoting the development of a sound, market-based financial system to enhance the potential for economic growth and the creation of employment opportunities, FSP II will be pivotal in improving financial intermediation in Cambodia. A sound, efficient, and integrated financial system is crucial for achieving broad-based sustainable economic growth; it will help reduce poverty by increasing job opportunities, lowering transaction costs of economic activities, and extending the outreach of the formal financial sector to poor and rural areas. An efficient financial system will promote private sector development and foreign direct investment. Beneficiaries are expected to include the poor and near-poor. A robust financial sector will protect the economy from unfavorable exogenous shocks that are becoming more common in increasingly global financial markets and which have serious implications for the poor.	

### B. Poverty Analysis

#### Targeting Classification: General intervention

The reform measures proposed under Subprogram 2 have no direct impact on the poor or the vulnerable. No specific element requiring poverty analysis was identified in the Program.
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### C. Participation Process

<b>Is there a stakeholder analysis?</b> <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
All reform measures have undergone substantive stakeholder consultations before implementation and the Government will continue to host the biannual Government-private sector forum, which provides opportunity for the private sector to raise policy issues and for the Government to respond and address them. Regular policy dialogue with stakeholders is to be conducted during ADB review missions.
<b>Is there a participation strategy?</b> <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No

### D. Gender Development

<b>Strategy to maximize impacts on women:</b> Implementation of reform measures will be gender neutral.
<b>Has an output been prepared?</b> <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No

### E. Social Safeguards and other Social Risks

Item	Significant/ Not Significant/ None	Strategy to Address Issues	Plan Required
Resettlement	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	The Program requires no construction or rehabilitation work; is not expected to require land acquisition; and has no potential to cause loss of assets, resources, or income.	<input type="checkbox"/> Full <input type="checkbox"/> Short <input checked="" type="checkbox"/> None

<b>Affordability</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	The Program will not affect access to goods and services by the poor or otherwise vulnerable groups.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Labor</b>	<input type="checkbox"/> Significant <input checked="" type="checkbox"/> Not significant <input type="checkbox"/> None	The Program is expected to contribute to sustained economic growth and will result in more jobs. FSP II does not envisage any changes to labor market policies.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Indigenous Peoples</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	The Program has no component that would impact indigenous people in any way.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Other Risks and/or Vulnerabilities</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	No social risks were identified in the Program.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No

## TECHNICAL ASSISTANCE

### A. Purpose and Outputs

1. The primary purpose of the technical assistance (TA) is to help the Government improve the capacity of the National Bank of Cambodia (NBC), which is the Executing Agency, and the Ministry of Economy and Finance (MEF) and Ministry of Commerce (MOC), which are the implementing agencies, to implement some reform triggers under Subprogram 3 as well as to provide the Government with timely policy advice as needed. Implementation of the reforms will require technical inputs and targeted on-the-job support to equip the key government agencies (NBC, MEF, MOC) with the required knowledge and skills to ensure that the results of the reforms will be sustained even after the second Financial Sector Program Cluster (FSP II).

2. The components of the TA are as follow:

- (i) **Strengthen bank supervision and surveillance.** Strengthen the on-site supervision capacity of the bank regulator in tandem with anti-money laundering (AML) and combating the financing of terrorism (CFT) implementation, and develop remedial measures to address emerging problems with high-risk banks. Assist NBC to evaluate progress of capacity building for banking supervision and determine the nature of further capacity support, as well as to help assess the feasibility of rating major banks.
- (ii) **Strengthen supervision of microfinance institutions (MFIs) with appropriate regulations.** Improve the prudential regulations for MFIs and strengthen the capacity of the regulator within NBC to implement those regulations through both off-site and on-site supervisions. Assist NBC to develop a code of conduct for registered moneychangers.
- (iii) **Updating regulations and strengthen supervision of the insurance industry.** Assist the MEF in revising the insurance law and its submission to the Council of Ministers, implementing the new standard on accounting for insurance firms, updating regulations, and strengthening staff capacity to supervise and enforce those regulations.

### B. Methodology and Key Activities

3. The TA consultants will provide expertise in the following: (i) on-site supervision of banks and training (4 person-months), (ii) supervision of MFIs (3 person-months), and (iii) regulations and supervision of the insurance industry (4 person-months). One national consultant will be engaged, an insurance expert (6 person-months), to assist the international insurance expert.

### C. Cost and Financing

4. The TA is estimated to cost a total of \$375,000 equivalent of which the Asian Development Bank (ADB) will provide \$300,000 on a grant basis from its TA funding program. The Government will provide the remaining \$75,000 equivalent in the form of office space, counterpart staff, and other support facilities (Table A7).

**Table A7: Cost Estimates and Financing Plan**

Item	Total Cost (\$)
<b>A. Asian Development Bank Financing<sup>a</sup></b>	
1. Consultants	
a. Remuneration and Per Diem	
i. International Consultants	200,000
ii. National Consultant	14,000
b. International and Local Travel	60,000
c. Reports and Communications	2,000
2. Training, Seminars, and Conferences	
a. Seminars/Workshops	4,000
3. Contingencies	20,000
<b>Subtotal (A)</b>	<b>300,000</b>
<b>B. Government Financing</b>	
1. Office Accommodation and Secretarial Services	30,000
2. Remuneration and Per Diem of Counterpart Staff	25,000
3. Others	20,000
<b>Subtotal (B)</b>	<b>75,000</b>
<b>Total</b>	<b>375,000</b>

<sup>a</sup> Financed by the ADB TA funding program.

Source: ADB estimates.

#### **A. Implementation Arrangements**

5. NBC, MEF, and MOC will provide the necessary office space, counterpart staff, and other support services to the consultants. These agencies will closely coordinate with other stakeholders involved in TA implementation.

6. The TA will require a total of 17 person-months of consulting inputs comprising 11 international and 6 national person-months. The consultants will be engaged by ADB on an individual basis in accordance with the *Guidelines on the Use of Consultants* (2007, as amended from time to time). Detailed terms of reference will be prepared to accompany the noncommittal inquiry.

7. The consultants will produce inception, interim, and draft final reports for each component. The inception report will be submitted within 3 weeks of the start of services and will contain a time-bound work plan of activities and deliverables, based on the agreed terms of reference. The interim report will be submitted halfway through the contract and the draft final report at least 3 weeks before completion of the assignment. Tripartite meetings will be held to review the draft final reports. The final report, incorporating comments of the executing and implementing agencies and ADB, should be submitted upon completion of the services. The TA is scheduled to commence by 1 February 2009 and be completed by 31 January 2010.