

Microfinance in Cambodia: Taking the Sector to the Next Level



In Cambodia, economic activities are dominated by micro, small and medium enterprises (MSMEs) which are largely based in rural areas. These MSMEs are beyond the reach of the banking sector, which tends to concentrate on serving businesses in urban areas. Thus, microfinance institutions (MFIs) are principally the main providers of financial services to the rural economy.

Services provided by MFIs could help the rural population, especially the poor, to increase their incomes and build up their assets. Microfinance also helps mitigate vulnerability to shocks such as sickness and natural disasters, and develops micro-enterprises. Microfinance, hence, plays an important role in the development of the country and alleviating poverty.

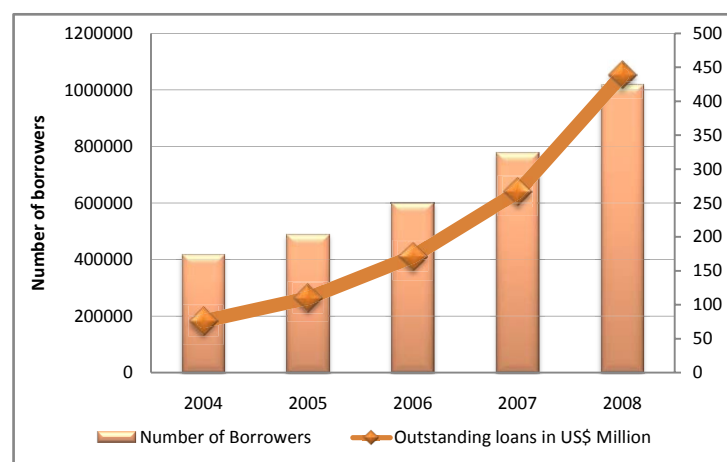
Cambodia has one of the most rapidly developing microfinance sectors globally and is also internationally recognized as a success story. Presently, there are 18 licensed microfinance institutions, in addition to 26 NGOs providing microfinance services which are registered with the National Bank of Cambodia (NBC).¹

In recent years, the microfinance sector in Cambodia has played a leading role in expanding the reach of the financial sector to the rural poor. The sector has experienced rapid growth over the last five years, reaching over a million borrowers and more than 520,000 savers in 24 provinces. By the end of 2008, the total loan portfolio in Cambodia was almost US\$440 million while deposits were more than US\$490 million. From 2006 – 2008, the number of borrowers grew at a very rapid rate at 23%, 29% and 31%, respectively, while total MFI lending increased at a rate of more than 55% a year.²

Despite the tremendous success of microfinance in Cambodia, the sector still faces challenges that include a legal framework limiting the ability of MFIs to diversify products and services, and the high cost of funding that prevents MFIs from achieving their potential in helping to develop the rural economy as well as the country as a whole. For MFIs to achieve their potential to serve more clients, they need to be able to offer a wider range of products and services, to access local currency and to reduce their costs of funds so as to remain commercially sustainable, while serving the lower end of the market.

This Business Issues Bulletin discusses two key areas that could help MFIs to achieve their goals: i) new products and services that would help the sector to grow while at the same time providing clients in rural areas with needed services; (ii) a better business environment and legal framework.

Figure 1: Number of MFI Borrowers and Total Loan Portfolio



Sources: Calculated based on data from NBC, CMA, ACLEDA and MIX



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¹ National Bank of Cambodia, Microfinance of Cambodia, 2007.

² The Microfinance Information Exchange (MIX), National Bank of Cambodia (NBC), Cambodia Microfinance Association (CMA) and ACLEDA Bank.

2. New Products and Services

Being able to offer a greater variety of products is crucial for Cambodian MFIs at this stage of their development. Not only will these products benefit existing consumers but they will also help MFIs to attract more customers, and generate more sustainable growth.

Given current market conditions, there is plenty of room for MFIs to develop new services, and many are willing to do so. However, the lack of an appropriate legal framework remains a barrier. MFIs complain that NBC places too many restrictions on them by not allowing them to easily take deposits or to offer other products that would be in high demand such as insurance, leasing, money transfers and remittance services.

Providing a legal framework that would enable MFIs to offer more products and services would help generate further growth in the sector, and improve access to finance for many more Cambodians.

2.1 Micro-insurance

Poor people are particularly vulnerable to risk, both in the form of natural calamities as well as more regular occurrences of illness and accidents. MFIs have played an active role in reducing or protecting against this vulnerability by providing credit for increasing income earning opportunities and savings services to build up resources that can be drawn down in cases of emergencies. However, credit and savings services are inadequate when the population is exposed to risks which cause losses that are beyond their means. Here micro-insurance can serve as a risk mitigant. Micro-insurance provides protection for low-income households against specific perils in exchange for premium payments proportionate to the likelihood and cost of the risk involved.

Micro-insurance is relatively new to Cambodia and no legal framework for this product currently exists. Nonetheless, there are some organizations experimenting with micro-insurance services for the rural population and the urban poor. To facilitate the expansion of such services, an appropriate legal framework needs to be adopted.

2.2. Micro-leasing

Leasing refers to making regular payments for the use of equipment such as vehicles or machinery without owning it. Leasing enables businesses to improve their operations without having to borrow money for large capital expenditures. Instead, a bank or leasing company owns the equipment and leases it to the user. This is particularly helpful to businesses which lack the necessary collateral to get bank lending. Leasing can help speed the growth of businesses and contribute to Cambodia's economic development.

Micro-leasing would be particularly helpful to small, micro-businesses and individual farmers who cannot access bank lending. With their greater understanding of the nature of small and micro-business and their markets, MFIs are

in a better position than banks to provide micro-leasing services.

However, it is not sufficiently clear if MFIs are currently allowed to engage in leasing. Under the *Law on Banking and Financial Institutions*, leasing is considered a 'banking' operation. Therefore, any institution with a banking license may also engage in leasing. It is unclear if MFIs need to obtain a banking license to engage in leasing – a requirement that is far beyond Cambodia's MFIs due to the high share capital required – or if MFIs as regulated financial institutions can include leasing in their product offerings. This blocks rural small and micro-business from access to leasing services, since they are largely beyond the banking sector's outreach.

We welcome the idea of introducing leasing into the Cambodian market; we believe this will help people to get more financing for their businesses. Already we can see the demand for leasing is there. However, as an MFI we are not allowed to do leasing operations.

Hout Ieng Tong, General Manager, Hattha Kasekar Limited (HKL), and Chairman of the Cambodia Microfinance Association (CMA)

2.3 Remittances

In Cambodia, there is strong demand for remittance services. Studies have shown that most of the workers employed in the garment sector send around US\$20 to US\$30 of their monthly income home to their rural families. These remittances add up to millions of dollars annually. Garment workers are just part of the market for remittance services in Cambodia.

The current legal framework allows only commercial banks to offer remittance services. Due to their limited outreach, commercial banks, with the exception of ACLEDA, are limited in their ability to provide remittance services for rural people, forcing the poor to send money back to family through risky and expensive informal services.

The ability of Cambodians to send money to their families in rural areas is limited, because only ACLEDA Bank has a broad enough reach and MFIs who have rural branches are not able to engage in remittances. It is costly and common for family members to organize the physical delivery of money, making them vulnerable to crime. Safe, affordable money transfers can be achieved by allowing banks to leverage the networks MFIs have as well as by utilizing new technologies, such as mobile phones, to complement branches with branchless banking.

Margarete O. Biallas, Program Manager, Access to Finance, Mekong Region, IFC

3. Business Environment and Legal Framework

By the second half of the 1990s, micro-credit provided by NGOs had reached a large population, and especially the rural poor. This expansion prompted the National Bank of Cambodia (NBC) to strengthen regulation and supervision. A Law on Banking and Financial Institutions

was introduced in 1999, and the NBC introduced a Prakas on microfinance regulation in 2000. Under the Prakas, MFIs with a portfolio of over CR100 million are required to register with NBC, whilst those with over CR1 billion must be licensed.

Since then 18 MFIs have become licensed microfinance institutions, and another 26 have registered with NBC. This has led to more public confidence in microfinance and has enabled the sector to grow significantly. The reach of MFIs has also increased tremendously and many have made impressive progress in reducing operating costs, and raising the quality of their loan portfolios, hence strengthening their financial sustainability. Larger loan sizes have been another major driver of the sector's growing efficiency.

Increased competition, better risk management and improved efficiency, combined with the availability of cheaper funding have led to a decline in interest rates charged by MFIs over the last ten years and most rapidly in the last three. As a result, the average annual interest rate charged by Cambodian MFIs has dropped from 42% in 2003 to 32% in 2006.³ In 2007, Cambodian licensed MFIs charged an average rate of 2.54% monthly or 29.82% annually⁴. Although there is no official data on the average interest rate charged in 2008, selected MFIs have indicated that their average rate for the year was more or less the same as in 2007. While the situation in 2009 is uncertain due to the current adverse economic environment, the improved ability of MFIs to raise deposits would help them to reduce their cost of funds and interest rates could decrease further.

Related to the cost of funds is the availability of local currency. While MFIs report that there is a substantial demand for local currency loans, they are unable to raise local currency at a reasonable price and an acceptable tenor. The result is that MFIs are either unable to lend as much as they could, reducing their ability to serve the poor, or they are exposed to currency and maturity mismatches if they do lend in local currency.

To help MFIs extend their financial services offerings the Cambodian government now permits licensed MFIs with adequate paid up capital to take deposits.

3.1. Deposit-taking Legislation

A Prakas licensing MFIs to take deposits from the public was issued in December 2007 by NBC, enabling MFIs to provide a valuable service to the public. Notionally, this should also provide MFIs with more and cheaper sources of funds, mainly in local currency, and reduce the risk of having to repay overseas financing at a higher interest rate if exchange rates turn unfavorable. Being allowed to take

deposits may in the long-term lead to more reductions in interest rates. In the short-term, the ability of MFIs to take deposits will improve access to finance for small and micro-businesses as well as farmers.

We introduced the prakas on the licensing of microfinance deposit-taking institutions so that sound MFI supervision maintains the trust and confidence of the people. Only the strongest MFIs can be authorized to collect deposits.

H.E. Tal Nay Im, Director General, National Bank of Cambodia

To protect savers and build their trust, NBC has chosen to be restrictive at this stage. The Prakas stipulates that an MFI applying for a license to take deposits must have minimum paid up capital of \$2.5 million to ensure adequate consumer protection. However, this strict capital requirement, which only a few licensed MFIs can meet, is causing concern for some microfinance providers.

The new Prakas on microfinance savings is an important step forward in formalizing and clarifying the status of licensed MFIs, with respect to their ability to mobilize voluntary savings from the public. However, at this stage, the requirements for obtaining a new license to collect voluntary savings, in particular the high minimum capital requirement, prevents more than two or three of the 18 licensed MFIs from applying for such a license. These MFIs alone will not be able to cater for the huge demand for voluntary savings services across all of Cambodia. Therefore, further efforts are still required from the government, donors and the microfinance industry, to ensure, without delay, that all Cambodians have access to safe, convenient and competitive savings services."

Robert Hickson, Microfinance Saving Specialist, ADB consultant

Currently, only a few of the licensed MFIs have enough capital to apply for a deposit taking license and no license has yet been issued. This shows that in spite of the new Prakas, MFIs are still facing challenges in the area of deposit taking. The government and the microfinance industry need to collaborate to ensure that more than a fraction of the licensed MFIs can benefit from the new legislation and at the same time put in place measures to protect savers.

As we often say at CGAP, Cambodian microfinance has been a success story 'so far'. Indeed Cambodian actors have created vibrant sustainable microfinance institutions and a conducive policy framework where the government plays its most useful role as supervisor. Looking ahead, continuing the success story will require dealing with a few challenges.

While Cambodia has excelled in attracting international social investors, local funding sources are largely untapped. Going forward, Cambodian commercial banks will need to consider MFIs as serious potential clients, and the National Bank of Cambodia should continue to promote the intermediation of savings, especially in local currency. Savings are a high-demand service for poor people, and can be a means for MFIs to finance themselves.

Eric Duflos, Microfinance Specialist, Consultative Group to Assist the Poor (CGAP)

³ CGAP, The New Money Lenders: Are the Poor Being Exploited by High Microcredit Interest Rates? Occasional Paper No. 15, CGAP, February 2009.

⁴ National Bank of Cambodia, *Microfinance of Cambodia*, 2007. These rates are for loans in US dollars. However, interest rates for loans in other currencies may be higher. For example, in 2007, the interest rate for a loan in Cambodian Riels was 3.36% per month, or 43.38% per year.

3.2. A private credit bureau would help MFIs to make better loans

When considering making loans, a lack of credit information on potential borrowers is a serious constraint for lending institutions. This lack of credit information greatly increases risk and uncertainty, with the result that unless borrowers have land or buildings worth far more than the value of the proposed loan, institutions avoid lending. Even if borrowers provide collateral, the risk of double borrowing persists and needs to be priced.

To increase the availability of credit information, NBC, with technical assistance from the Asian Development Bank, established a Credit Information System (CIS) in 2006. This was designed to collect and share only negative credit information from commercial banks (i.e. information on defaulting borrowers). Since the system does not collect and provide information on borrowers that repay or perform well, the information is limited. In addition, since only commercial banks can become members of the CIS, MFIs are prevented from gaining any benefit from the system. The result of this lack of credit information is that MFIs may lend to clients without knowing that they have several outstanding loans with other MFIs. As a result, borrowers could get into more debt than they can repay and default on their loans. This becomes apparent during an economic downturn when borrowers lose income they have depended on to make repayments.

A comprehensive credit bureau that would collect, maintain and share both positive and negative information on borrowers would eliminate information asymmetries. At the same time, if the credit bureau were private, it could offer financial institutions value-added services such as credit-scoring and processing credit applications. These value-added services would help lenders to become more efficient and save costs. Also a private credit bureau could be open to more credit providers beyond banks, and MFIs such as telephone companies or other utilities providing post paid services.

There is a need for a private credit bureau in Cambodia. Although individuals and businesses increasingly need financing, financial institutions find it difficult to meet the demand due to the lack of reliable credit information to help them make decisions.

Hout Ieng Tong, General Manager, Hattha Kasekar Limited (HKL), and Chairman of the Cambodia Microfinance Association (CMA)

Once MFIs have access to comprehensive credit information that will enable them to reduce their risk in lending, they should be able to offer more financing and better interest rates to borrowers with good credit histories. A comprehensive credit bureau will help prevent multiple loans to individuals or businesses without the ability to repay. Given the benefits

of a comprehensive credit bureau, the development of the necessary legal framework to allow all financial institutions to share credit information should be given priority.

4. Conclusion

Worldwide, microfinance plays a key role in providing financial services to the poor. In Cambodia, ten years of impressive growth indicates that microfinance can also reach large numbers of poor people. Greater cost efficiencies and higher revenues in the MFI sector have led to expanded outreach in all 24 provinces. Interest rates have fallen, and the quality of loan portfolios has improved as well.

The government has been supportive of this evolution. However, more can be done to help microfinance fulfill its potential in serving the development of the country, especially, rural economies. In particular, priority should be given to the regulatory framework governing MFIs that include:

1. Micro-insurance: the legal framework for micro-insurance has been drafted and consultations with market participants have taken place. Quick passage of the sub-decree on micro-insurance would help the industry, by providing legal clarity, and the poor, by providing consumer protection and new services.
2. Micro-leasing and remittances: a legal framework enabling MFIs to offer new products and services including micro-leasing and remittance would help MFIs to increase efficiency and to provide more financial services to rural people. As mentioned earlier, MFIs, with their micro and small business expertise and their national reach, are extremely well-placed to offer these important products and services.
3. Deposit taking legislation: more effort from government, the microfinance industry and development partners is needed to fine-tune the Prakas so that it helps, rather than hinders the development of the sector.
4. Local currency: legislation is needed to facilitate the creation of interbank markets and strengthen the availability of local currency liquidity.
5. Credit bureau: the legal framework for a comprehensive credit bureau is needed and should be issued as soon as possible. This framework will help not only the microfinance sector, but also the financial sector as a whole.

The legal framework related to microfinance would benefit from an overhaul – one that allows MFIs to develop and diversify their products and services, especially to take deposits more easily, offer leasing and remittance services, and provide MFIs access to good credit information. This would benefit not only poor people, but the entire economy.