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Trade in Banking Services: The Case of Cambodia

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TRADE IN BANKING SERVICES: THE CASE OF CAMBODIA[1]

1. Introduction

As in other transition economies, the collapse of the centrally planned regime has led to a radical change in the financial sector in Cambodia. The most striking characteristics have been the transformation of the mono-banking system into a two-tier system that allows the opening of bank's capital to private and, in particular, foreign investors, and the liberalization of the current and capital account movements.

From the point of view of the foreign services providers, trade in financial services (and in particular banking) has some analogue features with trade in goods to the extent that they can export their services trough the use of cross-border activities (arms-length transactions) or as foreign investment in the form of setting up a local establishment directly in the host countries in order to sell their products. However, unlike export and import of goods and commodities in general, given that the operations in the financial sector involve systemic risk to the whole economy and society, trade in financial services raises a distinct set of concerns, which in turn requires particular attention and active involvement of the competent authorities with respect to control, management, and supervision of financial market.

This short paper aims to provide an overview of the state of play of foreign direct investment (FDI) in banking services and the underlying policy framework in Cambodia, from the perspective of the monetary authorities, (and not from the point of view of the sellers or buyers/consumers of banking services). The author hopes that practical experiences of Cambodia could be a ground for debate and perhaps policy attention. The banking sector is the focus here, as other sub-sectors of the financial markets are not yet in existence or just emerging in Cambodia. Cross-border supply of banking services is deliberately excluded from the discussion, as little information is available on such activity. Due to infancy of the banking industry, there is no outward cross-border supply or outward financial FDI to a third country.

2. Banking and Financial System in Cambodia

In 1975, the banking system was completely destroyed and there were no financial services from 1975 to early 1979. In 1980 a mono-banking system was established, the National Bank of Cambodia was the only bank operating and performed central and commercial bank functions through a network of provincial branches.

After its establishment, the NBC literally had to reconstruct its financial sector from scratch, shaping monetary policy in a challenging and tough environment and started later on to liberalize and enhance standard in the banking sector, with the aim to upgrade the level of financial intermediation, and to promote the deepening of the financial sector.

The financial sector has been liberalized as needed and the liberalization proceeded rapidly in Cambodia from 1993 onwards. The number of licensed banks increased dramatically in the early years of transformation - to 24 at the end of 1994 and 31 by 2000. This wave of new entrants imposed a heavy supervisory burden on a central bank with little experience in the task. A large number of the new banks were inactive; some were poorly managed and prone to taking excessive risks. Accordingly, public confidence in the banking system (as well as mutual confidence among banks) remained very low.

To remedy this situation, while implementing the Banking Law, a bank re-licensing program was introduced in 2000. This based in particular on new level of minimum capital requirement and banks' compliance with relevant laws and regulations that were improved and made more specific thereby became stricter for the purpose of single out quality banks from non-viable ones.

[1] This paper express the views of the author only and does not necessary reflects those of the National Bank of Cambodia.

As a result, sixteen banks have been de-licensed and put under liquidation, of which 4 were insolvent and 12 were closed on a voluntary basis. Further, after the cleaning up activity, regulations and prudential standards that affect prudential capital adequacy, minimum liquidity, exposure ceilings and loan provisioning etc are continued to be improved. The banking system appears now to be financially healthy.

As of end of June 2005, besides the central bank and its 21 branches, the banking system consists of the following institutions:

- 15 commercial banks, of which 11 are locally, incorporated banks including three subsidiaries of foreign banks, three foreign bank branches and one state owned commercial bank.
- Three specialized banks, which are the state-owned Rural Development Bank, and two privately owned banks.
- A decentralized banking system, consisting of micro finance institutions and a number of NGOs operating in the rural finance.

The share of foreign banks branches and subsidiaries in total banks loan and deposits reached 27% and 35%, respectively in mid June 2005, and they accounted for 35% and 37%, respectively in the total banks assets and equity. The remaining private banks are also largely financed by foreign funds. Due to poor development throughout the country, most banks are only represented in the capital cities and in a few large cities.

There could be several reasons that foreign investors have interest in Cambodia's banking sector:

- Economic development potential supported by the government's open market policy and the active involvement of multilateral and bilateral donors in the process of economic and social reforms in Cambodia.
- Low level of financial intermediation which indicates that there are rooms for foreign investors to manoeuvre and gain from financial sector's development prospect in Cambodia. At present, banks enjoy comparably high margins, operating with a large spread between lending and deposit rate of around 10%.
- Attitude of "following their customers" observed in some foreign banks, in particular at the beginning of the entry into Cambodia, to serve specifically business activities of their own country investors.
- The interest of Cambodian expatriates in the development of their motherland.
- Other supporting government policies that promise stability and safety in doing business in Cambodia. In addition to a very liberal regime that is outlined below, there is also some argument that dollarization contributes to promote expansion of the banking sector as its reduce currency risks from banking operations (that is about 905 of banks deposits and loans are denominated in USD).

However, it is to note that no western bank with a global strategy in retail banking from United States, Japan or Europe is currently represented in Cambodia.

3. Legal and Regulatory Framework for the Banking System

Besides the 1996 central bank law that paved the way for an unwavering move to a two-tier system, there are two important laws directly governing banking operations.

The 1997 Law on Foreign exchange that form an important basis for a free current and capital account transactions, especially in view of the high degree of dollarization within and outside the banking sector in Cambodia. In 2002, Cambodia became a signatory to the Article VIII of the Articles of Agreement. This official commitment makes life simpler and more efficient for the enterprises that directly involved in trade and for producers of goods and services. By clarifying the rules that will apply to Cambodia and by promising not to change its trade regime toward the rest of the community, business society will have a clearer view of environment and opportunities surrounding their potential or future activities. In other words, the formal declaration and promise of the current account convertibility will add additional certainty and predictability to the business environment.

In November 1999 the Law on Banking and Financial Institutions was enacted together with a set of prudential regulations designed to promote a sound financial structure and orderly financial markets. This regulatory framework is largely in compliance with core principles adopted by the Basle Committee for effective bank supervision.

Witnessed by the current practices, Cambodia has virtually also no restrictions on capital movements. This, combined with a liberal foreign investment regime, has greatly facilitated foreign presence in the financial sector in Cambodia and also smoothes the process of recent Cambodia's accession into the WTO. In fact, Cambodia has made efforts to minimize horizontal limitations and include broad sectoral coverage in its schedule of commitments with the WTO that is consistent with the current market access practices.

Below are main features of the liberalized regime in Cambodia, which directly or indirectly affect trade in financial services:

- Residents and non-residents are permitted to maintain foreign currency accounts with bank in Cambodia.
- Consumption abroad is not restricted for all financial services. Cambodian consumers and firms are free to go abroad and can make use of any of the services that are offered to non-residents by another country. Those also include insurance services.
- Loans and borrowings, including trade credits, may be freely contracted between residents and non-residents, if loan disbursements and repayments are made through authorized intermediaries. Residents can borrow from abroad, while lending to non-residents doing local business
- There are no restrictions on foreign bank entry and expansion – including restrictions on foreign equity, number of branches and ATMs, number of foreign personnel etc.
- There are also no specific requirements on the form of the establishment of a legal entity in Cambodia in order to provide banking services, meaning that foreign banks can set up operations or establish a subsidiary or a branch or just a representative office in the banking sector.
- A 100-percent foreign ownership in locally incorporated banks is allowed; that is foreigners may establish a new locally incorporated bank or acquire or purchase local bank shares at their discretion, provided that those investors comply with all the licensing requirements for banks, which are the same for resident and non-residents of Cambodia.
- The level of minimum capital is set at 50mn riels (i.e. USD13mn), which is seen by some analysts as unusually high as against Euro 5mn in France (and generally in Europe), and much less than this in Canada. However, there is no clear evidence that this level could be an obstacle for FDI presence in Cambodia.
- Anti-money laundering rules are just being introduced, with the Financial Intelligence Unit planned to establish next year.

4. Overall Assessment of Financial Liberalization in Cambodia

Benefits

FDI in the banking system is welcomed by the Cambodian authorities. Since the opening of the banking sector, inward FDI in this market is significant, reaching about 11% of total estimates on stock of FDI in Cambodia, given the small size of the economy and the infancy of the sector. First of all, it brings financial resources to this poor country. Despite the reduction of number of banks as a result of the bank restructuring exercise, the banking system is now well capitalized and bank intermediation has improved. It is worth to note that although there are only three foreign branches in the system, the greater part of locally incorporated banks have majority foreign ownership. The owners are either foreign individuals or Cambodian expatriates.

Analogue to the benefits of FDI in the productive sector, the poorer a country is in terms of non-financial technical assets such as technological know-how, managerial skills, trained labor, and linkages to international markets, the more FDI appears to be the most suitable therapy. Most of the effects on local banking systems were positive in terms of efficiency gains, introduction of new technologies, and employment of more productive people with opportunity provided for the development of human capital and better risk management. The re-licensing exercise during 2000 had manifested that all foreign banks branches and subsidiaries were sound, while the insolvent banks were either owned by local or foreign individuals.

Increase efficiency in the locally incorporated banks through competition from foreign banks branches and subsidiaries is another important point to be observed. Those banks seem to alter the efficiency of foreign owned and domestically owned banks, including the state owned banks. The later institutions are forced to improve their operations and quality of services, given the fact that all banks in Cambodia, due to the adopted universal commercial banking system, operate more or less in the same line of business (collecting deposits, extending loans, money transfers…).

Just as good relations with the International Monetary Fund would have positive spillover effects on Cambodia's relations with other multilateral and bilateral donor community, the entry of foreign bank(s) with good reputation, good ratings, and which are active internationally seems to bring signaling-related benefit for the host country as well. In particular, at this earlier state of economic and banking development such entry could help enhance the image of the country domestically and externally, improving thus the confidence of the public and other potential investors in the government policies and the economic potential of this country.

As for the soundness and compliance with regulations, foreign banks branches tend to show healthier performance, and they co-operate well with the home country supervisory bodies. This suggested that imported risk management technique, good policies and best practices from parent banks have definitely influenced the activities of branches in a positive way.

Challenges

With the aims to absorb a good market share, new foreign bank entering the market tends to offer different products, which – although good from the point of view of the domestic customers – are new to the local supervisors and regulators. This practice initially appeared to pose strong regulatory challenges to the authorities in three ways: (i) to the bank supervision with respect to their responsibility to assess and monitor the health of the financial industry; (ii) to the payment system overseers that need to ensure the soundness of the country's payment system and (iii) to the legislators or regulators who might need time and expertise to create additional set of legislation in order to ensure the responsible behaviour of market participants, whereby making a smooth and transparent functioning of the markets possible. In general, for a developing country like Cambodia, where human resources capacity is still suffering the legacy of a total social destruction in recent history, the need to develop knowledge and expertise of the responsible agency of the practices and products, newly introduced into the local economies, is very crucial for the good functioning of the market.

The need to upgrade the skill and expertise of the regulators is not required just when there is new entrant with new line of business coming in. Financial sector involves very dynamic and fast growing activities. The authorities need to be forward looking and be prepared for the eventual future development of the financial market in an increasingly globalized environment. Continuous capacity building for the relevant staff is a must and here generous support from the international community through training efforts will have tremendous positive effects, not only on the actual performance of the market, but in particular on the quality of policy formulation. A policy planner can devise a good plan only when he or she has sufficient knowledge of the subject.

5. Lessons Learnt

- As a lesson from the banks re-licensing program in 2000, a clear entry policy has now been put in place. The authorities pay indeed greater attention to the specific criteria for selecting foreign investors and the requirements of granting licenses whereby besides the personal qualifications of the foreign shareholders, efforts are also made to diversify the country of origin of foreign investors. The general perception of the authorities is that the dominance of foreign investors originating from a single country or region makes the domestic financial sector more prone to financial vulnerability, a risk of international contagion, and dependency on foreign banking systems.
- Limited bank financing of small and medium-sized enterprises has been generally observed for both, the foreign banks branches and the locally incorporated commercial banks. Banks are reluctant to take lending risks with respect to lending to entrepreneurs with small and medium holding and business. The often cited reasons were insufficient transparent information about borrowers as witnessed by firms' poor financial accounting and reporting and a lack of contract enforcement to ensure the collection of loan in case of default.
- There is no evidence that financial incentives such as tax preference or tax holidays, or other special treatment of that kind have an influence on the interest of foreign entrants on the host economy. An open regime in an economy with growth potential seems to be the most relevant factor to attract foreign investors. There is nothing unusual about that; the same happens to different countries in transition or developing countries. A number of case studies on East-European countries confirm the important role of a liberal and non-discriminatory regime. That is: the financial FDI regime is relaxed; none of the countries had any legal limitations on the entry of the foreign banks; there are no special legal limitations for foreign banks as the same rules apply for both domestic and foreign owned banks and there is a freedom of choice in terms of form of establishment.
- A crucial point to attract the presence of internally active retail banks is to pay greater attention to anti-money laundering. Cambodia is thus moving the right direction on this issue.

6. Conclusion

On the whole, the opening of the banking sector to foreign investors played a key role in the restructuring of the banking sector in Cambodia. In addition, this process was seen as a unique opportunity to create an efficient banking system providing services that could meet international standard. However, despite improvements since the clean-up of the banking sector, at present the banking and financial sector can still be characterized as being at an earlier stage of its development and intermediation, though improving, but remains still modest. This development was not to blame to the presence of the FDI banks. Instead, lack of a favorable and supportive environment for banks to develop and expand seems to be the main source of deficiency. There is thus a definite need to remove deficiencies in markets and operating environment. Financial reforms now in progress and under consideration, as described in the financial sector blueprint for the long-term development of the banking sector, which was adopted in 2001 and focused on the establishment and improvement of existing institutional and legal framework, will enhance financial intermediation and make it possible for Cambodia to increasingly take advantage of international trade in financial services.