



IFC ADVISORY SERVICES | ACCESS TO FINANCE

WORKING IN THE CONTEXT OF TODAY'S CRISIS, MANAGING THE RISKS AND CHALLENGES

Cambodia's Microfinance Amid the Global Financial Crisis
Conference Proceedings

IN PARTNERSHIP WITH



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Foreword

I am pleased to introduce the conference proceedings for “*Working in the Context of Today's Crisis, Managing the Risks and Challenges*,” that took place in Phnom Penh. This conference, part of a larger forum on “Cambodia's Microfinance Amid the Global Financial Crisis,” was initially conceived as regional or even Cambodia-specific. However, we quickly realized the global relevance of the discussions in the context of the financial crisis and in the longer term perspective of historic trends in the microfinance industry. These proceedings are a valuable contribution to the global knowledge and current thinking on microfinance risk management.

The microfinance industry is at a turning point in its history. Started in various regions of the world by a few pioneers with impressive vision and leadership, microfinance is widely recognized as a critical tool for sustainable development and poverty reduction. The industry now needs to successfully enter into an age of maturity while keeping its unique soul and distinctiveness. To do so requires continuous improvement in institutional governance, risk management, and strategic focus. Placing a more urgent emphasis on improving these areas might well be an unexpected benefit of the financial crisis. Emerging from the conference and available in these proceedings are interesting insights on areas such as credit risk management, portfolio monitoring, and responsible lending practices.

IFC continues to support microfinance globally. We have supported the financing and capacity building of several dozen microfinance institutions (MFIs), including small business banks, nonbank financial institutions, and non-governmental organizations. Further, IFC has played a catalytic role in developing specialized microfinance banks, fostered the creation of international microfinance network banks, and developed collective investment vehicles leading to mobilization of private capital in the domestic and international capital markets.

Our flagship initiatives in microfinance include significantly expanding deposit mobilization in the industry; enhancing risk management frameworks for portfolio clients; supporting technological innovations; and developing microfinance credit reporting.

For ten years IFC has worked with the microfinance industry in Cambodia. During this time MFIs have made remarkable progress. Many Cambodian MFIs have transformed, cutting free from donor funding, they operate as commercially independent institutions to extend access to financial services to hundreds of thousands of Cambodians.

Let me congratulate those who helped organize this event and those who have worked tirelessly over the years to develop microfinance in Cambodia and provide access to finance to the underserved.



Ary Naim
Global Head, Products
IFC – Access to Finance Advisory

Overview and Key Themes

The objective of the Forum “Cambodia’s Microfinance Amid the Global Financial Crisis” was to raise awareness with stakeholders on the need for non-performing loan (NPL) resolution and facilitate distressed asset management as well as responsible lending practices for microfinance institutions (MFIs), as part of IFC’s crisis response work. The Forum presented a wide range of topics including an overview of the current situation of MFIs, risk and NPL management, debt collection practices, and financial inclusion. This conference also followed-up to past MFI forums held biennially since 2005 to explore ways to sustain growth and development of the sector. The event was organized by IFC in collaboration with key stakeholders such as the National Bank of Cambodia (NBC) and Cambodia Microfinance Association (CMA).

The theme of the second day of the Forum was “*Working in the Context of Today’s Crisis, Managing the Risks and Challenges*”. The objective of the session was to share and encourage discussions on best practices that MFIs can implement to tackle the challenges arising from the crisis.

The global financial crisis has had an impact on the entire Cambodian microfinance industry. MFIs report liquidity shortages, as committed loans are delayed and new loans are slow in being committed. This is limiting MFIs ability to grow in line with their projections, leading to decreased access to finance for the poor and rural communities, which are overwhelmingly served by MFIs. Financial products and services offered by most MFIs are primarily limited to individual loans using land as collateral or group loans, while a couple of MFIs are offering savings products. This limited product offering forces all financial institutions to compete with each other on the same products.

Escalated by the crisis and its impact on the country, Cambodia’s microfinance industry has been facing a rise in portfolio at risk and NPLs as over indebtedness and multiple loan problems have started to unravel and borrower’s ability to meet their debt obligations have become increasingly difficult. Expected foreclosures by creditors on properties pledged by borrowers, especially in the agricultural sector, are likely to happen more

frequently, bringing with them political pressures on the microfinance industry. Since the crisis began, default rates have increased from less than one percent to more than three percent. Although low compared to other markets, in real numbers this translates into tens of thousands of people defaulting throughout the country. One of the problems arguably attributable to the rising of NPL is the risk management systems of the MFIs. In such situations, some of the actions by MFIs to recover their micro-loans are prompting criticism about microfinance’s role in reducing poverty.

The following proceedings focus on discussions and presentations from the second day of the conference. Discussions of the day centered on:

- good practices in risk management;
- ethical and responsible collections practices;
- consumer protection;
- financial transparency;
- investments to strengthen social capital, and
- role of credit bureaus in promoting financial inclusion

The session was attended by more than 100 senior managers from around 50 MFIs and banks around the country. The most important message that emerged from the discussions was the *call for responsible finance, transparency and fair & equitable practices* to be at the heart of what’s needed to tackle the challenges of the crisis and build a healthy, competitive, and vibrant microfinance market.

The two-day Forum received strong interest from the media and high satisfaction from all participants and stakeholders, particularly the MFIs, the National Bank of Cambodia, and international finance institutions. To view presentations and learn more about the conference on “Cambodia’s Microfinance Amid the Global Financial Crisis,” please visit the Forum’s website at: <http://www.cambodia-mfi-forum.info>.

IFC & Microfinance: Global Overview & Strategic Direction

Speaker: Margarete Biallas, Business Line Manager, Access to Finance Advisory in the Mekong, IFC

Key Objective: Introduce IFC's global approach in Microfinance in context of the crisis and beyond.

Synopsis

IFC's key objective is to reduce poverty and create sustainable private sector development by providing both investment and advisory services to businesses and governments.

Over the years there has been a great deal of private sector investment in microfinance that has inclined towards the top end of the market. To achieve the greatest development impact and reach the underserved, IFC's role has been to engage at the lower frontier, working closely with the World Bank and Consultative Group to Assist the Poor (CGAP).

IFC follows four key approaches to expand the global range and volume of sustainable microfinance, which include: 1) Promoting collective investment vehicles, 2) Developing microfinance network partners, 3) Supporting individual institutions through strategic partnerships and 4) Engaging in selected advisory service projects at the financial institution, infrastructure, and policy level.

At June 2009, IFC's committed investment portfolio was over US\$1.2 billion in 140+ MFIs in 60+ countries with more than US\$70 million put into advisory services. Through its microfinance efforts, it is estimated IFC serves more than 20 million people worldwide, of whom 65 percent are women.

Key Highlights

How Resilient is Microfinance to the Global Financial

Crisis: Given microfinance institutions (MFIs) can relatively easily shift business lines and have diversified portfolios, they may not be as vulnerable on the asset side of the balance sheet. On the liability side, however, MFIs integrated with local and international capital markets will likely face funding constraints in the coming year as foreign direct investments (FDIs) decline. The lack of continued funding may curtail portfolio growth going forward and there does seem to be a global trend of rising NPLs in MFIs, although it is much more contained than in banks.

However, lessons learned from today's crisis highlight that there are certain business practices that contribute to **crisis-resilience**. Today's experiences reveal, for example, that (1) a lack of transparency and disclosure made it difficult to evaluate and price risk throughout the financial system, (2) consumers did not understand credit terms and too often become over-leveraged, and (3) exploitive business practices against consumers fueled the crisis.

Despite today's challenges, there are now **opportunities for the industry as a whole**. The crisis has affirmed that the more ethical and transparent businesses are less likely prone to be hit by downturns. IFC's approach in microfinance in context of the crisis and beyond underscores the **impetus for responsible finance**. The key question is how should MFIs, investors, donors, and regulators responsibly behave to ultimately reduce poverty and improve the lives of the people they are trying to reach? The following presentations will probe further into this question.

Case Studies: Risk Management and Governance – a Framework for Microfinance

Speaker: Hicham Mohamed Bayali, Regional Program Manager Microfinance MENA, IFC

Key Objective: Outline the key ingredients of a comprehensive risk management framework for Microfinance based on lessons learned from experiences in three different countries: Colombia, Morocco, and Indonesia.

Synopsis

Most microfinance institutions (MFIs) don't behave as mainstream financial players: their internal risk management systems are often a step or two behind the scale and scope of their activities. Some spectacular – country-wide and institution-specific – microfinance crises over the last decade have illustrated - how the failure in addressing the external and internal risks faced by MFIs can be responsible for an almost fatal surge in non-performing loans (NPLs) and/or financial bankruptcy. Through contextual analysis and concrete examples from 3 different countries, this session aims at highlighting i) why risk management is important to MFIs, ii) what is effective risk management and iii) how an MFI could implement an effective risk management system.

Key Highlights

Why is risk management important to MFIs?

In today's market with rapid growth and expansion in the industry as well as rising NPLs and asset quality problems, the need for a strong *risk management* framework is heightened. In this landscape, external stakeholders including regulators, investors, and donors are increasingly demanding stronger *risk management* frameworks.

Governance often lies at the heart of why *risk management* is still a step or two behind in MFIs in comparison to mainstream financial players. At best, MFIs may focus on credit risk but less on equally important areas such as operational or strategic risks. The risk associated with weak Governance is often underestimated. MFIs, in particular, tend to be more vulnerable to Governance risk due to their institutional structure, lacking shareholders to be accountable to. Further, the social mission of MFIs

may attract many high profile bankers and businesses to MFI boards but experience shows that they are often reluctant to apply the same commercial tools that led to the success of their institutions when dealing with MFIs. Management succession is another challenge – MFIs often face difficulties in recruiting managers that balance social and commercial objectives. From this perspective, the role of Directors becomes even more critical to ensure continuity and focus. Other obstacles to *risk management* observed reveal that (1) success can often breed over-confidence, (2) donors may sometimes encourage MFIs to take on additional risks, and (3) regulators may also overlook the distinctions of MFIs.

The major risks to MFIs are in fact common to all financial institutions and they can be grouped into three general categories: financial, operational, and strategic (see table below).

Financial Risks	Operational Risks	Strategic Risks
<ul style="list-style-type: none"> ▪ Credit Risk ▪ Portfolio Risk ▪ Liquidity Risk ▪ Market Risk ▪ Interest Rate Risk ▪ Foreign Exchange Risk ▪ Investment Portfolio Risk 	<ul style="list-style-type: none"> ▪ Transaction Risk ▪ Human Resources Risk ▪ Information & Technology Risk ▪ Fraud (Integrity)Risk ▪ Legal & Compliance Risk 	<ul style="list-style-type: none"> ▪ Governance Risk ▪ Ineffective Oversight ▪ Poor Governance Structure ▪ Reputation Risk ▪ External Business Risks ▪ Event Risk

For example, common **operational risks** include:

- MIS does not correctly reflect loan information such as disbursements, payments received, current outstanding balance
- There are inconsistencies between the loan management system and accounting system data
- Rescheduled loans are treated as on-time, disguising loan quality problems
- Loan tracking information is inadequate with no credit histories or aging balances

What is effective risk management?

Effective *risk management* is founded on an interactive and continual process that ensures management is in-tune with the actual changes in its internal and external business environment. There are six key elements to the framework:

- **Governance and Organizational Structure:** *Risk management starts with the right people and adequate authorities.* Here, it is critical to look at the board members, senior management team, chief risk officer, and internal audit system to examine whether the right governance and organizational structure is in place to manage risk.
- **Rigorous Operating Rhythm:** *Planning is the key navigation tool.* Here, it is important to examine whether the right sequence of business processes are set-up and whether the right bodies are in place to meet regularly and make decisions on risk management for today and tomorrow. A leading bank illustrates this point in the following quote: “Many are surprised to learn that the Banco Santander board’s risk committee meets for half

a day twice a week and that the board’s ten person executive committee meets every Monday for at least four hours, devoting a large portion of that time to reviewing risks and approving transactions. Not many of the banks do this. It consumes a lot of our director’s time. But we find it essential and it is never too much” – Emilio Botin, Banco Santander Chairman, Oct 16 2008.

- **Well Defined Risk Classifications & Definitions:** The chief question here is *what risks is the institution looking at and are they correctly measured.* Here, it is essential to have a clear understanding of the classic risk classifications including Credit, Market, Interest Rate, Liquidity, Operational, Legal, and Reputational.
- **Clear Risk Appetite & Strategy:** There are two basic questions here: (1) *Is there a transparent risk appetite statement both qualitatively* through the mission statement and remuneration policies and *quantitatively* through identification of the amount of risk that can be taken by products, regions, economic sectors, etc. and (2) *Does the institution rely on prescribed capital allocation methodologies or does it develop its own internal ratings based approach.* The simple principle here is that expected losses should be covered by reserves and capital and unexpected losses should be covered by capital or the risk should be transferred.
- **Relevant Measurement Metrics:** There is a cadre of risk management metrics to monitor. Most institutions look at lagging indicators such as write-offs, return on equity, and return on assets. But it is also critical to look at leading indicators such as repayment rates, pre-payment changes, and conversions from 1+ to 7+ to 14+ to 30+. In the end, *proactive monitoring leads to better identification of risk.*

Lessons Learned from Country Experiences: Colombia

The following country experiences highlight the diverse internal and external elements to consider when dealing with risk management in MFI's.

The Challenge of Growth: Colombia

The Problem: Finansol, a regulated financial institution (FI) and subsidiary of an NGO, Corposol, suffered severe deterioration of its loan portfolio. Several factors contributed to the problem including: (1) rapid portfolio growth without much regard for credit risk, (2) lack of transparency and separate accounting from its parent Corposol, (3) poorly trained credit officers, (4) a poor marketing strategy in pushing untested products, (5) no mechanism to prevent multiple borrowings, (6) inadequate MIS to manage diversity of products, (7) a poor strategy to reduce the negative impact of provisioning on the Income Statement by refinancing loans on a wide scale and extending credit terms, further deteriorating asset quality.

The Tactic: Accion International stepped in with a recapitalization plan that ended the Corposol Finansol relationship and brought in new investors to raise capital levels, giving birth to FINAMERICA SA – a leading institution in South America today.

- **Strong Control Processes:** Internal audit, risk management, and the business units should work together to reach consensus on where the risks are. *Risk management is effective when there is real dialogue between units.* How does an MFI know when it has enough capital to fund growth and mitigate future losses? How does an MFI know it has enough liquidity to manage through a tough cycle? *Stress testing is a key supplement here to other risk management approaches.* Stress testing benefits include (1) providing forward looking assessments of risk, (2) overcoming limitations of historical data, (3) improving capital and liquidity planning, and (4) facilitating risk mitigation and contingency planning.

In short, effective *risk management* is not about discouraging risk taking but rather about encouraging prudent risk taking.

How can MFIs implement an effective risk management system?

While it's important that *risk management* filters through all levels of the organization, the responsibility for the system begins at the top of the organization – with the Board of Directors. The Managing Director is also responsible for the overall *risk management* system and should act as the “risk management officer.” Further, every manager has *risk management* responsibilities within their scope of operations. For instance, Branch managers' focus should be on credit, operational, and fraud risk while for Treasury managers it's on the institution's investment portfolio and overall investment fund's risk. However, institutions should not assume managers simply understand their *risk management* roles because it falls under their area of supervision. Each manager's *risk management* responsibilities should be clearly stated.

In conclusion, *risk management* transcends individual areas and cannot be easily divided into committees or categories. Implementing an effective *risk management system* must be part of the culture of the Board of Directors and woven into the cultural fabric of the institution itself.

Lessons Learned from Country Experiences: Morocco

The Challenge of Growth: Morocco

The Problem: In recent years, the country's micro credit sector has explosively grown and since 2007 delinquency rates have surged reaching unsustainable levels. Diagnostic studies reveal that several factors contributed to the problem including: (1) Strong shift towards riskier product features, like longer loan terms – which can explain 40 percent of the rise in delinquency, (2) significant increase in the average debt burden from micro credit lending, (3) poor underwriting and monitoring processes, (4) substantial cross lending aggravated the crisis and (5) governance and operational weakness played a crucial role affecting most other dimensions.

The Tactic: At the time of this conference, MFIs in Morocco are still working through the problem.

Lessons Learned from Country Experiences: Indonesia

How BRI Survived the Economic Meltdown: Indonesia

The Problem: The 1997 Asian economic crisis led to several bank closures in the country with short term investments departing and short term foreign exchange debt running up.

The Tactic: Despite the external risks, BRI stormed through the crisis. Several factors contributed to BRI's success in not only maintaining strong repayment but also increasing microsavings amid the crisis including: (1) Microloans were installment loans linked to the borrower's cash flow, over time clients were less vulnerable to the crisis as they built up their equity and lowered their leverage, (2) Micro borrowers were more engaged in the purchase and sale of domestically produced goods and services, thus less sensitive to rate fluctuations and economic downturns, (3) BRI maintained diversified portfolios both geographically and by industry, and (4) BRI maintained strong long term relationships with clients. Clients valued their access to services and did not want to lose the relationship. BRI reinforced this by ensuring on-time repayers had rapid access to other services.

Best Practices in Collections for Microfinance Institutions (MFIs)

Speaker: Panos Varangis, Principal Banking Specialist, Global Loan Portfolio Monitoring and Workouts Program, Access to Finance, IFC

Key Objective: Define the key practices to effective and efficient collections in MFIs.

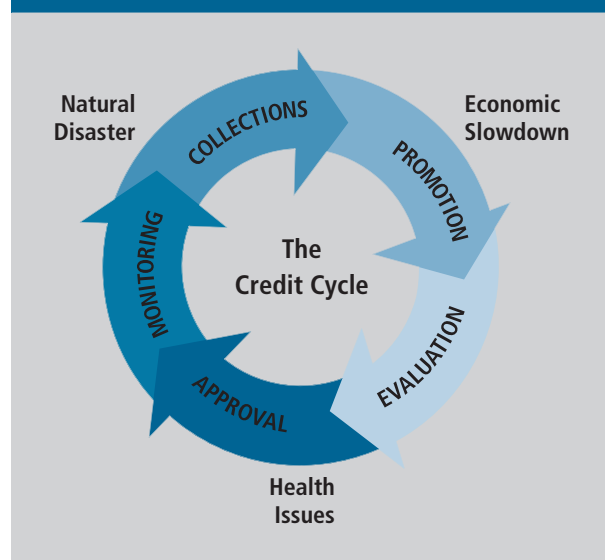
Synopsis

Delinquency management is a particularly critical issue for MFIs given (1) most microloans can have no or weak collateral; (2) microloans can become non-performing much quicker; (3) the motivation to repay may be based on access to other MFI products and services, and (4) the recovery cost/benefit is limited by a small loan size. To define the key practices to effective and efficient collections, it is important to understand that the root cause of loan defaults lie throughout the credit cycle and from exogenous factors that are beyond control such as economic slowdowns and natural disasters. To highlight the best practices, this presentation will delve into some of the main elements of the overall credit cycle.

Key Highlights

Experiences have shown that the bulk of loan problems often reside at the start of the credit cycle. Thus, it is important, for instance, (1) to develop appropriate products at the *Promotion* phase, (2) to have easy access to quality information to evaluate clients and their ability to repay at the *Evaluation* phase, and (3) implement robust risk management and approval systems at the *Approval* phase. At the *Monitoring* stage, the key is to have the appropriate delinquency indicators and Management Information System (MIS) to be able to assess the situation and raise red flags. There is no single delinquency indicator that works well for all MFIs, most MFIs should use multiple indicators.¹ Other points to emphasize here include: (1) renegotiated loans, which are higher risk, should be closely monitored and segmented from other loans, and (2) loan portfolio delinquency monitoring should be segregated to the extent possible by region, product, branch, loan officer, and client characteristics.

Defaults Have Their Roots Throughout The Credit Cycle And Beyond ...



At the *Collections* stage, best practices can be organized into three core guidelines². Firstly, adopt proactive strategies. This includes, for example, (1) adopting transparent policies and good communication to educate customers about product features and the consequences of default, (2) being customer driven and quickly addressing complaints, (3) ensuring ethical practices when collections is outsourced and most importantly (4) addressing the problem before there is a problem.

Secondly, improve information gathering and management. This is not only about having suitable software in place to analyze and report information but also about the ability to process information for follow-up action through the establishment of bodies like a Collections Committee.

Thirdly, develop clear policies and procedures. This includes clear policies and procedures on staff selection, training, and incentive structure. It also involves designing straightforward client contact policies and payment alternatives as well as defining appropriate procedures

on hiring specialized collections agencies versus creating internal collections units.

In context of the crisis, it is imperative to look at the issue of *customer protection* from not only the perspective of the institution but also the industry. At the industry level, elements that are critical include: (1) establishing independent avenues to solve disputes and (2) improving financial education and literacy. At the MFI level, the tasks are more detailed and include among others: (1) instituting a code of ethics for staff dealing with collections, (2) training staff to prevent customer mistreatment, (3) setting up a strong customer complaint mechanism, (4) explaining customer rights and responsibilities in simple form and most importantly (5) implementing an internal audit system to test compliance with the written policies and procedures.

In the end, good and ethical treatment of customers can be a **win-win** situation, as highlighted by the table below.

Good Ethical Treatment Of Customer Can Be A WIN-WIN	
<p>Not Willing But Able</p> <p>Possibly a Healthy Customer</p> <ul style="list-style-type: none"> Find out what is wrong. Did customer complain? Good treatment solves the complaint and retains the customer 	<p>Not Willing And Unable</p> <p>A Problem Customer</p> <ul style="list-style-type: none"> Good treatment resolves the customer relation with the least possible friction
<p>Willing And Able</p> <p>A Healthy Customer</p> <ul style="list-style-type: none"> Try to remind customer Good treatment retains the customer 	<p>Willing But Unable</p> <p>Possibly a Healthy Customer</p> <ul style="list-style-type: none"> Try to workout a solution Good treatment increases chances for recovery

¹ Refer to Consultative Group to Assist the Poor (CGAP), Occasional Paper No. 3, Measuring Microcredit Delinquency, June 1999

² Best Practices Adopted from Accion Insight, Number 26, November 2008

Global Practices in Responsible and Ethical Collections

Speaker: Amer Afiouni, Associate Principal, McKinsey & Company

Key Objective: Assess global practices and trends in collections and explore the key components of responsible and ethical collections.

Synopsis

In the current global landscape, delinquencies are surging worldwide making debt collection a priority for financial institutions, governments, and consumers. In the preceding economic boom, there was a reduced importance of collections capabilities and experience at most institutions given that the focus was mostly in loan portfolio growth. As a result, today most of these institutions are not necessarily prepared for collections from not only a capabilities standpoint but also a responsible and ethical perspective. At present, lenders that are able to work quickly and constructively with customers are improving their recovery rates by becoming first in line for customers' limited resources. Successful lenders are also seeking to maintain long-term relationships with distressed consumers, many of whom will recover after the current downturn. This session aims at looking at how collections practices can be fair and ethical while contributing to overall economic good. The following questions will be addressed.

- What constitutes ethical collections?
- What are the typical ethical issues along the different stages of the collections process?
- How do collection practices vary across countries in terms of their ethical standards and what drives such differences?
- What guiding principles should financial institutions follow in order to raise their ethical collections standards?
- What type of supporting infrastructure is required for the success of such efforts?

Key Highlights

What constitutes ethical collections?

Ethical collections can be defined as balancing the following three needs (1) **what is best for the borrower:** respecting individual rights while maintaining firm standards; (2) **what is best for the creditor:** recognizing that successful collections is critical to maintaining access to credit; and

(3) **what is best for the market:** balancing the broader market and institutional interdependencies to ensure collections activities support the management of systemic risk. Balancing each of these components is challenging but often results in overall positive outcomes as improving the borrower's situation will typically lead to better results for the creditor and market.

What are the typical ethical issues along the different stages of the collections process?

Collections Stage	Stage Description	Potential Ethical Issues
Initial borrower agreement	Initial agreement between customer and lender for credit	<ul style="list-style-type: none"> Incomplete or misleading disclosure of collections practices E.g. in India, collections practices are disclosed in English and Hindi and can be a problem for women and lower cast members that don't speak either language
Pre-delinquency & segmentation	Lenders segment borrowers based on a variety of risk characteristics to reduce likelihood of default	<ul style="list-style-type: none"> Profiling, aggressive borrower outreach , inappropriate offer
Borrower contact	Attempts to contact borrowers by telephone, email, postal mail, and in-person visit	<ul style="list-style-type: none"> Aggressive/inappropriate telephonic, email or postal outreach
Collection/treatment strategy	Offering options to and negotiating with borrowers to cure or settle accounts (e.g. payment plans)	<ul style="list-style-type: none"> Unfair negotiation, misleading disclosure, excessive late fees
Recovery action	Attempts to recover after failure of collecting	<ul style="list-style-type: none"> Unjustified asset seizure, improperly executed asset seizure
Lender-collection agency relationship	Outsourcing collections operations from lender to a collection agency	<ul style="list-style-type: none"> Misleading incentives, outsourcing unethical collections to agency

Every stage of the collections process raises ethical questions that institutions and governments must grapple with. The table above summarizes some of these issues.

How do collection practices vary across countries in terms of their ethical standards and what drives such differences?

Deep dive case studies in six countries (US, UK, Canada, India, Brazil, and Russia) show that although what is considered ethical and responsible collections is fairly

consistent across countries, practices do vary globally. In the developed world, the maturity of credit markets, regulations, and industry associations have produced practices that generally abide by responsible behavior, often codified in formal regulation. In emerging markets, however, there is greater variance in the degree ethical concerns influence collectors. The following graph provides a qualitative summary of what drives the major differences in how ethical and responsible collections is addressed across the six surveyed countries.

Comparison Of Collections Practices In Case Study Countries						
	Industry Performance		Regulation Drivers of Ethical Performance		Non-regulatory Drivers of Ethical Performance	
	Ethical Collections Practices	Maturity of Credit Market	Comprehensiveness of Regulation	Enforceability of Regulation	Strength of Industry Association	Importance of Ethical Reputation
<ul style="list-style-type: none"> Advanced Limited 						
United States	●	●	●	●	●	●
United Kingdom	●	●	●	●	●	●
Canada	●	●	●	●	●	●
India	●	●	●	●	●	●
Brazil	●	●	●	●	●	●
Russia	●	●	●	●	●	●

What guiding principles should financial institutions follow in order to raise their ethical collections standards?

Principle	Examples of Ethical Practice
1. Invest in a transparent relationship with the borrower	<ul style="list-style-type: none"> ▪ Disclose all lending and collections practices ▪ Educate borrower on ways to avoid delinquency in the future
2. Interact with the customer in a fair and respectful manner	<ul style="list-style-type: none"> ▪ Do not discriminate ▪ Contact borrower during reasonable hours ▪ Do not use physical violence/inappropriate language
3. Develop systems, infrastructure, and relationship with external stakeholders to support ethical practices	<ul style="list-style-type: none"> ▪ Train collectors in ethical practices and incentivize behavior ▪ Develop internal system to audit practices ▪ Do not outsource unethical practices

Lessons from developed credit markets helped form the three main guiding principles noted above that should be followed by financial institutions to raise their ethical and responsible collections practices.

What type of supporting infrastructure (e.g. regulations, association) is required for the success of such efforts?

The levers to achieve successful adoption of the above principles will vary from country to country. However, there are four primary models for supporting this:

Regulation: Offers the greatest degree of control over defining acceptable practices, but its success is dependent upon enforceability by governments and legal systems.

Industry-association: The model is optional and involves more self-enforcement than regulation. Associations may publicize membership to promote adherence to standards but borrowers may have no impartial arbiter when unethical actions occur.

Self-motivation (reputation risk management):

Collectors self-impose ethical standards. The model has the least degree of control over acceptable practices, but collectors not self-motivated to pursue certain practices are not likely to do so by any of the other models.

“Stamp of approval”: An independent organization develops acceptable practices and rates collectors on compliance. Sometimes, the media plays this role. This option leverages an impartial authority and industry pressure for compliance; but it may create a sub-market for unethical collectors.

In conclusion, implementing ethical standards will depend on the political, legal, and cultural environment of each country. The right model for adoption will require a mix of support from governmental authorities, industry players, independent local organizations, and international financial institutions. No single model for adoption will fit all countries!

Responsible and Ethical Collections – An Indian Perspective

Speaker: Samit Ghosh, Founder & Chief Executive Officer, Ujjivan Financial Services

Key Objective: Share experiences of the types of customer defaults & collection practices faced in the Indian microfinance industry.

Synopsis

The Indian microfinance industry is 15 years old. It is estimated there are 600 million poor people in the nation living outside the formal banking sector, with 83 percent of the poor residing in rural areas. Traditionally, microfinance in India has focused on the rural regions but there is a trend moving towards urban areas today. In general, there are two approaches to microfinance in India: 1) self-help groups directly funded by banks, which dominates the industry with an outreach of 64 million and 2) microfinance institutions (MFIs), which is a rapidly growing segment with 233 registered MFIs outreaching 23 million. Rooted in over a decade of experience in microfinance, this presentation highlights the different collections practices in India based on the types of defaults faced. It also identifies those practices which are unacceptable and those which are professional and desirable.

Key Highlights

What are the different types of defaults faced in India and their collections practices?

- **Temporary Defaults:** Typically, customers temporarily default due to uneven cash flows. To mitigate this, it is best to follow a joint liability and group guarantee mechanism. Temporary defaulters can gain access to internal group lending. Given entrance into groups is based on mutual trust and knowledge and it is expected that the customer and group would support each other.
- **Permanent Defaults:** Experience shows that permanent defaulters are usually intentional defaulters. To mitigate this, it is also recommended to follow a joint liability and group guarantee mechanism. The group could be held accountable for any skips or intentional defaulters, and at the very least be able to find where the individual has gone in cases of skips.
- **Long-Term Default:** In general, the source of these defaults are either from (1) a major economic setback like job loss, natural calamity, health issues, etc. or (2) multiple borrowings and over-indebtedness. The tactic to approach long-term defaults is contingent on the source of the default. For defaults due to the first cause, it is best to follow a loan reschedule plan that is based on the customer's current cash flow. Sufficient provisions must be maintained against these loans. For defaults due to the second cause, the long term solution is to establish

credit bureaus. In the absence of credit bureaus, it is difficult to assess the extent to which a customer may have borrowed from other MFIs. In view of poor customer information, the immediate solution is that MFIs must enforce internal self-discipline and policy on branching and extending credit. The other key is to work in jointly managed associations to resolve issues and coordinate solutions like the rescheduling of loans that have been borrowed from multiple MFIs.

- **En-Masse Default:** Normally, this is engineered by powerful stakeholders in society. In India there have been two cases of en-masse defaults: (1) the first in 2005, due to conflicts between two large MFIs and the local government in Andhra Pradesh; (2) the second in 2009, due to issues between the communal organization and MFIs in Karnataka. This can be a total disaster situation and reemphasizes the need to implement "good" practices and solve collections problems early on.

What are "bad" collection practices?

Experiences from India highlight several unethical practices, including:

- **Group liability systems creating pressure and getting out of control** by seizing assets from defaulting customers. In India there have been a few cases of customers being pushed to suicide due to such forces of humiliation.

- Holding **unending center meetings** till all payments are paid.
- **Holding** customer's **personal documents** as ration cards and collateral.
- **Harassing** and abusing customers at **all hours**.

What are "good" collection practices?

The "Good" practices not only involve collections but also the entire credit process from good customer selection to instituting policies to avoid multiple lending. Other noteworthy practices include:

- **Reviewing individual loans as businesses mature** given the group liability and guarantee structure weakens as loan sizes increase.
- Being proactive in implementing **professional collection policies and processes**.
- **Credit Bureaus**, although they take a long time to establish, are essential for credit extension in ultimate analysis.
- **Solidarity and united programs by MFIs** mitigate many dangers the industry may face. For instance in cases of mass defaults, it is important to have the co-operation of all MFIs and work together to resolve the situation.

Consumer and Market Conduct – The Example of Malaysia

Speaker: Thomas Tan Koon Peng, Deputy Director of the Development Finance and Enterprise Department, Bank Negara Malaysia

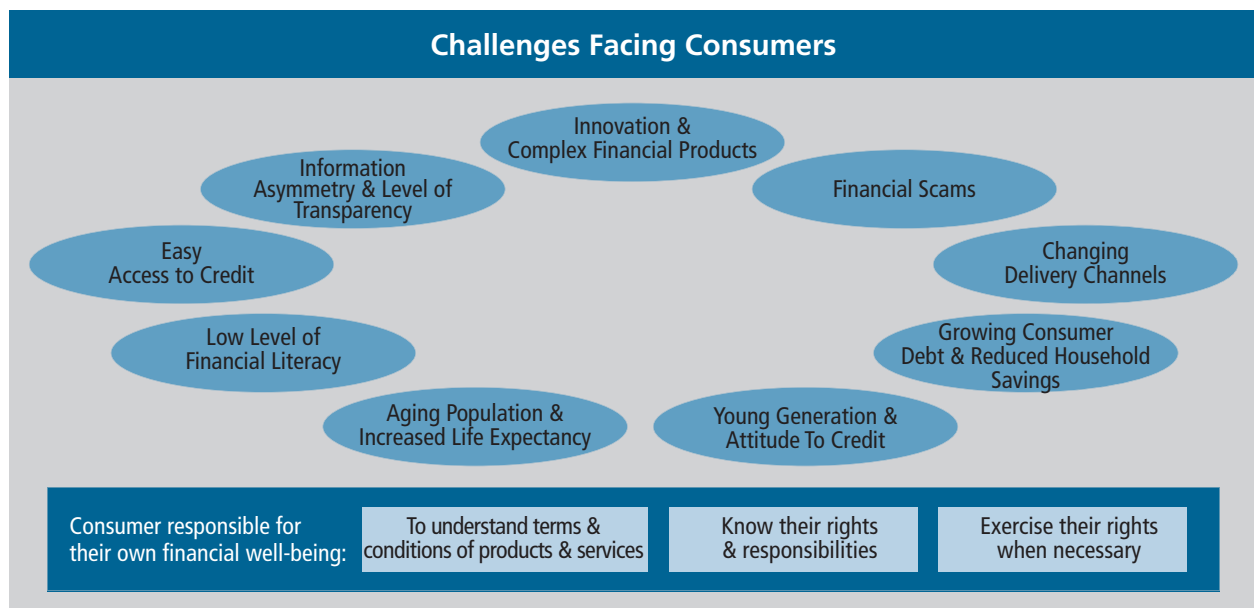
Key Objective: Outline the approach undertaken by the Central Bank of Malaysia in financial education and market conduct regulation.

Synopsis

Consumers face more diverse challenges due to the current environment of rapid changes in technology, product innovation, deregulation, and greater competition. Bank Negara Malaysia (BNM) has undertaken various initiatives in financial education and market conduct regulation to prepare consumers to face such challenges. With the initiatives undertaken, it is expected that Malaysian consumers will become more financially literate, responsible, empowered, well-informed, and confident in making financial decisions.

Key Highlights:

BNM has undertaken the following initiatives in financial education and market conduct regulation to help consumers face today's challenges:



- **Product transparency and disclosure mechanism:** The focus is on the basic disclosure standards for financial products and services. The objective is to provide consumers with relevant information to make informed financial decisions and be able to compare products and services. General principles of the guideline stipulate: (1) the board and senior management must provide oversight, (2) advertisements must comply with regulation

and must not be misleading, and (3) disclosure should be based on the timing of the consumer's key decision making. For instance, at the pre-contract stage, minimum disclosure requirements are the fees and charges that could be enforced and the circumstances in which benefits could be gained, etc. The bulk of the guidelines are product specific, covering the gamut of financial products and services offered. For example, depending

on the consumer's key decision making stage, disclosure requirements for loan products include: interest rates, repayment schedules, locking in periods, late payment fees, changes in interest rates, changes in charges, etc.

- **Ensuring fair and equitable market practices:** This includes among other areas, the monitoring of fees and charges and debt collection practices. In terms of monitoring of fees and charges, a balanced approach is adopted between market drivers and regulatory controls. In general, competition drives prices and banking institutions are allowed to impose charges in accordance with Central Bank guidelines. But the Central Bank reserves the right to moderate charges that are deemed excessive. In terms of fair debt collection practices, the guidelines recognize recovery is critical to good risk management but also must be professional, fair, and protect the consumer's privacy. The rules are very specific as to the types of conduct that are prohibited. For instance, debt collectors must not resort to intimidation or violence; should give borrowers written notice; and adhere to relevant information and secrecy provisions. Further, the guidelines specify when outsourcing collections, the financial institution remains accountable for the outsourced agents actions.

In formulating market policies a consultative approach is used with active discussions with relevant groups within the Central Bank and external parties from financial institutions to consumer associations to other government agencies. To ensure policies are being enforced, regular market surveillance is conducted. This includes inspections of customer care units and debt collecting agents. Also, mystery shopping is performed where Central Bank officers disguise themselves as customers and make on-site visits to certify guidelines are being adhered to. Other tactics include regularly monitoring the media and conducting industry and consumer surveys. There are also various mechanisms by which market conduct is enforced ranging from issuing letters of concern to penalties to public reprimand.

The long-term goal here is to work towards less regulatory intervention and allow competition to decide on market conduct activities as consumers grow financially sophisticated.

- **Promoting financial inclusion:** The objective is to make sure customers can enjoy a minimum level of banking services and access to financing. Banking institutions are required to offer a basic savings account (BSA) and basic current account (BCA) to all Malaysians. Small and Medium Enterprises (SMEs) are also eligible to open BCAs. Other measures include imposing minimum costs for basic services and transactions and ensuring charges imposed are reasonable.

- **Enhancing financial capability through financial education:** The objective is to increase consumer's knowledge to make informed decisions with the ultimate goal of breeding competition, efficiency, and innovation into the financial sector. Financial education is spread using a two-fold approach of 1) reaching a broad based audience and 2) targeting specific groups, which include among others, rural and disabled communities, women, and even school children. Education is delivered using various methods including seminars, training programs, face to face discussions, and by building networks and partnerships to achieve wider outreach. On-line platforms are also applied to disseminate critical information such as comparative data on product features. Many tools and resources have also been developed. For instance, pocket money books (see illustration to right) as well as an interactive on-line platform have been created as learning tools to inculcate the culture and habit of smart personal money management among students at a young age.



- **Availability of avenues to seek help and redress:** This is a key component of the consumer protection framework. It ensures information from consumers clearly flow through the system. The country has various avenues for redress and assistance that are regularly advertised to the public. Firstly, all financial institutions have established dedicated customer complaint units. The Central Bank also has an integrated customer service center for financial advice, inquiries, and redress. In addition, there is the Credit Counseling and Debt Management Agency, which offers services free of charge. Moreover, an independent body known as the Financial Mediation Bureau (FMB) has been set-up to settle disputes. The FMB offers a platform for fast and convenient out of court workouts and services are offered free of charge.

In conclusion, BNM has undertaken the above initiatives with the conviction that financially literate consumers and a sound consumer protection mechanism is essential in building a healthy credit culture for overall economic development.

Implementing Good Practices in the Context of Responsible Financing: Financial Transparency

Speaker: Alexandra D. Fiorillo, Vice-President, Microfinance Transparency

Key Objective: Explain the need for financial transparency in creating viable and sustainable microfinance industries.

Synopsis

The financial crisis started when a method for making loans to poor people was taken over by Wall Street investors supplying money through complicated financial instruments. The crisis taught us that pricing transparency at the client level is not enough. There is a need for transparency at all levels and improved financial literacy of borrowers. The subprime crisis also showed how the chance for increased profits overshadowed the increased costs and risks associated with the market.

The fear is that in five to ten years we repeat all of this again as more investors discover the rates in microfinance. By that time, we need to have pricing transparency, client protection, and appropriate regulation in place to make it impossible for the same sort of speculative bubble to blow up in microfinance.

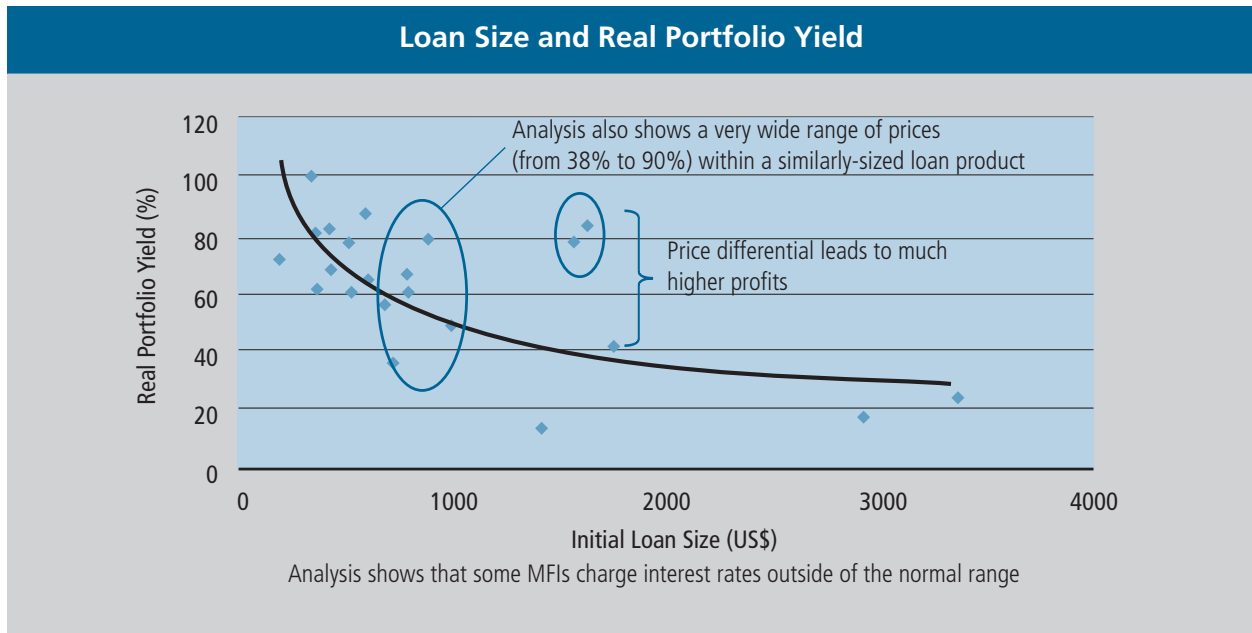
Key Highlights

Lessons Learned from the Crisis: The U.S. subprime market can be related to the microfinance market and lessons learned from the crisis can be applied to the industry today. The crisis shows that there was a problem with the lending methodology – the banks did not take into account the additional costs and risks associated with the borrower, like irregular cash flow scenarios, when lending to the subprime market. There was also a lack of understanding – not only did the customers not understand the complexity of the financial instruments being offered but also rarely did anyone else from the bankers to the journalists to the government. There was a problem with pricing as well – the crisis reveals that without the appropriate transparency, a substantial change in pricing relative to the loan size can have disastrous consequences.

The Opportunity: There is a considerable opportunity right now to make decisions that can prevent similar events from happening in microfinance. Decades of innovation and testing, have resulted in dramatic success in the industry. There have been strong efforts to raise a solid public image of microfinance as a noble means to lift the poor out of poverty. There have been strong efforts to attract investor money into the industry. However, there

have been weak efforts in consumer protection policies and transparency. What are the implications of this? The groundwork has been laid to attract a new contingent of actors into the industry, but there has been a neglect to build any serious checks and balances necessary to protect the poor. As more players seek a piece of the pie, the more at risk microfinance could be. It can already be seen that some activities in the market today are blurring the lines between microfinance and money lending. What the future holds, nobody knows, but there is an opportunity at this time given the crisis to make decisions that guarantee the survival of both social and financial missions in delivering financial services to the under-served.

The Call for Pricing Transparency: In microfinance today, transparency in financial performance is practiced but transparency on pricing is uncommon. Non-transparent pricing creates a major market imperfection, impeding competition and consumer choice. microfinance was born to provide a low cost alternative to money lenders but unintentionally what has resulted is a confusing environment where nobody knows the true price of microcredit products.



Global analysis shows that there is a very wide range of prices (from 38 percent to 90 percent) within a similarly-size loan product and some MFIs charge interest rates substantially outside of the normal range (*See graph above*). The idea is to be more transparent about the costs associated with doing business and what clients are actually paying at the end of the day. The industry needs to be clear in standardizing how it deals with the issue of pricing.

Why has microfinance practiced and tolerated such universal non-transparency?

- There is no “single interest rate” for microfinance products. Interest rates vary significantly relative to loan size, making transparency difficult.
- MFIs have very different products and they need to be priced very differently.
- It is a challenge to communicate and educate the public about these issues.

In the end, pricing transparency is essential to well functioning markets, promoting efficiency, healthy competition, and better prices for millions of the poor.

How Can the Industry Advocate Pricing Transparency:

It is a challenge to exercise transparency in an environment where non-transparency is the norm. It can be difficult to be the first or only MFI practicing transparent pricing. Microfinance Transparency Organization (MFTTransparency.Org) is a global initiative for fair and transparent pricing in the microfinance industry. Its objective is a microfinance industry where consumers and other stakeholders can make informed decisions. It works to create the proper “enabling environment” through initiatives like issuing reports that illustrate the relationship between loans sizes and interest rates country by country, and educating the public on why rates vary by loan size.

“We have made major investments in improving the quality and clarity of information on MFIs. But we have not yet invested as much as we should in making sure costs of financial services for poor clients are clear and fair. MFTTransparency’s initiative is a bold one that promises to fill an important gap,” said Elizabeth Littlefield, Director of Consultative Group to Assist the Poor (CGAP).

Investments to Strengthen Social Capital

Speaker: Tanmay Chetan, Co-founder and Managing Partner, Agora Microfinance Partners LLP

Key Objective: Layout the global landscape of microfinance investment vehicles and the need to strengthen social objectives in the industry.

Synopsis

Microfinance investment vehicles (MIVs) have become a key player in the microfinance market. To achieve healthy long-term returns, MIVs will need to explicitly include social performance in their guidelines for funding. Looking forward, ignoring social objectives in microfinance will not be sustainable for MIVs and MFIs alike.

Key Highlights

The Global Landscape and Need for Social Focus:

MIVs are private investment funds that play an increasingly important financial intermediation role between foreign investors and microfinance institutions (MFIs). MIVs are rapidly growing global players in bringing financing to MFIs, slowly overtaking donors and NGOs.

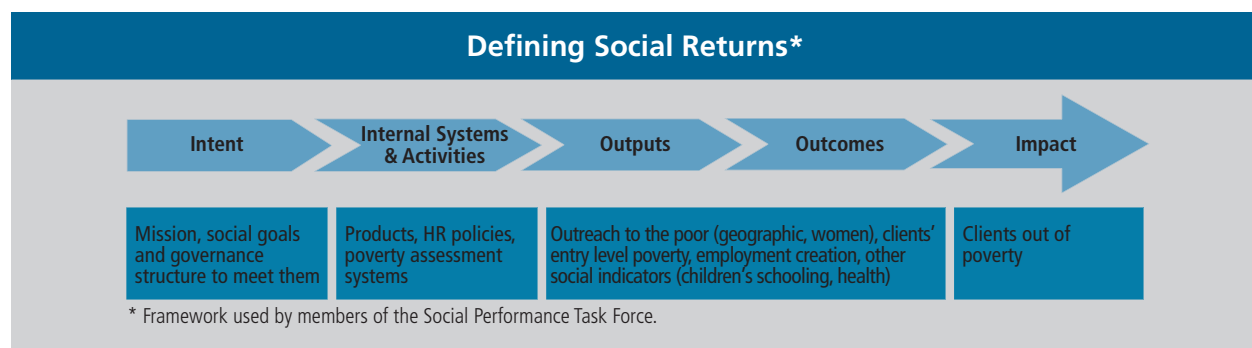
As of December 2008, there were more than 100 funds in the market with US\$6.5 billion in assets under management (AUM). The ten largest funds managed close to US\$4 billion, representing a 32 percent year-over-year growth rate.

Further indication of confidence and interest in microfinance globally is highlighted by the fact 11 new funds were created in 2008, and seven of them were after the crisis erupted in September. Microfinance funds' returns are also significant and compare favorably to other investments in emerging markets. For example, net returns for Euro denominated fixed income funds was 5.5 percent in a weak investment year like 2008.

On the other side, less than 5 percent of investments are in Sub-Saharan Africa (SSA), home to 25 percent of the

world's poor. The trend is for investments to be directed towards Eastern Europe and Central Asia as well Latin America. Further, most investments (~83 percent) are in short-term fixed income securities, highlighting a lack of long term commitments in the industry. This is where the need for social focus comes into play. Adequate social focus guarantees a more stable, sustained, and healthier financial return in microfinance. MIVs with long-term return expectations will need to include social performance in their funding criteria.

The tactic should be to create a balance between financial and social performance. Although the concept of social performance is still evolving, in essence it measures how well an institution has translated its social objectives into practice. Measuring social performance is an integrated process involving the evaluation of principles, actions, outputs into outcomes and impact (see diagram below). Of course, the appropriate systems and tools are needed to monitor, manage, and reliably report on the performance at the institution level. But beyond the institution, investments must also maintain sufficient focus on social objectives to ensure healthier and stronger financial returns within the industry for the long term.



Creating a Conducive Environment for Promoting Financial Inclusion: The Role of Credit Bureaus

Speaker: Peter Sheerin, Credit Bureau & Risk Management Advisor, Access to Finance, IFC

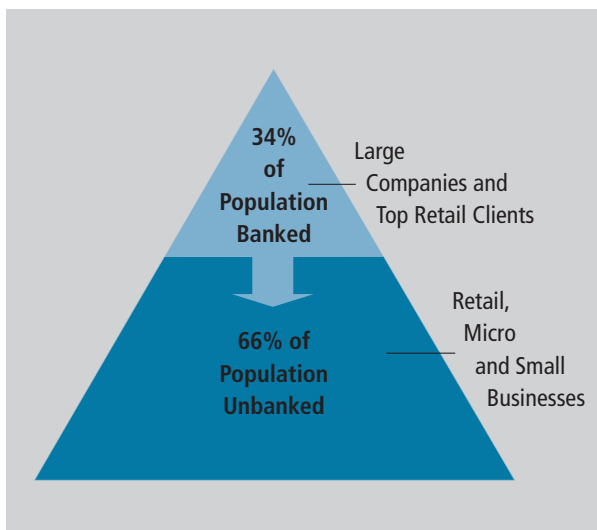
Key Objective: Describe the valuable role of credit bureaus in improving access to finance and benefiting Microfinance Institutions (MFIs) and their clients, as a vital part of financial infrastructure.

Synopsis

Credit bureaus help consumers and small businesses obtain access to financing. They offer timely, credible, and objective information on borrowers, allowing financial institutions to reduce loan processing time and costs by 25 percent or more and cut default rates by 40 to 80 percent. These savings can mean lower interest rates, making credit more affordable and available to those in need. Credit bureaus are also critical to avoid over-indebtedness and support responsible lending practices.

Key Highlights

Increasing access to finance for the underserved: Globalization and technology are fundamentally changing the financial services industry worldwide. Competition has accelerated; margins and fees are narrowing; and the development of securities markets is creating additional challenges for lenders. And yet, in most emerging markets lenders continue to focus on a limited market of big commercial and retail clients, leaving a substantial 66 percent of the population made up of small, retail, and micro, businesses untapped.



Credit Bureaus can correct this imbalance by allowing lenders to collect and share data on millions of potential borrowers and evaluate their creditworthiness. Based on data sourced from 5,000 small firms in 51 countries, 49 percent of the firms report high financing constraints when they do not have access to a credit bureau, but this falls to 27 percent when they have access to a credit bureau.

Broader information sharing also helps more people and businesses access credit. Studies show the percentage of applicants who obtain a loan increases by 89 percent when accessing a positive and negative bureau, rather than a bureau that contains only negative information. In addition, out of every 100,000 loan applications, 11,400 are “lost” if the assessment is based on negative information only.

To note: negative information only includes history on past defaults while positive information includes a more comprehensive credit portrait. It includes records on all open and close credit accounts, including the amount approved, defaulted, and other repayment details.

In summary, by facilitating information sharing among lenders, the benefits of credit bureaus are great and include: identifying good borrowers from bad; pricing loans appropriately; decreasing processing time; and reducing transaction costs. In addition, credit bureaus can help financial institutions to recover loans; when borrowers know their information will be shared they have an additional incentive to pay. Good borrowers also benefit from lower interest rates as lenders compete for their business.

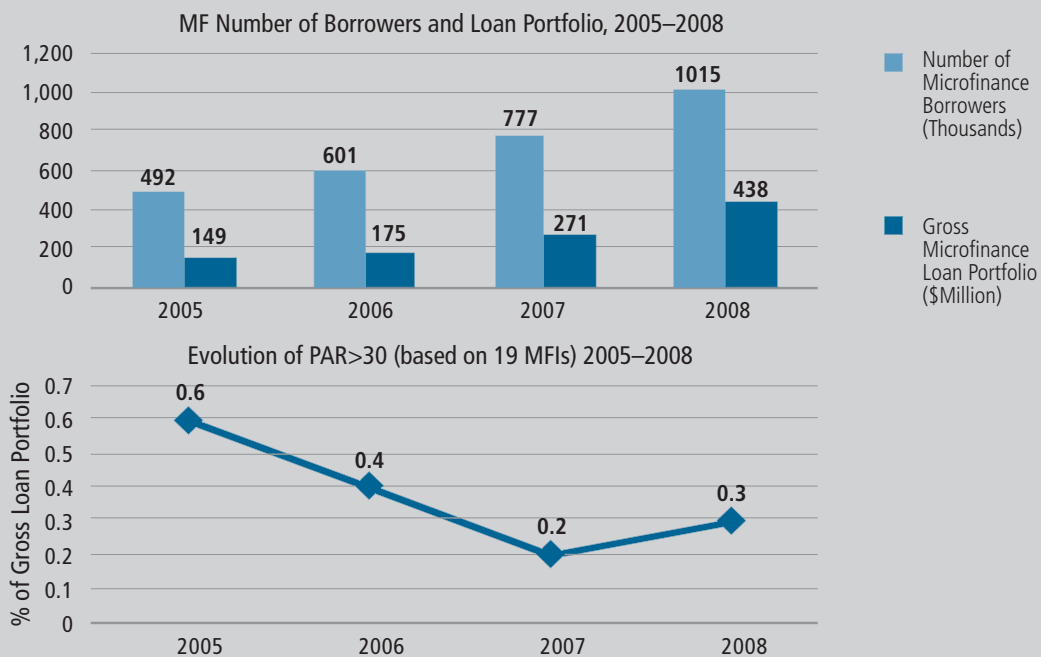
The Need for Microfinance Credit Reporting - A Lesson for All: Evidence from a functional microfinance credit bureau program in Ecuador shows that credit reporting can be tremendously beneficial for MFIs. The Ecuadorian Microfinance Association has MFIs with more than 560,000 clients. Most of these MFIs are non-regulated and not obligated to disclose credit information. However, the Association started a project to share information between non-regulated MFIs and a Private Credit Bureau (PCB), with the following objectives: (1) prevent over indebtedness, (2) increase access to credit, (3) increase efficiency in credit underwriting, and (4) decrease the level of default rate and operational costs. As in most countries, MFIs in Ecuador believed they had exclusivity with their clients. The reality was, however, the clients, who were mostly small producers from the rural areas (~80 percent), were borrowing from everybody. This was detected only because the lenders shared information with the same Private Credit Bureau. As a result of the partnership, the Association reported that in just over a year there was an increase in client number by 33 percent; total portfolio by 53 percent; with a decrease in Portfolio at Risk (PAR) figures and the number of legal actions filed. Most importantly, the number of micro-entrepreneurs with access to credit surged from 60,000 to 720,000 in just a span of five years.

The market in Ecuador can be related to Cambodia's. Cambodia is one of the most dynamic and rapidly developing microfinance markets globally. However, since the crisis started, the rate of microfinance NPLs and PARs have been rising. In this environment, MFIs sharing credit information with the wider lending community will ensure (1) greater access to finance and financial services, (2) responsible decision making and less discriminatory lending practices, and (3) improved risk assessments, enhancing portfolio quality.

IFC's Global Credit Bureau Program: IFC's key strategic priorities are to promote access to financial services and create deeper, more responsible and inclusive financial systems worldwide.

IFC's Global Credit Bureau Program was formulated to promote these objectives. As the current crisis evolves and liquidity margins are squeezed, IFC's Credit Bureau Program is moving towards supporting the development of more robust and inclusive credit reporting systems for microfinance and SMEs. It will focus on building capacity for prudential supervisors to better utilize credit information data; supporting the promotion of financial education and literacy on credit and credit reporting; targeting supervisors, regulators, lenders, and indirectly end-users.

Microfinance Sector Overview in Cambodia



Legal & Regulatory Issues & Challenges

Speaker: Brett Sciaroni, Senior Partner, Sciaroni & Associates

Key Objective: Define the key legal and regulatory challenges in Cambodia's Microfinance.

Synopsis

In a span of 15 years, the legal and regulatory environment in Cambodia has rapidly changed. Over the years, an outpouring of technical assistance from international finance institutions has shaped an increasingly professional financial environment. Further, the National Bank of Cambodia (NBC) has been a serious regulator with oversight responsibilities. A lot has been accomplished, but there is still progress to be made. Cambodia's Microfinance has benefited a great deal from foreign investments through the years. Although, this has now significantly slowed down due to the international economic downturn. As the global economy starts to pick-up and capital starts to come back, it is important to understand how external investors view legal and regulatory issues related to their investments in Cambodia.

Key Highlights

Assessing Information: A long standing issue has been assessing information. There is a lack of substantial public records, no credit agency, no court records available in a systemic and transparent manner. Those records that are available are typically difficult to access and not in user-friendly electronic formats. In short, there is a need for accessible comprehensive information.

For example, there is no official registry of *encumbrances on movable property*. It is possible under the Law on Secured Transactions (2007) to file a notice on collaterals at the Secured Transactions Filing Office (STFO) of the Ministry of Commerce (MOC). However, not all encumbrances are filed. Further, the STFO does not assess the validity of encumbrances filed. Hence, a search on the STFO's website will give an incomplete view of a company's encumbrances. As such, foreign investors often have to rely on the local MFIs' accounts rather than independent review in public registries. Similarly, local MFIs may have difficulties in assessing whether potential borrowers have already charged their assets or are involved in litigation.

Limited Perfection of Collateral: A foreign investor financing a local MFI will seek to secure its investment with collateral. In the case of local MFIs, those are mainly movable assets as MFIs seldom own land. As mentioned above, interests on movable assets may be filed at the STFO. However the Law on Secured Transactions does

not provide for a registration system. In fact, anyone who can pay a few thousand riels may file an interest on a third party. In the absence of a neutral independent validation process, the STFO cannot guarantee an investor's interest. At best, it only gives a presumption of priority. In practice, the collateral that investors obtain are charges over shares of the MFI or personal guarantees from directors or shareholders.

For immovable property, there is also limited perfection of collateral. As a matter of law, only mortgages over immovable property with hard title can officially be registered with the authorities. In practice, however, many landowners have yet to obtain hard title deeds, especially in rural areas targeted by the MFIs. In addition, the registration system for hard title deeds varies from one local office to another. This makes it difficult for MFIs dealing with multiple jurisdictions. In essence, the lack of a standardized and transparent registration process makes it arduous for MFIs to maneuver through the process.

Uncertainties in Enforcement of Collateral: Regarding litigation, there is a three-tiered court system characterized by limited resources, significant case backlogs, and a restricted number of attorneys. Regarding dispute resolution mechanisms, the legal infrastructure is still developing and there is a tradition of conciliation of disputes, but specialized and alternative dispute mechanisms are used in the country.

Examples of Specialized Dispute Resolution mechanisms include:

- Land Disputes: Cadastral Commission and the National Authority for Land Disputes
- Collective Labor disputes: Statutory Arbitration Council (see www.arbitrationcouncil.org)
- General Labor Disputes: Labor Court not yet established.
- Commercial Disputes: Law on Commercial Court now in draft form.

Examples of Alternative Dispute Resolution channels include:

- Commercial Arbitration Law (provides for National Arbitration Centre)
- Commercial contracts generally provide for arbitration outside of Cambodia (e.g. ICC, Singapore International Arbitration Centre)

Enforcement of Foreign Arbitral Awards: Foreign investors will most likely subject their investment to foreign laws and foreign jurisdictions or arbitration. However, there is a risk that Cambodian courts will not automatically enforce foreign judgment or awards. Cambodia has ratified the *New York Convention on the Recognition and Enforcement of Arbitral Awards* in May 2001, and passed the necessary domestic law. Therefore, awards of foreign arbitrators should be binding and enforceable on the parties in Cambodia. However, current judicial practice suggests that the Cambodian courts may not always be willing or able to recognize or enforce a foreign arbitral award without a re-examination of the merits of the case.

The Uncertainty of Rates: Under the Cambodian Contract Law the maximum interest chargeable of a loan enforceable in the country is five percent per annum “*unless otherwise provided by law*” (Article 59). However, a subsequent Regulation issued by NBC is interpreted as allowing banks and financial institutions to set interest rates on deposits and loans at a rate negotiated between the parties to the deposit or loan. As a matter of law, the Regulation should not rank superior to the Contract Law. However, as a matter of practice, the Regulation has been accepted as repealing the five percent provision. This remains a major legal uncertainty for foreign investors.

Panel Discussion: What's Next in Cambodia's Microfinance

Moderator: Margarete Biallas, (IFC)

Participants: Hicham Bayali (IFC), In Channy (Aclea), Chea Phallarin (Amret), Kim Vada (NBC), Stefan Harpe (Oiko Credit)

Key Objective: Reflect on the likely developments in the industry over the next years.

Synopsis

In a small market with a large number of very active players and the absence of appropriate financial infrastructure, such as credit information sharing systems, development opportunities are limited in Cambodia's Microfinance industry if economic growth significantly slows down. The current rise in competition, portfolio at risk figures, and non performing loans, bear witness to this. Given this background, how can the industry continue to develop and flourish?

Participants addressed the following questions and below are key highlights of the discussions:

- **In comparison with international standards, where does the Cambodian MFI industry stand, is it more affected by the crisis than MFIs in other countries?**

Cambodia's current turmoil in microfinance caused by rapid industry growth; heightened competition; taking greater risks – illustrates that its situation is very similar to other countries. To rise out of this state, there are several best practices MFIs can implement including: 1) know your customer; 2) review your marketing strategy, analyzing product, pricing, and portfolio details to ensure sustainable growth; 3) restore credit discipline; 4) ensure you have the right staff who are specialized; 5) strengthen risk management, focusing on governance; and 6) in the absence of a credit bureaus, take the initiative to share credit information amongst yourselves.

- **Integration and cooperation in the financial industry has no significant track record in Cambodia (to date there is not even shared use of ATM networks). Given this history, does the current crisis give new impetus to greater integration between banks and MFIs or among MFIs in the sphere of distressed asset management with scope for banks and MFIs joining forces to contain growth of NPLs and manage risks?**

To cope with the current situation, MFIs and commercial banks must work together and start sharing information about areas of operations and customers be-

ing serviced. Indeed, coordination between MFIs and banks will help improve the quality of loan portfolios and return strength to the industry. Even if there is agreement at the top level to share information, there needs to be understanding and coordination at the field level too. This forum exemplifies the fact that the private and public sectors are united. MFIs are listening to each other and finding ways to cooperate. There is also unanimous consensus on the need for a Credit Bureau but this will take time to set-up. In the meantime, short term solutions can be taken. The Cambodian Microfinance Association (CMA), for example, can take steps to set industry norms. We should work together on client education as well.

- **We have discussed the importance of credit culture as a way to preemptively manage risks and ultimately avoid non performing loans (NPLs). How well are Cambodia's MFIs positioned to employ this approach as a means of managing risks?**

Building credit culture has been important to Cambodia's Microfinance since the beginning. Over the years, Cambodia's MFIs have tried to provide credit using a simple methodology that does not discriminate against the client. However, the industry still needs to improve its customer complaint and financial education mechanisms. Customers need to understand that credit is not a donation and that it is important to repay on-time. For the industry to be sustainable, MFIs need to maintain their position and work to recover loans, even in difficult situations.

▪ **Would the NBC welcome a joint industry initiative of MFIs in order to deal with the increasing level of NPLs?**

The Central Bank is open to this. Why are we so late in setting up a Credit Bureau? Through the years there have been challenges between the financial institutions and the Central Bank, and vice versa. But from challenges comes successes. Every time the Central Bank issues new regulation, it always obtains feedback from the banks and MFIs. When legal frameworks become out-of-date, the Central Bank works to amend them. It tries to adopt a supportive rather than restrictive approach. It's always committed to learn from its members and the broader world. After discussions with IFC, the local MFI and bank community, and hearing experiences from other countries, NBC is committed to setting up a Credit Bureau to include both positive and negative information for MFIs.

▪ **From an investor's perspective, how can investors contribute to addressing the challenges in the industry and moving it forward?**

As the industry grows, the Cambodian Microfinance Association (CMA) has an increasingly important role to play. From an investors perspective, therefore, investments should be made to strengthen the CMA. For instance, the CMA should put in place mechanisms to support customer complaints and promote financial literacy. The CMA should develop common standards on client protection. Why not hold client education seminars? To be pioneering and protect the future of the industry, the CMA should put together such concrete initiatives and investors should put together the financing to support such efforts.

▪ **What does the future hold for Cambodian MFIs?**

The industry has a bright future ahead. To be sustainable and grow, it is clear microfinance needs to be able to provide more financial services. Thus, it will require product diversification. The Central Bank may want to consider allowing deposit taking as a source for local currency funding. Also, the opportunity is available to strengthen the CMA to play a more active role on behalf of the industry. Further, there is the opportunity for investors and IFIs alike to get more involved to address the challenges.

In the future, it would be good to see:

- Transition from foreign dominated investments and board composition to local governance and ownership.
- Decreased reliance on foreign capital and a deepening of financial intermediation.
- Expansion of financial services, beyond just credit.

The road to get there involves:

- Building an enabling system that supports MFIs through effective legal / regulatory frameworks, industry associations, and consumer associations.
- Setting-up the infrastructure to facilitate deposit mobilization.
- At the institution level – improving efficiency, reducing delays and the non-financial cost to the borrowers – this will make the whole system more efficient.
- Also, at the institution level – strengthening governance, which for the large part involves changing management culture.

A lot of progress has been made, but there is a way to go:

- The subject of social performance has been absent in discussions. We are social investors, achieving both social and financial returns. Microfinance does impact poverty – but there is a need to strengthen social performance measurement and accountability at the institution level.

Conclusion and Wrap-up

To conclude, Cambodia's microfinance is a critical component of the financial sector and has had great success in extending financial products and services to the poor throughout the country. In just a decade, almost a million Cambodians have borrowed more than US\$500 million notably to finance their farms and micro businesses.

Despite microfinance's great accomplishments in Cambodia, today's crisis emphasizes the gaps and challenges the industry continues to face. The conference highlighted some of the most pressing issues to be addressed:

- There is a clear need for a reliable and comprehensive (capturing negative and positive data from the financial services industry as well as utilities) credit information system to reduce opportunities for over-lending.
- Emphasis of responsible lending practices, starting with stronger financial literacy and education to ensure customers are better able to make informed choices and understand their obligations.
- Established principles of responsible and ethical collections practices.
- Robust internal control systems and tightened risk management frameworks at the institution level, in a rapidly growing market.
- Increased need for diversification of products available to the market.

To address this, the speakers shared their experiences and presented concrete tools and guidelines in the following areas:

- Building robust risk management and governance frameworks at the MFI level, starting with a risk assessment and followed by a detailed roadmap to improve systems and processes.
- Implementing responsible lending and ethical collections focusing on the core principles of 1) investing in a

transparent relationship with the borrower; 2) interacting with the customer in a fair and transparent manner; and 3) developing relationships and internal systems to support ethical practices.

- Establishing consumer protection mechanisms and market conduct regulations.
- Creating sustainable markets through financial transparency, stronger investments, and improved information infrastructures, such as credit bureaus.

Over the past ten years, IFC has been a strong supporter of microfinance in Cambodia. Starting in 1999 as advisor and later as a lender, IFC is proud of the contributions it has made to help transform the industry into a commercially viable sector that plays a critical role in reducing poverty and improving people's lives. Over the years, Cambodian MFIs have been cutting free from NGOs and donor funding, to operate as commercially independent institutions that have extended access to financial services to hundreds of thousands of Cambodians in a very short time-frame.

In response to the challenges amid the financial crisis, IFC has developed extensive capabilities and best practices in *risk management*, *loan portfolio monitoring*, *non-performing loan management & resolution*, and *responsible financing* to help clients put in place the foundations for a sustainable growth now and beyond the crisis.

To meet market needs, IFC is offering advisory services to assist MFIs in Cambodia strengthen their risk management capabilities, in which an initial risk assessment is followed by the design of a tailored risk management framework to mitigate the risks identified. IFC is committed to working with microfinance partners and stakeholders in Cambodia towards building a sustainable future and providing access to financial services to millions of the underserved.

Annex

Speaker's Biographical Notes



Afiouni, Amer
Associate Principal
McKinsey & Company, Dubai

Amer Afiouni is an Associate Principal in McKinsey & Company's Dubai Office. He joined the firm in 2003 and is a member of the Financial Institutions Practice and Risk management practice. His work covers a broad range of banking topics with a particular focus on retail credit risk management

His recent engagements include the following:

- Supporting a Middle Eastern bank in diagnosing their retail collection operations and designing an improvement program to tackle rising defaults
- Supporting a Middle Eastern bank in implementing a quick impact collection improvement program, focused on operational improvements as well as performance stimulation
- Supporting a Middle Eastern bank in developing their credit management infrastructure including development of rating systems and upgrading the credit process and policies

Prior to joining McKinsey, Amer worked for eight years in the IT consulting industry in Europe and the Middle East

Amer holds two engineering degrees from Ecole Polytechnique and Ecole Nationale Supérieure de Techniques Avancées, a Masters degree in economics from la Sorbonne university, and an MBA from INSEAD, France



Bayali, Hicham
Regional Program Manager
Microfinance Program
IFC Middle East and North Africa

Hicham Bayali currently oversees IFC's Microfinance Program for the Middle East and North Africa region. The Program provides the Microfinance industry across the region with technical support to build or enhance capacity, help MFIs transform into shareholding/for-profit corporate entities, support banks in downscaling their

activity to tackle the MSME market segment and create new greenfield MFIs. Before looking after the MENA Microfinance Program, Hicham Bayali was in charge of IFC's Business Enabling Environment Program for the Maghreb region. In this capacity, he led economic reform projects in the Maghreb relating to credit infrastructure, judiciary systems, local tax policies and business start up framework.

Before joining IFC, Hicham Bayali was the Chief Financial Officer of Fondation Zakoura Micro Crédit. In his previous assignments, he worked as an auditor for KPMG France, as the Financial Controller for Vivendi Universal in Eastern Europe, as a Senior Relationship Manager and then Head of Risk Management for the Corporate/Investment Banking Department of Citigroup.

Hicham Bayali, CPA, holds a Master in Finance and Management Control from Paris-Dauphine University, a Master in Accounting and Finance from Bordeaux-Montesquieu University and a Master in Business Law from La Sorbonne University.



Biallas, Margarette
Business Line Manager
Access to Finance Program
IFC Mekong Region

Being a manager of IFC's Access to Finance Program in the Mekong countries (Vietnam, Cambodia and Laos), Margarette is responsible for advisory services to financial institutions as well as regulators to bring new products to the respective markets and extending reach of financial institutions.

Margarete graduated with a Bachelor of Arts from the University of Cape Town, South Africa, majoring in Economics & Political Science and has a Master Degree in Economics from the University of Economics and Political Science, Hamburg, Germany. She was employed by the German Bank for Reconstruction and Development (KfW-Bankgroup) initially as a country manager with a multi sector portfolio. Her portfolio focus has been on structuring investments and designing accompanying TA. She had been both a Member and Chair of investment committees for a number of global funds on behalf of KfW. She was responsible for setting up microfinance investment vehicles with KfW.



Chetan, Tanmay
Co-Founder and Managing Partner
Agora Microfinance Partners LLP

Tanmay Chetan is a Managing Partner with Agora Microfinance Partners LLP, London which is a part of the newly launched Agora Microfinance Fund, Luxembourg (AMF).

Tanmay's work in microfinance encompasses more than 10 years in credit ratings, consulting and implementation in over 15 countries. Most recently he has been involved in setting up AMF with other partners. As part of the initiative he undertook a year of research into microfinance in 5 African countries during 2008.

Earlier, during 2003-7, he served as the first CEO of AMK Limited in Cambodia. Before that, during 1997-2003 he was the Team Leader for Ratings and Advisory services with M-CRIL, a specialised rating company for microfinance, during which he undertook and supervised ratings of more than 100 MFIs in a number of countries.

Tanmay holds an MPA from the Harvard Kennedy School and an MBA from the Indian Institute of Forest Management



Ghosh, Samit
Founder & Chief Executive Officer
Ujjivan Financial Service

Founder & Chief Executive Officer of Ujjivan Financial Service www.ujjivan.com, a micro finance institution which provides financial services to the urban & semi-urban poor in India. Ujjivan started operations on November 1, 2005 and is headquartered in Bangalore. Ujjivan is a Grameen Bank replicator. Currently Ujjivan has 170 branches across India covering 12 States and over 375,000 poor working women as customers. Ujjivan has disbursed over US\$ 88 million of loans and has a repayment rate exceeding 99.2%. Ujjivan plans to grow nationally across India with a goal of two million customers in the next six years. Ujjivan believes in holistic approach to poverty alleviate and works closely with a sister non-profit institution, Parinaam Foundation to provide services in healthcare, education, vocational training & community development to its microfinance customers.

Samit was a career banker spanning 30 years and worked both in South Asia & Middle East. He started his career with Citibank in 1975. He was part of Citibank's pioneering management team to launch consumer banking to the middle class in India in 1985-90 & the Arabian Gulf in 1990-93. He led the launch of Retail Banking in South Asia & Middle East for Standard Chartered Bank during 1993-96. In 1996 as Executive Director of HDFC Bank he initiated their Retail Banking business. His last banking assignment was Chief Executive of Bank Muscat in India from 1998 to 2003. Samit is a graduate of Economics from Jadavpur University, Kolkata; and Master of Business Administration from Wharton Business School, University of Pennsylvania, Philadelphia.



Fiorillo, Alexandra
Vice President
Microfinance Transparency

As Vice President of MicroFinance Transparency, Alex oversees international operations and global data collection on product pricing. She comes to MFT with over eight years of experience in the microfinance industry and with experience in Africa, Latin America and the Middle East. Most recently, she worked at ACCION International on the Marketing and Product Development and Global Investments teams.

Prior to ACCION, Alex worked as a microfinance and enterprise consultant in Jordan (Microfund for Women), Uganda (DFID's Financial Sector Deepening Project), Nicaragua (Agora Partnerships), Ecuador (Development Alternatives, Inc. and USAID), and New York City (Women's World Banking). In 2003 – 2004, she was a Fulbright Scholar in Ecuador where her research focused on rural and indigenous microfinance in the Amazon jungle. She has published papers, reports and case studies on various microfinance and economic development topics.

In addition to her professional experience, Alex holds a Master of International Affairs with a concentration in Microfinance and Economic and Political Development from Columbia University's School of International and Public Affairs. Her undergraduate degree in Economics and Latin American Studies is from Connecticut College.



Sciaroni, Brett
Senior Partner
Sciaroni & Associates

Brett G. Sciaroni, an American lawyer, is Senior Partner of Sciaroni & Associates. Working in Cambodia for 16 years, his firm represents many of the international companies operating in Cambodia. He serves on the Board of Directors of a number of banks and companies in Cambodia.

Mr. Sciaroni also serves as Chairman of the International Business Club and AmCham. He is Co-Chairman, along with Deputy Prime Minister and Minister of Economy and Finance Keat Chhon, of the Working Group on Law, Tax, and Good Governance (which is part of the system of consultation between the Royal Government and the business community). He also serves as one of the private sector representatives on the National Social Security Fund's board.

Mr. Sciaroni has served as Legal Adviser to the Royal Government of Cambodia in each of the four governments since the 1993 elections, with his most recent re-appointment occurring on October 10, 2008. The position, created by Royal Decree, carries with it the rank of Minister.



Sheerin, Peter
Credit Bureau and Risk Management
Advisor
Access to Finance, IFC

Peter was appointed as an IFC Credit Bureau and Risk Management Advisor in December 2005. Since assuming this role he has been actively engaged on the Egyptian, Nigerian, Vietnamese, Cambodia, Lao and various Pacific Island Credit Bureau projects, establishing world class consumer, SME and commercial Credit Bureaus. Prior to joining IFC, his professional experience included working for one of the leading international credit bureau and decision solutions companies, Baycorp Advantage Limited as General Manager – International, and was the Senior Executive for the company based in New Zealand. As part of that role, he was responsible to oversee the development, delivery and implementation of Baycorp Advantage international deployment of credit bureau in Singapore, Malaysia, Fiji and the Kingdom of Saudi Arabia.



Tan, Thomas Koon Peng
Deputy Director
Development Finance & Enterprise
Department
Bank of Negara Malaysia

Thomas Tan Koon Peng is Deputy Director of the Development Finance and Enterprise Department of Bank Negara Malaysia (BNM). The Department is responsible for fostering the development of sound and robust development financial institutions in meeting the strategic, economic and social objectives of the country, as well as formulating policies to enhance access to financing for micro, small and medium sized enterprises in Malaysia.

Previously, Thomas served in the Monetary Assessment and Strategy Department, where he was the Deputy Head of the Monetary Policy Committee Secretariat. He began his BNM career in 1995 in the Economics Department.

Thomas holds a BSc degree in Economics and Accounting from the University of Bristol, U.K. and an MBA from INSEAD, France. He is a Chartered Financial Analyst (CFA) and was a BNM scholar



Varangis, Panos
Principal Banking Specialist
Global Loan Portfolio Monitoring &
Workout Program, IFC

Since April 2009, Panos Varangis is a Principal Banking Specialist with IFC dealing with loan portfolio and NPL management issues. Prior to this, Mr. Varangis held the position of the Deputy CEO and Vice President of the Agricultural Bank of Greece (ATEbank), one of the top five banks in Greece with 25 billion euro in assets. At ATEbank he oversaw the corporate and SME departments, the loan restructuring and collection unit and the treasury department. From 1987 to 2004, he was at the World Bank where he held various positions at the International Economics Department, the Research Department and finally at the Agricultural and Rural Development department dealing with issues related to risk management, rural finance and insurance, commodity prices, and agricultural policies. He holds a Masters degree from Georgetown University in Development Economics and a Ph.D. degree from Columbia University in International Trade and Finance.

Recommended Readings

- Accion Insight Number 26, *Best Practices in Collections Strategies*, November 2008
- Cambodia Microfinance Association, *Microfinance in Cambodia*, August 2009
- CGAP Focus Note Number 52, *The Global Financial Crisis and Its Impact on Microfinance*, February 2009
- CGAP Occasional Paper Number 3, *Measuring Microcredit Delinquency*, June 1999
- Kay Kimsong. "Troubles loom, but AMK is golden," *Phnom Penh Post*, August 21, 2009, pg. 14.
- Ketaki Gokhale, "Global surge in tiny loans is spurring a credit bubble in a slum in India," *Wall Street Journal (WSJ)*, August 14-16, 2009, pg. 1.
- Samit Ghosh, Response to August 2009 article in WSJ on Microfinance, August 14, 2009

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