SUMMARY PROGRAM IMPACT ASSESSMENT

I. Introduction

1. This program impact assessment (PIA) presents the estimates of costs and benefits resulting from the Third Financial Sector Program (FSP III) on the economy. The framework used for the PIA draws on the regulatory impact assessment tool used by governments in over 50 countries to systematically identify and assess the expected costs and benefits of regulatory reforms. The PIA will help justify the loan amount for FSP III totaling $45 million equivalent (including $15 million for subprogram 3). The results of the PIA indicate that the FSP III could produce potential gains to the economy amounting to $125.0 million annually or 1.0% of GDP. The adjustment costs of the overall program are estimated at $59.0 million indicating a substantial net benefit to the economy.

2. The PIA framework includes: defining the sector challenges, defining the FSP III expected impact and outcome, analyzing the options with least costs towards achieving the expected outcomes, and assessing the benefits and costs of the proposed program. The PIA also discusses the pro-poor features of the Program and describes the transmission by which the FSP III will contribute to poverty reduction in the short to medium term.

II. Program Impact Assessment - The Developmental Impact of the Program

3. This section summarizes the challenges, identifies the intended impact and outcome of the proposed FSP III, options reviewed, and estimates of the potential benefits and costs of the FSP III.

A. Finance Sector Challenges

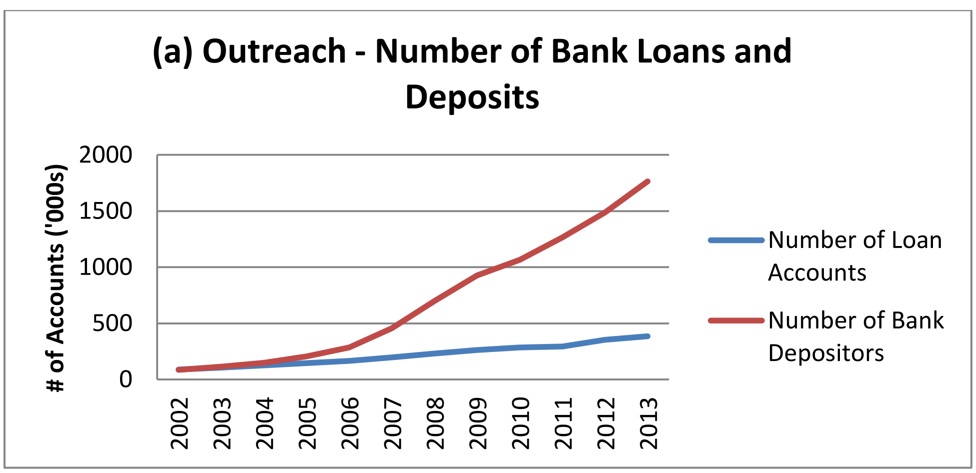
4. Cambodia's financial depth measured by financial assets to GDP is relatively low compared to regional neighbors. Like Viet Nam and Lao PDR, Cambodia's finance sector is at an early stage of development. It is also far less diverse compared to regional economies. Total bank assets are about 57% of GDP at the end of 2010, a little higher than Lao PDR, but well below that of neighboring countries—Hong Kong, China at 947% of GDP, Thailand at 227%, Philippines at 159%, and Viet Nam at 132%. The banking subsector dominates the finance sector and accounts for 95% of the finance sector assets. Currently there is no bond market in Cambodia. The Government does not issue bonds to finance its deficit until at least year 2018 according to the government Debt Management Strategy. Neither is there a fully functioning inter-bank market although a new NCD program has been introduced in 2012. On 11 July 2011, the government launched the Cambodian Securities Exchange jointly owned by the Ministry of Economy and Finance (MEF) (55%) and the Korea Exchange (45%), and finally commenced trading in April 2012. Once operational, it will contribute to diversification. The microfinance institution (MFI) subsector, while small, has grown rapidly in recent years boding well for economic development and poverty reduction. A consequence of the lack of depth and diversity is a relatively high, but interest rate margin has been declining due to the competition from new entries.

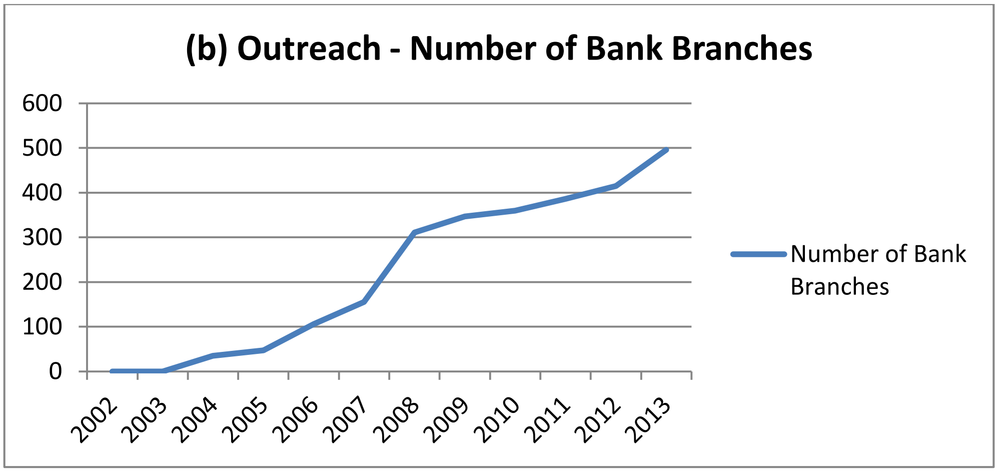
5. While Cambodia's finance sector is shallow and remains dominated by the banking subsector, it has grown exponentially during the period 2006 to 2013. Figures 1 and 2 present time trends in key finance sector indicators. Broad money supply, outstanding bank loans, and MFI loans have grown rapidly since 2005. Three features of these performance indicators

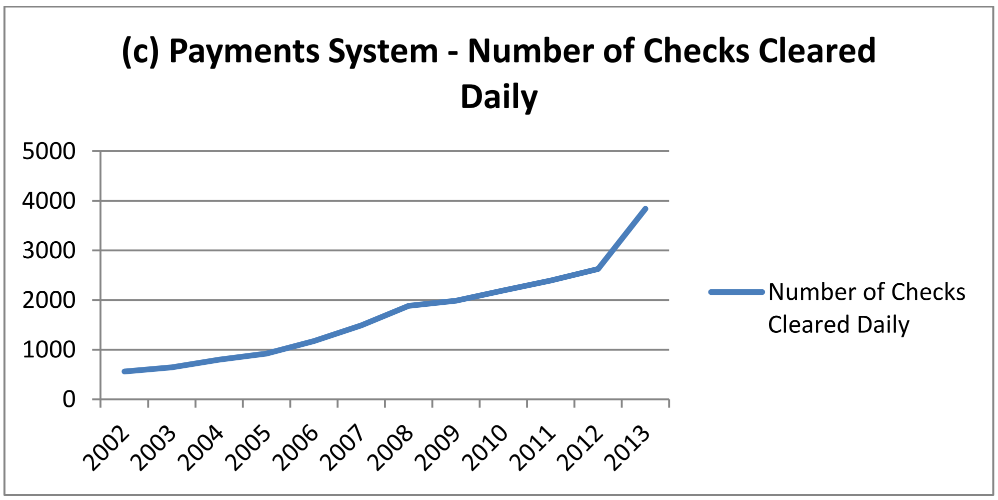
warrant emphasis. **First, outreach of financial services has also grown exponentially in the last five years**. The number of depositors in the banking system has almost tripled to over 1 million by 2010 and the number of loan accounts has doubled over the same period. **Indicators of inclusiveness of the poor in the finance sector have substantially improved**. The number of microfinance borrowers has doubled to almost 1 million from 2005 to 2010 with the value of MFI outstanding loans increasing tenfold to reach $439 million, and the number of depositors has increased 90.0% over the same period. **There have been improvements in finance sector efficiency as reflected in a long term decline in average interest margins (Figure 2)**. Increased competition, innovations (introduction of ATMs and debit cards, for example), and improvements in the payments system (reflective of increased and timely check clearances) have contributed to both operational and allocative efficiency and therefore improved margins. The banking system is relatively open with significant foreign investment in the sector and this has helped intensify competition and accelerate the diffusion of technology and innovations. In contrast to neighboring economies there is very limited state ownership in the Cambodian banking subsector and this has encouraged competitive banking practices.

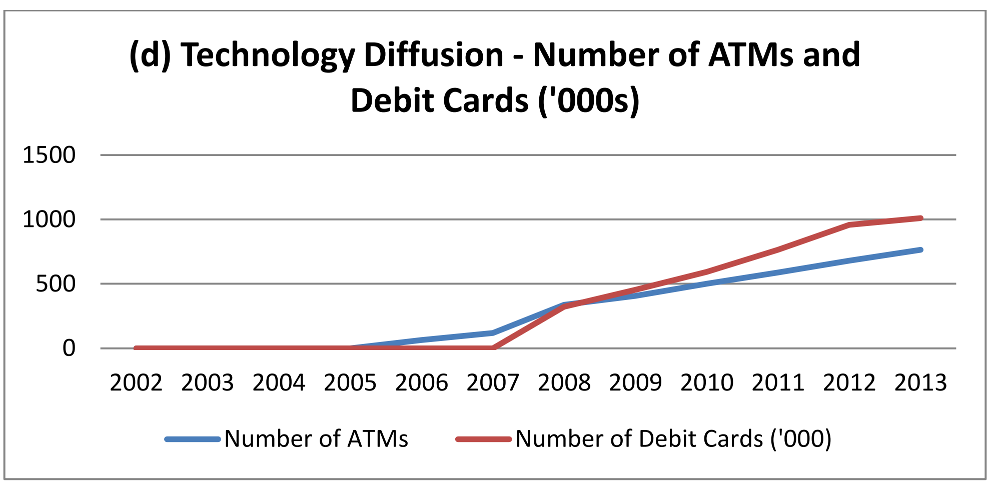
6. Despite the above, the relatively shallow depth and lack of diversity of Cambodia's finance sector is a drag on efficient investment and broad-based economic growth. Explanations for Cambodia's relatively shallow finance sector include the predominantly rural nature of the economy (85% of the population lives in rural areas), its stage of economic development (annual per capita income is about $800) and high transaction costs for financial intermediation because of the underdeveloped payments system and credit information bureau. The government recognizes these impediments and potential risks to financial system stability and its impact on the poor and has implemented a series of reforms over the last decade to develop the finance sector, increase inclusiveness of the poor and enhance stability. The government's short, medium and long term goals and road map for the finance sector are crystallized in its 10-year rolling Finance Sector Development Strategy (FSDS), last updated as the FSDS 2011–2020.

Figure 1: Development of the Finance Sector – Key indicators



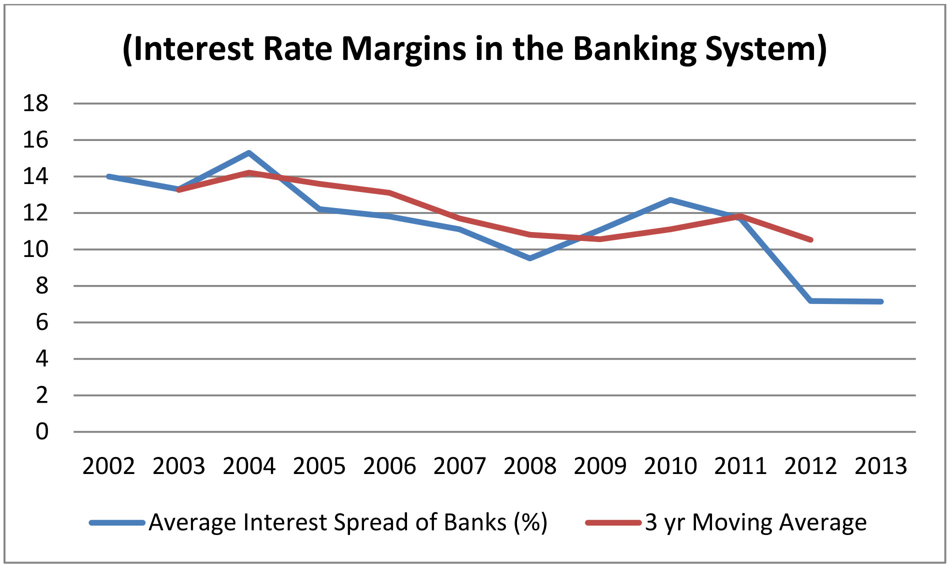






Source: National Bank of Cambodia and ADB staff estimates.

Figure 2: Efficiency in the Banking System



Note: The 3 year moving average illustrates the longer term trend in interest rate margins.
Source: National Bank Cambodia and ADB staff estimates.

B. Impact and Outcome

7. The impact of the FSP III is a sound, market-based finance sector to enhance resource mobilization and support sustainable growth. The expected outcome of the FSP III is a growing, resilient and efficient financial system.

C. Options

8. In formulating the FSP III, several options were considered. Consequently, the FSP III draws on ADB's experience with finance sector developments in the region and in implementing the previous FSP I and II in Cambodia. A key lesson is the recognition of the need to develop fundamental infrastructure and regulatory structure to support the operation of a competitive and efficient finance sector. Human resource development is critical in a post-conflict economy like Cambodia. In Cambodia the priority is to create the infrastructure for an efficient financial system (a modern payments system), establish the institutional base for the development of markets, continuously upgrade prudential regulations and further strengthen and clarify the supervisory functions of authorities to enhance financial system stability. Another general lesson is to develop an institutional framework comprising a mix of regulatory, industry self-regulatory, and non-regulatory initiatives to strengthen stability.

D. Impact Analysis

9. This section presents estimates of the economy-wide benefits and costs of the FSP III. The methodology used is to estimate potential benefits to the economy from implementing the reforms in the finance sector under FSP III. The immediate direct benefits from the FSP III reforms are the savings to investors, borrowers and households from lower cost of borrowing

and a larger variety of financial products to increase income and wealth. The estimated costs of the reforms are primarily the direct fiscal costs of selected reforms and investment on finance sector infrastructure, human resource development, and the short to medium-term costs of administering and enforcing reforms.

1. Estimating the economy-wide gains from the FSP III

10. Distortions in Cambodia's financial system impose several types of costs on the economy that could reduce long-term economic growth. The first is the cost of operating inefficiencies. Channeling funds from savers to borrowers has a cost in every financial system, but this cost is higher in financial systems with a payments system that is underdeveloped and relatively more costly to operate, a corporate governance environment that is evolving, and where equity and core financial markets are absent. Reforms in these areas can raise operating efficiency of intermediation, and the cost savings are passed to households in the form of higher return on savings and to investors in the form of lower cost of capital.

11. The major inefficiencies in the banking subsector appear to be operational arising from the underdeveloped payments system and absence of core financial markets such as inter-bank credit market, money market, bond and equity markets. Allocative inefficiencies are a lower order problem as the banking system is relatively open to foreign investment, and there is no significant state ownership of the banking subsector that is usually associated with directed lending and anti-competitive practices experienced in some neighboring countries. Further recent reforms have removed restrictions on branching of MFIs and deposit mobilization. Reforms focusing on improving the operational efficiency of the banking system and the MFI subsector, strengthening finance sector prudential regulations, and incentives framework would reduce the costs of intermediation and enhance efficiency thereby deepening and diversifying the finance sector.

12. Table 1 presents some quantifiable (gross) gains to Cambodia from the reforms to be implemented under FSP III which are aimed at improving efficiency and inclusive access to more affordable products and services from the formal finance sector. Such reforms could create *direct* gains in the order of $125.0 million at the completion of the Program, or about 1.0% of GDP equivalent. The potential gain comprises reduced interest margins from the private loans of the banking and MFI subsectors. The estimated figure ignores the potentially larger, second-round effects such as the stimulation to investment through increased mobilization of savings and lower cost of capital, and increased employment within and outside of the sector.

Table 1: Cambodia: Potential Economic Gains from Finance Sector Reforms and Contribution from the FSP III

	Short to medium term gains under the FSP III [a]	**% of GDP**
1. Improve banking subsector efficiency resulting in reduced interest margin	$110.6 million	0.9%
2. Improve MFI subsector efficiency resulting in reduced interest margin	$14.4 million	0.1%
Total Gains	**$125.0 million**	**1.0%**

[a] This refers to estimates of potential gains from the FSP III program. The interest margin is expected to decline while the level of loan stock will rise during the program period.
Source: ADB Staff estimates.

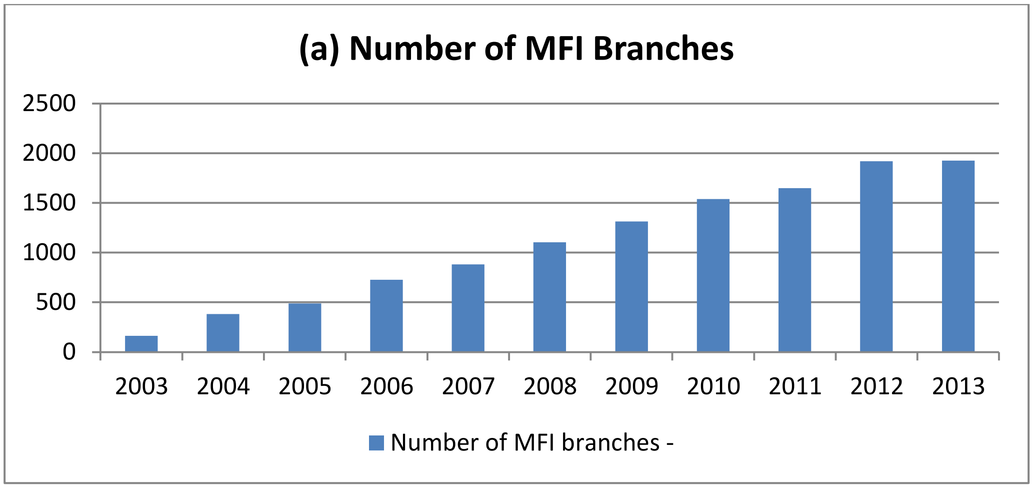
13. **Improved banking efficiency under FSP III could add as much as $110.6 million to GDP annually.** Reforms and measures that build the payments system, inter-bank, money and securities markets, improve corporate governance, and the incentives framework facing banks and other financial institutions would lower the cost of intermediation and this would be reflected in narrowing the spread between domestic lending and deposit rates. It is expected that interest margins will continue to narrow by almost 3% between 2010 and 2014 as these reforms lock in further efficiency gains in the banking system. We assume these reforms will also increase the level of lending to at least 35% of GDP at the conclusion of the FSP III. The average annual volume of banking loans combined with the expected reduction in interest margin will add $110.6 million to GDP annually.

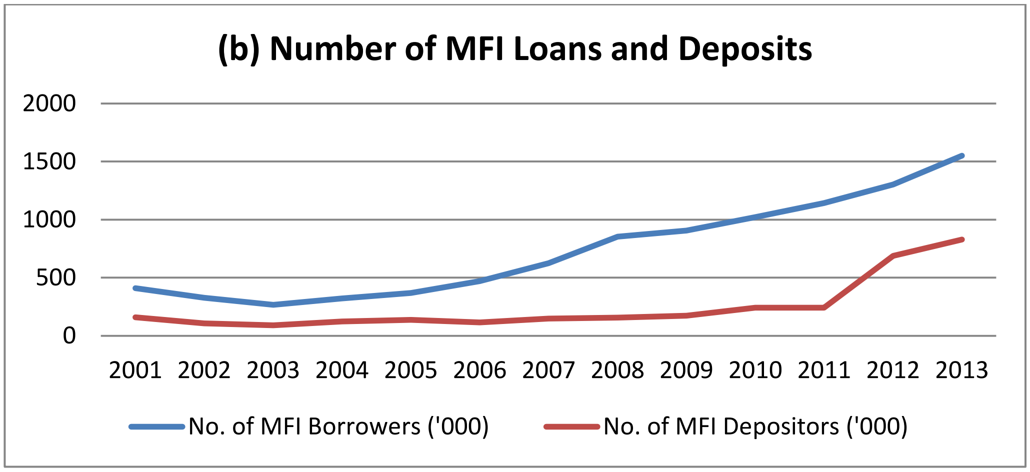
14. **Improved MFI efficiency under FSP III could add as much as $14.4 million to GDP annually.** Reforms and measures that expand the outreach of MFIs and improve their operational efficiency would increase access to finance for micro and SME enterprises and lower the cost of intermediation in this sector. These improvements would be reflected in both the MFI credit growth rate and the narrowing of the spread between domestic lending and deposit rates. Reforms under FSP III will help reduce interest margins between 2.0% to 4.0% and increase lending and deposit mobilization. Given Cambodia's volume of outstanding MFI loans in 2010 of $439 million which could grow by 6% annually, this reduction in interest margins adds $14.4 million to GDP annually.

2. Contribution to Poverty Reduction

15. **The FSP III would have a positive impact on reducing poverty and inequality through the creation of direct and indirect benefits to poor households.** It would contribute to sustainable reduction in poverty in the short and medium term through two channels. ***The first channel is through higher and sustained longer term economic growth*****.** By developing the banking and financial market infrastructure and developing new products, financial deepening and diversity will increase, operating inefficiencies in the finance sector will be reduced and these in turn will increase domestic financing of public and private investments thereby resulting in higher economic growth. ***The second channel is through inclusiveness of the poor in the formal finance sector*****.** By eliminating restrictions on bank branching and deposit mobilization by MFIs (as well as enhancing prudential supervision of MFIs), and improving public awareness of financial products, the savings rate and interest income of poor households and their access to credit will increase over time. Figure 3 shows the rapid expansion in the coverage of financial services to the poor since 2002 through the rapid growth in the number of MFI branches, the number of loan accounts and depositors at MFIs. All these indicate improved services and wider inclusiveness of the poor in the formal finance sector.

Figure 3: Inclusiveness of the Poor in the Finance Sector – Key Indicators





Source: CEIC and ADB staff estimates.

3. Estimating the economy-wide costs from the FSP III

16. The Government, relevant statutory agencies, banks and financial institutions are likely to bear most of the FSP III costs. These costs are identified as follows:

(a) Costs to Government and statutory agencies - $31.5 million: (i) Investment and administrative Costs - $26.5 million (costs to upgrade the payment, clearance and settlement system; Government administrative costs in drafting new legislation, and amendments to existing laws, new regulations and circulars; investment costs in enhancing NBC, MEF and SECC technical capacity; operating the arbitration center; investment costs in establishing the inter-bank credit market and government securities market; public education and dissemination of new policies; staffing and operational costs for CAFIU; (ii) Recurring and enforcements costs - $5.0 million (NBC's enhanced legal powers and institutional capacity to supervise banks and MFIs, enforcement of newly enacted laws and prudential regulations; MEF and SECC capacity development, accounting and CFA scholarship program).

(b) Costs to Private banks and financial institutions - $27.5 million: (i) Investment and administrative costs - $3.5 million (operate the Credit Bureau Cambodia, upgrade of MIS); (ii) Business compliance costs - $24.0 million (Banks, MFIs and insurance companies undertake annual external financial audits, banks and financial institutions produce regular prudential and AML reports, costs from additional responsibilities to implement standardized re-purchase agreements, new licensing requirements, improve corporate governance, to meet credit reporting requirements, to meet updated payment and settlement system, to meet the requirements of the new laws and regulations, etc.).