A STUDY ON TRANSFORMATION OF THE BANKING SYSTEM IN CAMBODIA

By

CHHUN Vattana

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
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MASTER OF BUSINESS ADMINISTRATION

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ABSTRACT

In a market-oriented economy, the banking sector plays an essential role in facilitating payments and intermediating between savers and investors and in allocating credits by relative risk and return to efficient economic agents. A sound banking sector thus contributes to the smooth operation of the economy and to economic welfare. Cambodia has been transformed a monobanking system into a two-tier banking system since 1989, as a result of changing in central planning economy to market economy during 1989. Considering that the proliferation of banks during this period left Cambodia with an excessively large number of banks relative to its size and development and Cambodia still has one of the lowest rates of banking intermediation in the world, we attempt to find a key challenge and option for further reform toward safety net and sound banking system in Cambodia. The analytical results show that the financial health of the banking sector by itself is not enough to promote Cambodia's development, no financial safety nets, such as deposit guarantee schemes and lending-of-last-resort facilities, and lack of some legal frameworks to protect banking system as a whole. To overcome these impediments, the Royal Government of Cambodia has adopted "Financial Sector Blueprint for 2001-2010" and the central bank has implemented in recent years policies akin to those of bank restructuring, in particular with respect to re-licensing. The paper concludes that further banking reform policy and legal frameworks have been appropriate for Cambodia's circumstances.

To

My Mother, Wife, Daughter, Son

And

All My Professors

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List of Abbreviations

NBC	:	National Bank of Cambodia
RDB	:	Rural Development Bank
NGO	:	Non-Government Organization
FTB	:	Foreign Trade Bank
PNBC	:	People's National Bank of Cambodia
ESAF	:	Enhanced Structural Adjustment Facility
IMF	:	Internal Monetary Fund
MFIs	:	Micro-Financing Institutions
LMCs	:	Low Mekong Countries
SOE	:	State Own Enterprise
SOCB	:	State Own Commercial Bank

CHAPTER I

INTRODUCTION

1. Purpose of the Thesis

Cambodia became independent from France in 1953 and experienced a 17-year period of relative political stability and steady economic growth, starting from a development base similar, if not superior, to that of other countries in South East Asia. During that period, the riel was the legal tender and was used both for financial transactions and as a store of value. Following the March 1970 coup d'état that topple the Government, the country was quickly drawn into the international turmoil of the subregion, and eventually into a civil war.

The extreme revolutionary experience (an "agrarian moneyless society") of Khmers Rouges during 1975-79 involved bans, inter alias, private property, banking, and money, and brought the country to utter economic and human disaster, during which an estimated one and a half million people, about one-fifth of the population, perished. The Khmer Rouges were driven out of most parts of Cambodia by the Vietnamese in 1979.

Since the mid 1980s, Cambodia has embarked on economic reforms and reached a no-U turn in 1989, when private property rights were restored and price control was abolished. State-owned enterprises were privatized and increased incentives were provided to local and foreign private investment. After the 1993 general elections, the newly formed Royal Government of Cambodia (the Government) began formulating a comprehensive macroeconomic and structural reform and achieved some significant success in stabilizing the economy. The economy has expanded rapidly during the first half of 1990s.

Progress was also made in implementing structural reforms: a two-tier banking system is being put in place and new large denominated banknotes were introduced to promote “de-dolarization”. The banking sector in particular needs strengthening, given its current low level of development and its dominant position in the present financial system. Cambodia’s banking system was thus transformed from a monobanking system into a two-tier banking system by separating the central bank functions from commercial banking activities. To support the reform, legislative framework has been improved.

To strengthen the banking system in the earlier 2000 the National Bank of Cambodia (NBC) introduced banking-restructuring program, requiring the existing banks to increase their capital base and to comply with relevant laws and regulations. As a result, in November 2000, nineteen banks were allowed to continue operations, while twelve others were de-licensed and put under liquidation procedure. With these actions, the Government has in mind to bring up all existing banks to a higher standard, improving the soundness and reliability of the banking system, which is crucial for confidence building.

However, Cambodia financial sector is at a rudimentary stage, with limited financial intermediation which played only a limited role in facilitating economic development. Due to the weak business and regulatory environment, public confidence in banking system, as well as mutual confidence among banks, remained very low, and financial intermediation by the banking sector continued to be marginal.

Cambodia still has one of the lowest rates of banking intermediation in the world: bank loans and deposits account for approximately 8 percent and 12 percent of gross domestic product, respectively. Lending activities of banks continue to stagnate. The proliferation of banks before bank restructuring left Cambodia with an excessively large number of banks relative to its size and development.

After banking reform during 2000, still many things remain to be done toward sound and safe banking system in Cambodia including dollarization of economy and monetary policy; short of savings and excess liquidity; a high cost of resources; an insufficient absorptive capacity; high lending rates; lack of borrowers' information; a lack of common accounting standards; a lack of legal environment; and the public confidence in the judicial system is very low.

The purpose of my thesis is to study on transformation of the banking system in Cambodia in order to find key challenges and options for further reform toward sound and safe banking system. In particular, I would like to study the following issues including the past and current situation of the banking system in Cambodia, the banking reform in Cambodia, the possibility for further reform toward bank soundness in Cambodia, and finding the way forward for Cambodian banking system.

In conclusion, my ultimate goal is to find the direction for Cambodian banking sector, by examining the current issues of banking sector, analyzing some key indicators and making cross-country comparison of banking reform in Low Mekong Countries (LMCs) in order to find safety net for further reforms.

2. Organization of the Study

Organization of the thesis is as follows:

Chapter I will cover the purpose and overview of this thesis.

Chapter II will examine the past and current banking system and the banking reform in Cambodia. This chapter will focus on explaining the transformation of the banking sector and finding the key challenges and options for further reform and development.

Chapter III will analyze the selected ratios of banking sectors and compare the banking reform in the Cambodia with Loa P.D.R and Vietnam in order to find the remaining issues for further reform toward sound and safe banking system in Cambodia.

Chapter IV is the conclusion. In this chapter, I will review the thesis briefly and give my opinion on the main problem of banking system in Cambodia.

CHAPTER II

BACKGROUND AND REFORM OF THE BANKING SYSTEM

1. Brief History of Banking System in Cambodia

After gaining independence in 1953, Cambodia’s economy performed relatively well for about a decade until interventionist policies gained influence and banking, along with foreign trade, were nationalized in 1963. Increasing strife in the region also led to internal political turmoil, and hopes for economic revival were quashed as the civil war escalated in the early 1970s and Khmer Rouge eventually took over the country. The Khmer Rouge (1975-79), with a view to creating an agrarian moneyless society, launched a radical economic experiment, whereby private property was denied and money, banks and markets were abolished.

After 1979 Cambodia literally had to reconstruct its financial sector from scratch. Under the extreme revolutionary experience of the Khmer Rouge during 1975-79 money had been abolished and the central bank physically destroyed. In 1980, once the Khmer Rouge had been driven out of most parts of the country by the Vietnamese, the riel was reintroduced and state-owned mono-bank (the People's National Bank of Cambodia [PNBC]) was established. Credit allocation became dependent on central planning and had a purely accounting character. The mono-banking system had functions such as the monetary authority, the cashier of the Government in the form of the National Treasury, and the provider of banking services including credit, deposits and payment system.

During the 1980, therefore, there was only limited monetization of the economy and most non-plan transactions were based on barter or gold, with the later being the universal means of hoarding. During 1988-91, the Vietnamese disengagement left an unsettled political situation. Massive central bank financing of recurrent budget deficit during that period resulted in high inflation, in the range of 90-177% a year (end period), and in an erosion of public confidence in the national currency.

The breakup of monobank system started in 1989. Since 1989, the banking system had been gradually reformed through transforming the 20-provincial and municipal banks into specialized provincial and municipal banks and had been operating with economic and financial autonomy in their territory, the People's Bank of Cambodia had played its role as monetary authority to direct and supervise these banks.

In 1991, the first Commercial Bank (Cambodia Commercial Bank "CCB") was established under the form of state Joint Venture Bank for attracting investors and serving banking activity during the United Nations Transitional Authorities being present in Cambodia (UNTAC). In January 30, 1992, in the 22nd ordinary session, the 1st legislature, the National Assembly of the State of Cambodia adopted the Law on the Change of Organization’s name and duty of the Bank of Cambodia from the People's Bank of Cambodia to the National Bank of Cambodia, which was promulgated by the council of state in February 8, 1992.

The Paris peace accord on 23 October 1991 was a political detour of the transforming the economic regime from planning economy to free market economy that made the Cambodia’s banking system transformed from the mono-banking system to the 2-tier banking system. Furthermore the state had completely authorized the banking activities to be operated in Cambodia through establishing the commercial banks under the local laws or under the form of foreign bank’s branches.

These required the National Bank of Cambodia to strengthen its role in improving its management capacity to direct and supervise through having continuously made some Laws and Prakas (Regulations) including the Law on the Organization and Conduction of the National Bank of Cambodia adopted by National assembly on January 26, 1996; the Law on Foreign Exchange adopted by National Assembly on August 22, 1997; and the Law on Banking and Financial Institution adopted by National Assembly on November18, 1999.

Currently, the Cambodia's banking system consists of the National Bank of Cambodia, with 20 NBC provincial branches, 15 commercial banks, 3 specialized banks, 1 state-owned bank, 14 micro finance institutions, 2158 exchange bureaus and a decentralized system of 31registered NGOs engaging in rural financing.

2. Banking Reform in Cambodia

2.1. Initial Reform in the Banking Sector 1989-1999

The transition from a centrally planned to a market economy meant first of all a change in the allocation mechanism of financial resources through decentralization. Since, in the centrally planned economy, banks had no active role in allocation of financial resources this role was initially taken up by non-bank institutions because neither commercial nor central banking skills had yet been developed.

The initial reforms gave state-owned enterprises greater autonomy in directing and managing their own business, including financial autonomy, supported by the legal restoration of private property. For the first time since 1975 foreign investors were encouraged.

Within the financial sector, reforms in 1990 also gave greater autonomy to provincial and municipal branches o the mono-bank, allowing them to extend credit to all economic sectors. While some of them had sufficient deposits, most had borrowed substantial amounts from headquarters. Inefficiencies of administrative lending under the previous policy contributed to the build-up of non-performance loans in the state banks.

In 1991 the People's National Bank of Cambodia (PNBC), which is the central bank of Cambodia and the National Treasury were separated. Two commercial joint ventures between PNBC and private banks were established. In 1992, as foreign investors began to arrive, eight additional commercial banks followed. These were either locally incorporated or subsidiaries or branches of foreign banks.

In the same year PNBC reacquired its pre-Khmer Rouge name of National Bank of Cambodia. Under the 1992 central bank law, the authorized capital of NBC was set at five billion riels (approximately USD 3.7 million). This law gave it financial autonomy and divested it of commercial banking functions. However, it still lacked independence in formulating and conducting monetary policy, especially in relation to financing of the budget. The result of this deficiency was soon visible. With the collapse of Eastern Europe and the end of financial support from the former Soviet Union, pressure to undertake inflationary, in the range of 90-177% a year (end period) financing was aggravate.

Although the various measures taken throughout 1989-1992 had helped create a new environment in the banking sector, the legal and structural framework of this sector in place by early 1993 was not yet well adapted to the requirements of the market economy. Lack of appropriate skills in the sector and uncertainty at the political level about the issues that needed to be addressed had continued to this deficiency, as did exogenous factors such as the dilapidated infrastructure and macroeconomic instability.

Formation of the coalition government following the UN-sponsored general election in May 1993 marked the beginning of new era in the reform process. Assistance from leading countries in the Paris Club to help Cambodia clear its arrears with the IMF enabled the resumption of the relations with the latter. As a result, a more comprehensive economic program was developed under the Fund's Systematic Transformation Facility. The focus of financial and technical assistance under this facility was on development of macroeconomic policy and the establishment of a market-based administrative and structural framework, including restructuring the banking system in mid-1994 the IMF, together with NBC, produced a Policy Framework Paper containing comprehensive economic reform programs to be supported by the Fund's Enhanced Structural Adjustment Facility (ESAF).

Within the framework of the overall objectives of the economic reform, the objective envisaged for the banking sector was developing a modern banking system and promoting competition among commercial banks; and strengthening the legal and regulatory framework in order to ensure an effective and smooth conduct of central and commercial banking activities.

From 1994 to 2000, the number of banks increased rapidly (see figure 1). At the start of the process, the number of banks reached 33 in 1999 and 32 in 2000 due to the relaxation of requirements for obtaining a license, which was limited essentially to meeting a low minimum capital requirement condition. The size of the banking system in Cambodia, in terms of deposit base, grew from 8.86 percent of GDP in 1999 to 10.95 percent in 2000. This reflects that the public confidence in the banking system and mutual confidence among banks remain very low, and financial intermediation by the banking sector continued to be marginal. Moreover, the proliferation of banks during this period left Cambodia with an excessively large number of banks relative to its size and development.

2.2.Reform in Banking Sector from 2000 to Present

Following the adoption of the Banking and Financial Institutions Law in 1999, the banking system has undergone extensive restructuring. In 2000, the government embarked on a comprehensive bank restructuring program with the assistance of the Internal Monetary Fund (IMF). The series of banking reform in Cambodia consists of (i) re-licensing of commercial banks under the newly promulgated Banking and Financial Institutions Law; (ii) strengthening bank supervision; and (iii) reforming and eventually privatizing the state-owned bank.

2.2.1. Banking Reform under the new Banking and Financial Institutions Law

The Banking and Financial Institutions Law, was promulgated in November 1999, three years after its submission to the National Assembly. The new law provided a fundamental framework for banks' operations and the NBC's supervisions, which include: (i) the definition of banks and the scope of banking operations; (ii) the supervisory and regulatory power of the NBC, including the NBC's ability to impose disciplinary sanctions and penalties against noncompliant banks; (iii) requirements for the integrity of bank management; and (iv) bank liquidation procedures. The 1999 Financial Institutions Law led to a further extensive restructuring of the banking system. Taking into account the scope and risk of their operations, NBC set minimum capital requirements for different types of institutions as follows:

- for commercial banks and each of their branches: 50 billion riel (approx. $13 million)[1]
- for specialized banks: 10 billion riel, and

[1] Exchange rate: 1USD = 3900 riel

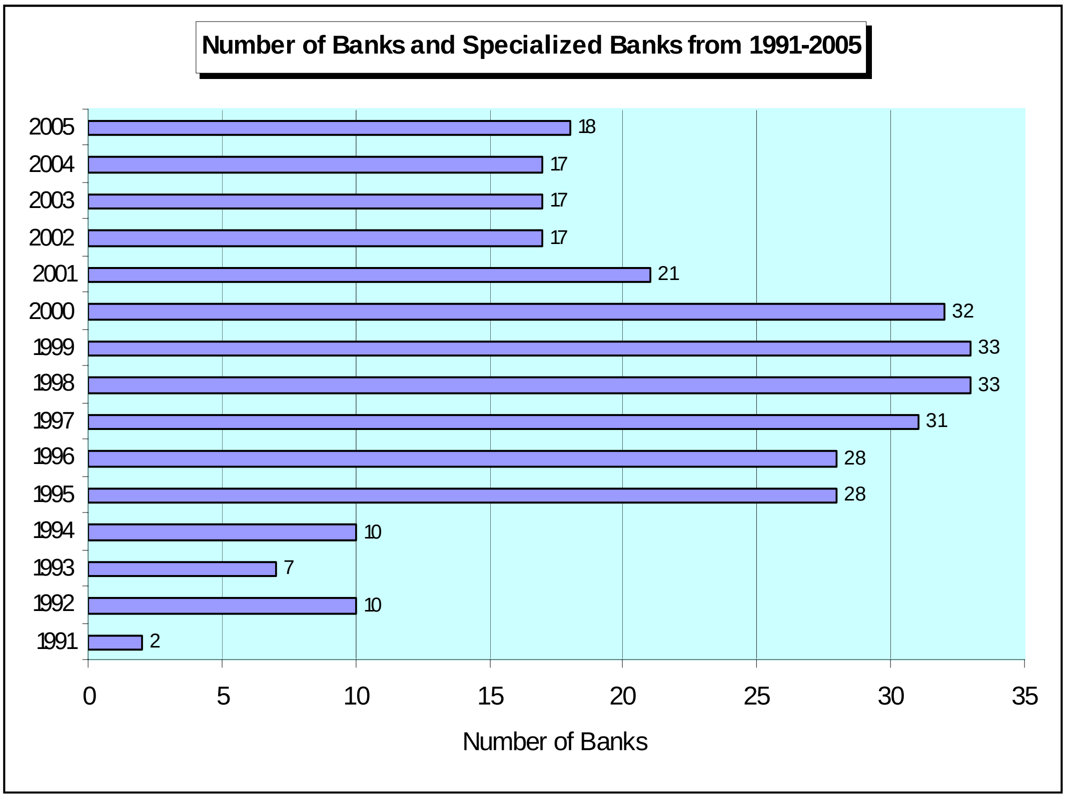
- for micro finance institutions: 250 million riel.

Under the new law, all private commercial banks were required to be re-licensed by the NBC. At end-1999, the Cambodian banking system consisted of 31 banks, comprising two state-owned banks, seven foreign bank branches, and 22 privately-owned commercial banks, and classified them into three categories: (i) viable and fully capitalized banks without need for restructuring; (ii) potentially viable banks requiring some corrective measures; and (iii) nonviable banks. Banks falling into the second category were asked to submit a memorandum of understanding to the NBC describing the details of their restructuring plan, including the timetable for capital increase to meet the new minimum capital requirement set at US$ 13 million. Banks falling into the third category were liquidated.

The re-licensing progress was completed in April, 2002. During the progress, the NBC closed 15 banks that were either insolvent or not in compliance with the law. Fourteen banks were awarded full banking licenses, and four banks were granted licenses to operate as specialized banks with restriction on the scope of their banking operations. In addition, two international banks with world-wide operations recently closed their branches in Cambodia as a result of a global strategic review of their operations by their respective headquarters. At the same time, a new local bank granted a banking license and started operations in November, 2002. As a consequence, Cambodia's banking system currently of 18 banks, comprising one state-owned bank, three foreign bank branches, fourteen locally incorporated commercial banks and four specialized banks.

The liquidation of nonviable banks is well under way, with 10 banks already completed. For the remaining five insolvent banks, four banks are under the liquidation process by the court, and one is being liquidated outside the court (see figure 1).

Figure 1: Total number of banks before and after banking reform



Source: National Bank of Cambodia

2.2.2. Strengthening Bank Supervision

Bank supervision is being strengthened on two fronts: (i) improving various prudential regulations; (ii) strengthening bank supervision capacity of the NBC. The Central Bank Law of 1996 and the Banking and Financial Institutions Law of 1999 provided an adequate legal framework for bank supervision. These laws were supplemented by a series of regulations issued in early 2000, setting out in greater detail prudential requirements such as capital adequacy requirements, minimum capital, liquidity requirements, limit on large exposures, loan classification and provisioning. Subsequently, these regulations were expanded to cover additional issues such as restrictions on related party lending and acquisition of fixed assets. In February 2002, the prudential regulations were extended to micro-financing institutions (MFIs), and those institutions with operations exceeding certain amounts were required to obtain a license or register at the NBC, and were against undercapitalized banks have been issued, along with regulation on standardized procedures for off-site surveillance and on-site inspections, supplemented by detailed manuals for these operations.

The supervision capacity at the Bank Supervision Department (BSD) of the NBC is gradually improving. The number of staff has been increased from about 40 to 60 in the last two years. In the past, the BSD had relied on international audit firms for conducting on-site inspections of banks to compensate for their limited experience and capacity. With technical assistance from the Asian Development Bank (ADB), the NBC is in the process of developing the capacity for off-site and on-site surveillance activities, and has already started to conduct on-site inspections on a limited scale. With the completion of bank re-licensing process, the NBC is now shifting its emphasis and resources to enhancing supervisory activities.

2.2.3. Restructuring of the Foreign Trade Bank

The FTB was a remnant of the mono-bank system in the 1980. It had operated commercial banking functions as a department of the NBC without a banking license and without an independent capital base. To establish a banking system operating on modern principles of good practice, the separation of the FTB from the NBC and the restructuring of the FTB as a fully independent state-owned financial institution operating on commercial basis were seen as essential. The reform of FTB’s operation was also critical for its eventual privatization, to complete the transition toward eliminating state involvement in the banking sector.

The FTB was legally separated from the NBC in August 2000, and a Board of Directors was established to provide operational independence. It completed an external audit (which was substantially qualified given the poor state of the accounts), and received its banking license in December 2000. However, during the transition period, the FTB was still under the NBC ownership who also provided physical assets to satisfy the initial minimum capital requirement of 10 billion riels. In June 2001, the NBC issued a central bank note for a full recapitalization of FTB to 50 billion riels (US$ 13 million). To complete the separation of the regulatory function of the NBC and the commercial bank function of the FTB, the Ministry of Economy and Finance (MEF) issued a recapitalization bond (40 billion riels) to replace the capital provided by the NBC and became the majority shareholder in April 2002. In January 2003, the FTB publicly announced its intention to privatize and to seek out strategic investors with international banking experience willing to run the operation of the FTB in a manner consistent with the broader objectives of financial market development in Cambodia.

Meanwhile, in an effort to introduce a market-oriented business culture, the first outside director with commercial banking experience was appointed to the FTB Executive Board in June 2001. At the same time, the FTB worked closely with its external auditors to eliminate long-standing problems in their accounts by reconciling outstanding discrepancies and provisioning against unrecoverable bad loans. Although the external audit of their end-2001 accounts remained qualified due to technical reasons, it received an unqualified opinion on a special audit of their financial position at end-March, 2002. With technical assistance being provided by Australia, progress is also under way to modernize the FTB’s operations by improving the management information system, developing procedure manuals for key areas such as credit processes and internal audit, computerizing operations, and establishing various training programs for the staff.

2.2.4. Legal Framework

The current legislative framework has largely been developed in the second half of the 1990s in response to deficiencies evident in earlier measures. These recent reforms have focused largely on re-regulation of a system that had earlier suffered from excessive liberalization following the collapse of the former centrally planned economy. The main elements in the new framework are: (1) the law on the organization and conduct of the National Bank of Cambodia, promulgated in January 1996, replaced the 1992 law; (2) the law on foreign exchange, enacted in May 1997, replaced the law on the management of foreign exchange, precious metal and stones promulgated in 1991; (3) the law on banking and financial institutions enacted in November 1999 and a number of subsequent regulations (*Prakas*) issued by the NBC.

However, the Law on Negotiable Instruments and Payment Transactions was already adopted by the Council of Ministers meeting on April 4, 2003 and submitted to the National Assembly for approval. This law will become an important instrument in strengthening the payment system by reducing the payment system risk, improving liquidity management, and promote stability in the development of a sound financial system.

Thus the banking system is still developing. Until now the focus of reform has been on issues relating to the build up of public confidence in the banking sector, chiefly by strengthening the regulatory system and prudential supervision.

2.2.5. Uniform Chart of Accounts

The NBC continued to monitor the implementation by banks of the uniform chart of accounts (COA) prepared in accordance with the accounting rules prescribed in the international accounting standard as well as the Cambodian accounting standard. Commercial banks and specialized banks started to implement the COA on the 1st of January 2003. By the end of 2004, thirteen commercial banks and three specialized banks have fully integrated the uniform chart of accounts into their system, except for one bank that still lagged behind due to a problem related to outdated computer software system which made adjustments and changes to the existing system more difficult than in other banks. Facing this constraint, the NBC gave additional time to this bank to find remedies to its problems and to improve its accounting system in line with the requirements of the uniform chart of accounts.

With the aim of promoting transparency and developing the confidence of the public in the banking system, the NBC has recently required all banks to publish their annual financial reports audited by the external auditors, starting in 2005. The disclosure of the annual financial reports will enhance transparency in banking operations and improve banks' accountability toward their customers, which in turn could enhance banks' credibility and promote the banks' reputation. To pursue this plan, the NBC held a discussion with external auditors to draw up a disclosure report form to be published by banking institutions.

2.2.6. Payment System Reforms

Progress has also been made in the area of payments system reform. A clearinghouse checks denominated in riels has been in operation since 1995. However, there were no such facilities for US dollars, raising concern among banks about the safety of the settlement of their dollar transactions, and posing a serious threat to the development of a sound financial system under the highly dollarized economy[2]. In

[2] The banking system continues to be highly dollarized, with 94% of the deposits and 96% of the loans denominated in the US dollars. Only a few banks take riel deposits, and the FTB dominates the market with a share of 84%. The high degree of dollarization poses a significant challenge for bank supervision, as the lender-of-last-resort functions of the NBC will be severely impaired.

response, the NBC established a second clearinghouse for checks denominated in US dollars in January 2001, which soon exceeded the first clearinghouse in terms of volume. Both clearinghouses operate under strict solvency rules, and the NBC does not assume any risk associated with their operations.

2.3. Banking Sector Development

The impact of the banking regulations has been very significant in Cambodia. Altogether, they lead to the closure of 15 banks that could not cope with the new licensing regulations. Generally speaking, the banks today seem “financially healthy”. With the assistance of Asian Development Bank (ADB), NBC has adopted late 2001 the “Blue Print for the financial sector development-2000-2010”. Since then the strategy pursued by the central bank has been to (i) set up/improve the regulatory framework, (ii) Initiate and impose accounting (international) standards, (iii) Implement banking supervision and prudential ratios. Three basic laws and subsequent prakas, especially since 2001, have been passed. Since that year the cleaning up activity translated into detailed regulations and prudential standards that affect capital adequacy, minimum liquidity, exposure ceilings and loan provisioning. In parallel, the only state-owned bank (FTB) was recapitalized in view of meeting the new requirements and preparing the steps for its privatization. As a consequence, the banking sector is today heavily capitalized, with on average a solvency ratio close to 50%. It is also heavily liquid.

3. Current Banking System in Cambodia

As in neighbouring transitional economies, the Cambodian banking system had to shift recently from a mono-system towards a three-tire system. A new legal and financial framework has been set up. This was made through a set of 3 laws including Law on the Organization and Conduct of the National Bank of Cambodia (26 January

1996); Law on Foreign Exchange (22 August 1997); Law on Banking and Financial Institutions (18 November 1999) and a number of sub-degree that are updated regularly.

After several years of serious reforms, there are three levels of financial institutions: a central bank, 18 commercial banks and 14 microfinance institutions[3] (see figure 2). Particularly during the past five years, serious efforts have been devoted to clean up the financial sector. Since 2000, 15 banks have been closed down. These drastic methods have proved effective. The three-tier banking system includes on the top, a central bank performing mostly supervisory tasks, then commercial banks and lastly micro-finance institutions (MFIs). Let's see what are their respective role and activities.

3.1. The National Bank of Cambodia

The transformation of the previous system was legally set up in January 1996, as the National Bank of Cambodia (NBC) took a new role. The central bank was created by Law on the Organization and Conduct of the National Bank of Cambodia promulgated on 26 January 1996. Its mission (art 2) is defined as "to determine and direct the monetary policy aimed at maintaining price stability in order to facilitate economic development". As the central bank, NBC is to act as the "sole issuer of national currency in the Kingdom of Cambodia". The bank "licenses, regulates and supervises financial institutions"; it also "participates in the formation and supervision of the money and financial markets". The Law provides for the bank to "set interest rate" (art 7). A Board of Director, comprising 7 members chaired by a governor, manages the bank.

[3] Licensed MFIs number 9. But there are also 27 MFIs that are simply registered (basically NGOs).

The central bank reports to the National Assembly and the government. Its capital is entirely subscribed by the government. The Bank is the sole depository-in the national currency- for the national Treasury. The foreign currencies received by the Treasury are deposited with the Central Bank that credits its account with the counter-value in Riels. The bank is the adviser to the government on monetary and financial matters, for instance it in public debt management, or through the issuance of public securities. The bank is legally authorized to purchase government securities under several conditions.

As a bank the NBC can extend credit to the National Treasury with strict limitations:

(i) The interest rate should be equivalent to the refinancing rate (to banks)

(ii) The maturity cannot exceed three months

(iii) The loan is supported by negotiable government securities, and lastly,

(iv) The consolidated outstanding of the credit granted to the government cannot exceed 10% of domestic budget revenues from the previous year (excluding foreign grants and sale of assets).

In other words, strong safeguards have been put to prevent any lax fiscal by a government that would have seen the Central Bank as a “money provider”.

The bank is not allowed to make any equity investment in banks, financial institutions or commercial firms. It is neither allowed to acquire real estate property except for carrying out its daily activities. The only investments that are accepted (not exceeding 5% of its capital) are investments made in companies whose activity is relevant to its basic functions; for instance in firms dealing with credit appraisal, printing or clearing, etc.

3.2. Commercial Banks

There are presently 18 banks in Cambodia (see figure 2). A remarkable feature in the region is that there is only one remaining state-owned bank, namely the Foreign Trade Bank (FTB). This bank was originally the foreign department of the previous monobank. Created in August 2000, the bank should soon be partially privatized. The 16 other commercial banks are fully private.

Licensing: the delivery of a license relies on standard criteria: qualification of shareholders, honesty of managers and minimum equity. The license is available for three years. An application for a license costs only 900 US$, but the bank has also to pay for an annual "license fee" of about 17,500 US$ for its headquarters (70 M riels) and 14,000 US$ for each branch (56 M riels). For instance a bank with 10 branches should pay annually to the central bank a sum of 157,500 US$. This amount is substantial.

Minimum capital: The minimum capital for a commercial bank has been fixed at 50 Billion riels (about 13 million US$). Such an amount is very high even by world standards. That level has been probably fixed to keep away adventures and amateurs, after several experiences in the beginning of the 90's.

Capital guarantee deposit: A "capital guarantee deposit", representing 10% of the registered capital has to be kept with the central bank. Originally half of this deposit (5%) was bearing no interest; the other half (5%) was bearing an interest equal to 3/4[15] of the 6-month SIBOR (Singapore Interbank Offered Rate). Since 2005 the conditions became less draconian. An interest is now paid on the totality of the deposit: If deposit is made in riels, the rate equals 4/8 of the 6-month refinancing rate of NBC; if the deposit is made in USD the interest rate paid is3/8 of the 6-month Sibor.

Table 1: Operation, Capital, Capital Guarantee & Reserve Requirement of the Commercial Bank

Operations	Capital	Capital Guarantee	Reserve	Fees

			Requirement	
1. Credit, leasing, guarantees and commitments under signature. 2. The collection of deposits from the public. 3. The provision of means of payment and the progressing of payment.	50 Billion riels	➢10% bearing interest: - in dollar at (3/8) or 75% of six month SIBOR - in Riel at (1/2) of six-month refinancing rate	8% on deposits	- Application 3.5 million riels - License: valid for 3 years - 70 million riel (Head office) - 56 million riel (Branch)

Source: National Bank of Cambodia

3.3. Specialized Banks

Licensing: The "specialized" bank pays a license fee that is lower than for the commercial bank. Its annual license fee is reduced to 10 million riels for the headquarters and 8 million riels per branch. For instance, a 10-branch specialized bank would pay 90 M riels, or 22,500 US$ per year.

Minimum capital: The minimum capital for a "rural credit specialized bank" is 10 Billion riels (2.5 Million US$). A "capital guarantee deposit" of 5% of the registered capital has to be kept with the central bank, bearing no interest.

Reserve requirement: Commercial and specialized bank have also to put, as a "reserve deposit", 5% of the deposits they have collected from the general public to the central bank.

Table 2: Operation, Capital, Capital Guarantee, and Reserve Requirement of the Specialized Banks

Operations	**Capital**	**Capital Guarantee**	**Reserve Requirement**	**Fees**
An entity carrying out only one of these three basic activities shall be known as a “specialized bank”.	10 Billion riels	➢5% no interest:	5% on deposits	- Application 0.5 million riel - License: valid for 3 years - 10 million riel (Head office) - 8 million riel (Branch)

Source: National Bank of Cambodia

3.4. Micro-financing institutions (MFIs)

According to the latest prakas, a Microfinance institution is defined as an entity “delivering financial services such as loans and deposits to the poor and low-income households, and to micro-enterprises”. The scope of activities opened to MFIs is very large (saving deposits, credits) except that they cannot open check accounts. Their legal status is large since they can be either a liability company or a cooperative (credit union). Depending on their size, MFIs are either “licensed or registered”. For historical reasons, the Law assumes that an MFI has already started its activities as an NGO. If an NGO adds some financial activities have developed beyond a certain threshold, the MFI has then to upgrade to a “license” status.

Registration: The registration of an MFI with the NBC is compulsory for all NGOs, associations and other entities if they meet the following criteria:

(a) If the NGO is engaged in credits, when their outstanding is above 100 million riels (25,000$)

(b) If the NGO is engaged in saving collection, when they have more than 100 depositors or if they collected more than 1 million riels (250$)

Licensing: The licensing becomes compulsory for a registered MFI when it meets the following conditions:

(a) If the MFI is engaged in lending activities, when the outstanding credit is above 1 billion riels (250,000$) or if they have more than 1,000 borrowers

(b) If the MFI is collecting deposits, when it receives more than 100 million riels (25,00$) in deposits, or if it has more than 1,000 depositors.

The annual "licensing fee" is lower than for a bank since it is only 1 M riels (250$).

Capital: The minimum registered capital is 250 million riels (62,500 US$). The MFI should also deposit 5% of this capital into a non-interest bearing account with the Central Bank.

Reserve requirement: The MFI should also deposit 5% of its deposits – as a reserve requirement into a non-interest bearing account with the Central Bank; However "compulsory saving, which are savings required as condition to participate in a credit scheme, shall be excluded".

Table 3: Operation, Capital, Capital Guarantee, and Reserve Requirement of MFIs

Operations	**Capital**	**Capital guarantee**	**Reserve Requirement**	**Fees**
Shall be excluded from: - Leasing derivatives and spot and forward market. Providing payment services.	KHR 250 million	5% no interest rate	5% on deposits	- Application 50,000 riel - License: valid for 3 years - 1 million riel

Source: National Bank of Cambodia

3.5. The other financial institutions

There are three types of financial intermediaries in Cambodia: (i) the "banks" (also sometimes called "commercial banks"), (ii) the "specialized banks" (also sometimes called "rural commercial banks", and (iii) the "micro-financing institutions" (or MFIs).

The **Bank** is defined as a legal entity that normally carries out three types of activities: (i) collecting deposits from the public, (ii) granting loans, and (iii) facilitating transaction in providing means of payments. A bank can be incorporated either as (i) a limited company under commercial law or as a (ii) credit union, consequently non-subject to commercial status. In the later case, the cooperative or mutual society has to belong to a federative[4] body, which insures financial soundness of their members (art 11).

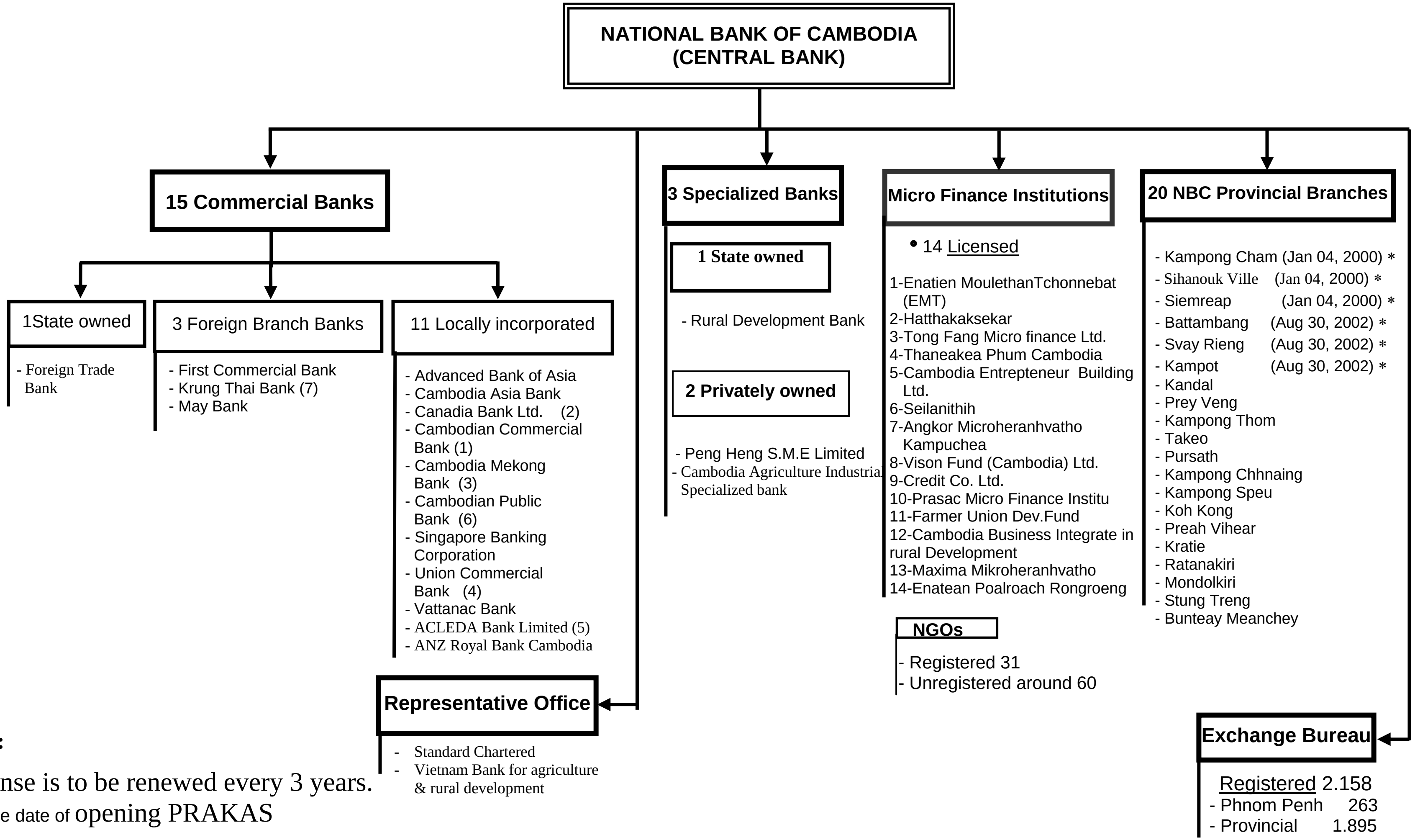
The "**specialized bank**[5]" is a "financial entity that engages into only one of the three activities" list above. Consequently this financial agent is either a borrower or a lender but it cannot be both.

The **microfinance institution** (or MFI) is a "financial entity that provides financial services such as loans and deposits to the poor and low income households and to micro-enterprises". Consequently the criterion applicable to a MFI is no longer the type of activity of the access to the public but the profile of their customers.

Although these intermediaries are different in terms of resources, fields of activity, types of loans and prudential constraints, they have to follow general conditions aiming at protecting their depositors (against any mismanagement by bank's managers) and ensuring that the general public keeps confidence into the banking system.

[4] Apparently, none of the banks or MFIs in Cambodia have so far consolidated into a federation
[5] New concept: Until the 1980's a bank was said "specialized" when its activities were limited to a specific economic sector: agriculture, industry, trade, housing, etc

Figure 2: THE BANKING SYSTEM IN CAMBODIA (As of Nov 30, 2005)



Note:

License is to be renewed every 3 years.

* The date of opening PRAKAS

Source: National Bank of Cambodia

4. Analysis Selected Ratios of Banking Sector

4.1. Prudential Ratio

The basic conditions required from financial institutions for performing their activities have been listed in table 4.

Table 4 : Prudential Regulations (As of Feb 11, 2005)

Regulations	Main Features	Date of Relevant Regulation 1/
Liquidity	Banks must at all times have a liquidity ratio of at least 100%. **Amendment** must at all times have a liquidity ratio of at least 80% **Amendment** must at all times have a liquidity ratio of at least 50% Liquidity ratio Miro-finance of at least 100%	Feb. 9, 2000 Sep. 13, 2002 Dec. 29, 2002 Feb. 25, 2002
Solvency ratio (CAR)	Banks must maintain solvency ratio (net worth divided by the aggregate of assets and off balance sheet commitments) at the minimum level of 20%. **Amendment** must maintain solvency ratio at minimum 15%	May. 22, 1995 Feb. 16, 2000 Dec. 29, 2004

Source: National Bank of Cambodia

However, these conditions are being complemented regularly by Prakas. The most important parkas to be considered from an operational point of view are the regulations aiming at protecting the general public, which is to say mainly the depositors. The National Bank of Cambodia has been embarking for the past three years on an ambitious path of reforms aiming at putting the whole banking sector on a safe and secure ground. NBC has consistently put into place standard **prudential ratios** as recommended by the Bank for International Settlements (BIS) in view of minimizing the risks for any bank collapsing. For the protection of Cambodian depositors, NBC demands that every bank follows several ratios. The main prudential ratios used in the country are the *solvency ratios* and the *liquidity ratio*. Beside these two basic constraints, some other safety rules have been implemented; these are conditions regarding reserves requirements and accounting and reporting procedures.

Table 5: Prudential Ratios of Deposit Money Banks*

No	Prudential Ratios	Requirement	Total/Average									
			2000	2001	2002	2003	Dec-04	Jan-05	Feb-05	Mar-05	Apr-05	May-05
1	**Liquidity Ratio>50%** (Debit items-Credit items)/Risk weighted deposits	**>80%**	160%	182%	155%	140%	131%	130%	167%	126%	124%	126%
2	**Loans to Related Parties<10%**	**<10%**	(63,028)	13,027	14,303	5,630	(5,330)	(4,933)	(4,927)	(8,065)	(4,121)	(4,159)
3	**Shortfall of Net Worth (Paid Up Capital < Net Worth)**				49,502	63,901	52,194	49,235	47,685	44,622	40,999	41,988
4	**Net Worth**		667,651	909,147	827,926	835,232	907,890	913,214	934,725	982,277	991,464	997,359
5	**Solvency Ratio>15%** (Net Worth / Risk weighted Assets)	**>20%**	48%	58%	49%	41%	34%	35%	35%	35%	34%	34%
6	**Fixed Assets Ratio<30%** (Fixed Assets / Net Worth)	**<30%**	13%	14%	12%	15%	15%	15%	14%	14%	14%	14%
7	**Large Exposures**		318,629	6,650	218,519	416,501	488,702	484,322	492,853	520,949	521,054	536,224
8	**Loans to Deposit Ratio>100%** (Loans &Advances to customers / Customers deposits)	**>100%**	61%	53%	47%	51%	55%	56%	56%	57%	58%	58%
9	**Effeciency Ratio<50%** (Operating Exp. / Gross Operating Inc. or loss(-)	**<50%**	54%	55%	65%	51%	46%	50%	42%	43%	48%	53%

	2000	2001	2002	2003	Dec-04	Jan-05	Feb-05	Mar-05	Apr-05	May-05
Exchange Rate (Riel/USD)	3905	3895	3930	3976	4027	4030	4027	4027	4042	4067

Note:

* DMBs = 14 Commercial banks + 3 Specialized banks

- Liquidity Ratio was >100% from 2000 to 09/2002.
- Loans to deposit ratio and Effeciency Ratio of commercial banks were lower than the requirement due to some banks could access the requirement and some could not.

Source: National Bank of Cambodia

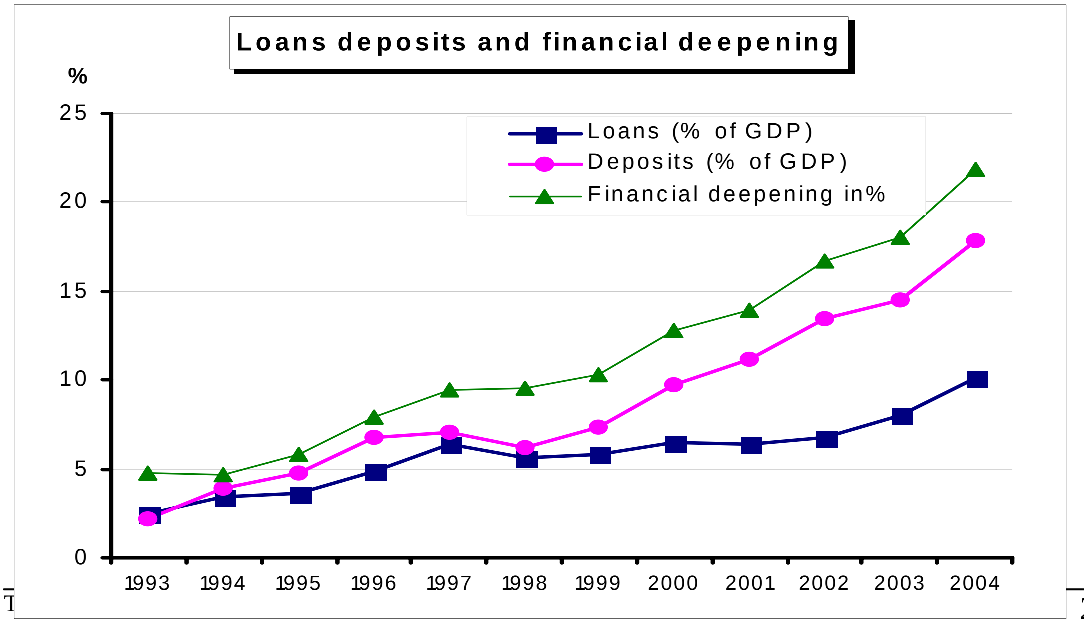
4.2. Financial Deepening

The role of the financial sector within the Cambodia economy is still limited. The total credit granted by banks in the country represents today only 10.1% of the GDP. In neighboring countries, it is, for instance as high as 52% in Vietnam and 165% in China.

The total deposits collected by banks in Cambodia are certainly far from being negligible but they remain modest. They represent **17.8%** of the GDP (against 56% in Vietnam and 180% in China). Such a modest rate should not be interpreted as reflecting the "low level" of incomes in the economy. The low rate of financial intermediation should be seen instead as reflecting three likely factors: (i) A limited development of bank branching in rural areas, (ii) A still limited confidence of the customers in the banking system at large, and perhaps (iii) A poor quality of the services offered by the banks to their customers (in terms of products, interest rates, and maturities).

All considered, the Cambodian financial sector looks to be at its infancy stage; there is still large room for manouvre in developing its activities and in better integrating it with the "real" sector in Cambodia.

Figure 3 : Loans and Deposits as Percentage of GDP and Financial Deepening

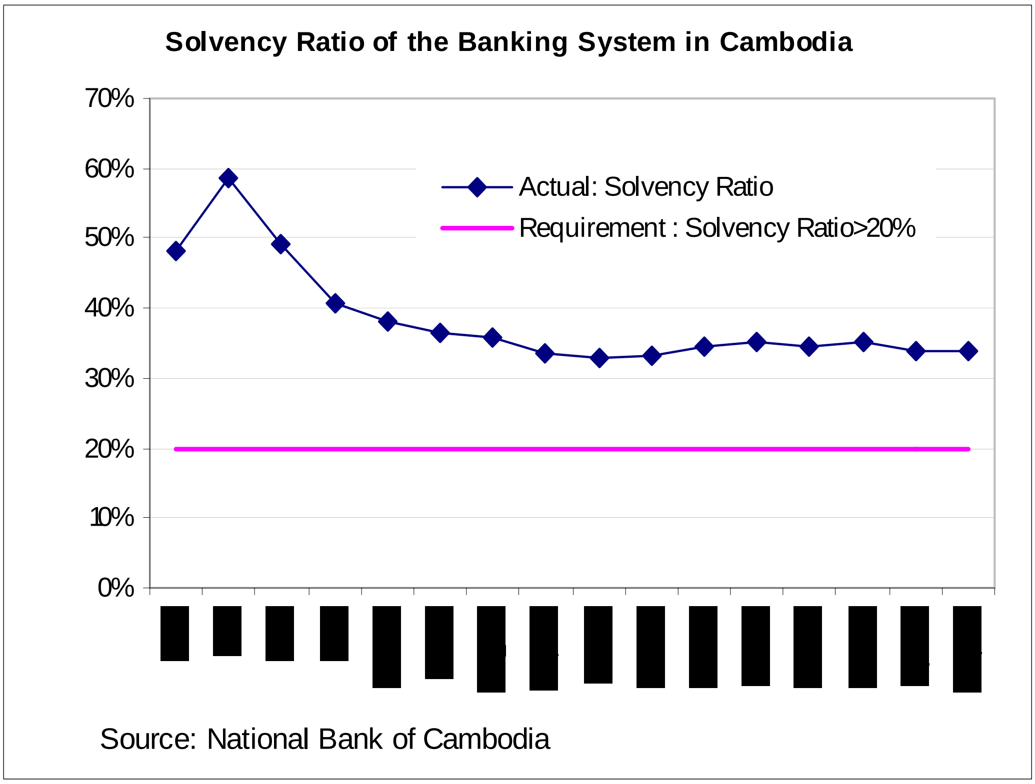


The solvency ratio aims at protecting the depositors in case of bank's heavy loss or bankruptcy. It ensures that, in such unfortunate case, the own capital of the bank (i.e equity + reserves) can cover the debt suddenly owed to the depositors.

The ratio is calculated as follows: On the numerator, we find the "Net worth", while the Denominator is represented by the Net assets (after deduction of provisions and depreciation) + Off-balance-sheet items. The risks are weighted according to their probability. The solvency ratio is presently 35%. Such a ratio seems rather high and conservative if we compare it to the world average standard, that is to say 8%.

MFIs are also subject to a similar ratio, called the capital adequacy ratio (CAR), that should also be above 20%, in which the numerator is the eligible capital and the denominator are the "weighted risks".

Figure 4 : Solvency Ratio of the Banking System in Cambodia



4.4. The liquidity ratio

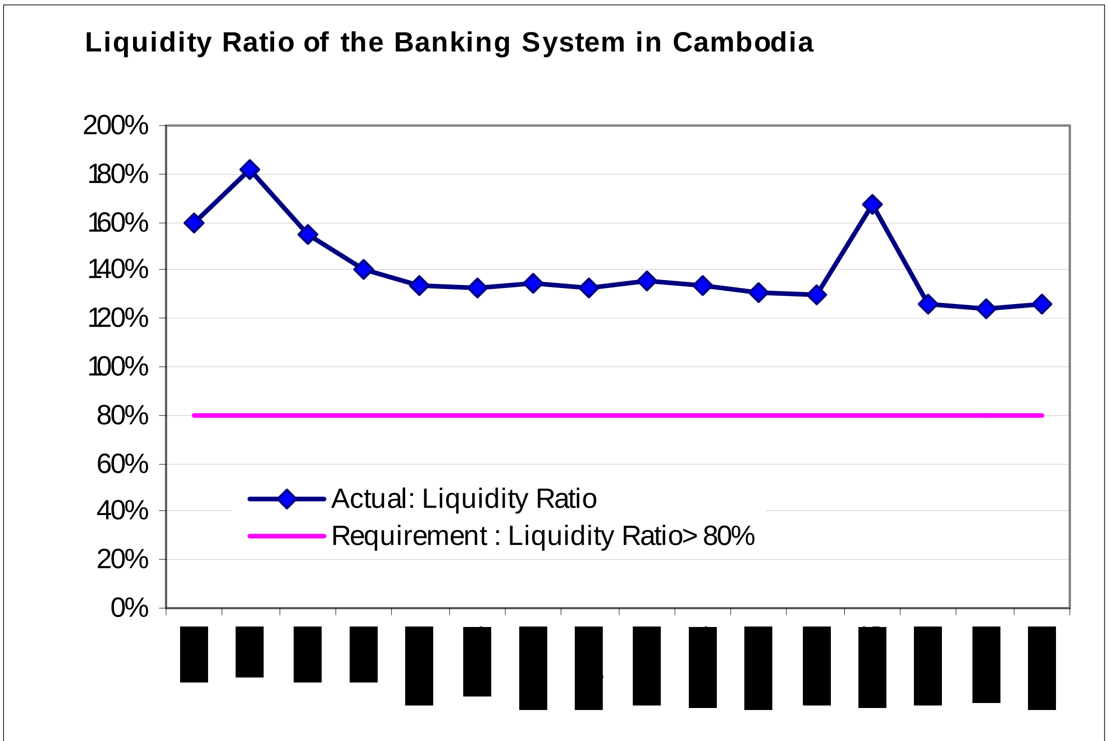
The purpose of the liquidity ratio is to ensure that any depositor having a current account in a bank can withdraw these funds at any time and without notice. In other words, the bank should keep, at all time, a minimum proportion of its assets in a liquid form. An important consequence of such a constraint is that a bank should be very careful not to run into maturity mismatching… to avoid being exposed to a liquidity crunch before the time the loan is recovered. The liquidity requirement is such that "liquid assets have to exceed (weighted) liquid liabilities".

The ratio for a given bank is calculated as follows: The numerator includes all available liquidities: Cash + net deposits of the bank with NBC and other banks + Net outstanding loans with less than one month maturity (excluding overdrafts) + Treasury bills (with less than one-month maturity). The denominator adds all the commitments of the bank towards its clients, but each category of liability is weighted according to a theoretical probability risk of withdrawal. We find consequently on the denominator: 80% of the time deposits due within the coming month + 50% of fixed deposits having more than one month to run + 60% of current accounts and demand deposits + 50% of savings accounts.

The liquidity ratio in Cambodia, both for banks and Microfinance institutions was 100% under a September 2002 Prakas. It has been reduced to 80% since then. In the case of licensed MFIs, the denominator is reduced to 25% of voluntary savings (excluding compulsory savings). Such a provision, in reducing the denominator, is a good incentive for the MFIs to develop their savings mobilization activities.

It is important to keep in mind that, for a banker, increasing its liquidity ratio translates into increasing its costs. Roughly summarized, one increases its liquid assets through either (i) decreasing its long assets or (ii) increasing its long-term funding. Similarly, one decreases its liquid liabilities through increasing its long borrowings or decreasing its long assets.

Figure 5 : Liquidity Ratio of the Banking System in Cambodia

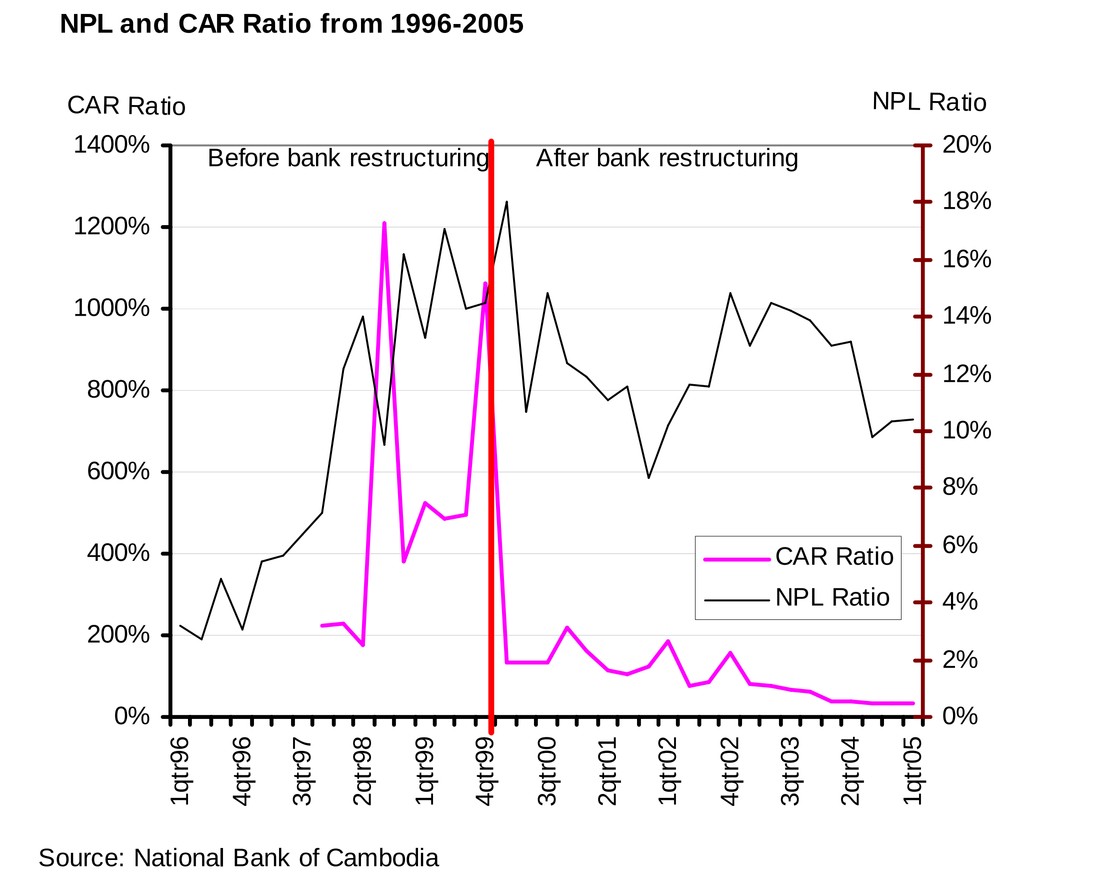


Source: National Bank of Cambodia

4.5. Non-Performing Loan and Capital Adequacy Ratios

The re-licensing program introduced in the early 2000 has greatly revamped the banking sector. 16 commercial banks have been de-licensing and put under liquidation. Currently, the banking system in Cambodia consists of 15 commercial banks and 3 specialized banks. The banking system is now shown the downward trend of the capital adequacy ratios (CARs) reaching 35% on average in the first quarter of 2005 (see figure 6). The Non-Performing Loan ratio is increasing slightly about 10.39% during the first quarter of 2005 (see figure 6).

Figure 6 : Non-Performing Loan and Capital Adequacy Ratios



4.6. Risk management requirements

(i) In order to enforce liquidity, the Prakas B7.01-186, dated 8 November 2001, has put a limit on the fixed assets (a building for instance) a bank can own. If directly used for bank's operations (i.e branches and offices), such fixed assets have to remain less than 30% of total net worth.

(ii) Other fixed assets, which became the property of the bank, for instance as the result of foreclosure, have to be sold out no later than one year after they became bank's property. Both provisions above are very positive in that not only do (i) they ensure liquidity of the bank vis a vis their depositors but they also (ii) help avoiding a confusion (and conflicting interests) between banker's responsibilities and developer’s responsibility. These two activities are totally stranger to one another and should never be mixed within the same enterprise.

(iii) A classification of loan portfolio has been made according to default risks. NBC is requiring minimum provisions to be made by banks for bad and doubtful debts. The levels of provisions are as follows: - “Substandard: 10%, regardless of collateral value, except cash “;- Doubtful: 30%, regardless of collateral value, except cash “,- Loss: 100%”.

5. Cross-Country Camarision of Banking Reform in Lao P.D.R and Vietnam

In all three countries, the monobank system was formally replaced by a two-tier banking system in the late 1990s. Defining the new roles and responsibilities for second-tier banks and creating independent institutions were no trivial achievements. However, in part as a legacy of the past, a banking system emerged, in particular in Vietnam and Lao P.D.R., that has been dominated by state-owned commercial banks (SOCBs), accounting for more than 70 percent of all bank deposits. Foreign bank branches and semiprivate joint-stock banks (JSBs) have operated on a limited local scale, serving niche markets, although, at least for Vietnam, they have been quite numerous. In Cambodia, the state-owned Foreign Trade Bank (FTB) retained its role as a key player, while lax licensing requirements led to a proliferation of weak joint-venture banks, whose problems eventually hampered the return of confidence in the banking system after episodes of political disturbances.

Operations of the dominant SOCBs in Vietnam and Lao P.D.R. have been characterized by weak balance sheets, in part reflecting a legacy of directed lending. The large SOCBs have maintained an exposure to state-owned enterprises (SOEs) significantly above average with lack of reforms in the state-sector leading to a buildup of nonperforming loans (NPLs). In Vietnam, the state-banks had accumulated

NPLs totaling D 23 trillion, 2 representing about twice their capital, 5 percent of GDP, and 15 percent of all outstanding credit to the economy by end-2000. About two-thirds of the NPLs were to SOEs.3 Similarly in Lao P.D.R., NPL ratios ranged from more than 20 percent to about 70 percent across the SOCBs, with about 70 percent of all NPLs considered state related, that is, lent to SOEs or for policy purposes. Generally weak lending practices and excessive exposure to the SOE sector had thus become a key source of vulnerability in the countries' financial system. The need for a more proactive corporate- and financial-sector restructuring increased further at the beginning of this decade, as competition following market-opening measures (the ASEAN Free Trade Area, the United States Bilateral Trade Agreement (USBTA), and, in the future, the World Trade Organization) was set to intensify.

By contrast, after decades of civil strife, Cambodia's main challenge was to reintroduce a banking system. Given the limited role of SOEs in the economy, the banking system's exposure to state-owned enterprises has played only a minor role, while growth of joint venture and foreign banks reduced the role of the only SOCB. However, the proliferation of new banks due to lax licensing requirements put a heavy strain on Cambodia's supervisory and regulatory capacity, limiting profitable banking opportunities, public confidence, and bank intermediation.

5.1. Approaches to Banking Reform

5.1.1. Approach to Banking Reform in Vietnam

Reform efforts initiated in 2001 were centered on restructuring the four large SOCBs and putting them on a commercial footing. The strategy was framed by the authorities' decision to retain full ownership and control of the banks and not to rely on any outside agents of change, such as strategic foreign investors. Beyond restructuring the SOCBs, banking sector reforms also aimed at strengthening the regulatory, supervisory, and institutional frameworks for more efficient banking. In addition, the authorities have also pursued consolidation of numerous small and undercapitalized JSBs.

By relying on banks' internal capacity for change, the success of the reforms was to rest on three key components: (i) phased and conditional recapitalization with public funds, based on SOCBs' meeting bank-specific operational and financial reform targets, above all, regarding resolution of NPLs and measures to improve credit risk management; (ii) phaseout of policy lending; and (iii) improved accounting and disclosure standards, through International Accounting Standards (IAS) audits and loan classification in line with international standards. These principles were adopted by the State Bank of Vietnam (SBV) in its overall bank restructuring framework. In line with this gradual approach, the framework also provided for a phasing-in of prudential standards, such as on required capital adequacy ratios.

5.1.2. Approach to Banking Reform in Lao P.D.R

Banking reform efforts in Lao P.D.R. have been largely modeled along the Vietnamese approach, albeit with less emphasis on banks' internal capacity for change. At present, key immediate measures to avoid further deterioration of banks' balance sheets consist of credit ceilings, prohibition of lending to defaulting borrowers, and a commitment to avoid any new noncommercial lending. International resident advisors have recently been placed in the banks to ensure implementation of these stricter lending measures. In particular, advisors have to certify that new loans (exceeding a certain threshold) are approved on commercial criteria. However, it should be noted that they cannot prevent noncompliant loans. Advisors have also been critical in the application of more transparent loan classification and provisioning. An international banking supervision expert has also been advising the central bank for more than a year on improvements of its supervision function, while measures to strengthen on-site supervision have been part of IMF program conditionality.

Over the medium term, measures are to focus on providing incentives for improving performance, including an injection of bank capital combined with a phased implementation of stricter banking regulations, and changes to management in the case of continued deterioration of performance. More specifically, the reform program envisages to upgrade the role of resident advisors to that of co-managers of the banks, if current bank management turns out to be unable to improve performance. Moreover, efficiency gains are expected from the consolidation of the two smaller SOCBs into one bank in late 2002, lifting restrictions on competition from foreign banks, and opening up one SOCB to strategic foreign equity partnership.

5.1.3. Approach to Banking Reform in Cambodia

Facing a situation of rebuilding rather than transforming a banking system, reforms in Cambodia consisted of (1) a program to re-license only viable commercial banks under a new banking law; (2) strengthened banking supervision; and (3) restructuring the only SOCB with a view to eventually privatize it. Under the new banking law and licensing requirements, banks were set to be liquidated if classified as nonviable or failing to meet corrective measures, including an increase in minimum capital requirement. At the same time, banking supervision was to be strengthened by a series of new regulations, in particular on capital adequacy and loan classification and provisioning, and strengthening the supervision capacity of the National Bank of Cambodia (NBC), including through a resident advisor. Restructuring of Cambodia’s only SOCB focused first on introducing commercial business criteria, by appointing an outside director with international banking experience, and then on privatizing the bank, after recapitalization, through inviting a strategic foreign investor.

5.2. Progress in Banking Reform in Low Mekong Countries

While banking system restructuring has made considerable progress in Cambodia, it is still at an early stage in Vietnam and Lao P.D.R., so that a comparison of reform experiences can only be tentative at best. Overall, progress in Cambodia, where the challenge was rather to develop a viable banking system with an emphasis on a solid legal and supervisory framework, appears to have been significant with banking system health visibly improved. By contrast, in Vietnam progress has proved particularly difficult in those areas of SOCB restructuring directly affecting banks' relationship to SOEs. While Lao P.D.R. has faced challenges similar to that of Vietnam, specific technical assistance through resident advisors appears to be relatively effective, in part because of the relatively small size of the problem banks. Turning to the key dimensions of the restructuring programs, the situation emerging is as follows.

5.3. Cleaning up balance sheets and recapitalization

In Vietnam, resolving NPLs, in particular to SOEs, has been slow. Although resolution of collateralized NPLs was sped up,7 helping banks to meet the first quarterly NPL resolution target in March 2002, SOCBs missed subsequent targets by a wide margin as they failed to resolve uncollateralized NPLs to SOEs. Banks do not have a mandate to trigger SOE loan workouts, and restructuring loans to SOEs has been hampered by the entanglement of government agencies and officials at the national and local levels with SOCBs' management. This notwithstanding, all SOCBs became eligible for state-funded recapitalization. The already limited incentives for reform, given government ownership of the banks, were thus diluted further.

In terms of cleaning up balance sheets, the Lao P.D.R. reform program is designed along the lines of that of Vietnam. Resolution of NPLs is to become a key criterion for phased and conditional recapitalization. But setting the criteria is still pending an assessment of the stock of NPLs. As in Vietnam, successful NPL resolution will depend on the political consensus to enforce hard budget constraints on the state enterprise sector, although it plays a somewhat less important role in the economy. As a first step, the process of resolving “triangular debt,” arising from government arrears to banks’ SOE borrowers, has started in 2003 through the issuance of debt clearance bonds, albeit at below-market interest rates, through the Ministry of Finance.

In Cambodia, efforts to clean up banks’ balance sheets were more drastic and led to the closure of 15 banks under a re-licensing program distinguishing between insolvent and viable banks and imposing high minimum capital requirements (Table 2).[9] In addition, the only state bank was recapitalized to meet the new capital requirements under the law. As a result, Cambodia’s banking system appears well capitalized with an average capital asset ratio (CAR) of over 50 percent in September 2002. While this may suggest too little risk taking and excessive curtailing of new lending by the restructured banks, it should be noted that, based on partial data, banks’ asset quality has remained generally poor, with NPLs still representing about 12 percent of total loans at end-2002.

5.4. Putting banks on a commercial footing

Notwithstanding that a change in lending behavior is expected to take time, an initial assessment suggests that Vietnamese SOCBs continue to give priority to asset growth over profitability and capital adequacy. In spite of their continued dominance of the banking sector, SOCBs have allowed interest rate margins to erode substantially as they have largely refrained from increasing lending rates while offering higher deposit rates to finance rapid credit growth. As a result, capital asset ratios (measured using domestic accounting standards) have declined further, and the cost of SOCB restructuring—driven by the need to clean up balance sheets and restore adequate capital—has likely risen. Moreover, while some of the new lending to SOEs has been shifted to specialized policy-lending institutions, in particular the Development Assistance Fund (DAF), SOCBs remain by far the single largest provider of credit to SOEs.

By contrast, credit growth in Lao P.D.R. has dropped markedly. International resident advisors have been placed in the state banks to ensure implementation of stricter lending requirements. More specifically, advisors have to certify that new loans (exceeding a certain threshold) are appraised on commercial criteria. Resident advisors also provide critical technical assistance in familiarizing credit officers with market-based credit risk management practices. However, while credit decisions appear to have been strengthened considerably in the two remaining SOCBs, there are indications that the sharp restraint on credit may be adversely affecting economic activity, although non-SOCB credit has continued to grow.

In Cambodia, efforts to strengthen commercial decision making focused on the one remaining SOCB, the Foreign Trade Bank (FTB). After separation from the NBC in August 2000, a Board of Directors was established to provide operational independence, with the first outside director with commercial banking experience appointed in June 2001. To complete this separation, the FTB announced in January 2003 that it will be partially privatized and will seek a strategic international investor. However, for the system as a whole, lending activities remain relatively limited, with loans only accounting for about one third of banks' total assets. This points to factors beyond banks' financial health that continue to hamper Cambodia's financial development, including a weak corporate sector, absence of reliable borrower information, and contract enforcement.

Improving the regulatory framework, accounting standards, and banking supervision Moving loan classification closer to international standards and subjecting SOCBs to IAS audits have been key elements of a strategy to promote greater transparency in Lao P.D.R. and Vietnam. In December 2001, Decision 1627 was adopted in Vietnam, requiring banks to classify the entire loan balance as overdue if any interest and/or principal payment becomes overdue. Furthermore, to help assess the true size of NPLs and accurately monitor improvements in banks' performance, the four large SOCBs have been undergoing IAS audits of their financial statements beginning with the year 2000 accounts. Based on these audits, banks have also been instructed to implement an initial plan for phasing in loan loss provisions. However, implementation of the new loan classification remains nontransparent and plans to address key qualifications of the IAS audits have not yet been carried out. By contrast, adequate loan classification standards had already been in place in Lao P.D.R., but resident advisors have been playing an instrumental role in bringing banks' accounting practices in line with these standards. At the same time, 2001 and 2002 audits at both international and domestic accounting standards were completed by international auditing firms at end-2003, providing an independent assessment of the financial situation of SOCBs and their progress toward reforms.

Efforts to strengthen banking supervision are still at an early stage. In Vietnam, the allocation of supervisory responsibilities among the various departments involved at the SBV, the lead agency in banking supervision, is complex and may need simplification. Enforcement mechanisms where banks violate prudential and other regulations need to be tightened. In addition, supervision by the central bank may be affected by the SBV's co-ownership function at the SOCBs, which appears to undermine credibility of enforcement as well. Similarly in Lao P.D.R., strengthening banking supervision, especially on- and off-site inspections to monitor bank developments in a timely manner, is part of the overall reform strategy to improve the banking environment over the medium term, but pending specific measures of implementation and enforcement.

By contrast, strengthening accounting standards *and* banking supervision has been a centerpiece of reforms in Cambodia early on. Comprehensive legal changes, including the new central bank and financial institutions law, provided an adequate legal framework for banking supervision in the late 1990s, which was soon supplemented by detailed regulations on prudential norms (affecting capital adequacy, liquidity, exposure limits, and loan classification and provisioning) and regulations on prompt corrective action, spelling out procedures and disciplinary actions by the NBC. Moreover, supervisors have been equipped with detailed manuals on standardized procedures for off-site banking surveillance and onsite inspections. With the re-licensing process completed, substantial technical assistance and increased staff resources, the NBC has been gradually enhancing its supervisory activities in recent years.

5.5. Challenges in Maintaining Reform Momentum

While Cambodia has made significant progress toward developing a privately owned banking system with a strong regulatory framework, the transition to a market-oriented two-tier commercial banking system is still far from complete in Vietnam and Lao P.D.R. Even though reforms in these two countries are constrained by reliance on state ownership, more can be done to induce and enable banks to become commercially sound. Key elements to bring forward reforms in Vietnam and, to a lesser degree, in Lao P.D.R. could thus include:

- Strengthening incentives for managers and staff to ensure commercially based decision making. As long as state ownership precludes a market for corporate control to exercise commercial discipline, governments should set explicit performance benchmarks and compensate banks' management and staff accordingly. Performance should be based in particular on profits after adequate provisioning for risks and nonperforming loans. The design of performance contracts is a complex issue, given institutional and political constraints (e.g., differential treatment of banks compared with other civil service agencies). Against this background, commercial decision making is being strengthened in Lao P.D.R. through resident advisors, providing management control independent of the government. With the adequate incentive structure, the need to invest in training and technology, to provide for adequate loan loss reserves, and, above all, to price credit risk adequately, should become central objectives. Moreover, to create room for strengthened incentives to work the political influence on banks, including by party committees and agencies at the local level, will need to be curtailed.

- Building capabilities for sound commercial decision making, in particular improved credit risk management. Twinning arrangements with internationally reputable partners could prove particularly useful for transferring critical management know-how. In addition, efforts to train thousands of credit officers and managers need to be strengthened, including through increased technical assistance. In this regard, the sheer size of the banks poses a greater challenge in Vietnam than in Lao P.D.R., where resident advisors are already in place to certify that loans are being extended on commercial criteria.

- Strengthening creditor rights by providing banks with more effective means to resolve NPLs, especially to loss-making SOEs. While it remains to be seen how Lao P.D.R. SOCBs will deal with SOE NPLs, it is already evident that Vietnamese banks need a stronger mandate. Efforts to reform the banking system will thus also depend on progress in reforming the state enterprise sector and the enforcement of hard budget constraints, in particular in Vietnam with a comparatively larger SOE sector. As the case of China suggests, without significant SOE reforms the NPL problem of the banking sector is at risk to grow in tandem with the deepening of the financial markets. Providing banks both with incentives and key instruments to operate commercially would be supported by measures that create an environment more conducive to reforms, including:

- Creating a level competitive playing field in both Vietnam and Lao P.D.R., the current framework still hampers competition, by restricting on the type of deposits foreign bank branches can offer, the branch network, and the acquisition of domestic banks. While Vietnamese commitments under the USBTA would result in a phase out of competitive restrictions on U.S. banks, these should apply to all foreign banks to promote a more competitive domestic banking environment.

- Strengthening bank supervision: without improved supervision, progress in bank restructuring cannot be independently assessed, a necessary condition for reform incentives.

- Strengthening accounting standards: as long as banks can hide problems, the incentives for reform will remain ineffective. In Vietnam's case this means that improved loan classification standards need to be fully enforced, while IAS audits would provide an independent assessment of banks' performance. In Lao P.D.R., recently completed external audits will help improve transparency and resident advisors are expected to help implement the improved accounting standards. Banks' recapitalization needs should be based on the IAS accounts to transparently reflect the past and future cost of their operations to taxpayers and further increase accountability.

Turning to Cambodia, the main challenge is to promote financial intermediation. Despite a stronger regulatory framework and improvements in banks' financial soundness, lending activities have remained limited by international standards, suggesting that the financial health of the banking sector by itself is not enough to promote Cambodia's development. Looking ahead, Cambodia needs to: (1) develop a system of reliable borrower information, requiring firms to use a common set of accounting standards and produce financial statements; (2) strengthen contract enforcement; (3) improve the availability of financial services in rural areas; and (4) push ahead with upgrading the FTB's management, including through eventual privatization. These challenges have been recognized in the NBC's *Financial Sector Blueprint for 2001–10*.

In conclusion, in both Lao P.D.R. and Vietnam, SOCBs remain wholly state owned and their transition to commercially oriented banks relies essentially on their internal resources and the credibility of incentives set by the government. While reforms are still at an initial stage, the need for reinforcing efforts already emerges in Vietnam in three critical areas: (1) strengthening the incentives for reform of banks and their management, including through performance contracts and strict recapitalization conditions; (2) improving credit risk management in line with international practice, supported by substantial technical assistance (including through twinning arrangements); and (3) providing banks with more effective mechanisms to resolve NPLs. If China's example is any guide, without these critical changes Vietnam's banking sector problems are only likely to grow further. By comparison, progress in Lao P.D.R. appears to be facilitated by the relatively limited role of SOEs in the economy and thus banks' exposure to the state sector. The smaller size of banks has also helped resident advisors to play a more effective role in putting SOCBs on a commercial footing and strengthening their accounting frameworks. Moving beyond the existing approach in Vietnam and Lao P.D.R. would likely entail privatization of a large SOCB by seeking a strategic foreign equity partner, an approach that is now under consideration in China. As for, Cambodia, the challenge lies less in reforming banks but in continuing the development of a commercial banking system that helps promote efficient investment and growth.

CHAPTER III

PROGRESS IN BANKING REFORM AND REMAINING ISSUES

1. Progress in Banking Reform

1.1. Bank Restructuring

The bank re-licensing program has been successful in terms of improving the financial soundness of the banking sector. In this process, nonviable banks were closed, and the size of the banking system was downsized to a level more in line with the size of the Cambodian economy and the supervisory capacity of the NBC. In response, public confidence in the banking system appears to be gradually improving, as a reflected in the 22 percent increase in the deposit base during the first 10 months of the year. The lending activities, however, continue to stagnate. Growth in private sector credit has been virtually non-existent in the past two years, showing serious signs that improving the financial health of the banking sector by itself will not be enough to promote increased intermediation.

1.2. Current State of the Banking System

The Cambodian Banking System is well capitalized and highly liquid. Due to the increased minimum capital requirement (US$ 13 million), banks are well capitalized with average capital adequacy ratios reaching 34 percent. Banks are also very liquid as they carry large amounts of vault cash and keep huge excess reserves at the NBC. The liquid assets ratio (liquid assets to total assets) is close to 55 percent. However, due to the fact that a large proportion of bank assets are held in low-yielding liquid assets, the profitability of the banking sector is low. The return on assets and return on equity are about one percent and five percent, respectively, at end-2004. Although the asset quality of banks' loan portfolio is generally poor, the volume of nonperforming loans stands at a manageable level with the rate of nonperforming loans to total loans declining from around 13 percent in the first quarter of 2004 to 10.4 percent in the first quarter of 2005.

Table 6: Selected Financial Indicators (In percent)

	Dec. 2001	Dec. 2002	Dec. 2003	Dec. 2004
Capital adequacy ratio 1/	122	155	62	34
Liquid asset ratio 2/	58.9	57.1	56.3	54.8
Return on assets	1.0	0.9	0.9	1.2
Return on equity	3.2	2.8	3.8	5.7

Source: National Bank of Cambodia.

1/ Capital (net worth) / risk weighted assets.
2/ Liquid assets / total assets.

Lending activities of the banking sector are quite limited relative to the size of the economy, as well as the size of their deposit base. Credit to the private sector is 7 percent of GDP, significantly lower than other Asian countries at a comparable stage of development. The size of the loan portfolio is less than a third of their total assets and less than half of their deposit base. The remaining assets consist primarily of cash balances, deposits at overseas banks and placements at the NBC. Loans are mostly short-term, mainly providing import/export financing interest rates charged on these loans are usually very high, with an average spread of 13 to 14 percentage points over the interest rates paid on deposits.

Table 7: Cambodia: Interest Rates, Dec. 1997-Dec. 2004 1/ (In percent)

	1997	1998	1999	2000	2001	2002	2003	2004
Deposit rates								
Riel saving deposits	7.4	7.5	7.3	5.9	2.6	2.2	1.9	1.9
Foreign currency savings deposits	2.4	2.5	2.2	2.3	1.6	1.5	1.3	0.9
Foreign currency term deposits	3.9	4.0	3.5	3.7	2.7	2.8	2.6	2.4
Lending rate 2/								
Foreign currency loans: rate charged to private enterprise	18.4	17.6	17.3	17.4	15.0	18.6	18.2	17.3

Source: National Bank of Cambodia.

1/ Simple averages of rates reported by the ten commercial banks with the largest deposits.
2/ Virtually all loans to the private sector in Cambodia are denominated in foreign currencies. The recent rise reflects the closing of some banks offering lower lending rates.

Demand for credit by high quality borrowers, such as multinational corporations, is limited, owing to their limited presence in Cambodia and their reliance on internal funds. This has caused some prominent foreign banks to pull out of Cambodia in response to higher minimum capital requirement. On the other hand, demand in the lower segment, consisting mainly of local small-and medium-sized enterprises (SMEs), seems to be relatively strong.

Most banks are foreign-owned and many of them have limited interest in meeting local financial needs. Their focuses are on providing financial services to their home country customers in Cambodia. Banks are concentrated in the urban areas, and only a few banks have branch offices outside the major cities, leaving most of the rural population with no access to financial services provided by banks.

1.3. Reform of the FTB

The FTB has the potential to become a major player in the Cambodian financial market due to its size and its uniqueness in providing financial services in local currency. Given the limited interest by the majority of the foreign banks in providing financial services in local currency, the business plan to be formulated by the FTB during its reform process as well as its eventual privatization could have a significant implication to the future development of the banking sector. Identifying a competent manager who is willing to run the FTB in a way conducive to the financial development of Cambodia will be a major challenge.

1.4. Strengthening Banking Supervision

Strengthening the NBC's supervision capacity will become increasingly important as private credit picks up. Detecting imprudent lending activities and preventing deterioration of the quality of banks' assets will be all the more important given the NBC's limited capacity to serve as a lender-of-last-resort due to the high degree of dollarization in the banking sector. Early introduction and full implementation of the standard chart of accounts by the banks will contribute to increased transparency of banks' operation and should be one of the top priorities. Emphasis should be given to strengthening on-site inspection and enough resources should be allocated to that end. Quality of off-site surveillance activities should be strengthened by improving the analysis of various reports received from the banks, and both the on-site and the off-site team should exchange their information systematically to improve the effectiveness of the supervisory activities.

1.5. Legal Framework

The draft law on negotiable instruments and payment transactions was re-submitted by the Prime Minister to the National Assembly on 18 January 2005 and is expected to be approved later in the year. This draft law will provide the legal basis for further developments in the payment systems, introducing new negotiable instruments and promoting the development of a money market.

The draft law on commercial enterprises was submitted to the National Assembly in March 2002. Intensive discussions of the draft law by members of the 9th Commission of the new National Assembly commented in February 2005. The draft Secured Transaction Law has been discussed by the Council of Ministers up to the end of April 2005. The Minster Councils is confident that the draft law will be submitted to the National Assembly at the end of 2005.

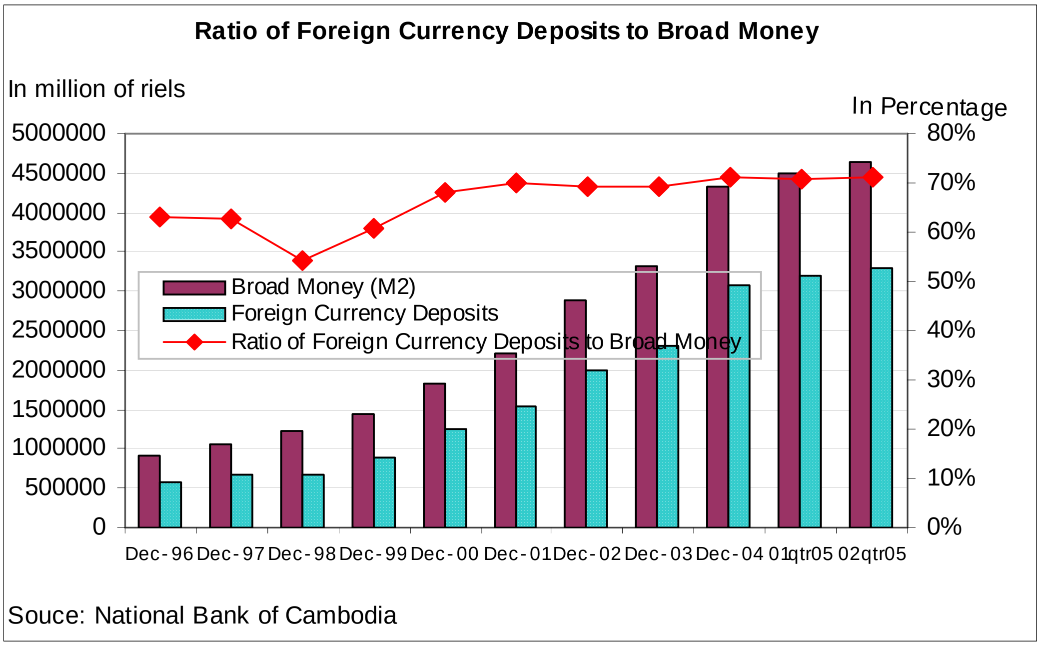
2. The main Issues in the Banking Sector

All the reforms implemented by NBC since 2001 have strongly developed the confidence of the public in the financial system. Over the past years, the average annual growth of the domestic credit was 17% while the growth of deposits was 24% during the same period. This gap between savings capacities and actual lending results from several issues concerning lending interest rates and excess liquidity in the same economy.

2.1. Dollarisation of economy and monetary policy

According to the Banking Law, “there shall be no restriction on foreign exchange operations… transfers, all kinds of capital flows, in foreign or domestic currency, between Cambodia and the rest of the world or between residents and nonresidents”. “However such operations shall be undertaken trough authorized intermediaries”, (i.e “banks permanently established in Cambodia” (art.5). “Residents may hold foreign currency freely, both in form and location, inside the country”. “Loans and borrowings may be freely contracted between residents and non residents… provided that the transactions are made through authorized intermediaries”. The focus of the Law is on the information system, in that intermediaries have to report large transactions, but that is all. The Central Bank does not have the means to control the monetary policy due to the extensive dollarisation in the country. About 96% of the bank deposits are made in US$. Due to their large capital basis, the banks do not need to come to the central bank for refinancing. Lastly, the government is wise enough not to use the central bank as an easy lender. As a consequence, NBC does not have the tools to control the monetary policy.

Figure 7: Ratio of Foreign Currency Deposits to Broad Money



2.2. Short Savings and Excess Liquidity

Despite their large resources, banks are reluctant to take lending risks. These fears are justified if we notice that despite such a cautious behavior, the non-performing loans (NPL) in Cambodia represent around 12% of their portfolio. Why is it then that there seems to be some type of "gap" between the real and the financial sectors in this country?

Up to recently the NBC liquidity ratio constraint was not an incentive for the banks to receive long-term deposits. As a logical consequence, the banks were not prepared to run into any maturity mismatching risk and had no interest in granting long-term loans. We can add the fact that commercial banks knew that their resources could become particularly volatile in an insecure political context. Their customers, holding their deposits in US$ (96% of the total) would be prone to withdraw these funds with no warning. Last but not least, the banks themselves do not feel secure enough to grant long-term loans. For their part, MFIs intervene significantly as lenders for the low-income households. They usually use two types of instruments: (i) "group lending", which is in reality a loan to an individual, but benefiting from group guarantee, and (ii) "individual credit", that is guaranteed by collateral (land title, cow, motorbike, or any sizeable asset…). In both cases, the amounts are low (generally from 25 to 500 $), the interest rates are very high (from 3% to 5% per MONTH) and the maturities are very short (from 3 to 24 months, but mostly less than one year).

However, in terms of savings collections, MFIs do not seem dynamic. Except for ACLEDA, which recently upgraded to a "bank" status, most MFIs seriously underestimate the need to raise themselves the bulk of their resources. Focusing basically on lending activities they have forgotten the liability side of their balance sheet. It could be that they took the easy way of focusing on foreign aid funs to be simply on lent to their low-income borrowers.

2.3. Costly collection of saving resources

The yield paid by the banks to raise their deposits/savings account seems high. Let's take, as an example, the interest paid by Canadia Bank to their depositors:

Table 8: Interest Paid by Commercial Bank to Depositors

TYPE	US $ A/C	RIEL A/C	BAHT A/C	GOLD A/C
1 month fixed	2.5% yearly	(N.A)	2.5% yearly	2.5% yearly
3 month fixed	3% yearly	4% yearly	3% yearly	3% yearly
6 month fixed	4% yearly	5% yearly	4% yearly	4% yearly
12 month fixed	5% yearly	6% yearly	5% yearly	5% yearly
24 month fixed	5.5% yearly	7% yearly	5.5% yearly	5.5% yearly

Source: National Bank of Cambodia

Consequently, the average cost of resources for commercial banks must generally between 3% and 4%. To such basis rate, we have to add the management costs, the costs resulting from compulsory deposits with the central bank, the "supervision" costs paid to the NBC, etc. Altogether, the domestic resources collected by the banks are roughly as costly as foreign borrowings. Whenever they are engaged in savings collection, MFIs for their part also pay a high rate to their depositors, sometimes as high as 1% per month.

The refinancing with the Central Bank is not needed by commercial banks, since they are highly liquid. (See below). However, MFIs do need such a facility and when they go to the Central Bank for refinancing, they are requested to provide physical assets collateral. Due to their lack of dynamism in raising domestic savings, MFIs have to turn to foreign borrowing…particularly in US$. In which case, they run into an exchange risk should they wish to on lend these funs in Riels to their customers (low-income households, farmers). The total cost of these resources, including the exchange risk rate is about 12% per year.

A tax system imposes a 6% withholding tax on payments of interest made to depositors. This rate is unique, and applicable to any type of deposit or savings accounts. It seems there is no government's policy in favor of long term saving mobilization since the rate is no different according to the savings period. The rate used to be 15% up to last year (2004). This tax is paid, not only on deposits received in Cambodia but also on funs borrowed from foreign financial institutions.

The prudential ratios translate into an extra cost for the banks. The solvency ratio, that used to be 20%, has been reduced to 15% since December 2004. This is certainly a positive measure that makes the ratio no more a constraint for banks that have a very high capital.

-The liquidity ratio was 100%, then 80%, and now is 50% (since Dec 2004);

- The compulsory deposit of 10% of the capital in NBC is costly since this deposit receives a modest interest.

The “supervision fees” paid by every bank to the central bank are not negligible. They pay 17,500 us$ per year to the NBC Bank for their headquarters and 14,000 US$ for each branch. These costs have to be included also in their spread.

Considering the costs listed above and the limited proportion of funds the banks are on-lending, we may wonder why commercial banks still go on raising deposit at the expense of their return.

2.4. A Lack of Absorptive Capacity

The financial soundness of the banking sector in Cambodia is not sufficient to promote development in the country. In terms of intermediation, the potential supply of funds largely overtakes the demand. The absorptive capacity of the real sector is still limited as compared to the financial resources raised in the country. The 18 commercial banks considered as a whole have considerable part of their assets. The balance is simply deposited with the Central Bank. In economic terms a considerable part of the savings collected in the country is sort of “frozen”, instead of being used domestically to finance economic development.

2.5. High Lending Rates

Bank’s lending rates have to cover the cost of resources + their “spread”, that is to say their administrative cost + default risk + “willingness to repay”. But we have to keep in mind that such a spread will apply only to that part of the resources that are converted into loans. Everything being equal, the resource “price” is paid on 100, while the spread “cost” can only apply on 40.

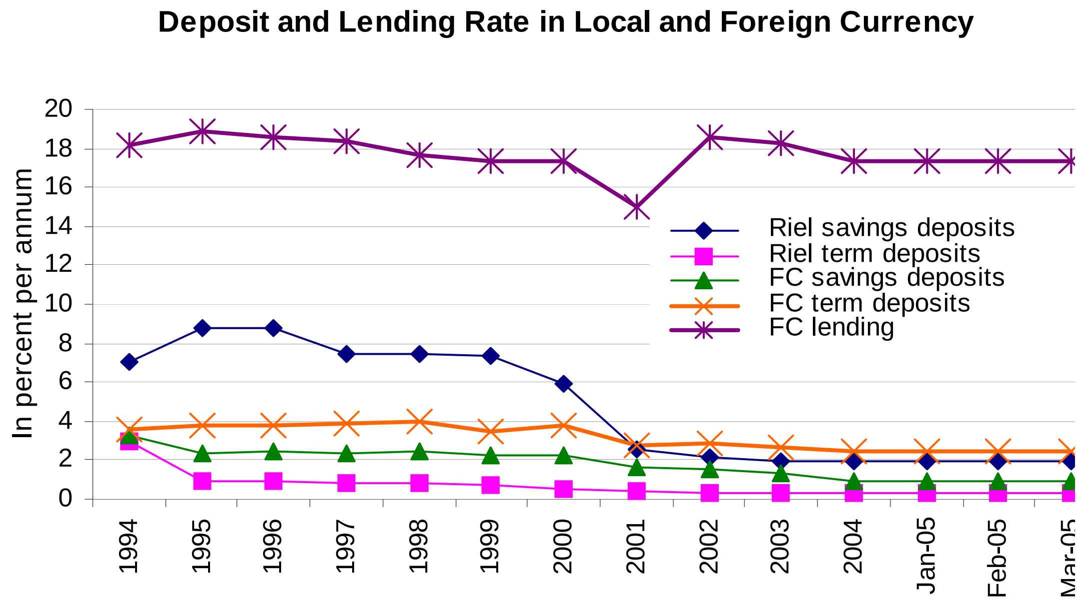
Example: If we assume that only 50% of the deposits are onlent by a bank, then the actual cost of these (used) resources has to be multiplied by two. If the bank is raising 1 million dollars (for instance through saving deposits passbooks), which are paid at 4% to the savers.

The first annual cost for the bank is = 40,000$ (4% of 1,000,000); to which we have to add other costs:

⇨	=> cost 1 =	40,000 $
⇨Management costs of the bank (salaries, pencil, etc (3%)	=> cost 2 =	30,000 $
⇨Supervision fees paid to central bank	=> cost 3 =	14,000 $
⇨Provisions for delinquant loans	=> cost 4 =	10,000 $
⇨Margin for profit and taxes	=> cost 5 =	6,000 $

Altogether, the actual amount paid for obtaining the resource will be = 100,000 $ (i.e 10% of the resource). But since only 500,000 out of 1 million are onlent, the interest that the banker has to charge the loan is the double of what it should normally be. That is : (10% x 2)= 20% (or 100,000/500,000). Depending on the margins taken by some bank to cover specific default risk, it is no surprise that the lending rate can be as high as 21%.

Figure 8: Deposit and Lending Rate in Local and Foreign Currency



Source: National Bank of Cambodia

Besides the personal sector, SMEs are suffering from insufficient lending by the banking sector. Surveys have been carried out to explain bankers' behavior. Their reluctance to lend has been justified by a number of factors, applicable to SMEs as well as to households, which they perceive as seriously increasing their default risks.

2.7. Insufficient Information about Borrowers

There is a definite of developing a borrower's information system in Cambodia. This policy should start with basic requirements, such as the compulsory use of standard accounting principles by the SMEs and the need for establishing annual financial statements. When it comes to the "personal" market (i.e households) there is probably the need for a "credit bureau system" that would keep track of borrowers' debt and previous default history.

2.8. A Lack of Contract Enforcement

The legal framework in Cambodia is said to be very weak, if not practically non-existant. According to recent surveys carried out among bankers and private firms, there is no actual enforcement of contracts due to a lack of basic legislation and unadequate behavior of the courts. Among the main “barriers” listed in a December 2001 survey prepared by MPDF/IFC on “financing the SMEs”, the first one is the fact that “existing laws are inadequate to protect lenders’ interests”.

Every bank considers that the weakness of the legal system in the country is the main obstacle to their lending activities. For instance, the present legal system does not provide any procedure for registering security interest in movable property.

2.9. Other Issues

The NBC should start designing the appropriate structure of deposit insurance system (DIS) for possible introduction in the future. Although it is not a matter of immediate concern, the lack of a deposit insurance system could potentially force banks to hold large amounts of vault cash to prepare for a possible bank run, hindering effective allocation of funds. A well designed and sufficiently funded DIS will promote the use of the banking system and encourage the monetization of the economy. It can also contribute to gradual de-dollarization by introducing different modalities of insurance coverage between domestic and foreign currency deposits.

Providing effective means for banks to manage their liquidity is also one of the issues that should be addressed in the medium term. The lack of an interbank market, together with the inability of the NBC to provide liquidity to banks to meet temporary liquidity shortages, results in banks maintaining an unusually high level of liquidity. Increasing transparency of banks’ operations will contribute to building up mutual confidence among banks and should help establish an interbank market. Although the Central Bank Law provides the legal basis for the NBC to provide rediscount facilities, it cannot do so due to lack of eligible negotiable instruments such as bills of exchange and promissory notes. The Law on Negotiable Instruments and Payments Transactions, expected to be adopted in 2005, will provide the legal basis for the development of such financial instruments. This, in turn, could lead to the establishment of an interbank repo market.

CHAPTER IV

CONCLUSION AND RECOMMENDATIONS

1. Conclusion

The transformation and the restructuring of the banking system were broadly successful Cambodia's banking system was transformation from a monobanking system into a two-tier banking system by separating the central bank functions from commercial banking activities. To date, the financial health of the banks has improved, and public confidence in the banking system is recovering. Lending activities, however, continue to stagnate. Improving financial intermediation by creating an environment conducive to the promotion of financial transactions should be the focus of bank regulators in the coming years. Legal infrastructure needs to be strengthened to improve enforceability of financial contracts. Availability of accurate borrower information must be improved by strengthening various accounting regulations; access to financial services in the rural area has to be improved to promote nation-wide economic development. The regulatory and supervisory capacity of the National Bank of Cambodia should continue to be strengthened in line with the increasing activities of the banks to ensure sound and safe banking system and the development of the financial sector. However, many things and further reform need to be done in order to find the safety net and the soundness of the banking system in Cambodia.

2. Recommendations

At present, there is no formal system of credit information sharing in Cambodia. This is a serious issue in such a high-risk lending environment, a lack of information among inter-banks and borrowers. To reduce risks and increase lending activities, the National Bank of Cambodia should establish Credit Information Sharing System (CIS) or credit bureau in the banking system in Cambodia.

Cambodia still has one of the lowest rates of banking intermediation in the world. To promote banking intermediation, Cambodia needs to: (1) develop a system of reliable borrower information, requiring firms to use a common set of accounting standards and produce financial statements; (2) strengthen contract enforcement; (3) improve the availability of financial services in rural areas; and (4) push ahead with upgrading the FTB's management, including through eventual privatization.

Due to Cambodia has a high degree of dollarization in the economy and the absence of last resource policy from the Central Bank of Cambodia has a potential to make dollarized systems more prone to runs, and runs more difficult to stop when they occur. A strategy to address runs cannot rely to the same extent on the provision of liquidity and on deposit guarantees, the two key elements identified for other cases. I suggest that the authorities should have last resort policy in U.S. Dollars and may need to resort earlier and more frequently to administrative measures that restrict the availability of deposits, or else seek international support at a large scale.

Development of banking sector infrastructure and safe net need to adopt a secured transactions law, establish a deposit insurance system for commercial banks, and establish a public registry for secured transactions.

Strengthening capacity building in the banking sector through ensuring the bankers association establish a banking institute for private bank staff under the bankers association, pursuant to its approved articles of association, and establish a professional training course for private bank staff, the banking institute should be open to staff of microfinance institutions.

Development of the insurance sector through promoting private sector development and should adopt a plan to divest its share in the joint venture insurance company.

Development of accounting/auditing and legal infrastructure: Ministry of Economy and Finance should submit to the National Assembly a draft securities and exchange law.

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