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Liquidity and Credit Squeeze: Impact of the Global Financial and Economic Crisis on the Domestic Banking System[1]

The National Bank of Cambodia, main regulator for the banking sector

Introduction

The impact of the global financial and economic crisis on Cambodia has been all too clear. From one of the fastest growing economies in the world, Cambodia is expected to experience one of the steepest growth contractions in developing East Asia in 2009 (CDRI 2009c; World Bank 2009a, 2009b; ADB 2009; IMF 2009b, 2009c). The crisis has been felt chiefly through its blitz against trade, capital flows and, ultimately, the country's growth engines. While sheltered from the first-round effects of the shock due to its lack of exposure to toxic sub-prime products, the domestic banking system eventually had to deal with mounting strain as the real economy soured and global liquidity and credit dried up. Like the global economy, the Cambodian economy appears to have bottomed, but serious downside risks remain (see Jalilian et al. 2009; CDRI 2009a, 2009b, 2009c). Here we consider the impact of the crisis on Cambodia's banking sector.

Impact on Domestic Banking System

The squeeze in domestic liquidity and credit underpinned the clear tightening in broad money conditions from the middle of 2008, although improvements have been tracked in the past months in line with the recent pick-up in economic activity.

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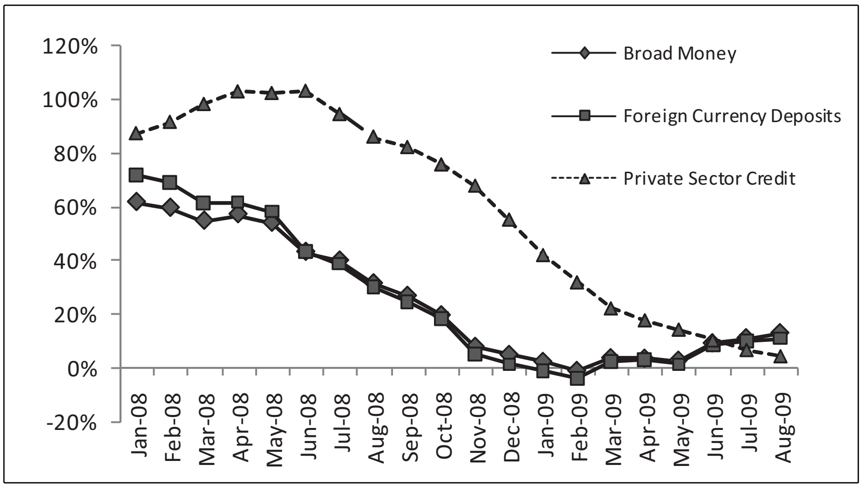
1 This article is prepared by Hossein Jalilian and Glenda Reyes contains excerpts from the draft report prepared for the Overseas Development Institute's Global Financial Series Discussion Papers. The report is soon to be finalised. Consultations with banking sector representatives were held to support and substantiate assessments of the impact of the crisis on the banking system.
Acknowledgement and gratitude also go to Saing Chan Hang for his involvement in the stakeholder consultations.

Figure 1: Broad Money Growth (year-on-year change)



Source: NBC

Year-on-year broad money growth dropped from nearly 60 percent in February 2008 to -1 percent a year later, then made a slight rebound to about 13 percent in August 2009 (Figure 1).

Earlier, financial soundness indicators showed that domestic banks on the whole maintained a robust position alongside their expansion, with adequate capital cushions and liquidity on top of few problematic loans (Jalilian *et al.* 2009; IMF 2009a). The number of banks rapidly grew to the current composition of 27 commercial banks, one state-owned bank and five specialised banks. Though concentrated in few banking institutions, total bank assets as a share of GDP grew from 26 percent in December 2006 to 47 percent in December 2008, while loans as a proportion of GDP grew by about 11 percentage points over the same period (National Bank of Cambodia).

Since then, however, signs of greater strain have become evident as banks confronted heightened liquidity and credit risks. About 70 percent back in February 2008, year-on-year growth of foreign currency deposits, which are about 97 percent of total bank deposits, dropped to -4 percent a year later (Figure 1). Some major foreign currency withdrawals have reportedly been made as well as infusions of emergency funds from overseas parent companies, the banking system being significantly reliant on foreign capital.[2]

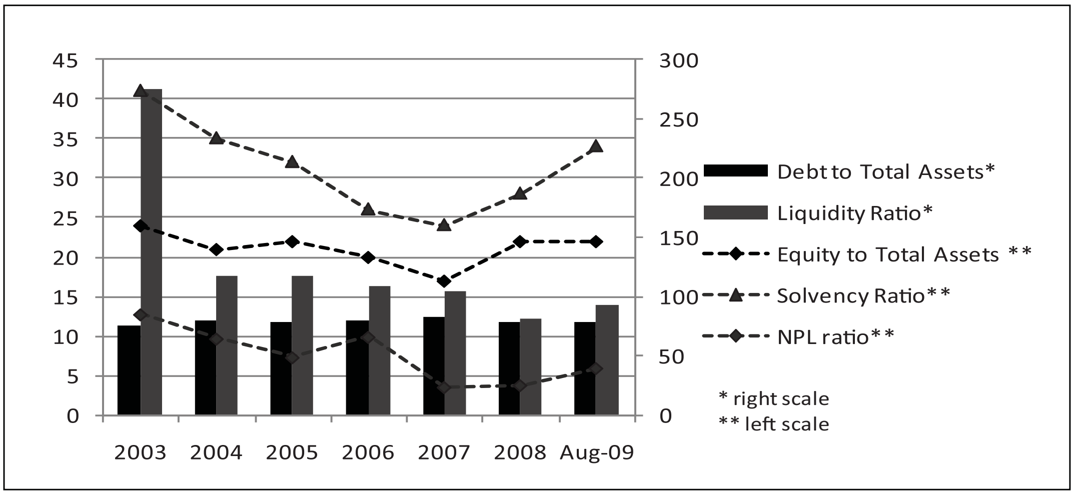
2 Foreign capital constituted about 67 percent of the commercial banking system's total paid-up capital at the end of December 2008 (NBC).

At the start of 2009's second half, however, a small but definite upturn in liquidity took place, prompting assessments that the liquidity threat had passed. The growth of foreign currency deposits year on year rose to 11 percent by August. Liquidity ratios were well up (and above the prudential limit), from 81 percent at the end of 2008 to 93 percent by August 2009 (Figure 2). The IMF has agreed that there is now ample liquidity in the system (IMF 2009b), and domestic banking sector representatives concur, although caution has been expressed regarding how liquidity is concentrated in big banks and how downside risks can easily overturn the situation (stakeholder consultations).

In contrast, concern over credit risks, as reflected in the continued guardedness over private lending, has not yet dissipated although sentiments vary as to the gravity of such risks. Private sector credit grew year-on-year by more than 100 percent in each month of the second quarter of 2008 and remained strong with 50 percent growth at the end of that year.

This boom, however, appeared to have occurred on the back of some problems that the National Bank of Cambodia sought to resolve as part of its efforts to help shield the domestic banking system from further strain. From about 3.7 percent at the end of December 2008, the share of non-performing loans (NPL) in total loans rose to 5.9 percent by August 2009 (Figure 2). Still, this is a small share, especially considering the past rapid expansion of credit. Furthermore, the increase is partly attributable to

Figure 2: Bank Prudential Ratios* (%)



Source: NBC

* Bank prudential ratios are indicators of the financial health of banks. Liquidity and solvency ratios indicate the ability of the bank to pay off its short-term and long-term debt respectively, while capital adequacy ratio (equity to total assets) indicates the bank's ability to cover any potential loss. The debt to total assets ratio indicates the share of bank assets that is financed by debt rather than equity, while the non-performing loan (NPL) ratio indicates the proportion of bank loans that are unpaid or close to being unpaid.

the loan reclassification implemented by the NBC according to its earlier toughened regulation on asset classification and provisioning (stakeholder consultations).[3]

The portfolio share of bank lending to real estate (Figure 3), whose risks more than intensified due to the domestic real estate bust and the pinch of the crisis, also turned out to be modest, although this may not be completely accurate because part of personal lending, for instance, may have been channelled to real estate activities. Given the close link between construction and real estate development in the country, bank credit to the construction sector also carries part of the risks associated with the latter. In addition to these concerns, loan reschedulings may continue to mask NPL problems.[4] The NPL ratio is expected to reach 10 percent at the maximum by the end of this year (*Phnom Penh Post,* 27 August 2009).

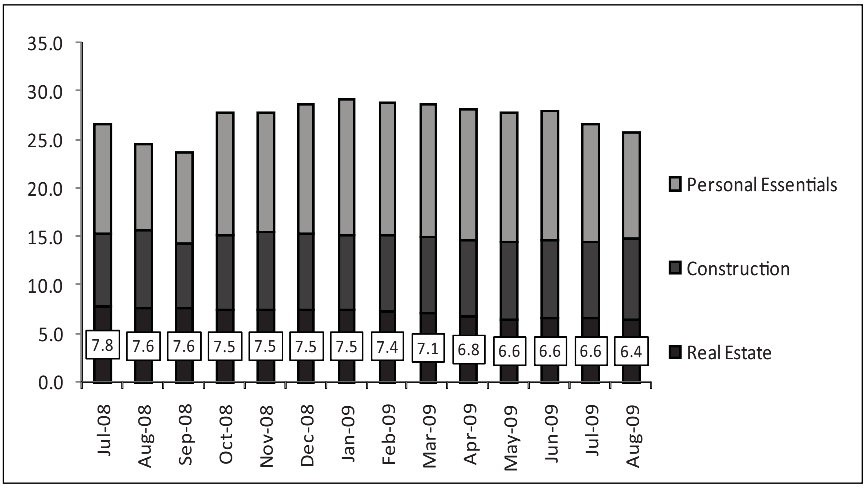
Proving continued cautiousness in lending, year-on-year growth of private sector credit fizzled out to a mere 4 percent by August 2009. Bank lending to the real estate sector in particular dropped to 6.4 percent in the same month from 7.6 percent a year earlier (Figure 3). Performance against other prudential indicators such as the liquidity ratio cited above and capital adequacy ratio suggestthat the banking system may have adequate cushion to cover potential credit and other risks.

Not only commercial and specialised banks but also micro-finance institutions (MFIs) have been feeling the second-round effects of the crisis after appearing unperturbed earlier on. Due to their proximity to rural clients and extension of loans to small and medium enterprises and the agricultural

3 See also the Prakas on Asset Classification and Provisioning in Banking and Financial Institutions issued in early 2009 and downloadable at http://www.nbc.org/read-prakas/asp?id=63. Due significantly to the expansion of the banking sector in 2008 and said Prakas which also increased provisioning requirements, return on earnings fell from 13.11 percent at the end of 2008 to 3.69 percent, while return on assets dropped from 2.88 percent to 0.82 percent (NBC data).

4 It was expressed during the stakeholder consultations that some "window dressing" of balance sheets may be occurring. Some very problematic loans may be restructured as longer term liabilities with smaller amortisation payments. This practice may only postpone the problem for those banks implementing it.

Figure 3: Bank Lending Shares (% of total loans)



Source: NBC

sector, MFIs have become increasingly popular over the years although the sector remains small compared to the commercial banking system (Jalilian *et al.* 2009). As of August 2009, there were 20 licensed MFIs as well as 25 registered and over 60 unregistered NGOs extending micro-finance (NBC).

While having fewer holdings of riskier loans such as those to real estate and construction, MFIs nonetheless experienced greater strain as the crisis deepened. The sector is heavily reliant on foreign capital[5] and eventually felt the effects of the global choke-up in liquidity and increase in risk aversion. Foreign lenders to domestic MFIs have reportedly tightened loans, causing cancellation of contracts in some cases, upping the cost of available financing and augmenting the burden on their clients as some or all of the interest hike is passed on (Chhun 2009).

More so than in the case of commercial banks, prudential indicators seem to suggest, however, that MFIs have been able to bypass most of the impact of the crisis. Their NPL ratio climbed to 2.7 percent in August 2009 from 0.4 percent at the end of 2008, but this remains a low level, considering especially how fast micro-credit has expanded. Part of the increase is also attributable to the loan reclassification mandated by the NBC. Capital adequacy ratios also climbed from 20.4 percent in 2008 to 23.5 percent in August 2009 (NBC and stakeholder consultations).

On the whole, therefore, the banking sector in Cambodia, together with the MFIs and other financial service providers, seems not to have been severely affected by the crisis. However, there is a possibility that the impact on the banking sector is underestimated, and associated problems may come later, at least for some banks.

Policy Responses

The underdevelopment of Cambodia's financial sector can be credited for the country's immunity to the first-round impact of the crisis. However, such underdevelopment also acted as a constraint on the ability of the government and financial institutions to respond more effectively to the second-round effects. While the NBC's responses to the strain experienced by the financial sector have been timely and well deserving of praise, the capacity of the central bank to do more has been restrained by the heavy unofficial dollarisation of the economy. Limited supervisory capacity of the NBC and regulatory constraints are other important factors in this context.

While the exploration of the issue on Cambodia's bi-currency economy is beyond the scope of this article, three important points will be made. First, the nature of Cambodia's current dollarisation is not straightforward. As argued, it is composed of both "good news" and "bad news" dollarisation;

5 Foreign capital constitutes about 73 percent of the MFI sector's total paid-up capital (NBC).

that is, it reflects both the country's economic take-off in the past decade and the underdevelopment of the domestic financial sector, institutions and legal framework (CDRI 2009c; Menon 2008).

Second, the case for or against dollarisation is also not clear-cut. The claimed chief costs of dollarisation include loss of seignorage, loss of the central bank's ability to act as lender of last resort and loss of independent monetary policy, all of which restrain the ability to respond to external shocks. Without needing to mention the benefits of dollarisation, these losses must not be assessed by themselves, that is, without taking stock of other considerations, not least the factors that can and do moderate them. For instance, the fiscal benefits of macroeconomic stability emerging from the beneficial effects of dollarisation (lower inflation, interest rates and currency risk) can well counter the seignorage loss

Third, there are sources of liquidity other than the central bank, and this cushions the feared greater liquidity and solvency risks associated with dollarisation in times of crisis. When monetary institutions are also facing credibility problems, the scenario minus dollarisation can be more problematic and miss out on the benefits of dollarisation's role as commitment device (see for instance Chang & Velasco 2002; Schmitt-Grohé & Uribe 2000; Alvarez-Plata & Garcia-Herrero 2008; Antinolfi & Keister 2001; Edwards & Magendzo 2003; Baliño *et al.* 1999).

With the above in consideration, there has been an inevitable limit on what the NBC can do in response to the crisis. However, whatever it has done has proven timely, pre-emptive and worthy of recognition. Especially with the global crisis coming on the heels of exceptionally high price levels, the central bank had to time carefully monetary easing with inflation easing. With prices having come down from their high levels, the NBC slashed the reserve requirement from 16 percent to 12 percent to inject more liquidity into the system. It removed the cap on real estate lending to stem the effects of the bubble burst. It created an overdraft facility (though backed by a limited initial amount of USD100 million [CEW 2009]) to help solvent banks struggling with temporary liquidity shortages. It issued a tougher regulation on asset classification and provisioning to diagnose more accurately the NPL situation and ensure that banks are in a better position to cover potential losses. It toughened regulation on reporting of major exposures to better assess credit risk concentration. It strengthened regular and targeted, off-site and on-site surveillance. It has started granting licences allowing MFIs to directly access public deposits (Keat 2009; CEW 2009; Jalilian *et al.* 2009; Chhun 2009; see also NBC's web site, www.nbc.org.kh/index.asp).

To be more effective and avoid future problems, further steps should be taken. Potential loopholes on NPL monitoring must be sealed because misled diagnoses lead to a false sense of security, which in turn results in neglect or off-track responses. More than quick fixes directly responding to the short-term requirements of the crisis, bigger steps aimed at deepening the financial system are also necessary to fortify the capacity to withstand an external shock or avoid the system itself being the source of a crisis. The financial structure remains immature, with a limited number of financial instruments, underdeveloped interbank market, absence of official deposit insurance and rating agencies and limited credit information sharing (Pak *et al.* 2008). The NBC has been weighing its choices in addressing these deficiencies, careful to consider the pros and cons of possible remedies and the system's absorptive capability. Internally, the NBC is also trying to build the capacity of its manpower given the resources available to it (stakeholder consultations).

The financial infrastructure also noticeably lacks equity markets. While this shielded the country from some major direct and contagion effects of the financial crisis, it also constrained the generation of additional funds for stimulating the sour economy and stale bank balance sheets. While the exploration of this topic is also beyond the scope of this article, suffice it to point out that while the government's Financial Sector Blueprint 2001–2010 and Financial Sector Development Strategy 2006–2015 set off some preparatory steps, including enactment of some of the necessary laws and regulations and establishment of the Securities and Exchange Commission, a lot of the prerequisites for the successful operation of a bourse are still missing. A basic aim of capital market development is to capture savings, but the domestic savings rate is low, partly due to the still low level of public financial literacy and confidence in the financial system. Other problems include a narrow investor base, problematic compliance with transparency and corporate governance standards, which affects the size of eligible issuers, and absence of security intermediaries.

Outlook and Risks

Even with the recent upturn in the global and Cambodian economies and encouraging performance against financial soundness indicators, concerns remain about the robustness of the banking sector. The gravity of such concerns, however, varies. Those less pessimistic point to a recovering real estate and tend to focus on how any potential worsening of, say, NPL holdings will only affect selected banks; those more pessimistic direct attention to hidden problems, the already overstretched capacity of the central bank, and external risks such as a potential global double dip upon withdrawal of fiscal stimulus programmes. The former's verdict is that the danger has passed while the latter warn that the worst may yet to come.

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