

Chapter 6

Financial and Banking Reforms

As previously noted, viable financial and banking systems are crucial for private sector development and effective monetary policy. Until recent years, the scars of past political turmoil and civil war have naturally restricted the public's confidence in the country's financial systems. For that reason, it is likely that unused savings, in both in domestic and foreign currencies, are kept idle by a majority of Cambodian households. Also, most transactions are done in cash, thereby causing low, frequent circulation of money (low velocity of money). A high degree of dollarization and a lack of monetary instruments also constrain any effective implementation of monetary policy on the part of the Cambodian central bank, the National Bank of Cambodia.

6.1. Financial Sector Reforms

It will be a challenge for the banking sector to win the trust of the public for it to act effectively in its intermediary role for financial transactions. Along with other structural reform agendas, the government has played a very important role in strengthening the current inadequate financial system. New laws and regulations, policies, institutions and procedures have been adopted and established to provide a legal framework for the licensing and re-licensing, organization, operation and supervision of financial institutions.

In late 2001 under ADB technical assistance, the National Bank of Cambodia (NBC) adopted a financial blueprint called the "Vision and Financial Sector Development Plan for 2001-2010" as a long-term plan for finance sector development and workable monetary policy. The Blueprint identifies the types of financial institutions and functions to be developed within 10 years to create a sound, market-based financial system, enabling effective resource mobilization for sustainable economic growth. On top of the institutional and legal strengthening of the financial sector, the Blueprint also pushes modernization by calling for an upgrade of the financial information system and an increase in the capacity of human resources to meet future challenges, *see matrix 6.1 for recent developments*.

Matrix 6.1: Banking Sector Reforms

Reforms Agenda ^(a)	Measures Taken ^(b)
Establish a basic framework for monetary policy	
- Streamline reserve requirements	- Reserve requirement is 8 percent for banks and 5 percent for MFIs. - Liquidity ratio requirement was lowered from 100 to 80 percent.
- Phase out the guarantee deposit or capital reserve required for bank licensing	- Still in practice, banks must maintain 10 percent of capital as a form of guarantee.
- Implement rediscount and refinance facilities	- Unidentifiable.
Establish a framework for supervision	
- Establish a complete body of prudential regulations	- Introducing CAMELS rating to assess and boost public confidence on commercial banks.
- Adopt surveillance and inspection procedures	- Issuing complete procedures on off-site surveillance and on-site inspection
- Establish a fully staffed banking supervision department	- The supervision department was established
- Establish a uniform chart of bank accounts and disclosure rules consistent with international Accounting Standards (IAS)	- A uniform Chart of Account was made available for all commercial banks in 2003. - The international based uniform Chart of Account is expected to be completed by the end of 2004 for all commercial banks and specialized banks.
- Establish a prompt corrective action (PCA) system	- Prakas (October 17, 2002) on Standardized Procedure for prompt corrective action for banking and financial institutions.
- Establish an anti-money-laundering regulation	- Prakas (October 21, 2002) on standardized procedure for identification of money laundering at the banking and financial institutions. - Law on Anti-money Laundering was drafted.
Restructure the banking industry	
- Complete bank re-licensing and liquidation of problem banks	- By the end of 2002, 16 commercial banks were de-licensed and liquidated. - As the end of June 2004, there are 14 commercial banks, 3 specialized banks in operation.
- Restructure/privatize the Foreign Trade Bank	- Announcing the policy to privatize and seek potential investors to run the FTB
Establish a framework for the payment system	
- Improve operational procedures for both the riel and dollar clearing systems, considering the compliance capability of commercial banks	- Establishing a clearing house for dollar dominated checks.
- Adopt a payment law to underpin the payment system	- Draft law on Negotiable Instruments and Payments Transactions - Bankruptcy law has been drafted. - Law on Secured Transaction has been drafted for consultations.
- NBC and the Bankers Association should adopt a protocol for an on-line banking system to facilitate future integration of an on-line banking network	- Unidentifiable.

Source: ^(a) Selected from Cambodia: Financial Sector Blueprint for 2001 – 2010.

^(b) EIC compiled from WB, IMF and Government Sources.

Some reform progresses have been made during the last three years. The banking system is now perceived as well capitalized, if not over-capitalized. This requirement forced some foreign banks to close down their branches, due to the minimum capital requirement of US\$ 13 million and a capital adequacy ratio of 36 percent mandated as of the end of July 2004.⁴¹ The NBC has reinforced prudential guidelines on risk management, capital adequacy requirement, and other norms such as CAMELS ratings to assess and boost public confidence in commercial banks. An international standard uniform chart of accounts was introduced and full compliance is expected by the end of 2004.⁴² On-site inspections of banks have been conducted. Regulations and measures to combat terrorist financing and money laundering are being drafted with the assistance of the IMF. Also, a clearing house for both riel and dollar-denominated checks is in operation.

Matrix 6.2: Rural Finance Reforms

Reforms Agenda ^(a)	Measures Taken ^(b)
Implement policy actions in Rural Credit Policy (RCP)	
• Make applicable the provisions of the Banking Law to develop the rural finance sector	- Prakas (February 25, 2002) on Registration and Licensing of MFIs - By the end of June 2004, 9 licenses were issued for micro finance institutions.
Strengthen supervision and regulation	
• Establish supervision system for licensed microfinance institutions (MFIs) consistent with the overall framework for the banking industry	- Under NBC's Supervision Department.
• Introduce appropriate prudential norms for licensed MFIs	- Prakas (February 25, 2002) on Reporting Requirement for NGOs and licensed MFIs
Facilitate institutional transformation linkages, and services delivery	
• Facilitate transformation of identified NGOs into licensed MFIs	- ACLEDA specialized bank was licensed to become a commercial bank effective December, 2003. - By the end of June 2004, 9 licenses were issued for micro finance institutions - 30 NGOs have been registered.

Source: ^(a) Selected from Cambodia: Financial Sector Blueprint for 2001 – 2010.

^(b) EIC compiled from WB, IMF and Government Sources.

⁴¹ Cambodia: 2004 Article IV Consultation—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Cambodia. p. 71. See IMF, available at <http://www.imf.org/external/pubs/ft/scr/2004/cr04328.pdf>

⁴² National Bank of Cambodia Review, No. 9, 3th Quarter 2004, p. 25.

To expand credit coverage to rural areas and strengthen micro-finance institutions (MFIs) as envisaged in the Blueprint, the NBC has imposed regulatory requirements on all MFIs either to obtain a license as a formal MFI or to register as a rural credit operator. This oversight will help ensure their sound operation and legal status. By the end of 2003, 5 licenses had been issued to MFIs and 30 NGOs had been registered. These institutions provided about 90 billion riel loans to more than 250,000 customers in 2003.⁴³ However, these loans accounted for only 7 percent of total credits provided to the private sector in 2003, *see matrix 6.2 for recent developments*.

To further improve its supervisory capacity, NBC has issued and reinforced several Prakas (regulations with the force of law) such as limits on an overly large exposure of credit to individual customers (lending of not more than 20 percent of net worth to one customer) and related parties (no more than 10 percent), reserve requirements against deposits (8 percent for banks and 5 percent for MFIs) and other operational regulations. Many other laws such as the Negotiable Instruments and Payment Transactions Law, the Secured Transaction Law, the Insolvency Law and the Securities and Exchange Law are being drafted, in part to fulfill Cambodia's WTO accession obligations. These laws will likely be submitted to the National Assembly for approval in 2005.

For the insurance sector, the government has taken stiffer measures to enforce the Insurance Law passed in June 2000 and the sub-decree adopted in 2002 requiring all insurance companies to meet a capital requirement and solvency margin. As a result, the dominant insurance company, Indochine Insurance was recently forced to close due to its failure to comply with the law. Generally, the sector is underdeveloped given the low generation of insurance premiums and policy coverage, *see matrix 6.3 for recent developments*.

The Pension System and Interbank, Money and Capital Markets Development have been far behind the schedule laid down in the blueprint. Further preparation is needed to form a foundation for their establishment and operation. Lessons from Vietnam show that without proper capacity and the clear need for its establishment, the creation and operation of a stock market would be unlikely to succeed.

⁴³ National Bank of Cambodia Review, No. 9, 3th Quarter 2004, p. 26.

Matrix 6.3: Insurance Sector Reforms

Reforms Agenda ^(a)	Measures Taken ^(b)
Establish a regulatory and supervisory framework for insurance	
• Establish an insurance supervisory unit within Ministry of Economy and Finance (MEF)	- Department of Financial Industry was established.
• Adopt a sub-decree to implement the insurance law	- Adopted in 2002.
• Establish prudential regulations including uniform chart of accounts and disclosure rules consistent with IAS/ ISA and a PCA system	- Same as for Banking Sector.
Establish a framework for compulsory insurance	
• Adopt a plan and establish legal frameworks and enforcement mechanisms to implement compulsory insurance	- Insurance Law passed in 2000.
• Establish an inter-ministerial working group to develop enforcement and monitoring system for compulsory insurance	- Unidentifiable.
Establish a basis for private sector development	
• Establish a joint venture between the state-owned insurance company and a private company	- There are four insurance companies, Caminco, Asia Insurance, Forte and Indochine Insurance, and a re-insurance company, Cambodia Re. - Indochine Insurance closed in September 2004 due to failure to inject SDR 5 million, capital as required by law.
• Adopt regulations to encourage the use of domestic insurance companies	- Unidentifiable.

Source: ^(a) Selected from Cambodia: Financial Sector Blueprint for 2001 – 2010.

^(b) EIC compiled from WB, IMF and Government Sources.

6.2. Credits and Interest Rates

Overall, reforms have gradually boosted the confidence of the public and business community in the financial system. It is clear that while Cambodia has been enjoying accelerated economic growth, the demand for more capital investments from both inflows of FDI and mobilized domestic savings through the banking system has resulted in financial deepening. Average annual growth of total domestic credits during 1999 – 2003 was 17 percent, while the annual growth of deposits was 24 percent during the same period.

However, the average annual ratio of credits to deposits was slightly more than 50 percent, reflecting low credit provisions to finance economic activities with many deposits existing as a large idle fund. One reason behind the low credit portfolios is high interest rates on loans and a concentration of banking activities in Phnom Penh. The interest rates

on lending have been declining but remain very high at about 17 percent per annum as of June 2004⁴⁴. Moreover, there is limited geographic coverage, despite the expansion of credits by MFIs and registered NGOs in many parts of country. In fact, many banks are reluctant to lend money given the risks inherent in the patchwork of partial laws governing contracts, business entities, bankruptcy, insolvency etc. More prosaically, poor book-keeping abilities by businesses may simply dampen their creditworthiness in the eyes of banks. Moreover, other risks stemming from political uncertainties, rising inflation and an uneven playing field in the business environment, due to corruption and smuggling, are also no doubt factors contributing to the sustained high lending rates.

To lower the interest rates on bank loans, it will be necessary to maintain political stability, low and stable inflation, encourage a lowering of the costs of wholesale banking, promote competition and strengthen law enforcement in business activities. Continuing to strengthen the role and capacity of the Cambodian central bank, the NBC, will be key to ensuring the stability and development of the financial system.

6.3. Monetary and Exchange Rate Policy Reforms

The primary objective of monetary policy in Cambodia is to maintain price stability through exchange rate policy given the absence of other policy instruments due to dollarization. In the last few years, the NBC has been pursuing a tightening of monetary policy by limiting the financing of the budget deficit to mitigate liquidity pressure on inflation.

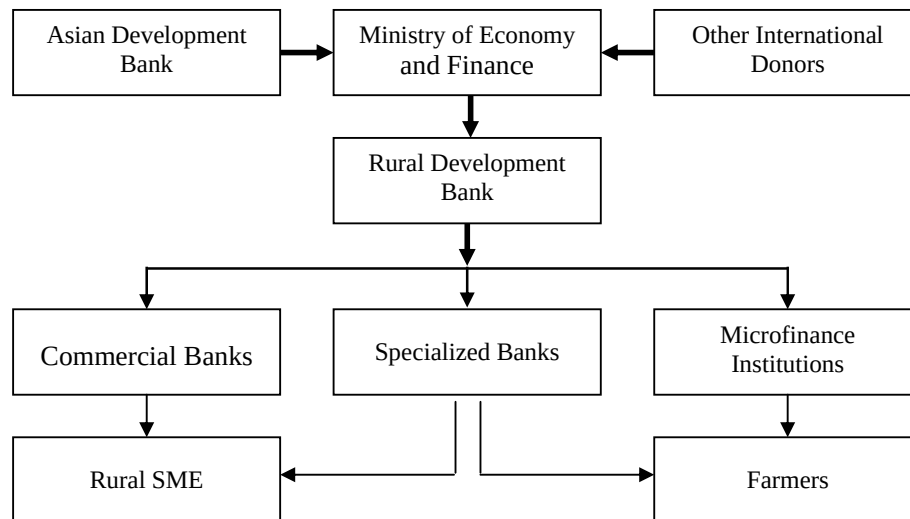
The NBC has no influence on interest rates, which are fundamentally determined by commercial banks. As a result, the Cambodian central bank resorts to reserve requirements, liquidity ratios and refinancing facilities as its regulatory tools. But the absence of government securities and other discount facilities limits the effectiveness of these tools. The NBC has been also pursuing a flexible market-based exchange rate policy to keep the spread of the official exchange and parallel market rate at 1 percent to prevent disruptive fluctuations and avoid adverse pressures on inflation.

Coupled with a prudent fiscal policy, the government has been successful in maintaining a low inflation rate, which declined from 3.7 percent in 2002 to 0.5 percent in 2003. However, inflation in Phnom Penh has risen significantly over the past year, hitting 6.7 percent from August 2003 to August 2004. At the same time, the riel has been increasingly

⁴⁴ See Chapter 3 section 3.4

weak against the US dollar. The official rate depreciated at annual rate of 1.9 percent by September 2004 and the market rate depreciated by 2.8 percent during the same period. The exchange rate crossed the level of 4,100 per US dollar in September, as compared to only 3,980 in early January⁴⁵.

Chart 6.1: Rural Credit System in Cambodia



Source: Rural Development Bank and EIC

The depreciation of the exchange rate will affect the rural poor through its inflationary pressure and concurrent reduction of financial assets for those who earn their income in riels. Therefore, it is important to maintain the stability of the national currency at around 4,000 riels per US dollar by reducing the recently accelerated growth in the amount of riel in circulation. Moreover, the NBC must stand ready to cope with the deterioration of the exchange rate in 2005, when the phase-out of quotas in the garment industry will perhaps lowering export earnings and thus foreign currency generation.

The government also must take measures to promote de-dollarization, in an effort to allow the more effective conduct of a monetary policy which is conducive to growth and reinforces the economy's ability to absorb external shocks. Such measures should include the requirement that all government domestic transactions be conducted in riel. The exchange rate must be stable to foster confidence in holding riel and inflation must be contained to avoid the further loss of purchasing power for the riel.

⁴⁵ See Chapter 3 section 3.2