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The Cambodian Financial Sector Development Strategy 2011-2020

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Abstract: **With a rapidly growing commercial economy that requires a sound financial system to sustain growth, Cambodia is committed to the long-term development of the financial sector, channeling financial resources to productive investments, and managing the inherent risks to achieve sustainable economic growth over the long term and contribute to poverty reduction. Financial Sector Development Strategy 2011–2020 reflects Cambodia's achievements to date, provides an assessment of current challenges and constraints to financial sector development, the long-term goals, and a prioritized set of action plans for the next decade. Said strategy will enable Cambodia's financial sector to integrate into the regional financial system and support her long-term economic development agenda.**

This paper reviews the theoretical and empirical literature on the role of financial sector development, with a view to deepening understanding of the rationale of development assistance to the financial sector of developing countries. The review leads to the following broad conclusions: there are convincing arguments that financial sector development plays a vital role in facilitating economic growth and poverty reduction, and these arguments are supported by overwhelming empirical evidence from both cross-country and country specific studies; there are however disagreements over how financial sector development should be sequenced in developing countries, particularly the relative importance of domestic banks and capital markets and, in developing the banking sector, the relative importance of large and small banks; while broadening the access to finance by microenterprises, small and medium-sized enterprises (SMEs), and vulnerable groups is recognized as critically important for poverty reduction, it is also widely believed that microfinance and SME credit programs need to be well designed and targeted to be effective. In particular, these programs need to be accompanied by other support services such as provision of training and capacity building, assistance in accessing markets and technologies, and addressing other market failures; and financial sector development and innovation will bring risks, and it is therefore essential to maintain sound macroeconomic management, put in place effective regulatory and supervisory mechanisms, and carry out structural reforms in developing the financial sector.

There are benefits to dollarization, such as limited exchange rate movements that promote growth in foreign investment and provide a stable environment for the implementation of prudent fiscal policy. However, the loss of seignior age and constraints on the wider use of market-based instruments in implementing monetary policy, such as open market operations3 and foreign currency interventions, raise serious concerns over how well a crisis would be handled, should one occur. This is exacerbated by the limited ability of the NBC to act as the lender of 2 Association of Southeast Asian Nations plus the People's Republic of China, Japan, and the Republic of Korea. 3 When the riel becomes the dominant currency and a broad-based government securities market develops.

Keywords: **Country indicators, economic reforms, objectives, strategies, action plans, financial systems, import export, assessment, and inflation.**

1. INTRODUCTION

Cambodia, known as the Kingdom of Cambodia, is one of the ASEAN member economies located in the southern portion of the Indochina Peninsula in Southeast Asia. Cambodia is described as a unitary parliamentary constitutional monarch.

Cambodia has gone through many historic turns, including French colonization from 1867 to 1953 and the infamous Khmer Rouge regime; just to name a few, where almost everything was demolished. Cambodia is presently considered as a low income country in which 80% of its total population of 14.8 million is engaged in agricultural sector. The total land mass of the nation is 181,035 square kilometers, which is divided into 25 provinces and municipalities and bordered by Laos, Vietnam, Thailand and the Gulf of Thailand. As at December 2013, Cambodia's GDP was US$15,251 million, while the per capita GDP stood to US$1,043.

Cambodia's economy has expanded remarkably over the past few years as reflected by the rapid increase of its GDP as well as its per capita income. However, these increases still remain relatively low compared to other countries in the region. As mentioned earlier, the majority of the Cambodian people are presently engaged in the agricultural sector which is the prioritized sector recognized by the Royal Government of Cambodia. In addition to this, Cambodia's economy has also relied heavily on its tourism industry which earns huge revenues for the nation. Rice, fish, timber, garments and rubber are the major exports. Unlike many of the ASEAN member economies, Cambodia's economy is cash-based and highly dollarized. Huge amounts of US dollars are being circulated within the banking and financial system as well as within the economy as a whole. Dollarization has a long history in Cambodia. Although there is no administrative action against the use of US dollars in the economy,

2. OBJECTIIVES

The objective of the FSDS 2011–2020 is to develop a sound financial sector that can contribute to poverty reduction by supporting economic growth and increasing poor people's access to finance.

Adjustments to the institutional framework need to take into account new finance industry developments. The Law on the Issuance and Trading of Non-Governmental Securities has established the Securities and Exchange Commission of Cambodia to act as regulator of the securities market and market participants. Given the interconnection between the securities market and the banking sector, to ensure effective supervision of both, an effective cooperation mechanism needs to be established among related financial sector authorities.

The revision of legal and cooperation frameworks; there are currently some inconsistencies between existing laws and international standards that need to be addressed. The problem of supervision agencies whose jurisdictions overlap in some areas also needs to be addressed.

Crisis preparedness: a crisis management framework needs to be established and will require periodic testing to ensure that it suits Cambodian economic and financial conditions and addresses the new risks that may arise as a result of growing interconnections within the banking system will help identify potential risks. In order to establish a financial stability unit and early warning system, the concerned financial authorities should set up a national financial stability committee the financial sector. Because of the high level of dollarization, it is necessary to pay close attention to the potential systemic risks. Establishing a financial stability unit within the National Bank of Cambodia and an early warning system within the banking system;

1. The objective of study is to present the matter of Cambodian Financial Sector Development Strategy to audience of management researcher.

2. To identify the opportunities for further research in the new and developing country.

3. Passage of major commercial and financial sector laws to support development of a sound and market-driven financial sector,

4. restructuring of the banking sector and the strengthening of key financial institutions, introduction of the financial sector infrastructure necessary to support financial market activities and improve outreach to the rural poor,

5. Development of human resources and specialized knowledge, and mobilization of the domestic financial resources needed to meet the demands of a fast growing economy.

3. METHOD

The survey collected qualitative and quantitative data. The financial sector development facilitates economic growth and the magnitude of the impact; whether certain components of the financial sector (such as banks or stock markets) play a particularly important role in fostering growth at certain stages of economic development; and whether and to what extent financial sector development directly benefits the poor. A large body of literature also investigates the extent to which economic growth leads to poverty reduction. This section provides surveys of these empirical studies in three parts. The first part focuses on cross-country studies based on growth regression using country-, industry- or firm level data. The second part looks at country-specific studies, including those based on time-series data and project-level cases. The third part presents findings from selected case studies of programs and projects by multilateral development banks designed to develop well-functioning financial markets and improve the poor's access to finance in developing countries.

4. RESULTS

– **The Financial Sector:**

The financial sector of Cambodia has developed quickly and is highly competitive. The value added by the sector increased an average of 22.1% per year from 2004 to 2008, reflecting the deepening and wider scope of financial intermediation. When preparing the Vision and Financial Sector Development Plan in 2000, the ratio of money supply to GDP was only equal to 12.5%. This ratio rose to 20.5% in 2006, when the Financial Sector Development Strategy 2006–2015 was updated, and it has further increased to 38.3%. The ongoing rise in deposits and use of credit demonstrates growing public confidence in the banking sector. The country's banks are all privately owned and most with majority foreign shareholders. Over the last decade, the banking sector has experienced high growth. NBC supervises the banking system of the country. Despite progress in the banking sector, the financial sector is still in the early stage of development as it lacks the infrastructure to engage in all financial operations. The challenges that need to be addressed in the FSDS 2011–2020 include the high dependence on the banking system for resource mobilization, the concentration of financial assets in a few large banks that could suffer from systemic risks, the high cost of bank intermediation, lack of long-term finance, lack of qualified human resources, lack of managerial and supervision capacity, lack of reliable credit information and related infrastructure, limited use of the national payment system, the need to strengthen supervision in the nonbank financial sector, lack of a coordinating mechanism and exchange of information between concerned regulatory bodies, and limited financial services in rural areas. Cambodia's financial sector is entering a stage of specialization with the development of specialized institutions and financial instruments. The government is expected to launch an interbank market and is considering issuing government securities after the necessary infrastructure and regulatory framework have been put in place. This is a major condition for establishing a domestic money market. A broad-based government securities market would enable the authorities to conduct an open market operation. This has to be implemented in parallel with promoting increased use of the riel. Cambodia's securities market will commence trading after the key market players receive their business licenses. The growing insurance sector provides general insurance, life insurance, compulsory vehicle insurance, and micro insurance. The upgrading of the national payment system has helped implement the mobile banking market and increased funds transfer through electronic systems and the emergence of money exchange services. Other new developments in the financial sector include the establishment of trusts, leasing operations, pension schemes, pawn businesses, and collective investment schemes.

– **Structure and Strategic Document Preparation:**

To prepare the FSDS 2011–2020, broad consultation took place with the line ministries of the government, including the Ministry of Economy and Finance (MEF); NBC; Ministry of Commerce (MOC); Securities and Exchange Commission of Cambodia (SECC); Ministry of Justice; Council of Jurists; Ministry of Social Affairs, Veterans and Youth Rehabilitation; and Ministry of Land Management, Urban Planning and Construction (MLMUPC), as well as with banks and other private sector financial institutions, insurance companies, securities firms, and nongovernment organizations. Key development partners such as the Asian Development Bank, International Finance Corporation, International Monetary Fund, and World Bank were also consulted.

The data for preparing this strategy were obtained from the MEF, MOC, MLMUPC, NBC, and SECC as well as from other relevant institutions in the financial sector. Inputs for analysis and for documenting this strategy include the study on the financial sector and the discussion paper on Article IV between the government and the International Monetary Fund. In addition, a number of consultative workshops were held with the ministries and institutions of the government, regulators, supervisory bodies, financial market participants, and development partners so they could provide their comments on the draft FSDS 2011–2020.This strategic document has been prepared to reflect the relationship between the bank and nonbank financial sectors and the infrastructure that supports financial sector development. Currently, the banking and microfinance sectors experience the highest growth in the financial sector in delivering financial intermediation services to all sectors, including financing to small enterprises and rural households. The development of the domestic money and capital markets should offer (i) new sources of financing; (ii) the longer-term financing needed for infrastructure, manufacturing, and other forms of industry; and (iii) financing for large enterprises. The growing nonbank financial sector is another source of funds for promoting large-scale and effective financial intermediation. In the long term, the initiative to develop the infrastructure necessary to support development of the financial sector and capacity building should ensure development of both the bank and nonbank financial sectors.

The overall strategy and a large part of the action plans for reform as prescribed in the FSDS 2011–2020 are closely interconnected. The process and the strengthening of reform policy require an appropriate timeline. To effectively implement the reform program, the strategy must take into consideration challenges over the course of implementation as the majority of reform activities necessitate preconditions that are tailored to economic and political circumstances. On the other hand, any delay in achieving objectives in one sector may deter the reform process in other sectors. Based on experience gained in implementing the previous strategy for financial development, coordination and cooperation among competent authorities, international organizations, and development partners are crucial to reform success. Hence, the government pays close attention to the pace of the reforms and regularly monitors their implementation and challenges that arise due to rapid market evolution so that appropriate and timely measures can be taken.

Banking in Detail:

– **Current Players in the Sector:** As the growth of Cambodia economy, the financial sector also expands eventually to serve the increasing demand. According to the data from National Bank of Cambodia (NBC), there are 32 commercial banks and 7 specialized banks operating by December 2012. Definitely, commercial bank is permissible to provide loans, collect deposits and provides means of payments while specialized bank hold only one of the above three functions. Among 32 commercial banks, the four leading institution in terms of asset, loan portfolio size and deposits included Acleda Bank, Canadia Bank, Cambodian Public Bank and ANZ Royal Bank. These big fours represents more than half of the banking asset in total and shares about two-thirds of banks' total loan and deposit.

At the same time, for microfinance institution (MFI), there are 32 microfinance and 7 microfinance deposit taking institution, in which granting a license to collect deposit from customers. Among all, there are also four leading in term of assets in which held around 65% of total assets in the MFI. Those include Prasac, Amret, Sathapana and Hatakaksekar microfinance institute.

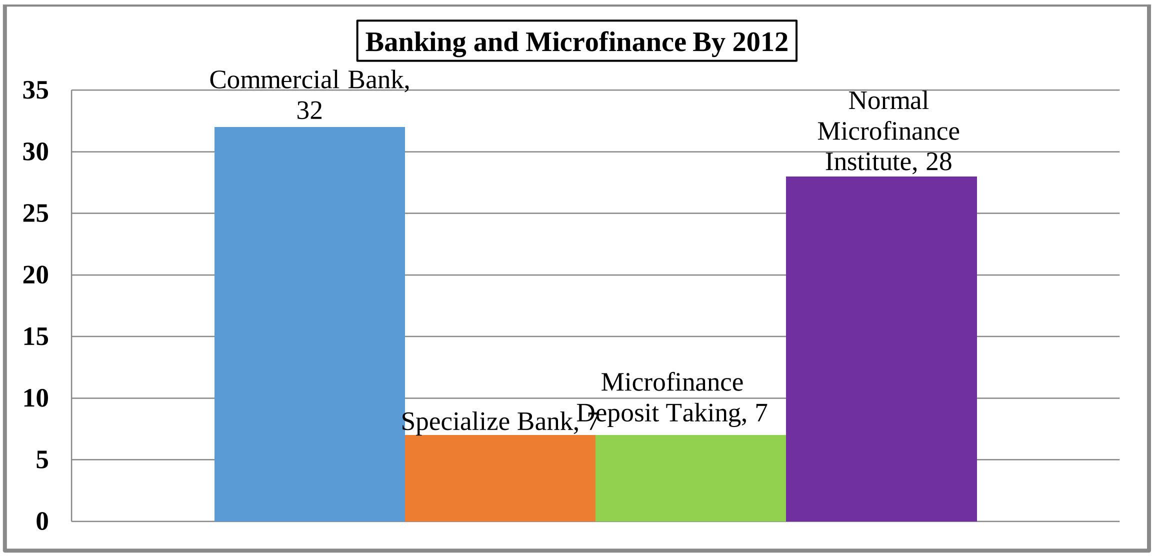


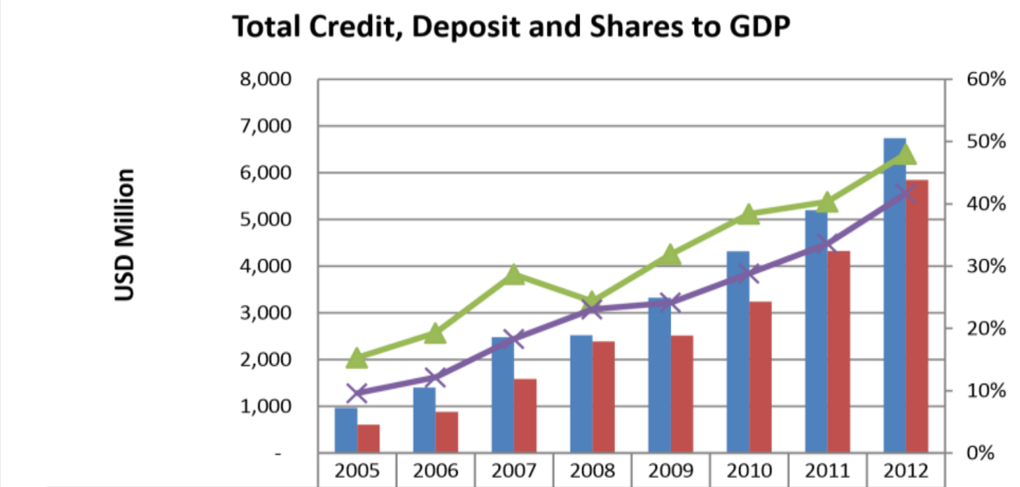
Figure 01: Number of Bank and Microfinance Institute

Of course, the amounts of 32 or 34 commercial banks do not show the sector is relatively small or large, but the important things are to ensure strengthening and sustainable development of the sector with promising quality.

– **Loan and Deposit to Country's GDP:** Along with the increasing number of institution, total value of deposit and loan in the banks also increases substantially. According to the data from the NBC, the total amount of loan increased from US$963 million in 2005 to US$6.7 billion in 2012, an annual growth rate of 33%. This gradually expanding was supported by the need of investment, domestic consumption and the expectation of economic growth in the medium term. On the other hand, total amount of deposit also grew from US$604 million to US$5.8 billion between from to 2012, with an average growth more than 39% per year. This growing also reflected the confident of Cambodian over the banking sector. However, comparing with the amount of GDP, Cambodia credit and loan is on the way so far even the market is very crowded, up to 34 banks by July 2013. As the figure shown below, the total loan to GDP was only 42%, while the total saving equal to 48% to GDP. If we look at other countries like Thailand, Vietnam or Malaysia, the rate was more than 100%. Therefore, from this viewpoint, it is evidentially that there is still room for new comers who favors for business opportunities in this financial sector.

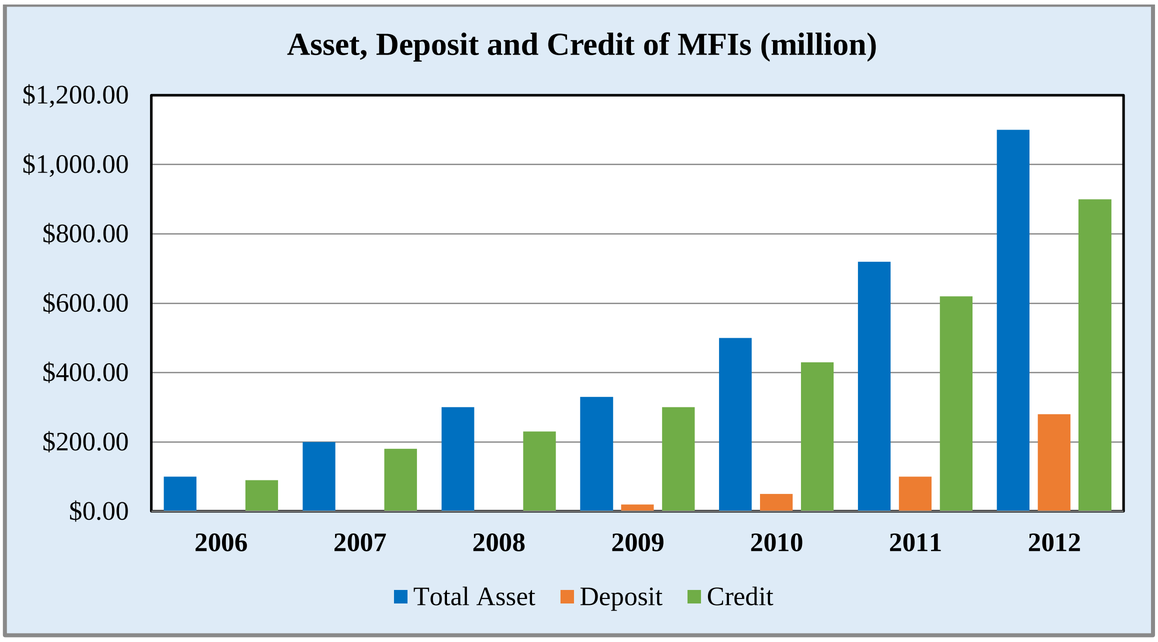
– **Total Asset, Loan and Deposit of MFIs**

In parallel with the growth of banking, the rise of microfinance sector is also significant (the figure 2and 3: Credit and Deposit to GDP)**.** Based on the diagram below, total assets reached more than US$1 billion in 2012, an increased around 43% compared to the previous year. At the same time, total credit surged up around 38% while 58% for deposit and this notice able rise in deposit in 2011 and 2012 as a matter of issuing license for MFIs to collect deposit from customers.



	2005	2006	2007	2008	2009	2010	2011	2012
Total Deposit	963	1,402	2,479	2,521	3,320	4,313	5,193	6,736
Total Credit	604	882	1,583	2,388	2,511	3,241	4,326	5,846
Total Deposit to GDP	15%	19%	29%	24%	32%	38%	40%	48%
Total Credit to GDP	10%	12%	18%	23%	24%	29%	34%	42%

Figure 2



Source: NBC Supervision Annual Report 2012

Figure 3

– **Non-Performing Loan Record:** Even the amount of loan to different sector has grown up gradually, the ratio of non-performing loan (NPL), the loan which is or close to default, remained in lower rate. Based on the data from the NBC, the NPL ratio was at 2.45% of total. *By the end of June, the no* loans, in which the provision level was 54% of NPL. Hence, the *performing loan at the Microfinance level positioned at* amount of loan loss was significantly low, as the supported from *3% of total loans*. Better risk management as well as the diversification of loan into many economic sectors. The impressive point fell on the Acleda Bank since the NPL rate stayed at 0.27% to the total loan in 2012.

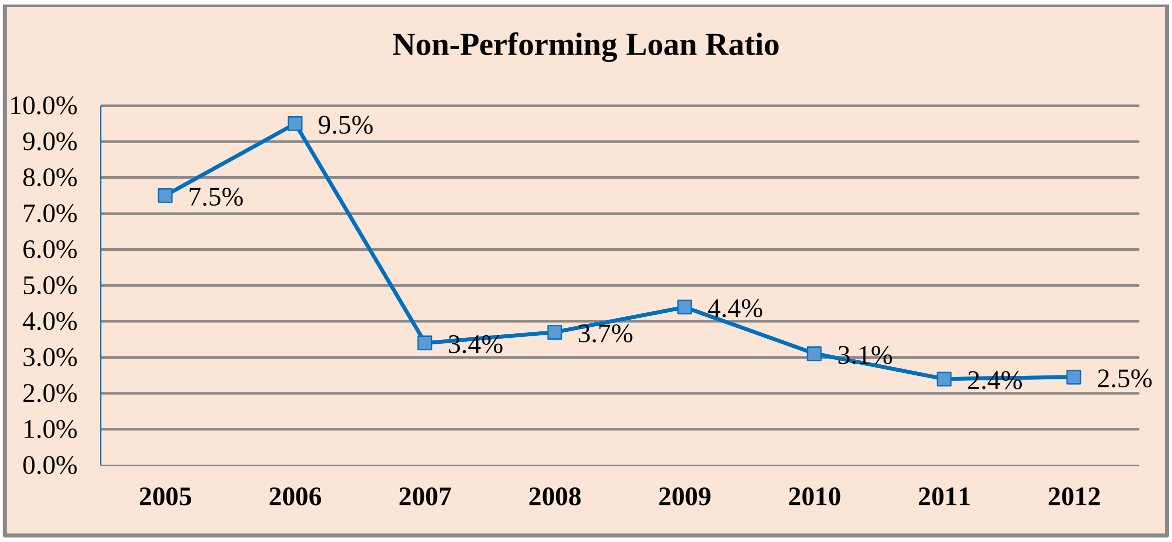


Figure 4: Non Performing Ratio

Liquidity Management: Referring to liquidity management, an ability to meet short term debt, it is still in good position. By the end of 2012liquidity in Cambodia banking system was at 82%, which was higher than the requirement of the NBC, 50%. Those liquid assets are sourced mainly from the core deposit and overseas borrowing. It is worth to notice that low liquidity management is very vulnerable to banking crisis or the bank run.

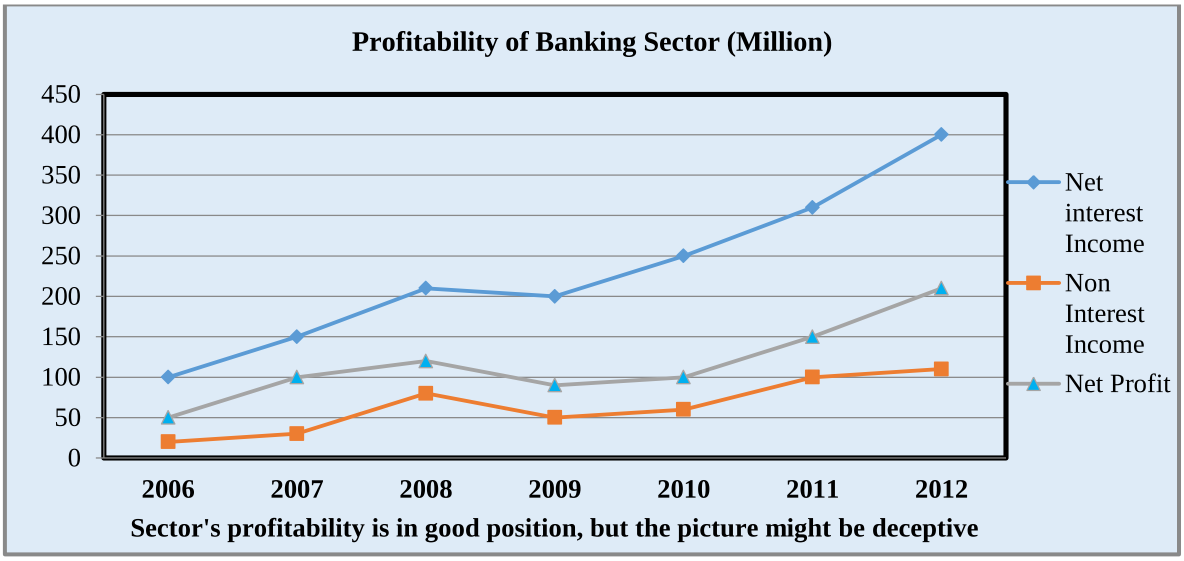


Figure 5

Current Interest Rate: From the economic growth with the robust and promising of the banking sector plus the competitive environment, the spread of interest rate both US Dollar and Khmer Riel is getting smaller. The accounted factor counted for lowering spread includes the competition, business strategies modification, especially the new entrance of international banks to involve in this market. However, the decline of interest rate may turn out some risks for the profitability and growth of the banks and the entire sector. The thing is to have more and exact information about the borrowers for having better decision making on the lending. As a result, loan to be issued also hold better quality with the improvement of efficiency. After for more than a year of operating, the bureau reported to have positive effects on the banking sector by producing more than 1.7 million credit reports, and so more loan has been approved based on those accurate reports. With this report, loans are easy to access and people who are already in debt are protected from becoming over indebted.

– **Cooperation and integration with ASEAN:**

It is clearly in Cambodia's interest to foster closer cooperation with ASEAN, especially in the financial sector. Since the East Asian Financial Crisis in 1997, much emphasis has been given to regional arrangements in helping individual countries to prevent financial crises. Through active participation in various ASEAN forums, Cambodia is preparing for eventual integration with its regional neighbors and greater cross-border flows. Based on the Development Action Plan, necessary reforms to achieve policy alignment and coordination with ASEAN are through developing the market and legal infrastructure for (i) accounting and auditing; (ii) the payment, clearing, and settlement system; (iii) stock market listing and securities trading; (iv) taxation of financial instruments; (v) credit rating, (vi) insolvency; (vii) secured transactions; and (viii) intellectual property. The ultimate objective is to establish a single common market where ASEAN investors may invest in each member country as if it were one market. However, achieving integration in various areas requires specialized expertise and in-depth treatment, especially where the region is concerned.

Implementation of an interbank market: while demand for using the interbank market is limited as banks have excess liquidity, there is clear need to start an interbank market because of the difficulties that banks have in covering their reserve positions and also in seeking temporary investments for their excess funds. To fulfill the need for such securities, NBC expects to introduce negotiable certificates of deposit shortly. Nonetheless, before an active market can emerge, all banks will have to be confident that the interbank market can provide reliable backup liquidity to bridge their short-term liquidity needs. This will allow them to eventually lessen their reliance on retained deposits to meet their temporary liquidity needs.

Development of a money market: to facilitate money market development as Cambodia plans, the relevant authorities need to set up the legal and regulatory framework to allow specialized nonbank financial institutions the right to issue and use various trading instruments in the market. Once documentary credits become more prevalent in the market, this means being able to issue and use various negotiable instruments such as commercial papers and negotiable promissory notes, including bills of exchange. Repurchase agreements that cover these underlying instruments have already been addressed. Limits on how much can be issued to the public by securities firms or financial institutions themselves will have to be established and monitored. In some jurisdictions, part of the issue may require a bank guarantee (say 10% of the issue). This provides some protection for investors, as it provides a partial guarantee in case of loss and ensures that the issue will be reviewed by a bank before it is issued to the market. As the market broadens and deepens, more market players will participate so long as profits can be made. However, the market will likely develop at its own pace.

The government may consider offering incentives to attract market players, especially foreign institutions that could help introduce the required technology. Once a broad and deep market for securities develops over time, financial institutions should find it attractive to securitize their loan portfolios. For borrowers who require large loans that exceed what any individual bank can provide owing to their single-borrower limits, the sale of securities directly to investors would allow borrowers to raise the amount of capital they require. Moreover, such requirements could be syndicated, either on a private placement basis (held by the underwriting syndicate itself and not sold publicly) or through a publicly underwritten issue (sold and distributed to various investors). However, a suitable framework for syndicating loans and issuing securities needs to be established that defines the legal rights and obligations of each participant in a syndication, the terms and conditions of the loan or security to be issued, the yield on the security or offering price, the related fees, how modifications are to be handled, and the procedures to be followed in case of a lawsuit (including who will act as the paying and collecting agent, who will be the legal counsel for the syndicated loan, etc.). This is necessary, as some attempts at syndication have been made but did not succeed since banks are not accustomed to cooperating with each other. For a capital market in debt instruments to develop (bonds and long-term commercial papers, for example), the money market must be developed first. This is because the money market serves as the secondary market where debt instruments of long duration can be sold, liquidated, and transformed into cash in the same way that a stock exchange provides secondary market support for equity instruments.

5. CONCLUSION AND RECOMMENDATION

The paper argues that these conclusions provide a strong justification for development assistance to target financial sector development as a priority area, and that, like any public sector intervention, such assistance should be designed to address market and nonmarket failures. The paper also highlights several areas where more research is urgently needed, in particular, how to sequence financial sector development, how to balance the need for financial innovation and that for economic and financial stability, and how to make microfinance and SME credit programs work better to reduce poverty.

The government would (i) formulate regulations for implementing the law on the commercial contracts; (ii) introduce the law on. In the longer term, the government will develop a financial sector competition policy to prevent anticompetitive practices. This commercial court; (iii) establish a commercial court; and (iv) establish a national center for commercial arbitration with an independent, ongoing executive board will include a competition law and a consumer protection law. Also over the longer term, the government will establish authorities for enforcing the Competition Law and the Consumer Protection Law. Over the medium term, the government will develop a law on agency, together with its implementing regulations.

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