

SECTOR OVERVIEW

A. Economy

1. The Cambodian economy has grown at about 7% annually since 2012. The strong gross domestic product (GDP) growth has been supported by garment exports, tourism, construction, and real estate development. Foreign direct investment continued to flow into the country, leading to a reduction in the trade deficit and a balance of payments surplus. As a result, international reserves increased and covered about 5 months of imports. The current account deficit in 2016 decreased to 8.2% of GDP, the lowest since 2013 and down from 9.2% in 2015. The decrease in the current account deficit was due to an increase in exports, surplus in the net services account, and remittances from Cambodians living overseas. The inflation rate in 2016 remained low at 2.9% because of the low international oil price and accommodative fiscal and monetary policy. Cambodia's economy has remained robust and is on track with the government's Rectangular Strategy (Phase III)¹ and the National Strategic Development Plan, 2014–2018.² In 2016, the World Bank reclassified Cambodia from a low-income or least developed economy to a low middle-income country.³ Cambodia's gross national income (GNI) per capita was \$1,140 in 2016 and purchasing power adjusted GDP per capita reached an estimated \$3,717 at the end of 2016. Poverty has reduced significantly from 53.2% in 2004 to 13.5% in 2015, and is estimated to have decreased to about 12.5% in 2016.⁴

2. The Cambodian economy will likely maintain its growth rate of about 7% from 2017 to 2019. The projected growth will be supported by (i) the government's continuous efforts on structural reforms; (ii) an increase in trade with the completion of roads and waterways under the People's Republic of China's "One Belt, One Road" initiative; (iii) the preferential trade arrangement with the European Union and the United States for Cambodia's export products; and (iv) a rising young population under 35 years old, which accounts for 65% of the total population.

3. Cambodia's strong economic outlook is challenged by (i) high dollarization of the economy, (ii) the high cost of energy and transportation in the country, and (iii) lack of physical infrastructure and skilled human resources. The National Bank of Cambodia (NBC) continues to promote greater use of the riel through various policy measures, including raising awareness on the benefits of using riel, enabling faster and cheaper payments in local currency, developing financial instruments to provide banks with liquidity in riel, and encouraging financial institutions to provide riel-denominated loans. The NBC sold about KR3.3 trillion in local currency during 2016, up 11% from 2015, to support growing demand for the local currency in business and everyday transactions (footnote 2). The NBC is expected to continue to absorb United States dollars from the market and provide financial institutions with liquidity in riel, enabling the banks to engage in further lending in local currency. This was an important move by the NBC to reduce the country's dependence on the use of United States dollars.

4. Political stability in Cambodia has weakened after a relatively calm period since July 2014 when protests ended following the general election in 2013. Heightened political tensions

¹ Royal Government of Cambodia. 2013. "Rectangular Strategy" for Growth, Employment, Equity and Efficiency Phase III. Phnom Penh.

² Royal Government of Cambodia. 2014. *National Strategic Development Plan 2014-2018*. Phnom Penh.

³ The World Bank defines low-income economies as those with gross national income (GNI) per capita of less than \$1,025, Lower middle-income countries have GNI per capita of \$1,026–\$4,035; upper middle-income economies have GNI per capita of \$4,037–\$12,745; and high-income countries have GNI per capita above \$12,745.

⁴ National Bank of Cambodia. 2016. *Annual Report*.

https://www.nbc.org.kh/download_files/publication/annual_rep_eng/Annual_Report_2016_English.pdf.

persisted between the administration led by the Cambodian People's Party and the main opposition party, the Cambodian National Rescue Party, following the government's issuance of an arrest warrant for the opposition party leader. The local election held in June 2017 was relatively peaceful and the Cambodian People's Party won with just 51% of the votes. Given the tight margin of victory, some political uncertainty is expected before the July 2018 general election.

B. Banking Sector

5. Cambodia's solid economic growth created a favorable environment for the banking sector to expand and become more competitive and integrated with the local and international markets. Total financial intermediaries' assets increased to \$23.9 billion or 118% of GDP at the end of 2016, up from \$18.9 billion or 108% of GDP at the end of 2015. Commercial banks account for 84.5% of total financial sector assets, microfinance institutions (MFIs) account for 13.9%, and specialized banks account for 1.6%. In 2016, total credit to the private sector was \$17.6 billion (71% of GDP) and total sector deposits were \$15.5 billion (64% of GDP). This increase was due to new foreign banks entering the market, increased foreign funding for domestic banks and stronger demand for credit. At the end of 2016, the banking sector has attracted foreign investment worth \$2.7 billion, equivalent to 16.5% of total foreign investment in Cambodia (footnote 2).

6. The banking system in Cambodia consists of 37 commercial banks, 71 MFIs, and 15 specialized banks, most of which are small and cannot accept deposits (see Figure). Despite the large number of banks, the Cambodian banking industry remains concentrated in the six largest institutions (the three largest banks account for 40.8% of total bank assets, and the six largest banks account for almost 60%).⁵ ACLEDA Bank, with a 20.3% share in total loans, is the largest bank in Cambodia, followed by Canadia Bank and Cambodian Public Bank.⁶ The other banks remain small and service niches (many of them are foreign bank affiliates servicing only their domestic clients with business interests in Cambodia).⁷ This is partly why only 17% of Cambodians use universal banks and about 70% of consumers consider the overall service provided by banks to be lacking.⁸ The 2016 increase in required bank capital to \$75 million is expected to cause the industry to contract, with the more competitive and efficient institutions remaining. Rural Development Bank, a specialized bank with a focus on agriculture development, is the only state-owned bank. It represented 0.4% of the banking sector's assets at the end of 2016. The NBC has been selective in issuing new banking licenses, prioritizing investments made by reputable international investors that can bring best banking practices to the Cambodian market. In 2016, the NBC granted a banking license to Sathapana Bank, previously a microfinance deposit taking institution, after an acquisition by Maruhan Investments, and in 2017 two banks obtained banking licenses (BRED Bank Cambodia and Mizuho Bank).

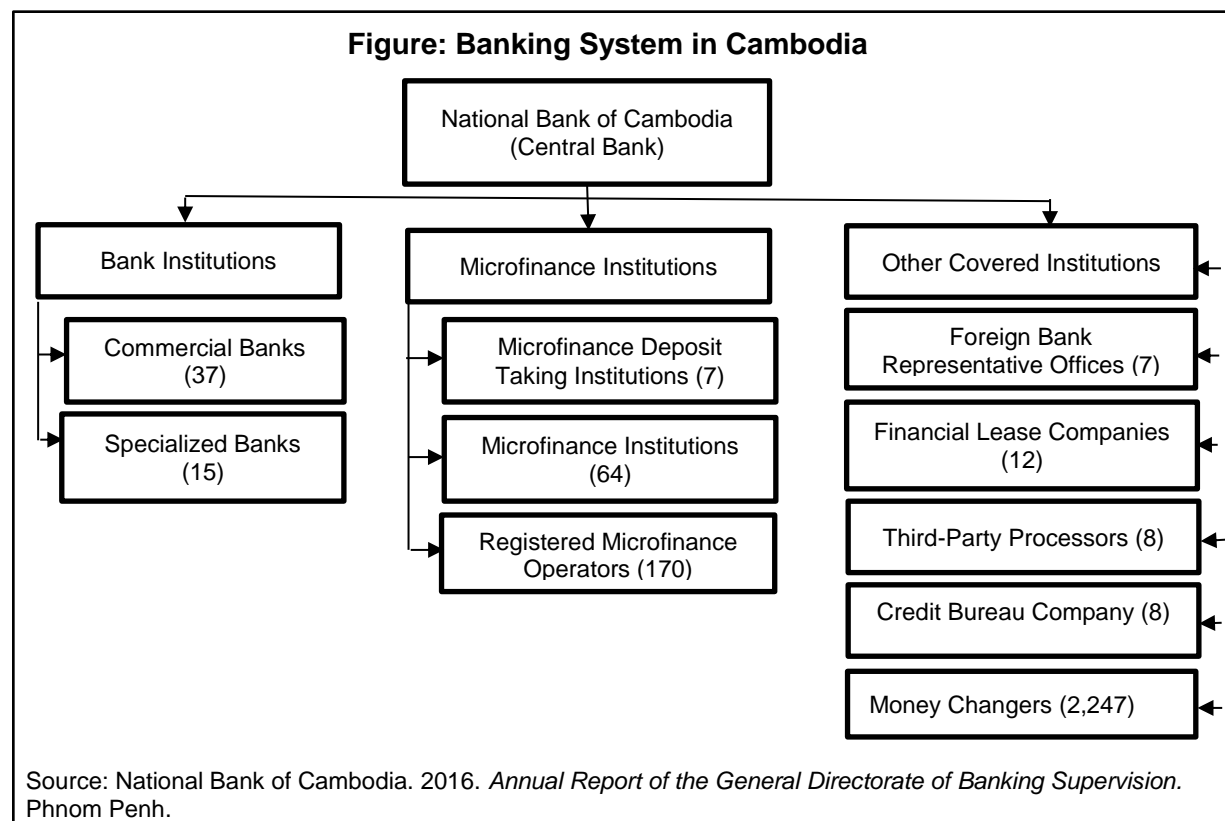
⁵ NBC. 2016. *Annual Report of the General Directorate of Banking Supervision*. Phnom Penh.

⁶ NBC. 2016. *Annual Report*.

https://www.nbc.org.kh/download_files/publication/annual_rep_eng/Annual_Report_2016_English.pdf.

⁷ At the end of 2016, foreign-owned banks, which constituted most banks in the country, accounted for 55.7% of total assets, 53.7% of total loans, and 53.2% of deposits. In 2015, foreign-owned banks accounted for 54.3% of total assets, 51.6% of total loans, and 51.4% of deposits.

⁸ K. Kotoski. 2016. Banking service deemed poor. *The Phnom Penh Post*. 27 June. <http://www.phnompenhpost.com/business/banking-service-deemed-poor>.



7. The banking sector continues to play an important role in poverty reduction by providing financial services to the poor to improve their living standards. This has been reflected in the increasing number of borrowers and depositors. In 2016, the number of depositors grew by 12.9% to 3.0 million, up from 2.65 million at the end of 2015. The number of borrowers grew by 45.7% in 2016 to 0.75 million, up from 0.51 million at the end of 2015 (footnote 7). The banking sector also contributed to job creation through improvement in the size and scope of banking activities, which provided employment opportunities for Cambodians. The workforce in the banking sector (including NBC, the commercial banks, and MFIs) rose significantly from 16,000 in 2007 to 61,000 in 2016 (footnote 7).

8. **Capitalization.** The banking sector remains well capitalized with total shareholders' equity of \$4.2 billion, an 18% increase from 2015 to 2016 (see Table 1). The total capital adequacy ratio improved to 22.3% in 2016 from 21.8% in 2015, comfortably above the prudential minimum of 15%. In 2016, the NBC increased the required minimum capital of Cambodian commercial banks (para. 16). Banks were allowed a phased-in implementation in 2017 and full compliance will be required from the end of March 2018.

Table 1: Capital Adequacy Ratio of Commercial and Specialized Banks (%)

Ratio	2016	2015	2014	2013	2012
Capital Adequacy Ratio	22.3	21.8	21.5	24.8	25.0
Total equity to total assets	18.0	18.0	18.4	20.2	19.6

Source: National Bank of Cambodia. 2016. *Annual Report of the General Directorate of Banking Supervision*. Phnom Penh.

9. **Asset quality.** The banking sector's total assets grew by 18.6% to reach \$23.7 billion in 2016, with the growth rate having declined from 22.2% in 2015 (29.9% in 2014). Loan growth also fell from 30.1% in 2014 to 24.9% in 2015 and 17.1% in 2016 (footnote 6). Factors contributing to the slower loan growth were the imposition of new government regulations, more prudent risk management of financial institutions, and more challenging market conditions.⁹ The NBC issued a new set of regulations, which included higher reserve requirements, increased minimum registered capital, and maintaining a liquidity coverage ratio compliant with Basel III standards; and imposed an 18% interest rate cap on microfinance loans. The NBC is focused on strengthening the financial stability of the banking system rather than rapidly increasing the total credit portfolio.

10. At the end of 2016, the banking sector's largest economic sector exposures were retail trade (17.4%), wholesale trade (14.2%), agriculture, forestry and fisheries (10.8%), other non-financial services (8.0%), mortgages (7.8%), and manufacturing (6.9%). The NBC did not impose any concentration limits by economic sector, but considered an exposure of 20%–30% in any one sector as a threshold for notifying the bank.

11. Asset quality is weakening but remains sound, with the nonperforming loan (NPL) ratio at 2.3% in 2016, up from 1.9% in 2015.¹⁰ The main drivers of weaker asset quality were challenges in the agricultural sector caused by poor climate conditions and increased competition in the financial sector, leading some institutions to extend loans to less creditworthy borrowers and signs of over-indebtedness in certain areas. The NPL coverage ratio of the banking sector was 46.6% at the end of 2016. See Table 2.

Table 2: Asset Quality Ratios of Commercial Banks (%)

Ratio	2016	2015	2014	2013	2012
Growth rate of gross loans	17.1	24.9	30.1	25.5	33.8
Nonperforming loan ratio	2.3	1.9	1.9	2.3	2.2
Loan loss reserves divided by nonperforming loans ratio	46.6	47.8	50.9	50.0	54.3

Source: National Bank of Cambodia. 2016. *Annual Report of the General Directorate of Banking Supervision*. Phnom Penh.

12. **Profitability.** The profitability of the banking sector remained healthy despite the decline in the rate of loan portfolio growth. The net interest margin expanded by 0.7%, mainly because of higher loan yields, but net interest income only grew by 20.0% in 2016, down from 28.0% in 2015 because of lower credit growth. Non-interest income rose by 9.7% (17.2% in 2015) while the average cost to income ratio among commercial banks remained unchanged at 44.5% in 2016.

13. The higher loan loss provisioning, at 20.4% of pre-provision income in 2016 (15.0% in 2015), impacted the growth of net income, which decreased to 9.0% in 2016 from 24.3% in 2015. The return on average equity decreased to 11.4% from 12.5% in 2015, and the return on average assets declined to 1.9% in 2016 from 2.2% in 2015. See Table 3.

⁹ Agricultural production was largely affected by severe droughts. Although weather conditions improved in 2016, agricultural commodity prices remain depressed, limiting growth in total agricultural exports.

¹⁰ The calculation of the NPL ratio includes substandard, doubtful, and loss. Substandard loans are defined as past due loans in excess of 90 days, doubtful loans are past due loans in excess of 180 days, and loans that are past due in excess of 360 days are considered loss.

Table 3: Profitability Ratios of Commercial Banks

Ratio	2016	2015	2014	2013	2012
Net income (\$ million)	417.8	382.0	305.6	243.1	205.3
Net income growth rate	9.0%	24.3%	28.2%	18.4%	36.1%
Return on average equity ^a	11.4%	12.5%	12.0%	11.0%	11.6%
Return on average assets ^a	1.9%	2.2%	2.2%	2.1%	2.2%

^a Return on average equity and return on average assets include specialized banks for all periods.
Source: National Bank of Cambodia. 2016. *Annual Report of the General Directorate of Banking Supervision*. Phnom Penh.

14. **Funding and liquidity.** Customer deposits remained the main source of funding for commercial banks in 2016, despite an increase of 65% in the banking sector's total borrowings from 2015. Customer deposits increased by 18% to \$13.9 billion in 2016 and the number of depositors grew by 13% to 3 million customers. The loan to deposit ratio, although still high, reduced marginally to 98.4% in 2016 compared with 100.9% in 2015 because of a lower rate of loan growth in 2016.

C. Recently Approved Macprudential Measures

15. **Prakas No. B7-015-349 on liquidity coverage ratio.** In December 2015, the NBC issued the proclamation (*prakas*) on the liquidity coverage ratio (LCR) in accordance with Basel III standards. The LCR is defined as eligible liquid assets divided by net cash outflows within 30 days. The NBC required banks and MFIs to raise their LCR to 60% of their projected 30-day net cash outflows by 1 September 2016. The prudential limit is expected to increase by 10% each year to reach an LCR of 100% by 1 January 2020.

16. **Prakas No. B7-016-117 on minimum registered capital of banking and financial institutions.** On 16 June 2016, the NBC increased the minimum capital of banks to strengthen the capitalization of the banking sector. Commercial banks incorporated as foreign branches, whose parent bank is rated investment grade, must raise their minimum registered capital to KR200 billion or \$50 million, while commercial banks incorporated as a foreign subsidiary must have a minimum registered capital of KR300 billion or \$75 million, regardless of the rating of the parent bank. All banks must fully comply by 22 March 2018. Banks that are not able to meet these new requirements must either (i) find a new potential investor, (ii) undergo a merger or acquisition, (iii) change their legal status, or (iv) apply for a voluntary liquidation.

17. **Prakas No. B7-016-334 on credit provision in national currency.** In December 2016, the NBC required all banks and financial institutions under its supervision to maintain at least 10% of their total loan portfolio in riel. The deadline for full compliance is 31 December 2019. This regulation aims to encourage the usage of the riel in the economy.

18. **Prakas No. B7-017-109 on interest rate ceiling on loans.** The NBC required all MFIs and banks offering microfinance loans to charge a maximum interest rate of 18% on microfinance loans effective 1 April 2017. This provision applies to all new loan contracts, including restructured loans and refinancing loans, from 1 April 2017. The NBC aims to promote market competition and contribute to poverty reduction by exploring ways to reduce interest rates on microfinance loans.