

## SECTOR ASSESSMENT (SUMMARY): FINANCE<sup>1</sup>

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

1. **Overall finance sector.** Since the political instability and institutional destruction of the late 1970s and early 1980s, Cambodia's finance sector has been undergoing rapid development driven by strong private sector participation. As of 2013, the formal financial system comprised the National Bank of Cambodia (NBC), 35 private commercial banks, 9 specialized financial institutions, 38 licensed and 35 registered microfinance institutions (MFIs), and 12 insurance companies. The government also took the necessary initial steps to develop a capital market, including the adoption of a Securities Law (2007) and formation of a Securities and Exchange Commission in 2009. The predominantly rural nature of the economy, high transaction costs, and low creditor confidence had been the main causes of low formal intermediation and outreach within the sector.

2. **Sector performance satisfactory but challenging.** Financial deepening has accelerated thanks to a reasonably strong banking subsector and the promotion of more financial services through the progressive reforms implemented under the first and second financial sector programs of the Asian Development Bank (ADB), which began in 2001 and ended in December 2010. Broad money supply (M2) as a percentage of gross domestic product (GDP) has risen from 13.0% in 2001 to 53.0% in 2013. Credit to the private sector has correspondingly risen from 6.0% of GDP in 2001 to 47.7% of GDP in 2013, and total deposits reached 49.1% of GDP in 2013 compared with 10.4% of GDP in 2001. ADB's Third Financial Sector Program was approved in November 2011 and is ongoing. The number of financial institutions increased, including the number of foreign-owned banks. This has substantially bolstered financial intermediation. Despite these positive developments, policy gaps, implementation challenges, and capacity constraints still need to be overcome in each of the subsectors.

3. **Banking system.** No legal barriers prevent the entry of foreign banks. Most of the 32 private commercial banks have majority foreign ownership. The seven specialized banks in Cambodia include one state-owned bank—the Rural Development Bank—and six privately owned banks. Total bank assets represented about 82.8% of the estimated GDP in 2013, compared with 21% in 2003—a marked improvement in public confidence in the banking system. Recent performance indicators suggest that the banking system is reasonably profitable, efficient, has adequate liquidity, and is well capitalized. On average, banks have maintained overall solvency at more than 20% since 2004 (24.8% in 2013), above the minimum prudential requirement of 15%. Furthermore, the capital requirement for banks that are owned by nonbank entities recently tripled from \$13 million equivalent as a precaution against potential shocks. The reported nonperforming loan (NPL) ratio of banks has decreased from 4.4% in December 2009 to 2.7% in 2013. Banks have been free to set their own interest rates since 1995. The increased number of banks has sparked competition and the average annual interest rate spread has declined from 15.2% in 2004 to 7.1% in 2013. However, there is still evidence of market segmentation. With the exception of the Rural Development Bank, the banking system is entirely owned by the private sector.

4. **Microfinance.** Microfinance is growing rapidly with total loans expanding at approximately 50% in 2011. The expansion is allowing microfinance to support and boost the economy, especially in its target market, which comprises the poor and remote rural population.

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<sup>1</sup> This summary is based on inputs from Asian Development Bank staff.

The microfinance subsector in 2013 consisted of 38 licensed MFIs and 35 registered rural credit operations spread across the country. Registration and licensing commenced in 2002. Some have transitioned from aid-focused nongovernment organizations to commercial MFIs, and some continue to operate as commercial, profit-oriented MFIs, much like originally set up. Most MFIs have plans to rapidly expand by either establishing additional branches or by increasing lending activities at existing branches. In 2013, Cambodia boasted 2,217 licensed MFI branches, compared with 727 branches in 2006.

5. The number of active MFI borrowers who took advantage of rural household credits, credit for agriculture, and small-business loans increased from 471,000 in 2006 to more than 1.55 million in 2013—or 10.5% of the total population of 14.74 million in 2012—with potential for further growth. Microfinance lending also grew from \$92.2 million in 2006 to \$1,317.1 million in 2013, with reported NPLs declining from 2.8% in 2009 to 0.6% in 2013. In 2013, 38% of the outstanding MFI loans were for agriculture, 23% were for trade and commercial activities, and 39% were for other services. Voluntary savings remain very small, and access to local finance by MFIs has been limited. With technical assistance from ADB,<sup>2</sup> the NBC issued a *prakas*<sup>3</sup> in December 2007 setting out the criteria for MFIs that are eligible to mobilize voluntary public savings. NBC granted licenses to seven MFIs to mobilize savings from the public. With the NBC's encouragement, several commercial banks have begun to provide credit facilities to MFIs.

6. **Insurance.** The Department of Financial Industry within the Ministry of Economy and Finance (MEF) is responsible for prudential regulation and supervision of the insurance industry, which consists of six private nonlife insurance companies and a reinsurance company that is 80% state-owned. The insurance industry is young and small in size with a total premium income of \$45.6 million in 2013. The regulator requires the capital of each company to be distributed as follows: 10% deposited with the NBC, 50% deposited in commercial banks, and the remaining 40% invested at the discretion of the respective insurance company. MEF initiated a revision of the insurance law with technical support from ADB. The revised law was submitted to the Council of Ministers in October 2010, mainly to establish a life insurance sector in Cambodia. One state majority owned JV life insurance company started its operation in 2012 and a few major foreign players followed.

7. **Capital market.** The Securities Exchange Commission of Cambodia (SECC) was established in July 2008 as part of the implementation of the Financial Sector Development Strategy (FSDS), 2006–2015. SECC is mandated to supervise the operations of the securities market. Supported by a newly developed legal and regulatory framework, SECC granted licenses to 15 securities firms in October 2010, including underwriters, dealers, brokers, and investment advisors. The Cambodia Securities Exchange opened in 2011 and began trading in April 2012. The second IPO took place in June 2014. SECC is also working on the promotion of corporate governance and consumer protection in the capital market development.

8. **Development hurdles in Cambodia's finance sector.** The following four groups of issues adequately summarize the hurdles faced by the proposed subprogram 3 (the problem tree in this linked document illustrates the sector's overall issues):

- (i) **Systemic risk.** While currently limited and manageable, systemic risk is a concern owing to (i) heavy dollarization, (ii) high concentration of deposits and assets in five banks, and (iii) rapid expansion of private sector credit with high

<sup>2</sup> ADB. 2005. *Technical Assistance to the Kingdom of Cambodia for Developing Deposit Services in Rural Cambodia*. Manila (TA 4755-CAM).

<sup>3</sup> Khmer term for regulations or instructions issued by the NBC governor or a government minister.

- exposure to vulnerable sectors (real estate, garment industry, and tourism).
- (ii) **High information costs.** These stem from weak compliance by corporate entities with the Cambodian accounting and auditing standards, early phases of borrower transparency, and limited infrastructure for information exchange. Although standards have been introduced, few enterprises (including small and medium-sized ones) have begun producing financial statements. In close cooperation between the NBC and the Association of Banks (ABC), a pilot online credit information sharing system was established in August 2006 to support the credit appraisal processes of participating banks. The NBC is now working with the ABC and the Cambodian Microfinance Association to establish a credit information bureau owned by the private sector.
  - (iii) **Moderate to high operating costs.** These constrain financial sector efficiency due to (i) the rural and informal nature of the economy, (ii) a lack of return opportunities for idle funds, and (iii) conservative prudential regulations. Banks, MFIs, and insurance companies still operate with high margins.
  - (iv) **Weak human and technical capacity.** This is manifest throughout the finance sector, the real sector, and government. While the open policy toward foreign banks has attracted a cadre of professional bankers to fill senior positions, qualified staff at functional levels in banks, regulatory agencies, and commercial enterprises is scarce.

## 2. Government's Sector Strategy

9. **Policy and planning tools.** The government launched the new National Strategy and Development Plan, 2014–2018 (NSDP 2014-2018) in July 2014, with the overarching objective of gaining the benefits from ASEAN Economic Integration in 2015 and reaching upper middle-income status in 2030. The policy priorities of NSDP 2014–2018 intersect closely with ADB's Strategy 2020, especially in the core areas of infrastructure, education, and finance. The government seeks a new development paradigm to respond to changes in the global economy, to strengthen resilience to external shocks, and to achieve higher quality growth. The FSDS, 2011–2020 is aligned with the NSDP 2014–2018 and it prioritizes the Government's reform agenda in financial sector and is a manifestation of strengthened government ownership and increased potential for development partner alignment.

10. **Accelerating and diversifying growth.** The government is committed to developing the finance sector as outlined in the NSDP. Its Vision and Financial Sector Development Plan for 2001–2010 (Blueprint) and the updated Blueprint, known as the FSDS 2006–2015, provided a long-term strategy and a framework of reforms. Those have been updated to take into account the acceleration of Cambodia's economic development, challenges faced during implementation, and the needs of the country. The updated FSDS for 2011–2020 was approved by the Council of Ministers in November 2011 and officially launched by the Deputy Prime Minister in July 2012. It features a coherent, pragmatic, and sustainable approach to finance sector development and was formulated with technical support from ADB.

## 3. ADB Sector Experience and Assistance Program

11. ADB's involvement in the development of the 2001–2010 Blueprint helped crystallize the vision, objectives, and framework for the government's finance sector reforms. While this framework belonged to the government and proved a useful guide, other development partners viewed it as ADB owned and held that its implementation should be fully financed by ADB. As a result of lessons learned during the implementation of the first Financial Sector Program, the

Blueprint was updated and became the FSDS 2006–2015. It reprioritized the government's reform agenda in the finance sector and manifested strengthened government ownership and increased potential for development partner buy-in. The latest update is the FSDS 2011–2020.

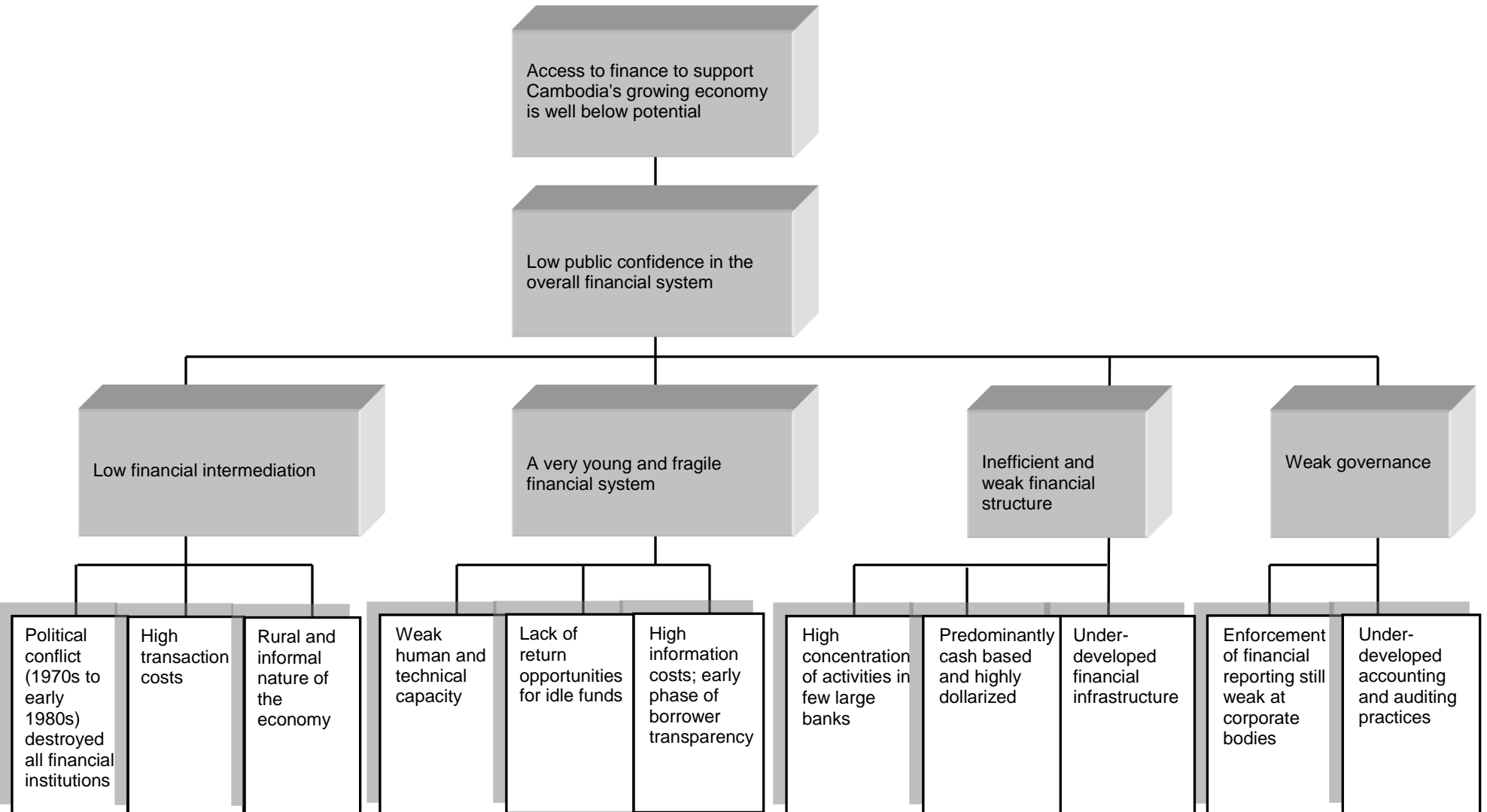
12. In line with the objectives of all three financial sector programs, the government adopted legal, policy, and institutional measures, many of which were relatively new concepts and therefore required extensive coordination and consultation to ascertain stakeholders' understanding, acceptance, and adoption. Substantial TA support ensured that best practices were incorporated and then consolidated throughout implementation to achieve the intended results. ADB's involvement has expedited the legislative process and has resulted in the timely enactment of key commercial laws. The program cluster approach provides flexibility and allows more effective design of reform measures in a changing political, economic, and financial environment. Progress in all areas of finance sector reform, and particularly in the banking and microfinance subsectors, has been significant. The presence of international banks, the provision of more sophisticated products and services to depositors, and an increase in lending demonstrate growing public confidence in the financial system.

13. The 2009 performance evaluation review of the first program noted the time lag between the implementation of reforms and their actual enforcement or comprehensive compliance with them. The delays in enforcement of commercial laws and comprehensive application of compulsory insurance, credit information system, interbank market, and accounting and auditing standards were specifically mentioned, as these could weaken the effectiveness of the overall program. The enforcement of commercial laws, however, relates to the development of the judicial system as a whole and involves projects funded and implemented by other multilateral and bilateral development partners. The design of the second program took into account the progressive enforcement of the remaining reforms toward wider compliance in the sector and identified a suite of TA projects to support implementation. The 2009 country assistance program evaluation (CAPE) noted that ADB assistance had made an important contribution to planning and guiding sector reforms by helping formulate the Blueprint and a framework for developing small and medium-sized enterprises.<sup>4</sup> ADB assistance also significantly helped improve access to finance throughout Cambodia. ADB will also support the implementation of the FSDS 2011–2020.

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<sup>4</sup> ADB. 2009. *Country Assistance Program Evaluation for Cambodia*. Manila.

## Problem Tree for Finance Sector



## Finance Sector Road Map and Results Framework

Country Sector Outcomes Supported by ADB	Country Sector Outcomes Indicators with Targets & Baselines	Country Sector Outputs Supported by ADB	Country Sector Outputs Indicators with Incremental Targets	ADB Sector Operations Planned and Ongoing ADB Interventions	ADB Sector Operations Main Outputs Expected from ADB Interventions
Increased size, efficiency, and resilience of financial system	Access to credit increased to 12% of total population by 2013 (2010 baseline: 9.1%)	Modernized payment, clearance, and settlement system	<u>By 2013</u> Number of checks cleared daily increased by 10% (2010 baseline: 2,195 checks)	<b>(i) Planned Key Activity Areas:</b>  Upgrade payment instruments and clearance system Capacity building support for supervision staff Scholarships for accounting training Submit revised laws to COM and NA Workshops and training on operating the credit bureau  <b>(ii) Projects in the Pipeline</b> PPTA (2014-2015) to prepare the next program  <b>(iii) Ongoing Projects</b> FSP III SP 3 with CDTA (2013-2014)	Full solution system for check clearance installed and operational by 2013 Credit bureau established and operational by 2013 Revised banking and insurance laws with implementing regulations adopted and implemented by 2013 Management information system of NBC computerized and information technology division upgraded to a department by 2012 Banks and MFIs are using the credit information by 2012 More Cambodians qualified as CPAs and CATs by 2013
	100% of banks and MFIs meet minimum capital adequacy ratio of 15% (2010 baseline: 31.4% for banks and 22% for MFIs)	Strengthened prudential supervision of banks and MFIs	Number of ATMs and EFTPOS increased by 10% (2010 baseline: 501 ATMs and 3,529 EFTPOS)		
	Bank average interest rate spread dropped to 10% by 2013 (2010 baseline: 12.7%)	Revised laws on banking and financial institutions, and insurance adopted	Prompt corrective action system and regular onsite reviews or inspections of banks implemented  Revised banking law and revised insurance law promulgated by 2012		
Number of microfinance loan accounts opened increased to 1.20 million by 2013 (2010 baseline: 1.02 million)	Improved accounting and auditing practices	Core banking system installed at NBC and rolled out to all branches	Number of qualified national accountants increased by 10% (2010 baseline: 47 national CPAs)		
		Private sector-owned credit information bureau established	100% of branches (including NBC headquarters) with core banking system fully installed and rolled out by 2011 (2010 baseline: NBC headquarters and 9 branches)  Credit bureau established by 2011 and used by 50% of banks and MFIs		

ADB = Asian Development Bank, CDTA = capacity development technical assistance, COM = Council of Ministers, CPA = certified public accountant, CTA = certified accounting technician, EFTPOS = electronic fund transfer point of sale, FSDDS = Financial Sector Development Strategy, FSP = Financial Sector Program, IT = information technology, MFI = microfinance institution, NA = National Assembly, NBC = National Bank of Cambodia, PPTA = project preparatory technical assistance, SP = subprogram.

Source: Asian Development Bank.