FOR AGENDA

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October 18, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Cambodia—Financial System Stability Assessment**

This paper provides background to the staff report on the 2010 Article IV consultation discussions with Cambodia (SM/10/278, 10/18/10), which is tentatively scheduled for discussion on **Friday, October 29, 2010.** Unless an objection from the authorities of Cambodia is received prior to the conclusion of the Board's consideration, the document will be published. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

Questions may be referred to Ms. Ong, MCM (ext. 34842).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, October 26, 2010; and to the Asian Development Bank, following its consideration by the Executive Board.

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CAMBODIA

Financial System Stability Assessment

Prepared by the Monetary and Capital Markets and Asia and Pacific Departments

Approved by José Viñals and Anoop Singh

October 15, 2010

This Financial System Stability Assessment (FSSA) is based on the work of a joint IMF/World Bank Financial Sector Assessment Program (FSAP) mission to Phnom Penh during March 11–30, 2010. A second mission was not required. The main findings are:

- Cambodia's financial system emerged seemingly intact from the crisis, but there are significant risks to the system's ability to sustain stability in the absence of significant reforms.
- The shortage of qualified human resources, the lack of technical capacity, and data weaknesses significantly impair supervision and are an overarching problem for the financial sector.
- Although banking supervision has improved considerably, it remains predominantly compliance-based and does not adequately address risks.
- There is currently no formal framework for crisis management in Cambodia, placing an inappropriate burden on the NBC's supervisory framework and the PCA framework.

The main authors of this report are Li Lian Ong and Diane Mendoza, with contributions from other members of the team.

The FSAP team comprised Li Lian Ong (IMF mission chief), Nombulelo Duma, Rodolfo Maino, and Nancy Rawlings (all IMF); and James Seward (mission chief, World Bank), Nagavalli Annamalai, Christopher Fabling, James Hanson, Damodaran Krishnamurti, Colleen Mascenik, Sebastian Molineus, Allan Schott, Craig Thorburn, Sau Ngan Wong, Alice Zanza (all World Bank); Diane Mendoza (previously World Bank external consultant, currently IMF); Mark Flaming (World Bank external consultant) and Ruziana Mohd Mokhtar (IMF external consultant, Bank Negara Malaysia).

FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

AML/CFT	Anti-Money Laundering / Counter-Terrorist Financing
BCP	Basel Core Principles
BSD	Bank Supervision Department
CAR	Capital adequacy ratio
FIU	Financial Intelligence Unit
FSIs	Financial Soundness Indicators
IFRS	International Financial Reporting Standards
LBFI	Law on Banking and Financial Institutions (November 1999)
LNBC	Law on the Organization and Conduct of the National Bank of Cambodia (January 1996)
LOLR	Lender of last resort
MEF	Ministry of Economy and Finance
MFI	Microfinance institution
MoU	Memorandum of Understanding
NBC	National Bank of Cambodia
NGO	Non-Governmental Organization
NOP	Net open position
NPL	Non-performing loan
PCA	Prompt Corrective Action
RBS	Risk-based supervision
SECC	Securities and Exchange Commission of Cambodia
TA	Technical Assistance

EXECUTIVE SUMMARY

1. **A joint IMF/World Bank team undertook the Financial Sector Assessment Program exercise for Cambodia during March 11–30, 2010.** The mission assessed a broad range of financial stability and structural issues, as well as the observance of the Basel Core Principles (BCP) for Effective Banking Supervision, after meeting with a broad spectrum of public and private sector officials in performing its assessments.[1]

2. **Cambodia's financial system emerged seemingly intact from the crisis, but there are significant risks to the system's ability to sustain stability in the absence of further reform.** The FSAP found several overarching problems in the financial sector, including: the general shortage of human resources and the lack of capacity across supervisory agencies and elsewhere; the inability to adequately monitor risks as a result of data gaps and poor data quality; the uneven implementation and enforcement of laws and regulations; weak regulatory and supervisory frameworks and the overall lack of coordination across financial supervisory agencies; very high levels of dollarization in the economy; and outdated and inconsistent laws across different financial activities.

3. **The shortage of qualified human resources and the lack of technical capacity pervade all segments and activities of the financial system.** The result of decades of civil conflict, there is a widespread lack of trained financial professionals in the country—including at the supervisory and regulatory bodies—that cannot be easily addressed except over a medium- to long-term horizon. The supervisor was successful in hiring several new staff recently; however some will not be able to contribute effectively to the work for some time, while they undergo training and gain relevant experience.

4. **Data inadequacies, which impair surveillance and supervisory activities, need to be addressed.** The reliability of the reported numbers is highly questionable, largely due to uneven implementation and enforcement of existing laws and regulations, as well as to inadequate validation on the supervisors' part. The lack of assessment of banks' information technology systems also undermines confidence in data consistency and quality. Moreover, much of the off-site work is performed without documented criteria, policies and procedures.

5. **Strict and evenhanded enforcement of existing laws and regulations is crucial for the credibility of the supervisor.** In the near term, enforcement of regulations on asset classification and provisioning and minimum capital requirements will be an important litmus test for the NBC's and the government's commitment to a healthy and well-supervised banking system. The latter needs to be implemented in a transparent and orderly manner to preserve confidence, while enforcement of the former will help to address some of the problems with data quality. As highlighted by the 2007 AML/CFT assessment and World

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[1]In addition to the Detailed Assessment Report for the BCP, ten Technical Notes were prepared, covering the broad range of financial stability issues discussed in this report, as well as developmental issues.

Bank Governance Indicators, corruption is a pervasive concern, and it weakens confidence in the overall regulatory framework.[2] The recently passed Anti-Corruption Law is a welcome step forward but will need to be pursued vigorously.

6. **Banks, especially foreign-controlled ones, dominate the financial system and the sector is necessarily a key focus of the FSAP.** Several supervisory concerns have become increasingly urgent and need to be addressed: banking sector assets are highly concentrated in a few banks, some of which are facing significant asset quality problems that could be exacerbated by weaker growth or real estate prices (Table 1); banks are authorized to undertake a very wide range of activities without regard to their capacity to control the risks or additional capital buffers; and foreign-controlled banks, owned by non-financial corporates and therefore not subject to home country supervision, are entering the market. The authorities are strongly encouraged to put a moratorium on the issuance of new bank licenses until supervisory capacity and resources are more adequate; they also need to start moving away from compliance- towards more risk-based supervision (RBS) to alleviate the strain on resources.

7. **The fledgling non-bank financial sector remains very small but has the potential to expand quickly.** Thus, oversight of this sector needs to be significantly enhanced. The Ministry of Economy and Finance (MEF) has made progress in developing the supervisory regime for the insurance sector, but a considerable amount of work at the policy and regulatory levels is still required to ensure safe and prudent development and to keep up with industry growth. The Stock Exchange Commission of Cambodia (SECC) has been created and will have oversight of the forthcoming stock market and the Cambodia Mercantile Exchange, but the authorities are cautioned against launching these markets before the necessary supervisory and regulatory frameworks and infrastructure are in place.

8. **There is an urgent need to upgrade existing financial sector laws to include clarity of supervisory mandates and coordination frameworks.** For example the Law on Banking and Financial Institutions of November 1999 (LBFI) needs to be amended to take into account changes in the supervisory landscape. Revisions to the LBFI should include giving the National Bank of Cambodia (NBC) a clear mandate to conduct consolidated supervision and for safeguarding financial stability. However, ministerial discussions have stalled and need to be reactivated. There is also no formal Memorandum of Understanding (MoU) among the NBC, SECC, and MEF for coordination across supervisors, or for exchange of information on a regular basis on cross-cutting issues; the supervisory agencies are in the process of preparing a MoU on crisis management. MoUs have been signed with bank supervisors in Vietnam, and more recently, Malaysia, but Cambodia also needs to have MoUs with other home countries to the numerous foreign banks that are present.

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[2] See Appendix I, Figure A1.

9. **A crisis management framework needs to be developed but there are significant barriers.** The very high levels of dollarization in the economy, which resulted from sudden and massive foreign currency inflows following more than 20 years of continuous conflict, impairs the development of a robust crisis management framework.[3] Specifically, it limits the ability of the central bank to provide lender-of-last-resort (LOLR) assistance to distressed, but viable, banks during a crisis as the NBC may not hold sufficient international reserves. The central bank's role in managing systemic liquidity is also severely constrained.

10. **The Cambodian government has adopted a roadmap for the development of the financial sector over the 2006–15 period.** The authorities have indicated a strong desire to use the findings and recommendations of the IMF/World Bank Financial Sector Assessment Program (FSAP) to inform the update to the five-year plan.

11. **The implementation of these recommendations will likely require significant additional Technical Assistance (TA) from international financial institutions and bilateral donors.** Implementation of past TA advice has been slow, partly owing to capacity constraints, which will need to be considered as future assistance is designed. The list of high priority FSAP recommendations, including those for areas covered by the World Bank, is summarized in Table 2.[4]

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[3]The implications of dollarization are examined in the 2010 Article IV.

[4]Medium priority recommendations are presented in Appendix II.

Table 1. Cambodia: Risk Assessment Matrix

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years *(high, medium or low)*	**Expected Impact on Financial Stability if Threat is Realized** *(high, medium or low)*
1. *Economic growth is weaker than expected due to a double dip recession in the country's main export market, the United States.*	*Low* • The IMF's World Economic Outlook projections identify a risk of weaker U.S. growth, but place a low probability on a double dip recession.	*High* • Most credit-worthy borrowers are in the higher value-added sectors of the economy, such as manufacturing. Weak economic activity would weigh significantly on banks' loan portfolios, which were already severely affected by the crisis. With NPLs at some systemically-important banks at high levels, the banking system is vulnerable to a sudden loss of confidence if the recapitalization of some banks, found by on-site supervisors to have very high NPLs, is not undertaken.
2. *Continuing weakness in real estate prices.*	*Medium* • Real estate prices appear to have bottomed and are showing signs of turning around. However, the extent of the overhang from the boom period is unknown, given the lack of any official real estate price data.	*High* • Given the heavy concentration of banks' portfolios in real estate, continuing weakness in this sector poses a significant threat for banking system soundness. Even flat prices would be detrimental to banks' balance sheets, in light of the extent of the previous price collapse.
3. *Regulatory forbearance.*	***High*** • Supervisors have been exercising regulatory forbearance. Banks have been allowed to evergreen principal repayments and to capitalize interest on loans with late payments, while related-party lending—and bank ownership details—remain opaque. The uneven implementation and enforcement of existing regulations has resulted in high NPLs, inadequate provisioning, and weak capitalization.	***Medium*** • Economic conditions are improving, and concerns about the health of the banking sector have moderated. Forbearance by supervisors—and its implications for the soundness of the banking sector—is less likely to cause depositor alarm in the current environment. • However, any unexpected triggering of concerns about the health of the banking sector, if supervisors do not enforce recapitalization of under-capitalized banks, could potentially lead to a sharp loss of confidence and a systemic run on deposits.

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years *(high, medium or low)*	**Expected Impact on Financial Stability if Threat is Realized** *(high, medium or low)*
4. *Liquidity overhang*	***High*** • There is currently a significant liquidity overhang in the banking system, as a result of the aggressive competition for deposits during the crisis. Banks' profit margins are being squeezed as they compete for the few lending opportunities.	***High*** • With bank balance sheets yet to recover from the impact of the crisis, further shocks to loan quality pose a severe threat to solvency.
5. *Political developments.*	***Low*** • The threat of a systemic run on deposits has moderated significantly. However, the experience of 2008 illustrates that renewed political unrest in neighboring Thailand could spill over and have a similarly detrimental impact on Cambodia.	***High*** • A systemic run could be severe, especially given the historical distrust in the banking system and the lack of financial safety nets.
6. *Shortcomings in the crisis management framework.*	***Medium*** • The likelihood that crisis management may be needed has lessened, with economic and financial conditions improving. A key mitigating factor is that the banking system appears to have withstood the worst of the financial crisis—albeit weakened—and the probability of a huge shock to the system has declined.	***High*** • The authorities would not have the means to deal with a significant shock to the financial system. The existing bank resolution framework is inadequate, and the ability of the NBC to provide speedy liquidity support to banks is extremely limited, as is the LOLR function of the NBC, given the very high dollarization in the banking system. The limited fiscal policy space and Cambodia's assessed medium level of debt distress constrain the government's ability to provide support for the banking system. Further, the weaknesses in supervisory capacity would also hamper an effective crisis response.
7. *Poor management of banking sector consolidation*	***Medium*** • The NBC has announced a substantial increase in the minimum capital of banks, effective end-2010. This policy is likely to reduce the number of banks through mergers or closures. Supervisors have had previous experience with intervening in banks (in 2000) without incident but the current environment may require greater caution.	***High*** • The issues relating to bank closures and treatment of depositors and creditors will need to be conducted in a transparent, equitable, and orderly manner in order to preserve confidence in the banking system. Otherwise, the impact of a widespread run on deposits will have devastating consequences.

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years *(high, medium or low)*	**Expected Impact on Financial Stability if Threat is Realized** *(high, medium or low)*
8. ***The failure of systemically important banks.***	***Medium*** • Economic and financial conditions are improving, and any depositor concerns about the health of the banking system are likely to be receding. That said, there has been little effort to boost the capital of large banks weakened by the crisis. Onsite inspections of these banks indicate that their balance sheets remain vulnerable.	***High*** • The five largest banks account for almost three-quarters of the banking system's assets. • The lack of a crisis management framework, information on ownership structures, and financial safety nets (see above) means that there is little ability to mitigate shocks in the event of a realization of the risks.
9. ***Lack of human resources and severe capacity constraints to adequately supervise financial institutions and markets.***	***High*** • Supervisors have acknowledged the difficulties they face in recruiting and retaining staff and the risk this poses to their oversight. Nonetheless, the authorities continue to support the entry of new market participants and a new stock market.	***Medium*** • Inadequate supervision of an increasingly large and complex financial system will result in the building-up of risks over time that is left unchecked and unmonitored, and leaves the system vulnerable to shocks from various unforeseen sources.

Table 2. Cambodia: Key FSAP Recommendations of High Priority

Recommendation	Timeframe 2/
General Stability	
• Improve the quality of data to enable an appropriate assessment of risks, and to enhance the reliability of stress tests, including through strengthening supervision and collecting additional credit-related information.	Short-term
• Ensure that banks retain an appropriate level of liquid assets to be able to meet short-term obligations by enforcing existing regulations.	Short-term
• Upgrade law to formalize delineation of responsibilities among supervisors, and establish procedures through MoUs for practical information exchange, coordination, and accountability among domestic supervisors (NBC, MEF, SECC), and with foreign supervisors.	Short-term
• Upgrade both the number and capacity of staff in the areas of banking, insurance, securities, and payment system supervision; and develop training programs for financial institutions on accounting, corporate governance, risk management, and for the external audit profession.	Medium-term
• Develop and implement a strategic plan to address the legal lacunas, conflicts, and overlaps in the financial sector legal and regulatory frameworks; define and publish codes of conduct for supervisory staff to prevent exploitation of conflicts of interest and general fiduciary obligations	Medium-term
Supervision and Regulation	
Banking	
• Develop a supervisory strategy to deal with banks that cannot meet the new capital requirements.	Short-term
• Introduce forward-looking, risk-based supervision.	Short-term
• Impose a moratorium on the issuance of new bank licenses until supervisory capacity and resources are adequate.	Short-term
Non-Bank Financial Sector	
• Revise capital regulations in concert with liability, investment, and accounting rules to better reflect the risks in a growing insurance market.	Short-term
• Enhance supervisory powers for intervention, corrective measures, and enforcement.	Short-term
• Conduct a readiness study prior to the launch of the stock exchange.	Short-term
Access to Finance	
• Enhance supervisory practices to keep pace with the development of microfinance deposit-taking institutions, and impose a moratorium on new licenses until supervisory capacity and resources are adequate.	Medium-term
Crisis Management Framework	
• Revise the prompt corrective framework (PCA) framework by developing additional triggers for asset quality and liquidity, providing more specificity in the CAMELS elements, and establishing a more conservative capital adequacy ratio (CAR) trigger.	Medium-term
• Introduce regulation allowing banks to use their fixed deposits at the NBC and any issue of government (including government bodies) or government-guaranteed securities as eligible collateral for interbank and NBC repos.	Short term
• Develop a crisis management framework.	Medium-term
Transparency of Monetary and Financial Policies	
• Introduce due process for the dismissal of NBC Board members and the Governor by specifying the legal grounds for doing so and an appeal process.	Medium-term
• Amend the law to reduce the government's representation on the Board of the NBC, and to reflect the practice of appointing two Deputy Governors.	Short-term
Corporate governance of banks	
• Draft and/or implement banking regulations on internal audit and controls, risk management, and compliance functions at banks.	Short-term
AML/CFT	
• Introduce new rules and measures for conducting overall AML/CFT risk assessments and risk profiling of financial institutions.	Short-term

1/ Key recommendations of medium priority are presented in Appendix II; 2/ Short term: up to 1 year; medium term: 1-3 years.

I. MACROECONOMIC AND FINANCIAL BACKDROP

12. **The FSAP took place against a backdrop of an economy that is recovering from the spillovers of the global financial crisis.** Cambodia's high degree of openness made it vulnerable to the contagion effects of the crisis, notably, through the external sector and the general impact on confidence. Growth is estimated to have declined by 2 percent in 2009, having averaged 9½ percent in the ten years prior, as activity in key economic sectors was severely affected. The bursting of the property bubble in early-2008 saw real estate prices almost halve in the period to end-2009 (Figure 1), while corporate sector vulnerabilities increased as demand for their products declined sharply.

13. **The economic contraction weakened banks' balance sheets.** With loans to businesses accounting for almost 70 percent of banks' total lending (and the balance to the household sector), credit risk rose significantly and banks' asset quality deteriorated (Figure 2). Corporate profitability is estimated to have declined by 30 percent (y/y) following the collapse in garment exports, sharp slowdown in tourism, and a virtual halt in construction activity.[5] Loan quality was also affected by the damage to household balance sheets.[6] Consequently, banks cut back on their lending substantially—credit growth slowed from 103 percent (y/y) in mid-2008 to 6½ percent in December 2009—and the demand for credit also weakened.[7]

14. **Liquidity conditions in the banking system tightened significantly at the peak of the crisis, as rising risk aversion among depositors led to withdrawals.** Nervousness surrounding the domestic outlook and the health of the banking system was further heightened by the border dispute between Cambodia and Thailand. Supportive policy actions had to be taken by the NBC, notably through reduced reserve requirements on foreign currency deposits and (the limited use of) a newly-introduced overdraft facility. Banks increased their liquid balances by offering higher interest rates to attract deposits, which account for more than 90 percent of their non-equity funding, while curtailing lending. Some foreign subsidiaries accessed liquidity from their parent institutions.

15. **A broadening export-led turnaround appears to be taking hold in 2010, but significant downside risks remain.** Growth is projected to reach 4½–5 percent this year, led by garment exports and tourism, which grew between 10–20 percent (y/y) in Q2 2010. Deflation has ended and headline inflation is forecast to average 4 percent in 2010. However,

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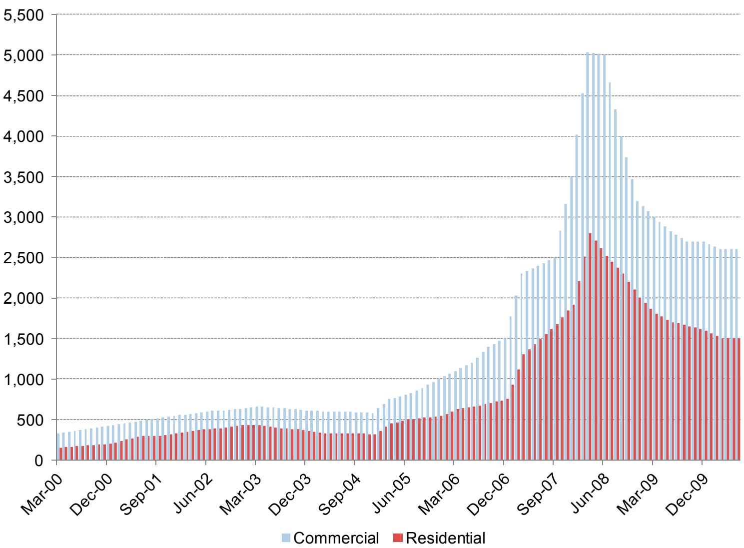
[5]The World Bank conducted a survey of 370 firms, of which 270 are from the formal sector, between July and September 2009, to determine the impact of the crisis on local firms.

[6]World Bank estimates suggest that about 20 percent of households were directly exposed to the crisis through formal employment in the hardest hit sectors (garment, construction, and tourism).

[7]Appendix I, Figure A.2 shows the macro-financial developments in Cambodia.

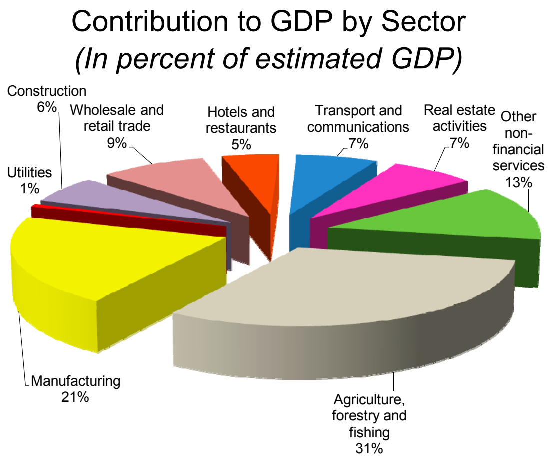
construction activity remains sluggish, while a late start to the rainy season could negatively impact the agriculture sector. The export sector is also exposed to developments in U.S. and European markets, where recovery prospects are also uncertain.

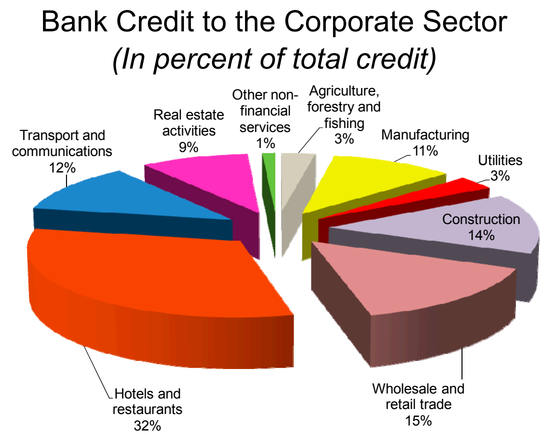
Figure 1: Real Estate Prices in Phnom Penh
(In U.S. dollars per square meter)



Source: Bonna Realty Group.

Figure 2: Cambodia: Sector Composition, 2009





Source: National Bank of Cambodia.

16. **Banking sector developments also show signs of improvement.** Some banks report that the asset quality in their loan portfolios is improving, and that some of the existing non-performing loans (NPLs) are being repaid. That said, banks remain wary about lending to real estate, where activity is reportedly improving slightly; they are focusing on the agriculture sector instead. Amid ample liquidity in the system, the data suggests that credit growth could exceed 20 percent in the second half of 2010.

II. STRUCTURE OF THE FINANCIAL SYSTEM

17. **Cambodia's financial system remains largely underdeveloped.** It is almost fully dominated by commercial banks, mostly foreign-owned, and is highly dollarized. The banking system has grown rapidly from a small base, with average asset growth of 43 percent from 2006–2009, but bank deposits are still only about 22 percent of GDP, much lower than other low-income or regional comparators (Figure 3). Bank credit to the private sector is correspondingly low at 26 percent of GDP. Total banking sector assets amount to almost 50 percent of GDP.

- *In recent years, a large number of financial institutions have been licensed.* There are currently 27 commercial banks, six specialized banks, 25 MFIs, and one bank holding company. All commercial banks are privately-owned;[8] one specialized bank is 100 percent state-owned. Subsidiaries have been established by some banks, primarily to conduct insurance business. Some banks are also seeking to establish subsidiaries to trade securities upon the launch of the stock market, reportedly planned for the third quarter of 2011.

- *The commercial banking industry is concentrated.* The 27 commercial banks account for over 90 percent of financial sector assets (Figure 4). The three largest banks account for 55 percent of total assets; the "big five" banks hold 71 percent of total assets, and account for 77 percent of net credits from the banking sector.

- *Foreign banks have a large presence.* Of the 27 commercial banks, 22 are foreign-owned, including two of the five largest; five are branches of foreign banks, and 17 are majority foreign-owned.[9] Together, the foreign-owned banks account for about two-thirds of banking sector assets. Meanwhile, one Cambodian bank has established operations in neighboring Laos.

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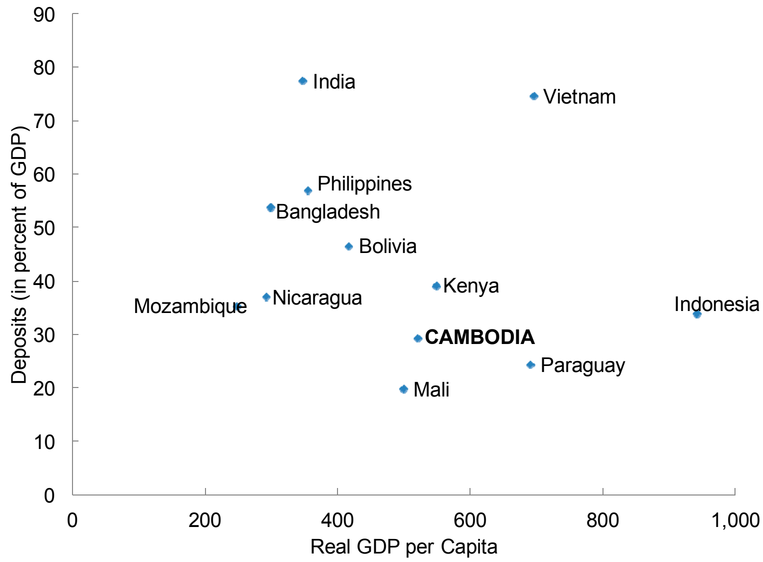
[8]The government holds a minority share in one of these banks.

[9]The key home jurisdictions of foreign banks in Cambodia include Japan, Malaysia, South Korea, Thailand, and Vietnam.

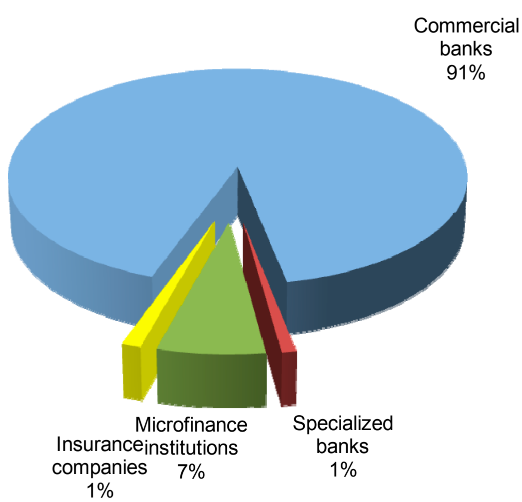
Figure 3. Selected Countries: Deposits to GDP and GDP per Capita, 2009 1/



Sources: IMF, International Financial Statistics; and IMF, World Economic Outlook.

1/ Cambodia's GDP figure for 2009 is estimated.

Figure 4. Cambodia: Structure of the Financial Sector, End-2009



Source: National Bank of Cambodia.

18. **Activity in the non-bank financial sector remains very limited.** The 25 MFIs account for about 7 percent of the assets in the system (over 3 percent of GDP); four of them have recently been allowed to take deposits. The 60 Non-Governmental Organization (NGO)-sponsored MFIs which are currently operating will be required to obtain licenses from the NBC upon meeting certain conditions. The insurance sector, which is under the supervision of the MEF, is very small (accounting for about 1 percent of total financial sector assets, with a penetration rate, or premium as a percentage of GDP, of 0.2 percent), with five licensed companies, and no life insurance segment. No formal market exists for interbank loans, government bonds, corporate bonds or equity, although a stock market and a derivatives exchange are being set up for trading, and a regulator, the SECC, has been established to license, regulate and supervise securities firms and market operators.

III. Banking Sector Stability

A. Key Risks

19. **Remaining vulnerabilities and new risks pose threats to the stability of the financial sector** (Table 1)**.** Weaker growth or real estate prices would be high-impact events for bank balance sheets. The failure of systemically important banks or a loss of depositor confidence could also have a devastating impact, given the lack of a crisis management framework. The risk of these events would be exacerbated if regulatory forbearance persists and weak bank balance sheets are not adequately shored up. Further, the lack of human resources and capacity to adequately supervise the fast-growing financial sector heightens these vulnerabilities and weighs on prospects for financial sector development.

20. **Credit risk remains the one of the biggest vulnerabilities for the banking system.** Although there are signs of a nascent turnaround in real estate prices in the capital city, price levels have remained relatively stagnant. With some 90 percent of loans reportedly collateralized by real estate, the quality of banks' loan portfolios—and any consequent impact on capital adequacy—will largely depend on a recovery in the sector. However, weak data, arising from lack of strict supervisory enforcement and poor infrastructure, make assessments of the real estate overhang from the boom period, and therefore the extent of the risks, difficult:

- Anecdotal evidence on previous loan-to-value ratios varies widely (25–50 percent) depending on the source, and there is a lack of a robust property valuation industry. On-site examinations by supervisors reveal that the non-performing loans (NPLs) at some banks may be significantly under-reported.

- Supervisors exercised regulatory forbearance during the crisis, allowing banks to evergreen principal repayments and to capitalize interest on loans with late payments. Some banks acknowledge granting overdraft facilities to their customers to avoid or to postpone loan loss recognition and provisioning.

- Legal and procedural mechanisms for foreclosing on collateral are weak and generally untested, complicated by poor documentation on loans and land titles.

21. **The NBC issued revised regulations on asset classification and provisioning in mid-2009, but implementation and enforcement have been uneven.** Supervisors found that some banks implemented the strengthened regulation on asset classification incorrectly, while others were slow in complying with the new requirements, suggesting that the reported aggregate NPL ratio for 2009 of around 4 percent may be substantially understated. Indeed, one major bank recently revised its 2009 NPLs upwards, while another has publicly revealed that its NPL ratio exceeded 30 percent. Separately, the supervisors have taken little action to address the issue of related-party lending, and bank ownership details remain opaque.

22. **Thus, while the NBC is to be commended for starting to compile the core Financial Soundness Indicators (FSIs) for Cambodia's banking system, the numbers need to be interpreted with considerable caution.** In addition to the relatively low NPL ratios, the reported FSIs show improving capitalization in the banking sector during 2009, despite the worsening crisis and the sharp economic contraction.[10] It is likely that some of the other banks that are yet to be subjected to on-site examinations may have misclassified loans, and consequently, underprovisioned against NPLs and reported higher capitalization than is actually the case. Further, assessed weaknesses in accounting and auditing practices; the corporate governance of banks; bank reporting infrastructure; and limited internal controls and risk management at many banks suggest that the reported data may be unreliable.

23. **Stiff competition and easier liquidity conditions could give rise to new strains in the banking system.** The general easing in liquidity conditions since 2009 represents a two-edged sword, since it could spur rising credit and solvency risks. The large banks currently have to manage a significant liquidity overhang, as a result of the aggressive competition for deposits during the crisis to self-insure (given the lack of deposit insurance). Banks' profit margins are being squeezed—interest rates on excess reserves placed with the NBC are close to zero and lending rates are down at around 8–9 percent, from as high as 16–17 percent previously—as banks vie for the few attractive lending opportunities. In order to reduce the cost of carrying excess liquidity, some of the larger banks have continued cutting deposit interest rates in recent months, down to around 1–2 percent in September, from around 4 percent in April this year. These developments could translate into riskier lending in the months ahead, if banks relax underwriting standards in order to issue more loans.

24. **Although political concerns relating to neighboring Thailand have moderated significantly, the impact of any recurrence on liquidity in the system could be very high.** During the crisis, political risk exacerbated the weakening in depositor confidence, when the unrest at the Cambodia-Thailand border resulted in accelerated withdrawals by depositors.

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[10] See Appendix I, Table A.1 for FSIs for the Cambodian banking system.

Any renewed political unrest, although assessed as a low risk event at this stage, could have a similarly detrimental impact on the banking sector, especially given that liquidity is unevenly distributed across banks. The larger banks are carrying more liquidity than they can lend out, while foreign-owned banks should be able to access support from their parents, as they did during the recent crisis. However, some of the smaller banks are already unable to borrow from the bigger banks, which remain very cautious about counterparty risk.

25. **The high level of dollarization in Cambodia increases the vulnerability of the financial system to liquidity risk and impairs the development of an adequate crisis management framework.** Given that dollar deposits at banks are only partially covered by liquid U.S. dollar assets, the NBC may not hold enough international reserves to adequately provide LOLR assistance to distressed, but viable, banks in a crisis.[11] In the event of a sharp depreciation in the riel, the banking system may also exposed to: (i) indirect credit risk from borrowers generating their incomes in riel and borrowing in U.S. dollars; and (ii) solvency risk from currency mismatches, given the growth in riel-denominated loan portfolios in recent years. That said, the direct impact of any riel depreciation should be positive given that most banks hold positive net open positions (NOPs) in U.S. dollars.

26. **The supervisor has announced a substantial increase in minimum capital by December 31, 2010, which may result in industry consolidation.**[12] Indeed, some of the smaller banks are reportedly seeking market solutions, either through selling off their deposit portfolios or seeking mergers with competitors. However, NBC will need to ensure that it has an appropriate strategy—taking into account the lack of qualified professionals in Cambodia to implement the necessary tasks—to deal with the banks that are not going to meet the higher capital requirement. Any bank closure and the corresponding treatment of depositors and creditors will need to be conducted in a transparent, equitable, and orderly manner in order to preserve the credibility of the supervisor and confidence in the banking system.

B. Stress Tests and Vulnerabilities

27. **The poor quality data reported by banks pose a significant disadvantage for stress testing the Cambodian banking system, and results should not be given too much weight.** Rather, they are used to corroborate the qualitative information gleaned from other sources. Sensitivity analysis stress tests are applied determine the impact of liquidity and market risks on the Cambodian banking sector, while a reverse stress test is utilized to provide a framework for determining credit risk. The dataset covers the five largest banks plus medium-sized banks of concern to the authorities—one state-owned commercial bank

[11] As at April 2010, foreign currency deposits exceeded gross official reserves by $1 billion.

[12] Per the regulation on *New Capital Requirement and Criteria for Licensing Approval of Banks*, dated September 19, 2008.

(SOCB), five domestic private commercial banks (DPCBs), and four foreign commercial banks (FCBs).

28. **The liquidity stress test confirms that the banking system as a whole is highly exposed to liquidity shocks.** The impact of an assumed 10 percent withdrawal of deposits per day on the liquidity ratio (liquid assets/liquid liabilities) is estimated. Following a five-day deposit run, only four banks—i.e., those that are currently above the 50 percent liquidity requirement--would maintain at least 10 percent of their liquid assets.[13]

29. **Market shocks, namely to the exchange rate and interest rate, appear to have a small impact on the banking system:**

- The exchange rate stress test measures net gains or losses from the NOP, from a shock to the riel exchange rate against the U.S. dollar. In this case, the high levels of dollarization in the banking system would actually protect banks' balance sheets in the event of a shock. Given that banks typically hold positive NOPs in foreign currency, any crisis in the financial system should result in the depreciation (appreciation) of the riel (U.S. dollar), and banks would actually benefit. In contrast, an ad hoc 100 percent *appreciation* in the riel—which would be unrealistic in a crisis—would result in a 2.2 percentage point decline in the capital adequacy ratio (CAR). Separately, indirect credit risk is negligible, even though more than 95 percent of total bank loans are made in foreign currency, as most incomes are also earned in foreign currency.[14]

- The interest rate stress test measures the impact a shock would have on banks' net operating profits and their CARs through a standard time-to-repricing gap model applied to interest-bearing instruments. Expected gains or losses from net interest income are calculated based on maturity gaps between earning assets and interest expense; in Cambodia these are largely represented by loans and deposits, given the lack of other fixed income instruments. A 500 basis points increase in interest rates, which would be consistent with Cambodia's previous extreme, results in a 1.1 percent decline in the system's CAR, while a corresponding decrease results in a 1 percentage increase in CAR.

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[13]The magnitude of the assumed shock is much larger than the actual liquidity event during the crisis, when banking system deposits declined by 9 percent from September to November 2008 and banks' excess reserves at the NBC declined by 20 percent.

[14]Foreign currency loans and foreign currency deposits account for more than 95 percent of total loans and deposits in the Cambodian banking system, respectively. Besides the government and agriculture sector, there is little evidence of wages being paid in riel elsewhere.

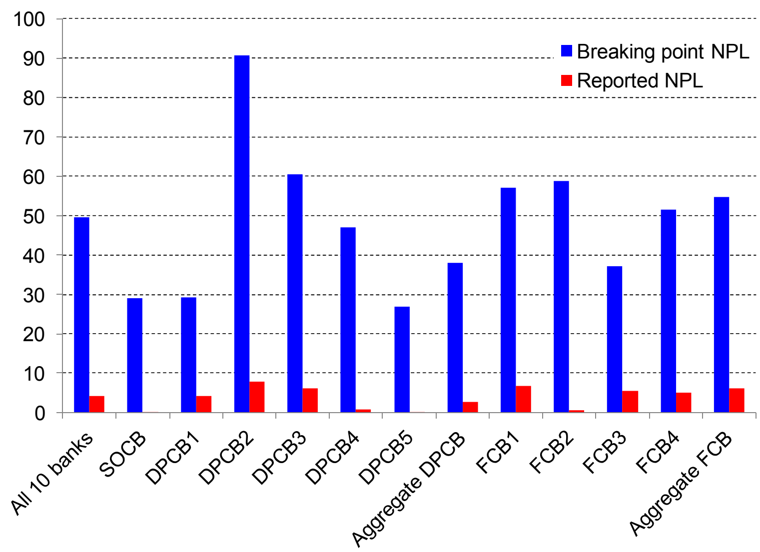
30. **The "breaking point" analysis of credit risk is utilized to avoid over-reliance on the reported credit data.** This approach estimates the magnitude of NPL ratios that would cause CAR to breach the required 15 percent minimum, i.e., it is a form of reverse stress testing. Presently, the aggregate CAR is 33 percent, and NPL is 4.2 percent. The assumption is that the amount of total loans does not change:

- This exercise suggests that an aggregate NPL ratio of 49.5 percent, i.e., a 45 percentage point increase in the ratio, would be necessary to bring the CAR down to 15 percent, reflecting the reported high levels of initial capital.

- However, the breaking-point NPL ratios for the 10 individual banks vary widely. They range from 27 to 91 percent, suggesting significant differences in the soundness of individual banks in the system, and their ability to absorb shocks (Figure 5).

- The results suggest that the systemic big-five banks, which account for almost three-quarters of the banking system's assets, are well-placed to absorb a significant credit shock. Breaking point NPLs, which range from 29–61 percent, are markedly higher than reported NPLs, of 0.8–6.8 percent. However, these findings should be interpreted with great caution, given significant concerns about data quality.

Figure 5. Cambodia: Breaking Point NPLs



Source: IMF staff calculations.

31. **The realization of high NPL ratios equivalent to the breaking point are not implausible in the case of Cambodia.** The findings from recent on-site examinations by supervisors, and public acknowledgements by some of the larger banks of very high NPL ratios (partly from the effects of the crisis) or of the need to revise previously reported NPL ratios upwards (from uneven implementation and enforcement of the regulation), suggest that

some banks may be closer to the 15 percent minimum required CAR than the reported data suggest.

32. **The NBC's Banking Supervision Department (BSD) is encouraged to integrate stress testing into its offsite supervision framework, to monitor potential vulnerabilities in the banking system.** However, strong implementation and enforcement of the regulation on loan classifications, and improved accounting and auditing practices would be crucial in ensuring that the reported data are sufficiently reliable in order for stress tests to be useful. When the reported data are of poor quality, it is imperative that the stress test findings be considered in light of the on-site and other off-site supervisory findings to monitor banks' capital adequacy.

IV. Financial Sector Oversight

A. Banking

33. **The NBC has responsibility for the oversight of the banking system.** Under the Law on the Organization and Conduct of the National Bank of Cambodia of January 1996 (LNBC), the NBC is responsible for the regulation and supervision of commercial and specialized banks, and microfinance institutions (MFIs); the NBC also oversees the payment system. The Bank Supervision Department (BSD) is a relatively new function within the NBC, established only about 15 years ago. The passage of the LBFI in 1999 gave the BSD the responsibility for implementing several key reforms, including granting licenses for banks; conducting supervision; drafting prudential regulations; and overseeing the liquidation of banks.

34. **The assessment of the BCP found a low level of compliance with international standards, primarily due to severe resource constraints.** Key areas that should be addressed include: (i) consolidated supervision; (ii) clarification of the supervisory responsibility over securities market participants; (iii) upgrades to the legal framework; (iv) coordination with domestic and foreign supervisors; (v) enforcement of laws, especially with regard to capital requirements; and (vi) staffing, capacity building and budgetary resources.

Legal framework

35. **The LBFI authorizes banks to engage in a very broad range of activities without regard for the banks' capacity to adequately and safely perform their activities, or their capital base.** The LBFI is currently being reviewed for amendment, and the NBC is encouraged to re-consider the very broad scope of authorized activities. Rather than grant blanket authority for all banks to participate in all authorized activities—e.g., non-traditional and riskier transactions such as trading in precious metals and raw materials—an application or notification process should be introduced. Applicant institutions should, at a minimum, provide evidence that adequate internal risk management systems are in place.

36. **Pursuant to the LNBC and the LBFI, the NBC is granted authority to supervise and regulate securities market participants, but its role in securities supervision is not well-defined.** The BSD holds the position that banks should be required to establish subsidiaries for securities market participation; however the legal framework does not specify this requirement. Moreover, there has not been a clear definition of the roles of the NBC vis-à-vis the SECC—which has been issuing regulations and is gearing up for market activity—as it relates to the supervision and regulation of banks participating in the securities market. The NBC and SECC are encouraged to address this critical issue to ensure consistent and continuous supervision.

37. **As banks have established insurance subsidiaries and have indicated their intent to engage in securities activities, there is a growing need to conduct consolidated supervision.** Legislation provides that the NBC can conduct on-site examinations of a subsidiary or any other related entity, but there is no clear authority or mandate for consolidated supervision. Such a supervision regime is essential for the BSD to effectively oversee and evaluate the risks associated with banks' participation in "non-bank" activities.

38. **In this context, the review of the LBFI provides an ideal opportunity for strengthening financial supervision.** The legal framework should be changed to give the NBC the necessary powers for consolidated supervision; however, this may take time to fully implement. The law should also be revised to provide for information sharing among the domestic financial supervisors. Despite the legal limitations on information sharing among the domestic supervisors, it is essential that the NBC, the SECC and the MEF work together to ensure that each has an understanding of the operations and risks arising from operating financial groups.

39. **Indeed, the legal framework for the banking industry would benefit from a comprehensive upgrade.** The BCP assessment identifies a number of conflicts, gaps and omissions, albeit not exhaustive, in the LBFI, and LNBC, and their implementation through the issuance of regulations. The NBC has been working on amendments to the LBFI; it is thus encouraged to conduct a full review of the existing laws and regulations to ensure that they are consistent and comprehensive. Ministerial discussions on amendments to the LBFI have stalled; and the NBC and other stakeholders are encouraged to re-activate the discussions. In addition, the parliament is encouraged to enact the new National Payment Systems Law to promote the effectiveness of the payment system.

40. **Separately, close collaboration and the exchange of information with foreign supervisors have become increasingly crucial in light of the proliferation of foreign banks in Cambodia.** During the licensing phase, the foreign applicants are required to provide the NBC with information regarding their respective parent companies and the supervisory requirements imposed by the home country supervisors. However, post-licensing, there has been almost no information received on the parent companies and little contact with the home country supervisors.

41. **The NBC is encouraged to enter into formal and informal agreements with foreign supervisors to facilitate information sharing.** Presently, the laws do not provide for information sharing between the NBC and foreign bank supervisors, and should be amended. MoUs have been signed with bank supervisors in Vietnam, and more recently, Malaysia. That said, the risks posed by foreign-controlled banks that are owned by non-financial corporates (such as real estate companies) would still be outside the purview of home-country supervision, thus reinforcing the importance of the NBC having a robust supervisory regime.

New capital requirements

42. **The minimum capital requirements, which will be effective as of December 31, 2010, will be based on the composition of the shareholding, when it should typically be based on a risk assessment.** Although the NBC has indicated that the objective is to promote the entry of high-quality institutions, the potential for unequal treatment under the new capital rules—i.e., favoring foreign banks which may have strong, well-rated parents as opposed to sound local banks which may not have requested a rating—represents a significant concern.[15] On the other hand, given the capacity constraints of the supervisor, this less-than-optimal approach is a workable alternative to strengthening the banking sector.

43. **Nonetheless, the NBC's enforcement of the new capital requirements will be a litmus test for its credibility as a supervisor.** According to NBC management, most banks have committed to meeting the new requirements by having already invested additional capital or by signing MoUs to do so by the deadline. It is incumbent upon the NBC and BSD to establish a supervisory strategy that will deal in a transparent and equitable manner with those institutions that are not expected to meet the new capital requirements, and to manage any exit in an orderly manner, in order to preserve confidence in the banking system.

44. **Meanwhile, the new capital requirements could have implications for credit risk at some of the smaller banks.** The injection of additional funds into an already-liquid banking system will increase liquidity at these banks, and potentially encourage some of them to push out more loans. Weak underwriting practices, coupled with imprudent investments could result in heightened credit risk and eventually, deterioration in asset quality. The NBC is cautioned to be alert to emerging trends arising from the influx of capital, and to hasten their work on the "institutionalization of liquidity" and the development of the interbank market.

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[15] Having at least one influential shareholder with an "investment grade" rating from one of the major international rating agencies will result in the capital requirement equaling one-third of the level required for banks not having such shareholders.

45. **Although the calculation of banks' net worth (capital) is largely compliant with international standards, there are a few significant omissions.** The net worth calculation does not consider a market risk component. This is relevant, as the securities markets are in the development stage and banks have expressed interest in dealing in precious metals, raw materials and commodities, which are authorized for all banks. The other omission is that the calculation does not require banks and financial institutions to deduct their holding of subordinated debt issued by other banks or financial institutions, which provides scope for "double gearing" capital.

Supervisory processes

46. **The BSD currently conducts outdated compliance-based supervision, and need to take steps towards forward-looking, RBS.** On- and off-site assessments are not supported by adequate or comprehensive risk assessment procedures. The reliability of the reported numbers is questionable, partly due to weak validation on the supervisors' part—on-site examinations do not include assessments of information technology systems, which raise concerns regarding the consistency and quality of banks' accounting systems. Meanwhile, much of the off-site work is performed without documented criteria, policies and procedures. The development of formal guidance would enhance consistent performance of duties and decision-making, as well as provide direction for new staff. The BSD should review, discard where appropriate, upgrade as needed, and document the criteria, policies, and processes currently used, to formalize its supervisory mandate.

47. **The NBC has taken steps to improve its supervisory oversight of credit risk by tightening its asset classification and increasing required provisioning; however enforcement is crucial, and additional tools need to be put in place.** The credit risk management processes and internal controls adopted by banks may allow manipulation of certain lending facilities. Supervisors need to be aware of these weaknesses and devote more resources to overseeing credit risk management in banks. Supervisors should require banks to establish policies and procedures for restructured loans, unsecured lending, overdrafts and charge-offs; alter the incentive structure by requiring a more conservative prudential treatment for overdraft facilities, and increase reporting and disclosure requirements on NPLs.

48. **There is a lack of adequate guidance and supervisory review in the areas of market, interest rate, liquidity, country, and operational risk.** Although the NBC has established limits on NOPs in foreign currency and imposed liquidity ratio requirements, it has not developed a comprehensive process to monitor, measure, and set standards in these areas. Following liquidity concerns during the recent crisis, the NBC required 16 banks to submit liquidity reports on a daily basis and five banks to submit liquidity plans. Regulations on the liquidity ratio need to be enhanced to include undrawn commitments and other off-balance sheet items into the calculation. The BSD is in the drafting stage of issuing regulations to address the various risks.

Corrective action

49. **The legal framework provides the NBC with the authority and tools to impose disciplinary sanctions against any breach in the laws and regulations, but it appears to be applied sparingly.** In practice, the NBC has an open dialogue with bank management regarding issues identified during off-site monitoring and on-site examinations. However, the corrective actions are generally limited to immediate and identified problems. It appears that sanctions are only exercised where there has been a contravention of the law.

50. **Moreover, there is little evidence to suggest that early corrective intervention action is taken by the supervisor when a bank is found to be operating in an unsafe or unsound manner.** A regulation for prompt corrective action (PCA) details the actions to be taken by the bank and the NBC in the event that a bank fails the minimum solvency ratio requirement. However, in practice, corrective action is only initiated when the bank is already below the minimum solvency ratio requirement; this is not consistent with the objective of instituting corrective measures at an early stage. Revision of the timing of corrective measures and expansion of circumstances—by developing additional triggers for asset quality and liquidity, drawing from specific CAMELS elements, and establishing a higher CAR trigger—that would lead to early corrective measures should be incorporated into the regulation.

Conclusion on bank oversight

51. **Ultimately, the BSD's biggest challenge is to address the problem of a severe shortage of supervisory staff to adequately deliver on its mandate.** The responsibilities of the off- and on-site supervisory units clearly outstrip the capacity and resources of the BSD. There are about 50 supervisors at the BSD; the BSD is competing for qualified candidates in a growing financial sector and with other financial agencies, and has struggled to attract and retain personnel. The effectiveness of technical assistance provided by various donors to the BSD over the years has also been negatively affected by the lack of qualified staff. As a more immediate measure, work should be reprioritized to facilitate the implementation of RBS, which could help to alleviate the resource constraints. More recently, several persons have been hired for supervisory positions; however some will not be able to contribute effectively to the work of the BSD for some time, while they undergo training and gain relevant experience.

52. **Legal protection of the supervisory staff and the NBC represents a basic requirement for effective supervision.** The LBFI must be amended to explicitly provide legal protection to the supervisory staff to fully and adequately discharge their duties, as well as to the NBC. The aim is to protect these parties from prosecution for any supervisory actions that they may take in good faith, and as well as indemnity from the costs arising from defending their actions. It should be noted that this lack of legal protection is a cross-cutting

issue for all of the financial supervisory agencies in Cambodia and the applicable laws in those cases should also be amended to provide for this essential element.[16]

53. **Notwithstanding the NBC's desire to encourage the participation of reputable foreign banks in its financial system, it is strongly encouraged to impose a moratorium on the issuance of new bank licenses.** Despite the acute resource and capacity constraints, the NBC recently licensed one bank and granted preliminary approval to two applicants. A moratorium should be formally instituted to (i) allow the NBC to increase the staffing of the BSD to a more appropriate size and capacity; (ii) provide the BSD time to develop a strategy to deal with the banks that may not meet the new capital requirement; (iii) free up resources to allow the BSD to work on the supervisory mandate and initiate forward-looking, RBS; and (iv) conduct a review of the legal framework.

B. Microfinance Institutions

54. **The microfinance institutions (MFIs) and Acleda Bank have been effective in providing access to finance in Cambodia.** The microfinance industry has achieved penetration rates in line with other developing markets with high- performing microfinance industries. The average ratio of loans to households was 36 percent in all 21 provinces in Cambodia, with some provinces achieving rates as high as 50 percent. Meanwhile, deposits to GDP are still relatively low, at 34 percent (or 134 accounts per 1,000 adults), reflecting the restrictions on MFI deposits. However, they are likely to expand now that four MFIs have been licensed to take deposits. MFIs may apply to the NBC for a license that will allow them to take savings and fixed deposits, but which would impose certain restrictions and requirements. The Microfinance Office of the BSD at the NBC supervises the MFI sector.

55. **The license for MFIs to take deposits creates an opportunity for them to expand their range of financial services, but also gives rise to new risks.** The main challenges for the newly licensed microfinance deposit-taking institution (MDIs) will be to meet the higher legal requirements; to adequately manage the risks associated with deposit-taking institutions; and to create the necessary capacity to mobilize deposits and win the confidence of small-scale depositors. From the NBC's perspective, the supervisor should adhere closely to the applicable licensing regulation and ensure tight oversight of the sector, and to consider a moratorium on issuing additional licenses for deposit-taking until it has built sufficient supervisory resources.

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[16]All relevant laws for the financial system lack provisions on legal protection and thus, all of the financial supervisory authorities in Cambodia (MEF, SECC, and NBC) lack such protection. This is an important prerequisite to enable regulators to carry out their duties without fear of legal suits.

C. Insurance

56. **Although progress has been made in developing the supervisory regime, a considerable amount of work at the policy and regulatory levels will be required to ensure the safe and prudent development of the nascent insurance sector.** Supervision of the industry by the Insurance Division within the MEF could be enhanced by the development of a more comprehensive supervisory policy, which would: (i) establish aspects of confidentiality and codes of conduct for staff of the insurance department; (ii) detail specific intervention steps including how choices are made between formal and informal intervention; (iii) establish procedures for information exchange with other domestic, as well as with foreign supervisors; and (iii) introduce market-wide analysis as a standard process. Its publication would enhance transparency. As in other parts of the financial sector, developing staff resources and capacity is paramount.

D. Capital Markets

57. **The stock market represents an important component of the government's 5-year plan to develop the financial sector.** The launch of the stock market is reportedly planned for the third quarter of 2011, with the stated target of listing 30–40 companies over the next five years. However, the authorities should give careful consideration to the proper sequencing in developing the financial sector. For instance, the development of a government securities market would be necessary to enable risk pricing in securities markets.

58. **The authorities are strongly encouraged to be vigilant against risks arising from launching the stock market in haste.** The first step should be to undertake a comprehensive readiness study. Significant barriers to the establishment of a well-governed stock market exist currently, notably, weaknesses in accounting and auditing practices; an ineffective judicial system; the weak legal infrastructure; limited technical capacity among market participants and supervisors; and limited financial literacy among the populace. Other essential elements would include infrastructure for a securities settlement system, and electronic systems for stock-watch and market surveillance, and for information disclosure and reporting. The SECC also needs to ensure that an adequate regulatory and supervisory framework is in place ahead of the opening of the stock market

V. Crisis Management Framework

59. **While the authorities have a broad understanding of their respective roles and the nature of the response in the event of severe stress, several components of the crisis management framework are yet to be formalized.** Essential components of such a framework that needs to be put in place for the Cambodian financial system are: (i) an apex crisis management committee comprising the Governor, the NBC and the Minister of Economy and Finance; (ii) MoUs for cooperation and coordination among the regulators

(among the MEF, NBC and SECC, and with foreign supervisory/regulatory authorities);[17] (iii) crisis management teams within the NBC and the MEF; (iv) a crisis management handbook, a crisis management manual, and contingency plans;[18] (v) a communication plan; (vi) a market and institutional monitoring framework; and (vii) periodic crisis simulations.

60. **Importantly, the LNBC should be expanded to include an explicit financial stability mandate for the NBC.** Presently, the LNBC defines the principal mission of the central bank as determining monetary policy objectives aimed at price stability, specifically, overseeing payment systems, setting interest rates, and monitoring monetary and exchange policies. However, the growing risks in the financial system highlight the need for a stability mandate for the NBC. In turn, the NBC should ensure effective supervision of systemic institutions, and develop crisis responses based on the assessed impact.

A. Financial Safety Nets

61. **There are presently few components of an effective financial safety net in place.**[19] The very high level of dollarization in the economy and the lack of eligible collateral are the main contributory factors for this shortcoming. Specifically, the ability of the NBC to provide speedy liquidity support to banks is extremely limited, and affects the central bank's ability to play a meaningful role in managing liquidity in the system. Technically, the NBC could provide liquidity to the banking system through three modes: (i) by purchasing or through repo of eligible assets from the banking system; (ii) by granting advances against government or government-guaranteed securities; and (iii) by granting overdrafts against banks' loans. However, the first two methods are effectively absent as they are generally dependent on government or central bank securities, which do not presently exist in Cambodia. Meanwhile, the NBC's overdraft facility with loans as collateral has legal and operational shortcomings, which impairs its function as LOLR.

62. **The authorities need to make available securities that qualify as eligible collateral for promoting the development of the interbank markets and the central bank liquidity facilities, while avoiding moral hazard.** In the short-term, this can be achieved by the NBC according "collateral" status to the fixed deposits placed by

[17] The supervisory agencies are in the process of preparing an MoU on crisis management.

[18] The areas where the system needs to be equipped with contingency plans include, among others, plans for: (a) managing liquidity stress; (b) capital augmentation, (c) addressing spillover (contagion) effects arising out of failure of a counterparty bank in Cambodia; and (c) business continuity.

[19] A financial safety net should include central bank liquidity facilities, the LOLR function, and a deposit insurance mechanism.

commercial banks with the central bank.[20] In addition, the LNBC could be upgraded to provide legal recognition of the overdraft facility and to enable the NBC to extend loans collateralized by banks' loan portfolios, although strict enforcement of all relevant laws and regulations, and the strengthening of corporate governance practices at banks should be crucial pre-conditions. Importantly, the process for sanctioning the provision of timely liquidity support to banks, when necessary, should be streamlined.

63. **Deposit insurance is absent and the priority accorded to depositors' claims is inadequate.**[21] However, critical preconditions—in particular, strong and effective banking supervision—must be in place before deposit insurance is established. In the meantime, there is a need to consider establishing liquidity buffers in each bank to facilitate timely and equitable payouts of deposits.[22]

64. **In the absence of the essential elements of a safety net, the burden falls squarely on the NBC's supervisory framework in general, and the PCA framework in particular.**[23] While a supervisory response and a PCA framework are in place, shortcomings exist and both need to be strengthened to allow for more effective and timely intervention to ensure that the banks and the banking system are not allowed to drift to the point of a crisis. The main improvements required include: (i) a broader assessment of an institution's condition for earlier supervisory response; (ii) increased specificity in triggers and responses; (iii) powers to undertake a wider range of supervisory actions; (iv) use of stress test outcomes to influence the early warning system; (v) streamlining and documenting the operational aspects of the framework; and (vi) enhanced supervisory powers to intervene.

B. Bank Resolution

65. **A key component missing from the NBC's supervisory toolkit is an adequate bank resolution framework.** Outside of official administration and liquidation, detailed in the LBFI, other resolution mechanisms for problem banks are not specified. While the LBFI allows a weak bank to be resolved through liquidation or through an administrator process, the triggers for placing the bank under an administrator and into liquidation are not clearly defined. The legal framework does not provide for private sector solutions and assisted bank resolution options, such as restructuring through mergers and acquisitions, purchase and

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[20] In this regard, the NBC is planning to "institutionalize" liquidity through the securitization of banks' fixed deposits, which is aimed at jump-starting the interbank market. The NBC anticipates issuing regulation on this instrument to banks before the end of 2010.

[21] Depositors holding deposits denominated in riel rank fifth and depositors holding deposits in other currencies will rank sixth, along with creditors that are banks and financial institutions.

[22] The specific authority should be established in the law with clarifications set forth in regulations.

[23] The PCA is set forth in a regulation.

assumption transactions, and bridge banks. Although a new insolvency law has been introduced, it is ill-suited for banks, and provisions should be made for resolution independent of the insolvency law.

VI. Transparency of Monetary and Financial Policies

66. **Improvements in transparency in the conduct of monetary policy are recommended in several areas.** Most importantly, the legal arrangements for the independence of the position of Governor of the central bank and its Board should be strengthened and clarified, and the LNBC should be amended to reflect the current practice of appointing two Deputy Governors. Better specification of the roles and responsibilities of the NBC would also contribute to improved transparency. Moreover, there is presently limited public information concerning the monetary policy process, namely, the specificity of the overall framework and methods. In this regard, the NBC needs to formulate and issue an annual monetary policy statement (preferably in both Khmer and English) to strengthen the process and improve its transparency. Accountability and assurances of integrity could also be improved through ensuring adequate and appropriate legal protection, and defining and publishing an appropriate Code of Conduct for its staff.

67. **Financial supervisory agencies in Cambodia display a less than complete degree of transparency in the formulation and implementation of financial policies.** There is presently no regulation in place that clearly describes the relationship between financial supervisory agencies, or the demarcation of responsibilities, an issue that needs to be addressed urgently. The broad objectives and responsibilities of financial agencies, and the modalities of accountability and public dissemination of the information, are described in the LBFI, but many changes have taken place since the Law was introduced. As noted earlier, there are no formal procedures in place for information sharing among those agencies, and there is also no regulation that describes the penalties associated with the lack of compliance with the Law by financial institutions. Financial supervisory agencies need to improve the accountability and assurances of the integrity of staff—there is little information on rules to prevent exploitation of conflicts of interest and general fiduciary obligations. Additionally, staff does not have adequate and appropriate legal protection in the discharge of their statutory functions, which are not fully and legally defined in the case of the SECC.

VII. AML/CFT

68. **Cambodia's anti-money laundering and combating the financing of terrorism (AML/CFT) framework was assessed against the standard on AML/CFT, the Financial Action Task Force (FATF) 40+9 Recommendations, in 2007.** The evaluation was conducted by the World Bank with a mutual evaluation report being adopted by the Asia/Pacific Group on Money Laundering (the FATF-style regional body of which

Cambodia is a member) in July 2007.[24] The evaluation report reveals that Cambodia's AML/CFT regime is still at an early stage of implementation and suffers from a number of deficiencies, such as the incomplete money laundering offense, the lack of criminalization of terrorist financing, the absence of a Financial Intelligence Unit and insufficient AML/CFT preventative measures and supervisory framework. The report indicates that, although there is no estimate of money laundering (ML) occurring in Cambodia, criminal proceeds come primarily from human exploitation and trafficking, corruption and drug trafficking. It also notes that corruption is a very significant challenge for Cambodia and that combating corruption should be a national priority.[25]

69. **Since the 2007 evaluation, there have been improvements in the AML/CFT legal framework, but significant implementation and enforcement issues remain.** The number of predicate crimes for money laundering has been expanded, terrorist financing has been criminalized, a Financial Intelligence Unit (FIU) was created in 2008 and housed within the NBC, and regulation has been promulgated to implement the new laws. Despite the actions taken to date, there is a lack of capacity in the FIU, and a lack of compliance systems for AML/CFT in place within financial institutions. The NBC has issued only corrective orders to enhance banks' compliance with the AML/CFT requirements. No penalties have been issued, and there appears to be little, if any, implementation with respect to non-banks. A serious concern is that the Financial Intelligence Unit (FIU) is not involved in the licensing process for incoming financial institutions, especially given the rapid processing of license applications and the high degree foreign ownership of incoming banks. The authorities would benefit from conducting an overall assessment of money laundering and financing of terrorism in the country, as well as a risk profiling of financial institutions. In addition, the FIU should begin to conduct regular threat/risk assessments for money laundering and terrorist financing.

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[24] See the Detailed Assessment Report on Anti-Money Laundering and Combating the Financing of Terrorism of July 2007, by the World Bank. http://www.apgml.org/documents/docs/17/Cambodia%20World%20Bank%20DAR%20July%2007.pdf.

[25] Cambodia passed the Anti-Corruption Law in March 2010.

ANNEX. OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

The annex contains a summary assessment of the Basel Core Principles for Effective Banking Supervision. The assessment has helped to identify the extent to which the supervisory and regulatory framework is adequate to address potential risks in the banking system. The assessment was undertaken by Ms. Mendoza (previously World Bank external consultant, now IMF staff) and Ms. Ruziana Mohd. Mokhtar (IMF external consultant, Bank Negara Malaysia).

The assessment was based on the self-assessment undertaken by the Cambodian authorities, a review of relevant documents and discussions with the Cambodian authorities, market participants and industry associations on actual practices.

Cambodia's observance of international banking system standards is weak. In each area, areas were identified where further improvements are strongly recommended. The Cambodian authorities are aware of the areas that require further reforms, and have begun to take steps to address them.

A. Introduction

70. This assessment of the Basel Core Principles (BCP) was conducted as part of the FSAP of the Cambodian financial system from March 8 to March 31, 2010. As agreed with the authorities, the supervisory framework was assessed against the BCP methodology issued in October 2006. Only the essential criteria were included in the analysis.

B. Information and Methodology Used for Assessment

71. **The NBC provided the assessors with various documents for the assessment:** a self-assessment performed as of September 2009; Laws and Regulations Applicable to Banks and Financial Institutions; the NBC annual reports for 2007 and 2008; on-site supervision manuals; the guideline for the use of the off-site surveillance system and related documents. Other relevant information was also accessed through the NBC's website. During the mission, meetings were held with representatives of the BSD as well as other NBC officials; and stakeholders including bankers, other domestic financial sector supervisors, the Association of Banks in Cambodia, the National Accounting Council and chartered accountant firms. The assessors enjoyed good cooperation with the authorities. In some cases the requested information was not provided due to the need for translation; however this was overcome through oral presentation of some documents. The team extends its appreciation to the staff of the various institutions and in particular to the staff of the NBC for their participation in the process and their hospitality.

72. **The assessment of compliance with each principle is made on a qualitative basis.** A four-part assessment system is used: compliant; largely compliant; materially non-compliant; and non-compliant. To achieve a 'compliant' assessment with a principle, all essential criteria generally must be met without any significant deficiencies. A 'largely compliant' assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective of that principle. A 'materially non-compliant' assessment is given when the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance, but substantive progress has been made. A 'non-compliant' assessment is given when no substantive progress toward compliance has been achieved.

C. Overview of Institutional and Macroeconomic Setting, and Market Structure

73. **Cambodia had experienced a decade of high economic growth, averaging** 9½ percent in the ten years prior **to 2009.** Garment manufacturing and export, tourism, construction and agriculture form the main pillars of the nation's economy. The growth prospects had attracted foreign participants into the banking system, which led to a rapid expansion in the banking sector. Total commercial banking assets grew from KHR 3,799 billion in 2003 to KHR 16,996 billion in 2008.[26] Cambodia is a highly dollarized economy with KHR used mainly for small transactions, transactions remain largely cash based. In the wake of the global recession, Cambodia's economy was hit hard. Export receipts plunged, the tourism industry suffered, and construction activity contracted. Real GDP contracted as key sectors faltered – reflective of Cambodia's high level of openness and narrow production base. Private investment was also affected, with project implementation slowing down and some foreign-funded construction activity put on hold.

74. **Cambodia's financial system remains underdeveloped.** The NBC was established in 1954, and has undergone a number of changes in its structure and purpose. For a short period in the mid 1970s, the NBC did supervise and regulate the banking system, but the NBC was closed in April 1975 during the civil war. Following the end of the war, the central bank was re-established in October 1979 and went through another series of transformations, until the current law, the Law on the Organization and Conduct of the National Bank of Cambodia was passed in 1996 (LNBC).

75. **The NBC is the licensing authority, regulator and supervisor of banks and microfinance institutions (collectively known as 'covered entities') as authorized in both the LNBC and Law on Banking and Financial Institutions 1999 (LBFI).** Prior to 2000, there were about 30 banks licensed by the NBC, but not supervised. With passage of the LBFI, the sector was reformed, and several institutions were closed. However, the number of banks quickly went up again during the recent boom period. Subsidiaries have been

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[26]Source: National Bank of Cambodia Annual Report 2008.

established by some banks, primarily to conduct insurance business; those operations are supervised by the Ministry of Economy and Finance. When the securities market becomes active, it is believed that the initial market participants will be subsidiaries established by the commercial banks. Those market participants will be supervised by the NBC and the Securities and Exchange Commission of Cambodia.

76. **At present, banking dominates the Cambodian financial sector, with total assets amounting to almost 50 percent of GDP, of which commercial banking accounts for 99 percent.** The commercial banking industry is highly concentrated with the three largest banks accounting for more than half of total assets. Preliminary June 2010 data reflect CAR of 31 percent , non-performing loans to total loans of around 4 percent and a return on assets of 0.5 per cent for the banking system. However, the reliability of the reported numbers is questionable, due to weak validation on the supervisors' part, as well as concerns regarding the consistency and quality banks' accounting systems. Liquidity is high, reportedly as the banks sought funds to 'self-insure' against heightened risks. Increased capital requirements for banks will be effective by end-2010. Cambodia has no interbank money market, government or private debt markets or an equity market, although a legal framework for an equity market and its regulation is under development. The NBC is planning to 'institutionalize' liquidity through the securitization of fixed deposits, which aimed at jump-starting the interbank market. The NBC anticipates issuing regulation on this instrument to banks sometime in 2010.

77. **Despite the recent expansion in number and size of intermediaries, the depth of bank intermediation is not high.** It is estimated that only 2 percent of the population is served by the banking sector, and this is largely concentrated in larger cities such as Phnom Penh. The MFI fill the gap by providing financial access to the rural population. MFI industry has been successful in terms of size and coverage, with assets totaling over 3 percent of GDP. Branch networks provide loans in all provinces. The Microfinance Office of the BSD at the NBC supervises the MFI sector.

D. Preconditions for Effective Banking Supervision

78. **Cambodia's business environment is not supported by a strong legal infrastructure.** A legal framework exists for companies, bankruptcy, taxation, and insurance, however there are some inconsistencies across some of the laws in the financial sector, and enforcement is weak. In addition, the regulatory framework for the banking sector is not comprehensive. The judiciary allegedly suffers from unpredictability and corruption.

79. **A two-tiered system for land registry exists, dependent on the location of the property, i.e., in the provinces vs. larger urban areas.** During the Khmer Rouge regime, private land ownership was abolished and records destroyed, raising doubts about claims to ownership. Lenders rely on relationship lending and take collateral thought to be in multiples in value over the loan amount. Real estate is the most common collateral held by banks, and

reportedly there have been few lawsuits to gain title to collateral acquired in satisfaction of a defaulted debt. Reasons for this abound: the strong credit culture in Cambodia, the up-until-recently very active real estate market; the desire to avoid protracted legal battles and the high loss potential due to the impact of corrupt practices. Asset valuations are performed, but standards for determining and reporting valuations do not exist. Many banks employ their own valuers, and heavily discount values assigned.

80. **The public accountancy profession in Cambodia is at an early stage of development; a legal framework sets out the basic requirements for financial reporting and requires all accounting firms to be registered.** Approximately 31 chartered accountant firms operate in Cambodia, including offices of three large international firms; five firms have been registered by the NBC to audit commercial and specialized banks. The Cambodia Accounting Standard is broadly aligned with international standards, with the adoption of 20 international standards. Full compliance with the International Financial Reporting Standards (IFRS) is set for January 2012, but applicable only to firms with public accountability including listed companies, banks, microfinance institutions and insurance companies. Cambodia will face a major challenge to IFRS implementation due to the severe shortage of well-trained accounting professionals. Efforts are on-going to provide scholarships, build capacity and to develop a quality assurance process for the accounting profession.

81. **Independent credit reporting bureaus do not exist; participation in the only bureau operating in Cambodia is voluntary and contains only negative information regarding a borrower.** Under the Law on Commercial Enterprises Section I. Financial Disclosure, companies that have not issued securities to the public or do not have securities held by more than one person are not required to appoint an auditor. This exemption coupled with the opaque ownership of many enterprises has resulted in many companies without audited financial statements. The lack of verifiable data on a borrower, either due to questionable or non-existent financial statements or through a credit bureau has contributed to 'relationship' lending. Also, sound credit underwriting is hampered by not having complete knowledge of a borrower's current indebtedness or credit history.

82. **Market discipline is uneven.** From July 2000 to September 2002, 16 banks were liquidated, representing about half of the number of existing banks at the time. The number of banks remained steady until about December 2006. The very high recent growth in the number of banks has been concentrated in foreign-ownership controlled institutions. Enforcement of the laws is considered weak, as the Bank Supervision Department (BSD) of the NBC has generally relied on financial sanctions and penalties rather than disciplinary corrective action. A PCA regulation was introduced in October 2002, but is considered too liberal to be effective. Shorter deadlines and more conservative triggers, as well as triggers based on components other than capital are recommended. Higher minimum capital requirements that become effective at end-2010 favor foreign-owned banks, as the minimum capital requirement for commercial banks that do not have at least one influential shareholder

as a bank or financial institution with a rating of 'investment grade' is three times higher, at KHR150 billion. The NBC is urged to develop a strategy to deal with those banks that will not meet the new capital requirement.

83. **No deposit insurance scheme exists.** However, under the LBFI, depositors, other than banks and financial institutions, with accounts denominated in riel would receive an equal amount up to two million riel in the event of liquidation. There is no prompt payment requirement as these obligations rank fifth, after liquidation expenses; tax and fees to the Treasury; employee salaries and preferential or secured claims.

E. Main Findings

84. **This is the first FSAP conducted in Cambodia; however the BSD has conducted BCP self-assessments annually since 2005.** The extreme shortage of qualified persons has constrained the efforts to conduct effective bank supervision, although considerable technical assistance has been provided. Initial steps have been taken to strengthen supervision; however, substantive progress has not been realized that would justify higher ratings. Many of the recommendations contained in this assessment are focused on expanding and strengthening those initial steps, as it is not reasonable to expect that the BSD could conduct comprehensive RBS in the near-term. However, a stronger commitment to implement some of the technical assistance as well as a re-direction of supervisory activities to embrace risk-based and forward-looking supervision is needed. The following summarizes the main findings of the detailed assessment of compliance with the BCP.

Objectives, Independence, Powers, Transparency and Cooperation (CP1)

85. **The NBC is established as an autonomous institution, however a clear legal basis for the dismissal of the Governor, as well as the lack of legal power to delegate authority to an internal committee are of concern.**[27] Clearly stated objectives of the NBC surround monetary policy and price stability, but there is no direct reference to the supervisory mandate. The BSD's functions and duties are posted on the NBC website and would benefit from restatement.

86. **The NBC is the supervisor and regulator of commercial banks, specialized banks and micro-finance institutions, as enshrined in the LNBC and the LBFI. The supervisory mandate extends to bank holding companies, entities operating in securities and foreign exchange markets; and the market for precious stones and precious metals.** The NBC is mandated to coordinate with the supervisor of the securities market. A majority of the commercial banks are controlled by foreign banks, but the BSD does not have formal arrangements for information sharing with the home supervisors. The NBC is encouraged to

[27] See Technical Note, *Transparency of Monetary and Financial Policies*.

initiate coordination and information sharing with both domestic and foreign supervisors. Internally, the BSD is encouraged to enhance and document their institutional knowledge of the banks, both on an individual basis and the system as a whole. Expanding the sources of information and its analysis should contribute to a stronger understanding of the risks in banks.

87. **In general, sufficient legal powers for supervision are granted to the NBC, but effectiveness is impacted by weak enforcement.** The legal framework appears adequate and during the assessment, it was learned that process to amend the LBFI had stalled. Efforts to re-activate the upgrade to both the LNBC and LBFI are strongly recommended. Regulations address a number of prudential issues, and would benefit from the input of a legal draftsperson or legal counsel during their development. Some conflicts and gaps were found in the regulations and these were pointed out to the authorities to facilitate correction. Supervisors are not provided legal protection against lawsuits and the cost of defending against actions taken and/or omissions made in good faith while discharging their duties. The NBC is encouraged to pursue this in the upgrade to the LNBC.

Licensing and Structure (CPs 2–5)

88. **In a three-year time frame, the number of commercial banks has almost doubled.** As of end-2009, there were 27 commercial banks. A considerable number of regulations address licensing, as well as the ongoing requirements that banks must meet. Despite the sizeable number of applications for licenses, comprehensive criteria and guidelines have not been developed and documented for the supervisors' use. Written guidance is essential to ensure consistent treatment, as well as a necessary step to building institutional knowledge of supervisory activities. The number of institutions clearly outstrips the capacity of the supervisory authority, and discussions with BSD representatives revealed that the licensing function was not viewed as a 'gatekeeper' function, but rather a means to attract (foreign) investment to Cambodia. Contrasting the resource constraints of the BSD with the current size and potential for an expanded scope of the banking industry, it is imperative that the BSD develop a strategy to address licensing of banks. In the interim, the BSD is encouraged to consider a moratorium on new licenses.

89. **Transfer of ownership or control over banks and financial institutions is subject to NBC approval; however there is ambiguity in the law and regulations, and clarifications should be made.** Some limits exist for major acquisitions, primarily equity investments, but most transactions are not subject to either review or pre-approval of the NBC. The law grants very broad powers to the banks, with almost no consideration given to the risks associated with the activities or an assessment of management's ability to control risks. These permissible bank and investment activities should be reconsidered and narrowed when the authorities upgrade the legal framework.

Prudential Regulation and Requirements (CPs 6–18)

90. **A minimum capital requirement of KHR 50 billion is required for commercial banks.** This amount is scheduled to rise to KHR 150 billion by end-2010 for banks that have shareholders as individuals or companies. Locally incorporated commercial banks that have at least one influential shareholder as a bank or financial institution with a rating of 'investment grade' can maintain the KHR 50 billion minimum capital. The solvency ratio, which largely follows the risk-weighted assets to total capital ratio, remains at 15 percent. The assessors are concerned about the unequal capital treatment, as well as the limited options available to address those institutions that may not meet the new minimum capital requirement. As the legal framework does not address mergers, the NBC is encouraged to develop a strategy for banks that fail the new capital requirement. Further, the potential for additional risky activity undertaken by banks may increase due to the cash inflow resulting from any capital infusion; supervisors may need to prepare for new or additional challenges.

91. **Compliance-based review is still the foundation on which supervision is conducted.** BSD management could not estimate when RBS would be implemented, primarily due to the severe human resource constraints. Recognizing that and the other resource constraints, the assessors have made a number of recommendations that would put BSD on the path to risk-based and forward-looking supervision. A vital key to success in this effort is a firm commitment to conduct meaningful supervision - through risk-based and forward-looking processes. Concurrently, the BSD needs to more effectively implement the technical assistance (TA) provided and to incorporate the products and lessons learned from the TA into the supervisory routine.

92. **Credit risk is, by far, one of the areas of bank operations in which the supervisors have a broad understanding.** A considerable amount of the on-site supervision is spent in various reviews of the loan portfolio, currently the single source of credit risk. Regulations have been issued that address the loan policies, accounting for loans, related party lending, large exposures, asset classification, and loss provisions. Despite the extensive legal framework addressing credits, there are shortcomings in assessing the credit risk and in the application of forward-looking supervision. BSD is encouraged to expand their on-site and especially their off-site processes to fully incorporate the risk-based, forward-looking supervision.

93. **Related party transactions regulation bears several deficiencies.** The definition of related party should be expanded and scope to include off-balance sheet and investment activities. Related party transactions should be subject to the 'regular' assessment process and persons with interest should be prevented from decision-making and monitoring processes. Supervisory process should place more emphasis on ensuring that risks are appropriately captured, evaluated and managed.

94. **There is a lack of adequate guidance and supervisory review in the areas of market, interest rate, liquidity, country, and operational risk.** Although the NBC has established limits on open currency positions and impose liquidity ratio requirements, it has not developed a comprehensive process to monitor, measure, and set standards in these areas. However, in light of potential liquidity concerns during the recent crisis, the NBC has required 16 banks to submit liquidity reports on a daily basis and required five banks to submit liquidity plans. Regulations on liquidity ratio need to be enhanced to include undrawn commitments and other off-balance sheet items into the calculation. There is no guidance on the internal control function and no comprehensive assessment to ensure that internal controls are adequate for the scope and level of operations. Nevertheless, the work of the internal audit is reviewed during inspections.

95. **It is recommended that the NBC develops guidance for identifying, measuring, monitoring and controlling the various risk components.** Of immediate importance is liquidity risk. The role of board and management to establish strategy, set limits, and provide oversight should also be articulated. Guidance on the internal audit function should also be issued. Supervisory analysis should contribute towards forming an integrated view of the overall risk profile and how banks manage their risks.

96. **The NBC has made significant strides in establishing the legal and regulatory framework for anti-money laundering and combating the financing of terrorism.** A Financial Intelligence Unit (FIU) has been established to administer the law and is responsible for receiving and analyzing suspicious transaction reports. However, only eight general assessment on-site examinations have been completed as at assessment date, and therefore insufficient to provide assurance that the requirements are effectively implemented and administered by banks. There is room for enhanced coordination between the FIU and off-site supervision to keep informed on the progress of the recommendations made.

Methods of Ongoing Banking Supervision (CPs 19–21)

97. **The NBC conducts compliance-based supervision.** Risk profiling is limited and there is no comprehensive assessment of the risk management practices of a bank. Communication with bank management and board is limited to situation where there has been a non-compliance event or in conjunction with on-site examination. There is also little interaction with external auditors.

98. **Supervision is conducted via off-site surveillance and on-site examination.** The on-site examination cycle is 24-months, with annual visits for the larger banks. Off-site unit assesses and assign internal ratings on a quarterly basis. Macro analysis on the banking sector is basic, and there is no established process to include wider economic observations into the supervisory assessment.

99. **The NBC is availed of a comprehensive range of powers to demand and access information.** However, there are concerns over the integrity and accuracy of reports

submitted by banks. Regular on-site examination does not include assessment of IT systems, which raises concerns over accounting records reliability. This poses serious issues on the overall effectiveness of the supervisory function.

100. **The BSD's capacity is heavily stretched under the burden of having to supervise a large number of banks, couple with inexperienced staff.** Staff turnover is high. The absence of a structured training program for new supervisors and general lack of documented guidance compounds concerns over the effectiveness of the supervisory process. It is recommended that the NBC reprioritise the supervisory functions with the intent to move towards a more risk-focused and forward looking approach. Banks should be grouped by risk profile with separate categories for systematically important and problematic banks. Supervisors will gain from a formalized and documented process for supervisory assessment and action, as well as from a comprehensive and regular training program.

Accounting and Disclosure (CP 22)

101. **The NBC has clear legal powers,** and has established comprehensive requirements relating to record-keeping, accounting standards, reporting, appointment of external auditor, and submission and presentation of annual audited financial statements. Financial accounts are required to be prepared in accordance with the Cambodian Accounting Standards and the NBC guidelines, and where the accounting requirements differ from the NBC's requirements, the latter shall prevail. Authorized external auditors are required to audit and provide an opinion on the financial statements.

Corrective and Remedial Powers of Supervisors (CP 23)

102. **The legal framework provides the NBC with the authority and tools to impose a broad range of disciplinary sanctions, including issuing a fine and withdrawal of license.** However, in practice, it appears that the sanctions are used only when banks are non-compliant with legal or regulatory requirements, and not to institute corrective measures at an early stage. Current PCA measures are only triggered when the solvency ratio has fallen below the minimum requirements. Moving forward, the NBC is encouraged to have a well-defined guidance on the processes and actions to be taken when a bank is found to be operating in unsafe or unsound manner.

Consolidated and Cross-Border Banking Supervision (CPs 24–25)

103. **Many banks are part of a larger conglomerate but only one has a bank holding company structure.** The NBC only conducts supervision on individual entity basis and does not collect group-wide information although it is empowered to do so under the law. Appropriate enhancement should be made to the legal and regulatory framework to support the NBC in performing consolidated supervision. The NBC is also encouraged to establish formal arrangements with domestic supervisory authorities responsible for the insurance and

securities industries, as well as to strengthen the legal framework to facilitate information sharing.

104. **Foreign bank presence in Cambodia is significant.** Two of the five largest banks are foreign-controlled and account for one-third of total banking assets. At present, the NBC does not actively engage with the home supervisors of foreign banks, here too, the NBC is encouraged to establish formal information sharing arrangements with home supervisors of foreign banks.

105. **Table 3 provides a principle-by-principle summary of the assessment.**

Table 3. Summary Compliance with the Basel Core Principles—ROSCs

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	Lack of clarity regarding supervision objectives of NBC and responsibility re: securities market participants.
1.2 Independence, accountability and transparency	Questions regarding the autonomy of the NBC and Governor as CEO of the NBC.
1.3 Legal framework	Upgrades to the LNBC, LBFI and regulations are needed to provide comprehensive coverage, as well as to remove gaps and conflicts.
1.4 Legal powers	Broadly adequate powers, need to enforce laws.
1.5 Legal protection	Supervisors should be provided adequate legal protection.
1.6 Cooperation	Legal framework should provide for confidential cooperation with domestic and foreign supervisors.
2. Permissible activities	Control over use of restricted terms, the NBC should consider reducing permissible activities.
3. Licensing criteria	Need to document criteria and processing procedures, number of banks outstrips the capacity of supervisors, the NBC should consider a moratorium on new licenses.
4. Transfer of significant ownership	Law is vague regarding the capacity of supervisor to reverse or stop change of control.
5. Major acquisitions	Supervisor does not have authority to review or prohibit major acquisitions, and the authorized acquisitions are very broad, the NBC should consider restricting.
6. Capital adequacy	Solvency ratio broadly meets international standard, should consider adding market component to capital calculation. Unequal treatment of banks in setting minimum capital requirement.
7. Risk management process	Supervision performed on compliance-based, need to consider move toward risk-based and forward-looking assessments.

Core Principle	Comments
8. Credit risk	Need to establish process to assess the suitability of credit risk activities.
9. Problem assets, provisions, and reserves	Banks should be required to amend financial statements to accurately reflect timing of loss provisions.
10. Large exposure limits	Inadequate definition of large exposures does not capture all types of exposures; supervisor should have authority to determine 'single beneficiary'.
11. Exposure to related parties	Definitions of exposure and related parties are inadequate. Persons benefiting from transactions should be excluded from the decision-making and monitoring process.
12. Country and transfer risks	Currently not a high risk, but domestic banks and MFI are engaged in international activities, raising risk profile.
13. Market risks	A lack of guidance and review of market risks, this an immediate concern, as securities market is expected to be operational soon.
14. Liquidity risk	Weak supervisory practices to assess risk management activities.
15. Operational risk	Supervision has not developed sufficient processes to evaluate operational risk.
16. Interest rate risk in the banking book	Supervision has not developed sufficient processes to evaluate interest rate risk.
17. Internal control and audit	Supervisory processes focus on area-specific internal control evaluation and not on ensuring an internal control system adequate to the needs of the bank.
18. Abuse of financial services	Supervisory processes should be enhanced to assure that banks and institutions are properly controlling and reporting AML/CFT transactions.
19. Supervisory approach	Compliance-based supervision being conducted does not enable comprehensive risk profile and assessment. Need to adopt risk focus and forward looking approach.
20. Supervisory techniques	Need to strengthen coordination between on- and off-site supervisors, maintain regular contact with bank management and share reports of exam with boards of directors.
21. Supervisory reporting	Strengthen validation of reports submitted.
22. Accounting and disclosure	Enhance legal framework to allow the NBC to establish audit scope, engage with external auditors to address common issues.
23. Corrective and remedial powers of supervisors	Formalize policy on early intervention, enforce laws and regulations with disciplinary action that is commensurate with the problem, with less focus on fines and monetary penalties.
24. Consolidated supervision	Enhance framework to allow consolidated supervision, expand analysis to include group-wide review.
25. Home-host relationships	Establish formal arrangements with home supervisors, enhance legal framework re: information sharing.

F. Recommended Action Plan and Authorities' Response

Recommended action plan

106. **These recommendations are based on assumption that the BSD cannot implement forward looking, RBS in the medium term, given the resource and capacity constraints.** However this action plan is proposed to be implemented in the immediate future, as the BSD recognizes the importance of starting the process despite the constraints. A strong commitment from the BSD to implement the changes will be needed, as there will still be a considerable amount of work to complete the shift to RBS. That commitment includes the proposals below, working more closely with the TA advisors to facilitate transfer of knowledge and to use the TA advisors as a reference and for guidance in development and implementation of products or processes below.

Overall

- Re-prioritize tasks (more emphasis to understand and profile banks, forward looking assessment) and resources (less emphasis on checking for operational compliance e.g., applications for branches, interviews for branch managers); and
- Develop and formalize the supervisory mandate – much of the recommendations below address this.

Application processing

- Develop policy for licensing (commercial banks, specialized, MFI, what participants does BSD want, branches vs. subsidiaries, unequal treatment for capital vs. risk based capital, moratorium on new licenses);
- Document procedures for processing;
- Document criteria for processing; and
- Develop decision trees, procedures and criteria for mergers, changes of control, transformation of entity – such as going from specialized bank to commercial bank.

Off site/data collection

- Profile individual banks. Build core knowledge of institution or group, meet with bank management & board, gather & analyze broader information on group – parent company & subsidiary, gather intelligence/observations from on-site;
- Form view of industry condition. Broader industry risk assessment (peer benchmark, identify areas of vulnerability), work with other stakeholders to expand information

base and to have broader knowledge of industry risks (economic & research dept, external auditors, other supervisors, ministry of commerce, labor, tourism);

- Group banks by risk (Low, Medium, High), systemic importance, problematic;
- Formalize policy on early intervention/corrective/disciplinary action, include delegated authority, establish standards, triggers and required actions;
- Use powers to require banks to take corrective action (establish procedures, record actions for future reference);
- Tighten controls over corrective action, such as progress reports, meetings with bank management and board;
- Establish MoU with foreign supervisors;
- Establish MoU with domestic supervisors; and
- Assess capacity to cope and actions that can be taken under stress conditions.

On-site supervision

- Validate the integrity of data received by the off-site and accounting/record-keeping by banks;
- Present and discuss report of examination to board of directors, not just CEO;
- Formalize and enforce corrective action on institutions (include board);
- Put expectations for all risk areas in writing – to industry and to supervisors; and
- Identify priorities for change and start looking at issues on a risk & forward looking approach (example: credit risk, underwriting weaknesses, document exceptions).

Internal to BSD

- Escalate supervisory reviews up the line of command – regular presentation of industry and individual bank assessment (from off-site), concerns requiring early intervention/enforcement action (from off-site or on-site), on-site examination findings and recommendation;
- Initiate efforts to expand and regularize training programs;
- Enhance the Code of conduct; and

- Share process for development of regulations.

Upgrade legal framework

- Both the LNBC and the LBFI would benefit from upgrades. During the assessment, it was learned that the process to upgrade the LBFI had stalled; the NBC is strongly encouraged to re-start the process.

- Throughout the detailed assessment, there are a number of recommendations to enhance/upgrade the laws and regulations. The BSD is encouraged to develop a strategy to comprehensively address the legal framework, to remove gaps and conflicts, and to incorporate necessary changes.

Authorities' response to the assessment

107. **During the review of the assessment findings, the assessors considered management's responses and where appropriate incorporated them into the written comments, or revised the comments as necessary.** The authorities preferred to provide their responses verbally, and these were included in the relevant principles' section "Recommended Action:"

- **Responsibilities and objectives.** The authorities indicated that they would consider upgrading the stated objective of the BSD.

- **Independence, accountability and transparency.** The authorities are of the view that the Governor has sufficient independence, despite the legal text; his removal is subject to the approval of the King, who constitutes an independent third party. Separately, the reorganization of central bank to make supervision independent is currently under consideration.

- **Legal framework.** The authorities acknowledge that areas for improvement exist.

- **Legal powers.** The authorities agreed that the recommended corrective actions would address the root causes, not just the symptoms.

- **Legal protection.** BSD management acknowledged the need for such protection and will ensure that it is in the proposed amendments to the LBFI.

- **Cooperation.** According to the authorities, efforts are currently underway to formalize MoUs.

- **Licensing criteria.** The authorities noted that in the case of applications filed by foreign-based financial institution shareholders, letters signed by supervisory authorities in the origination country are required. For a remitting bank whose capital funds originate from a blacklisted country, the BSD would check the anti-money laundering/combating the financing of terrorism (AML/CFT) procedures of that country; otherwise reliance is placed on the remitting bank to ensure a due diligence was performed.

- **Transfer of significant ownership.** According to the authorities, any shareholding of more than 10 percent requires approval; any holding between 5 and 10 percent requires notification. If a shareholder fails to notify the NBC, then any vote would be nullified; if a shareholder does not request prior approval, s/he would be deemed to have violated the law. Ultimately, it is up to the NBC's discretion to decide on the degree of compliance (the NBC has had a branch manager removed for non-compliance). The authorities will consider the recommendation that the BSD be given specific authority.

- **Major acquisitions.** The BSD reviews banks' participation in other activities. The BSD would request information on a planned subsidiary and how the operation of that subsidiary would affect the prudential ratios of a bank. The BSD would then assess if the risk of the proposed activity (property development) would be linked with the main activity of the bank (e.g., lending on real estate); it may take action (e.g., impose ceiling on the bank), if it is assessed that the activity is too risky. A law relating to risk exists; the BSD allows for some flexibility, but is also aware of the risks.

- **Credit risk.** According to the authorities, an internal control regulation has been drafted, but it has not yet been issued because it is not strong enough in its current form. Onsite inspectors have made recommendations on governance, policies, procedures, and minutes of credit committee; however internal control and stress testing are still lacking.

- **Problem assets, provisions and reserves**. The authorities agreed that asset classification is key, and that enforcement is most important. Banks currently provide monthly financial statements to the supervisors, who monitor them.

- **Large exposure limits.** The authorities noted that if banks do not follow the recommendations of the supervisors, then BSD could threaten to implement consolidated supervision. The NBC will review net worth calculations; it has the authority to amend the relevant regulations.

- **Interest rate risk in the banking book.** According to the authorities, the NBC has its own refinancing rate, but it only monitors and does not impose an interest rate ceiling benchmark. Banks are allowed to offer rates on a competitive basis. Onsite checks are made for calculations of interest rates.

- **Internal control and audit.** The authorities noted that they are currently reviewing the regulation.

- **Supervisory approach.** The authorities argued that at the very least, the BSD has onsite and offsite supervision. The BSD has implemented risk analysis, although it has not documented existing practices. The authorities accept all of the mission's recommendations in this area.

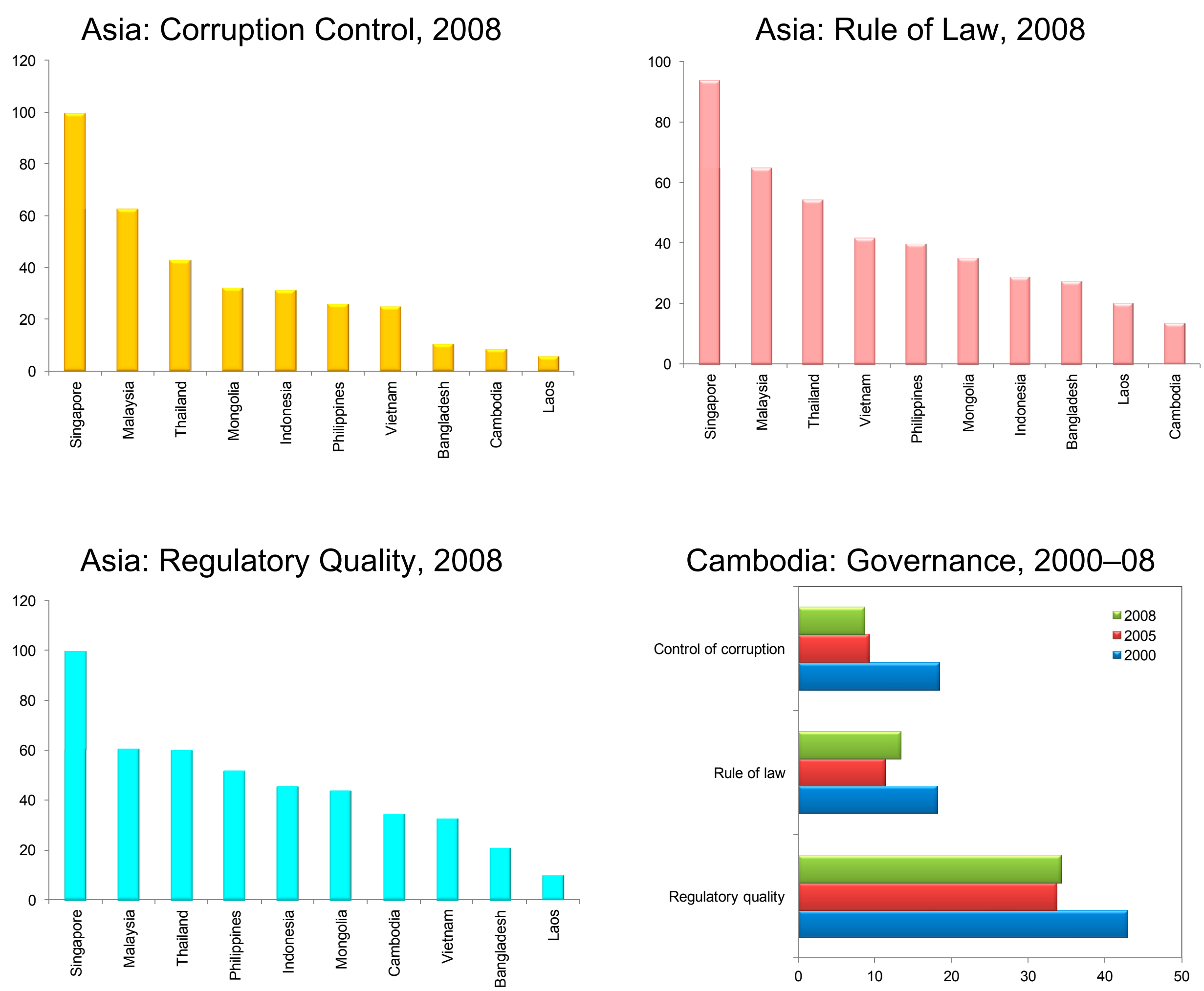
- **Supervisory reporting.** According to the authorities, supervisors perform pre-onsite examinations, to ensure compliance with NBC requirements. Examiners check to see if appropriate entries have been entered for accounts. In one case, onsite examination was performed on 45 percent of NPLs and when significant discrepancies were found, the examination was extended to 60 percent of NPLs.

- **Corrective and remedial powers of supervisors.** The authorities emphasized that the BSD also looks at the root of the problems with NPLs, not just at the classification. A report and requirement for corrective actions are then given to the bank, which are signed off by the Director General. A follow up check is then made on whether the bank has taken the necessary actions to address the requirements of BSD. There are trigger points for action on capital, plus compliance with other requirements beyond capital. To facilitate immediate intervention, however, the BSD needs to be given the direct power instead of having to go through several chains of command. The authorities requested that the mission to provide recommendations on when and how to alert banks to initiate action.

- **Consolidated supervision.** The authorities argued that a holding company is not a financial company, but if it sets up an investment bank to trade in securities, the NBC would supervise the subsidiary; the holding company is also a covered entity that needs to be licensed by law.

APPENDIX I. FIGURES AND TABLES

Figure A1. Governance Indicators 1/
(Percentile rank)

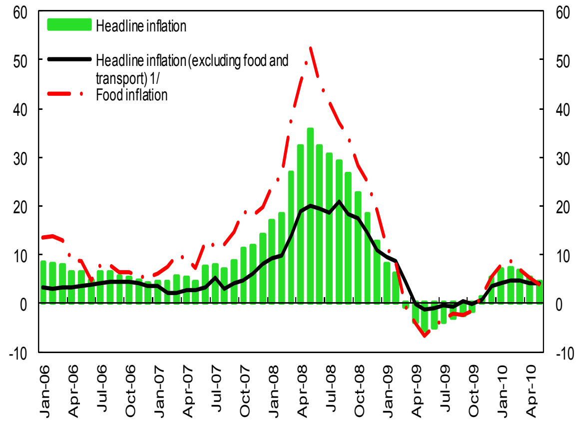


Source: The World Bank.

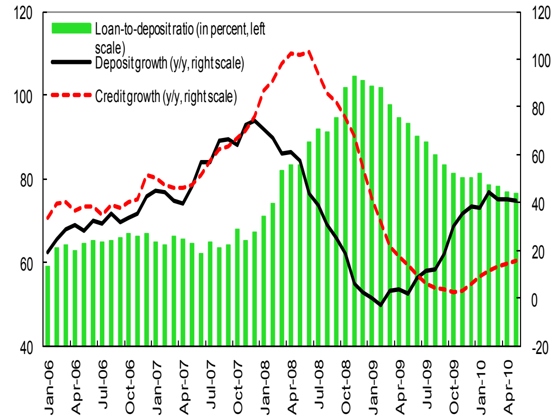
1/ The percentile rank ranges from 1–100; the higher the ranking, the better the governance outcome.

Figure A2. Macro-Financial Developments

Inflation Development
(Year-on-year percent change)

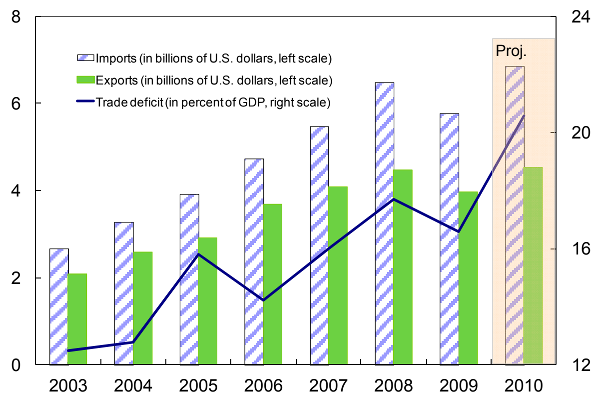


Deposit and Credit Growth
(Year-on-year percent change)

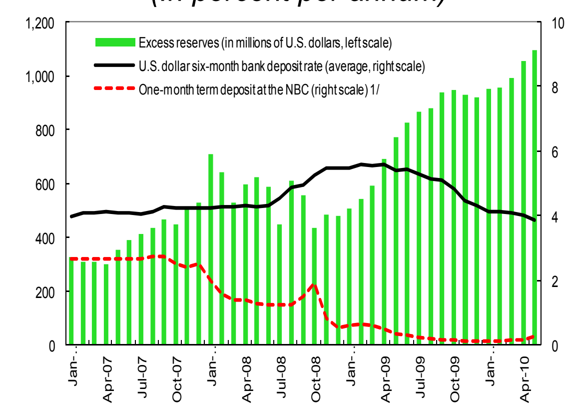


1/ Excludes food, beverages, and tobacco; and transportation and communication components of the consumer price index.

Trade Developments

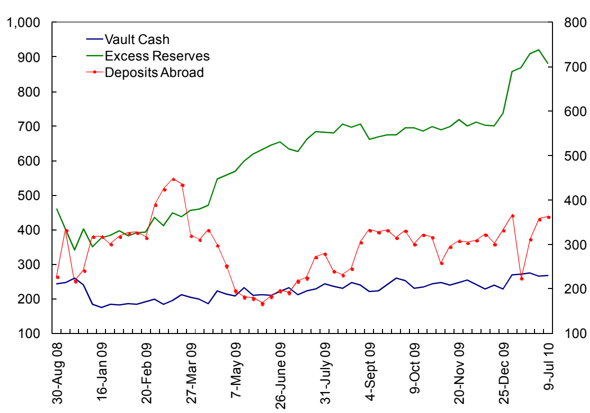


Interest Rates and Liquidity Conditions
(In percent per annum)

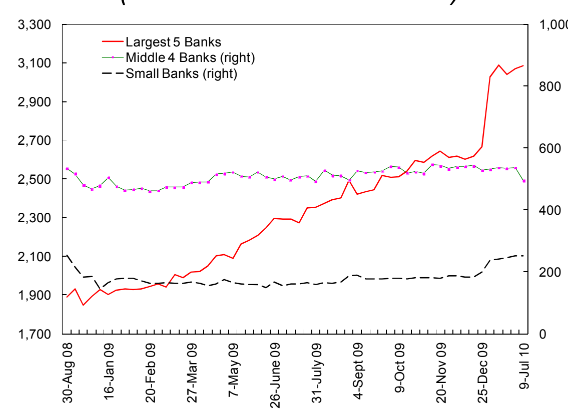


1/ Currently remunerated at one-half of Singapore Interbank Offer Rate (SIBOR).

Banks' Liquid Assets
(In millions of U.S. dollars)



Dollar Deposits
(In millions of U.S. dollars)



Sources: Cambodian authorities; and IMF staff calculations.

Table A.1. Financial Soundness Indicators

	2008	2009				2010	
	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Capital-based							
Regulatory Capital to risk-weighted assets *	27.6	32.4	33.1	34.2	32.3	31.5	31.3
Regulatory Tier 1 capital to risk-weighted assets *	27.7	32.8	37.2	34.8	33.0	32.6	32.7
Nonperforming loans net of provisions to capital *	6.6	8.2	8.3	9.7	5.3	5.1	5.5
Return on equity*	13.9	1.3	2.2	3.1	4.2	1.3	2.7
Net open position in foreign exchange to capital *	1.9	1.9	1.9	5.0	1.5	0.9	0.8
Asset-based							
Liquid assets (core) to total assets *	14.2	15.4	16.2	19.8	19.4	16.1	18.0
Liquid assets (core) to short-term liabilities *	30.6	35.0	42.0	50.2	56.3	22.1	24.6
Return on assets*	2.7	0.3	0.5	0.6	0.9	0.3	0.5
Nonperforming loans to total gross loans *	2.9	4.3	4.9	5.7	3.9	4.1	4.2
Sectoral distribution of loans to total gross loans							
Interbank loans resident *divided by* Total gross loans	3.8	3.5	4.5	5.9	6.5	6.6	6.1
Loans central bank *divided by* Total gross loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans OFCs *divided by* Total gross loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans nonfin corporations *divided by* Total gross loans	70.6	72.4	74.4	71.3	71.1	68.9	69.2
Loans other domestic sectors *divided by* Total gross loans	20.1	19.3	18.9	17.5	17.5	16.2	16.8
Loans government *divided by* Total gross loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans nonresidents *divided by* Total gross loans	5.6	4.9	2.2	5.3	5.0	8.3	7.9
Income- and expense-based							
Interest margin to gross income*	48.3	48.3	48.3	48.3	48.3	48.3	48.3
Noninterest expenses to gross income *	64.2	65.4	66.9	65.4	64.2	65.3	62.9

Source: National Bank of Cambodia.

APPENDIX II. CAMBODIA: KEY FSAP RECOMMENDATIONS OF MEDIUM PRIORITY

Recommendation
General Stability
• Integrate stress testing into the offsite supervision framework once data quality has improved.
Supervision and Regulation
Banking
• Conduct consolidated supervision of banks that have affiliated parties (parent, subsidiaries, sister organizations).
• Document processes used by off-site supervisors to provide for continuity and consistency in their performance and to provide guidance for new staff.
Insurance
• Develop additional regulations to reinforce, clarify and elaborate requirements in areas such as insurance fraud, consumer protection, fitness and propriety of officers.
• Develop regulations on the key aspects of the life insurance business, including finalizing new arrangements for distribution.
Securities
• Resolve all ambiguities or overlaps in the laws and regulations on the roles and responsibilities of the SECC.
• Develop an electronic system for stock-watch, market surveillance, and information disclosure and reporting.
• Develop the regulatory and supervisory framework for the Cambodia Mercantile Exchange.
Access to Finance
• Establish regulations and oversight framework that enable non-banks to provide e-money (electronic money) services.
Crisis Management Framework
• Revise the Law on Banking and Financial Institutions (LBFI) to provide for more options for bank restructuring; more powers for supervisory responses and intervention; and to empower the provisional administrator to intervene as appropriate in problem bank restructuring and management.
• Revise the Law on the Organization and Conduct of the National Bank of Cambodia (LNBC) to accord legal recognition to the NBC's overdraft facility by including loans as eligible collateral, and allow the NBC to grant loans or overdrafts.
• Define systemic bank and devote more supervisory focus to systemic issues.
Transparency of Monetary and Financial Policies
• Amend the law to clearly state that losses incurred by the NBC from any bank resolution process should be covered by the government budget, and to ensure that any resolution framework is consistent with the LOLR provisions already in the law.
• Define and publish the relationship between financial agencies.
Infrastructure
Legal and regulatory framework
• Design and develop the institutional arrangements to implement and enforce laws, and enhance the capacity of the relevant authorities to do so.
• Carry out a Creditors Rights and Insolvency Assessment to find ways to improve the collateral regime, risk management, and recovery of debts.

Recommendation
Accounting and auditing
• Create and implement a strategic plan for the eventual transition to IFRS, with particular focus on the application to financial institutions.
• Enhance collaboration among the financial regulators to ensure that inconsistent or duplication in financial reporting regulatory requirements are minimized.
Payment systems
• Complete the outstanding work on the National Payment Systems Law to strengthen the legal basis for payment systems and provide for a comprehensive payment system oversight framework.
• Develop and implement a strategy for promoting electronic money (also see Access to Finance recommendation).
Credit reporting
• Strengthen the legal framework for credit reporting (both for public credit registries and private credit bureaus) by amending appropriate sections of the LBFI, and completing the draft regulations on credit reporting.
• Establish a credit reporting oversight function within the NBC, and provide for its legal basis.
• Design awareness campaigns to educate the public about credit reporting mechanisms adopted and procedures for providing data.
AML/CFT
• Integrate the Financial Intelligence Unit (FIU) in some form in the bank licensing process, and begin to levy sanctions on financial institutions that violate the laws and regulations.
• Increase staffing of the FIU with the addition of specialists in law, investigations, and enforcement, and encourage the establishment of compliance departments of regulated institutions, coupled with training for these individuals on the AML/CFT laws and regulations.