

## SECTOR ASSESSMENT (SUMMARY): FINANCE

### 1. Sector Performance, Problems, and Opportunities

#### a. Sector Context and Performance

1. Starting from a very low base, financial deepening in Cambodia has accelerated, supported by a series of Asian Development Bank (ADB) programmatic approaches implemented during 2001–2015.<sup>1</sup> During this period, credit to the private sector rose from 6.0% of gross domestic product (GDP) in 2001 to 57.0% of GDP in 2014, while total deposits rose from 10.4% of GDP to 59.2% of GDP. At the end of 2015, there were 36 commercial banks (including 11 branches of foreign banks) and 12 specialized banks. The Securities and Exchange Commission of Cambodia was established in 2008 and the Cambodia Securities Exchange was established jointly with the Korea Exchange in 2011. There are 21 licensed insurance companies, 7 insurance brokers, and 10 insurance agents.<sup>2</sup> As of the end of 2015, there were 50 licensed microfinance institutions (MFIs), which do not take deposits, and there were 8 microfinance deposit-taking institutions (MDIs), 1,118 automated teller machines, and 1,439,887 debit cards.

2. Cambodia's financial sector is characterized as free and market-based with limited restrictions in terms of capital flows. With the exception of the Rural Development Bank, the country's banks are all privately-owned and most are controlled by foreign shareholders. The National Bank of Cambodia does not subject loans or deposits to interest rate controls. Moreover, Cambodia's growth model, which also emphasizes a market-based approach, relies heavily on foreign direct investments supported by inexpensive, low-skilled, and abundant labor. These strategies have skewed local preferences towards the US dollar. There are benefits to dollarization, such as limited exchange rate movements, which promote investment and provide a stable environment for the implementation of a prudent fiscal policy. However, dollarization also comes at a cost. Pervasive dollarization constrains the wider use of market-based instruments in implementing monetary policy, and reduces the government's flexibility in times of financial stress. The government has been promoting the use of local currency, focusing on retail and relatively small recurrent transactions including payrolls and utility bills. However, local currency money and government bond markets, which are the essential building blocks for developing an effective monetary policy and financial system, do not yet exist.

3. **Banking system.** The banking subsector is relatively strong. Total banking system assets were \$19.9 billion at the end of 2015, or 110% of GDP, while total deposits were 62% of GDP. Nonperforming loans (NPLs) represented only 2.0% of total loans at the end of 2015 and bank profitability was generally good: for 2015, the return on assets was 2.0% and the return on equity 10.9%. Nevertheless, the rapid growth of the banking subsector has amplified concerns over financial stability. Supervision capacity remains relatively low and coordination mechanisms between key oversight ministries have not yet been established.

4. **Capital market.** The nonbank financial subsector is underdeveloped and capital markets, and in particular money markets and government bond markets, do not yet exist. The stock market commenced market operations on 18 April 2012 with a listing by the Phnom Penh Water Supply, a state-owned enterprise. Privately owned garment company Grand Twins International was listed on 16 June 2014. The third listing, of state-owned enterprise Phnom Penh Autonomous Port, took place on 9 December 2015. While other listings are in the pipeline,

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<sup>1</sup> Cambodia is a post-conflict country whose banking industry was only reestablished in the late 1990s.

<sup>2</sup> Since 2010, one new general insurance company, one life insurance company, five microinsurance companies, and three community-based insurers—two for health insurance and one for crop insurance—have been licensed.

market activity and secondary liquidity are muted. A legal framework, including listing rules, has been enacted to cover most basic types of equity and debt securities and standard convertible or derivative securities. However, given Cambodia's size, a critical challenge to the further development of the securities market is dollarization and achieving a critical mass. Development efforts should focus on increasing the liquidity and depth of the market by enhancing its simplicity and flexibility, lowering market access costs, providing an appropriate level of regulation and enforcement, and educating investors.

5. **Insurance.** The insurance market is relatively small compared to Cambodia's larger peer countries in the Association of Southeast Asian Nations (ASEAN), but has grown steadily. Gross premium receipts from all insurance products were \$60 million at the end of 2014. During 2011–2015, the average growth rate for gross premiums was 28%.<sup>3</sup> Domestic insurance companies may also be 100% owned by a foreign investor provided that the company is registered as a public limited company. However, maintaining this growth rate will become more challenging as life companies build up their client base and accumulate long-duration liabilities that need to be matched with longer-term investments.

6. **Microfinance.** The microfinance subsector has grown significantly, with total aggregate assets of \$3.50 billion at the end of 2015 and total aggregate deposits of \$1.35 billion. Currently, more than 70% of deposits are term deposits. The financial condition of the subsector is sound, and aggregate NPLs remain low (0.77% in 2015). Only six MFIs had NPL ratios over 5.0%, while the highest NPL ratio among the MDIs was 0.6%. Subsector profitability is robust, with return on assets for 2015 at 3.68% for MFIs and 18.62% for MDIs. Market penetration is increasing, as the total number of MDI depositors was 1.33 million in 2015 and the number of staff of MFIs and MDIs was 26,268 in 2015.

#### b. Sector Problems and Opportunities

7. The government has recognized that generating more good jobs to sustain growth and raise income levels depends on diversifying the economy and deepening and broadening intermediation. To meet this objective, a number of development constraints must be addressed, including (i) limited financial inclusion due to the lack of reasonably priced credit in local currency and an absence of consumer protection mechanisms, (ii) the limited ability of the government to maintain financial stability along with the complications of dollarization, and (iii) weaknesses in key financial sector infrastructure which reduce market participation and increase costs.

8. **Market-oriented financial sector is not inclusive.** While credit growth has been significant, financial markets in Cambodia are focused almost exclusively on economic efficiencies. Financial inclusion has not been emphasized and lending is fragmented, with credit readily available in urban centers while the rural areas remain underserved. The study estimated that only 59% of the adult population with age over 18 has access to formal finance—68% in urban areas and only 55% in rural areas. Further, the study indicated that 30% of adult population is excluded from both formal and informal financial services altogether.<sup>4</sup> Furthermore, the study indicated that 30% of rural populations do not have access to either formal or informal financial services. First, supply is limited as a majority of participants in the banking subsector do not maintain branches outside of the Phnom Penh area. Second, dollarization tends to disadvantage local businesses, especially in rural agriculture, as the preferred local currency credit option is more expensive because of the costs of exchange and the small scale of the

<sup>3</sup> For the 12 months ending December 2015, non-life insurance premiums grew by 17%, life insurance premiums grew by 187%, and micro insurance grew by 477%.

<sup>4</sup> United Nations Capital Development Fund. 2015. *FinScope Consumer Survey 2015*. Phnom Penh.

transactions. As a result, even MFIs have been competing in the same market segments with the commercial banks. While the Rural Development Bank has a mandate to promote credit in the agriculture sector, it has been unable to fulfill this mandate because of poor financial performance arising out of a lack of credit assessment skills and poor risk management.<sup>5</sup> To address this issue, a more holistic process to address financial inclusion at a nationwide level will be required. At the same time, financial institutions should be encouraged to provide a more diverse range of products and services. Increasing choices will also give rise to a need for financial literacy programs and a formal consumer protection framework.

9. **Investor confidence remains low and inhibits financial sector development.** The dominance of the banking subsector has discouraged coordination between financial sector supervisors. While the nonbanking and capital market subsectors are in the early stages of development and currently pose limited risk, rapid and accelerating growth in the banking and nonbanking subsectors will require more robust crisis management coordination to improve confidence in the financial sector. Consumer protection mechanisms, such as a legal framework and a deposit insurance scheme, are also lacking. In the longer term, dollarization has left the economy without a lender of last resort to ensure financial sector stability. The absence of a local currency government debt market further entrenches dollarization and inhibits the use of locally influenced monetary interventions. Development of a local currency bond market could enhance the central bank's policy tools and would serve as a keystone for the continuing development of the financial markets.<sup>6</sup> Efforts to develop a larger and more diverse local currency securities market would also provide suitable and appropriate investment options for financial intermediaries, which would support financial inclusion. The recent launch of a credit bureau that covers both the banking and MFI subsectors is a welcome development, but it should be further expanded to lower the overall cost of credit. In the interim, credit risk management must be strengthened and could be supplemented with guarantee schemes in key sectors perceived to carry elevated levels of credit risk.

10. **Financial sector infrastructure development efforts have lagged.** To support comprehensive growth in the financial sector, the government will need to support development with legislation to enable market innovation and diversification. For example, Cambodia currently has no comprehensive trust law, which is necessary to support corporate and asset-backed securities. In addition, the government will need to continue upgrading financial market infrastructure, and in particular the clearing and payment system, toward internationally recognized standards and norms. At the same time, more needs to be done to foster an enabling environment for mobile money and cashless payments systems to bring banking services to the rural, underserved poor.<sup>7</sup> The credit bureau should be expanded to capture a broader spectrum of borrowers, and weaknesses in the conduct of anti-money-laundering activities should be addressed to reduce risk to the sector's large contingent of foreign participants, in particular the global banking franchises.

## 2. Government's Sector Strategy

11. The development of Cambodia's financial sector is based on a 10-year rolling financial

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<sup>5</sup> The Rural Development Bank is the only state-owned bank in Cambodia, and the only bank with such a mandate. This is a striking contrast with Cambodia's neighbor, Viet Nam, where state-owned policy banks dominate the banking subsector.

<sup>6</sup> The government bond market will work as a liquidity provision measure for the banking subsector and give the central bank the important policy tool to implement monetary policies and the basis for the yield curve for various financial market products, including corporate bonds.

<sup>7</sup> The recent upgrade of the national payments system has helped stimulate the mobile banking market and has increased the volume of funds transferred through electronic systems and money exchange services.

sector development strategy (FSDS), which is currently being updated as the FSDS, 2016–2025. The objective of the FSDS, 2016–2025 is to develop a sound financial sector that can contribute to poverty reduction by supporting economic growth and increasing poor people’s access to finance. This objective is aligned with the government’s Rectangular Strategy for Growth, Employment, Equity and Efficiency, and the National Strategic Development Plan, 2014–2018, which is the operation plan.<sup>8</sup> The government has made substantial achievements in the financial sector since 2001 but significant challenges remain. The updated FSDS prioritizes a number of key initiatives, including rapid diversification of the financial industry, including the development of the nonbanking subsector and capital markets. Regulations and supervision will be strengthened to international standards to support the delivery of new financial services and products, and a formal crisis management mechanism will be completed.

### 3. ADB Sector Experience and Assistance Program

12. ADB is Cambodia’s leading development partner in the financial sector. Beginning in 2001, the first Financial Sector Program established a legal and regulatory foundation for banking, insurance, and commercial development; encouraged consolidation in the banking subsector; and introduced key financial market infrastructure.<sup>9</sup> The Second Financial Sector Program supported the modernization of the payment, clearing, and settlement system.<sup>10</sup> Uniform accounting standards for the banking subsector, compatible with International Financial Reporting Standards, were introduced. Seven commercial banks started to extend credit to MFIs and four MFIs upgraded to become licensed deposit-taking financial institutions. Preparatory work was begun to establish a financial intelligence unit to support the government’s anti-money-laundering efforts. The Third Financial Sector Program expanded reforms undertaken in previous programs, initiated ADB’s first support to the nonbank financial subsector, and incorporated the recommendations of Cambodia’s first Financial Sector Assessment Program.<sup>11</sup>

13. There have been three independent program performance evaluation reviews covering the first three Financial Sector Programs and all three programs were rated *highly successful*.<sup>12</sup> Recommendations from the most recent program performance evaluation review noted a need to monitor program objectives closely as part of the policy dialogue under the post-program partnership framework, especially with regard to adequate resource allocation for financial sector supervision given the expanding scope of the financial sector in Cambodia. Likewise, the 2009 country assistance program evaluation noted that ADB assistance made an important contribution to planning and guiding sector reform, as a result of the development of the financial sector blueprint and small and medium-sized enterprise development framework. The evaluation also noted that ADB’s assistance also made an important contribution to improving access to finance throughout Cambodia.

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<sup>8</sup> The National Strategic Development Plan, 2014–2018, which will make the Rectangular Strategy for Growth, Employment, Equity and Efficiency operational, has the overarching objective of reducing poverty to about 15% by 2018.

<sup>9</sup> ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan Cluster to the Kingdom of Cambodia for the Financial Sector Program*. Manila.

<sup>10</sup> ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan Cluster to the Kingdom of Cambodia for the Second Financial Sector Program*. Manila.

<sup>11</sup> ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan Cluster to the Kingdom of Cambodia for the Third Financial Sector Program*. Manila.

<sup>12</sup> ADB. 2008. *Completion Report: First Financial Program Cluster*. Manila; ADB. 2011. *Completion Report: Second Financial Program Cluster*. Manila; ADB. 2016. *Completion Report: Third Financial Program Cluster*. Manila.

**Problem Tree for Finance Sector**

