

Industry Update



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Cambodian Microfinance

An overview of the challenges and opportunities for one of Asia's fastest growing sectors from the Cambodia Microfinance Association.

1. Introduction

Between 1975 and 1979 the Khmer Rouge regime purged one third of Cambodia's population in attempt to eliminate any social hierarchy, including symbols of wealth and culture. The genocide decimated the majority of the country's infrastructure and human resources, leaving the state with a baseless financial sector and its people in abject poverty. The subsequent regimes failed to promote an open and dynamic financial sector. However after the signing of the Paris Peace Agreements in 1992, Cambodia emerged from isolation and large-scale aid and relief operations, in partnership with the Royal Government of Cambodia (RGC), followed to support the development of the country. Currently, Cambodia has a population of approximately 14 million, of which approximately 85% live in rural areas and an estimated 35% of the population lives under the poverty line.

Cambodia Demographic and Microfinance Industry Data

Population: +13,395,682¹

Estimated population below poverty line: 30%²

Rural population: 10,781,655¹

Number of MFIs: 20³

Balance outstanding: 1,247,773.92 Million KHR³

Deposit Account Balance: 44,456.66 Million KHR³

Number of active microfinance borrowers: 878,559³

Number of active microfinance depositors: 126,099³

Percentage of women against total number of active borrowers: 81%³

Percentage of women against total number of active depositors: 74%³

Exchange rate: US\$1 = KHR4,187

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Most of the population works in the agricultural, garment, or construction sectors, the largest contributors to the GDP. Given this context, the RGC has made much headway to facilitate the development of the banking and financial sector by promoting a free-market economy.

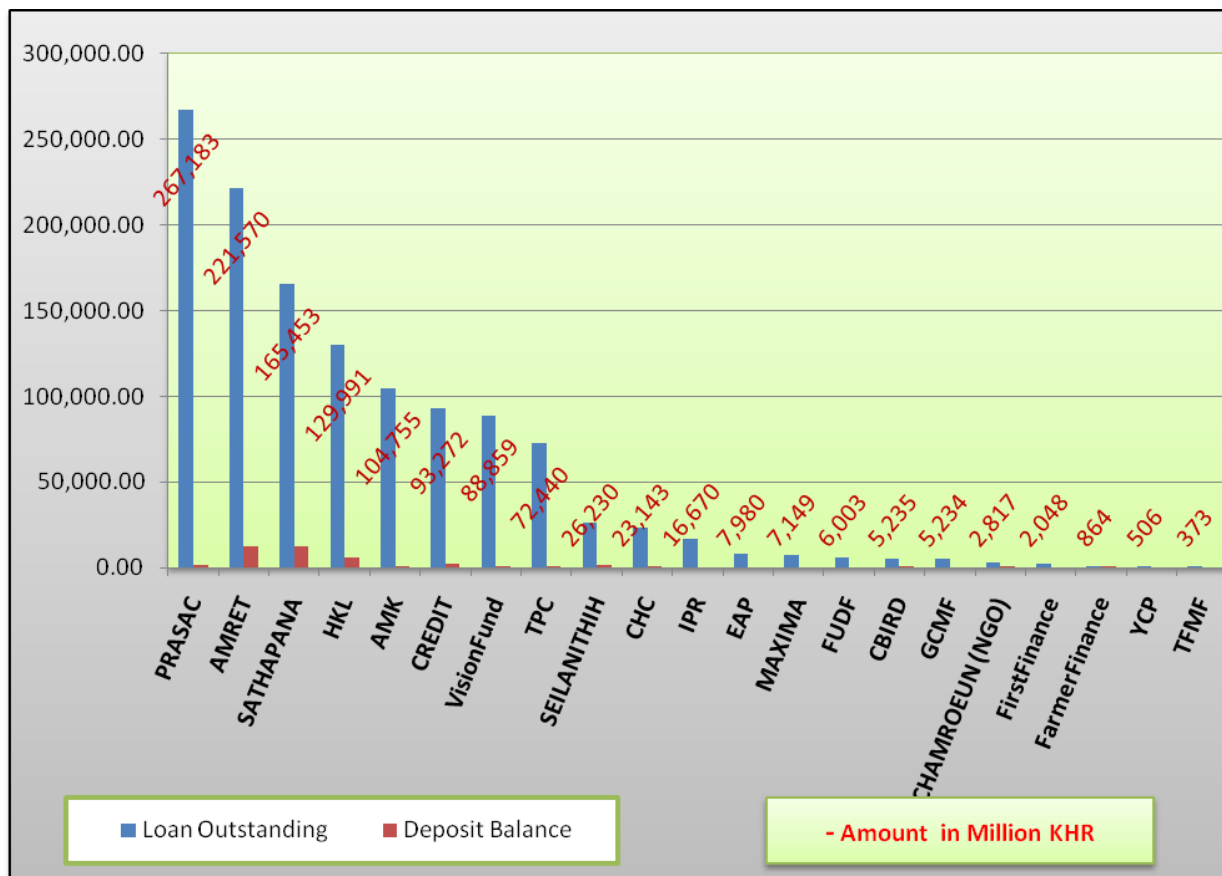
2. Microfinance Overview

20 microfinance institutions (MFIs) currently operate a gross loan outstanding portfolio of approximately 1,247,774 million KHR with a client borrower base of 878,559 mostly located in Phnom Penh and large provincial towns. See Charts 1 and 2 for operational figures broken down by MFI.

1990-1995: The First Microcredit Seeds are Planted

Microfinance in Cambodia emerged from non-profit microcredit projects initiated by international donors, NGOs, and institutions in the early 1990s. Without a working banking system, organizations such as GRET (1991), World Relief (1992), ACLEDA and CRS (1993) first ran microcredit projects by physically handling cash transfers themselves. After the international recognition of the new Cambodian government in 1993, aid started to flow into the country and into community rehabilitation projects.

Chart 1: Loan Outstanding and Deposit Balance per MFI as of December 31st, 2009³



¹ “General Population Census of Cambodia 2008. Final Census Results – Figures at a Glance.” *National Institute of Statistics*. September 2008

² “Sustaining Rapid Growth in a Challenging Environment – Cambodia Country Economic Memorandum.” *The World Bank*. February 2009

³ “Cambodia Microfinance Operation (December 31, 2009)”. Raw data. *Cambodia Microfinance Association*.

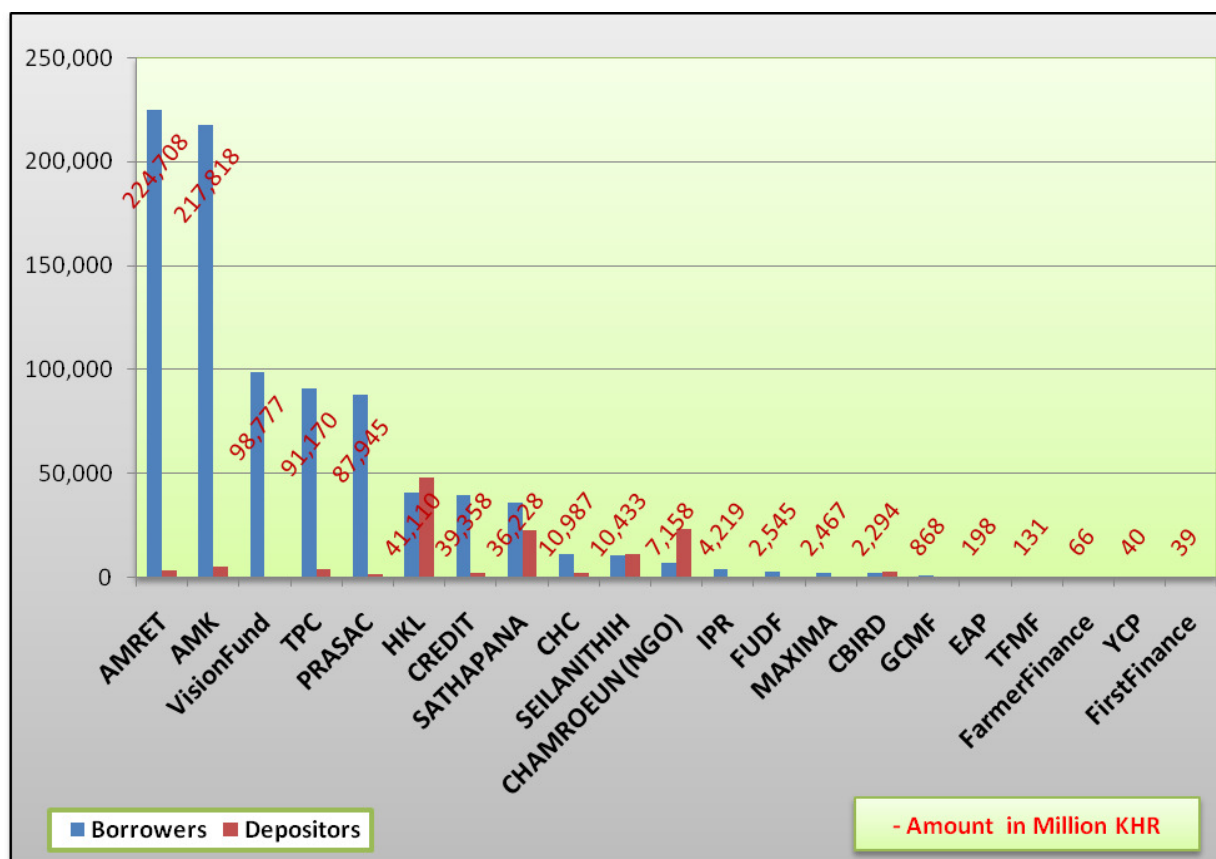
Despite several success stories, microfinance initiatives only reached isolated pockets of the population (approximately 44,000 in 1994).

1995-2000: Government-Supported Institutionalisation

In 1995, the RGC established the Credit Committee for Rural Development (CCRD) with funding support from UNDP and Agence Francaise de Developpement (AFD) to formulate a strategy for rural credit development, strengthen management, and manage funding. In 1997, the National Bank of Cambodia (NBC) set up the Supervision Office of Decentralised Banking System Bureau which was then separated in 2000 into two branches: the 'Specialized Bank & MFIs Supervision Office' to oversee the coordination, supervision and regulation of the sector and the "Project of Support

Microfinance Sector" to ensure capacity building. By 1998, the new industry served 214,000 people. Reaching a significant size also meant increased risks for clients as well as for microfinance promoters, thereby encouraging microfinance stakeholders to work towards formulating a regulatory framework. To this end, the NBC issued a sub-decree to license large deposit-taking institutions and to register the smaller ones. In 1998, the government set up the Rural Development Bank (RDB) as the main promoter of rural finance, and a state-owned apex institution, established to promote microfinance in Cambodia. The microfinance sector experienced exponential growth between 1995 and 1997, with a loan portfolio of 3,000,000 USD and 50,000 borrowers in 1995 to 15,000,000 USD and 225,030 borrowers in 1997⁴. This growth trend precipitated into the end of the decade.

Chart 2: Number of Borrowers and Depositors as of December 31st, 2009³



⁴ Duflos, Eric et al. "Country-Level Effectiveness and Accountability Review: Cambodia." *The Consultative Group to Assist the Poor*. January 2005.

2000-2005: Commercialisation and consolidation

In 1999, recognizing the MFIs' wider breadth of reach over the rural population, the RGC adopted a two-tier system under the laws on banking and financial institutions for supervising microfinance. A PRAKAS, or government decree, on microfinance regulation was enacted and implemented by the NBC in 2000. In October 2000 the industry leader, ACLEDA, transformed from an NGO into a specialised microfinance bank with the support of its founding donors and new institutional investors. This move set a precedent for other successful microcredit NGOs to transform into commercial MFIs. The procurement of loans from local commercial banks has generally been limited; however the RGC's support of a free-market economy and a more stable political environment attracted an astounding number of foreign private investors who financed approximately 80% of MFIs' loan portfolios since 2000⁵. Increasing efficiency has allowed MFIs to consecutively decrease their average annual interest rates charged to clients from 42% in 2003 to 32% in 2006⁶. The establishment of the Cambodia Microfinance Association (CMA) in 2004 by the NBC encouraged the microfinance sector to increase collaboration, including information sharing and training programs. Serving as a platform for MFI members and the NBC, CMA is mandated to operate as a sub-division of the Association of Banks in Cambodia (ABC) in accordance with the legal framework and is entitled to negotiate directly with NBC on relevant microfinance matters.

2005-Present: An Integral Economic Player

Since 2005, the microfinance field has undergone significant changes. In 2006 NBC with technical assistance from the ADB established a Credit Information System (CIS)

⁵ Chou Vannak, Deputy Director of the Financial Industry Department, Ministry of Economy and Finance. CMA interview. 17 December 2009.

⁶ Microfinance in Cambodia: Taking the Sector to the Next Level." *The International Finance Corporation*. June 2009.

designed to collect and share negative credit information from commercial banks. The scope of information available to MFIs has been very limited thereby decreasing incentives to use it. Between 2006 and 2008, microfinance activities fostered a healthy environment with the number of borrowers growing from 23%, 29% to 31% during each respective year, while total MFI lending increased at a rate of more than 55% per year. This growth was however stumped by the global financial crisis in between 2008 and 2009 as elaborated in the next section. The PRAKAS on Licensing Microfinance Deposit Taking Institutions was issued in December 2007 by NBC which grants eligible MFIs to receive deposits from the general public. This has provided MFIs with cheaper sources of funds, mainly in the local currency, and comes at a crucial time as foreign investment has contracted significantly as a result of the global economic slowdown.

3. Industry Challenges

After having pushed through the past decade with tremendous growth, the Cambodian microfinance sector is currently undergoing numerous stress tests. The following section presents the significant challenges faced by the sector.

3.1 Environmental Threats

Global Financial Crisis

The recent global financial crisis adversely impacted Cambodia's national economy across all sectors including its microfinance sector. This is reflected by the rising nonperforming loans (NPL) and portfolios at risk (PAR) ratio: NPLs rose an estimated 2.3% in 2009, up from just 0.67% in 2008⁷ and as of September 30, 2009, the PAR ration rose 0.5%, up from the previous quarter's 2.7%. Due to contracting market demands, MFI clients have strained themselves to meet payment schedules, which in turn jeopardize MFIs' ability to pay back investors. The

⁷ Sovan, Nguon. "MFIs Suffered Difficult 2009." *Phnom Penh Post* [Phnom Penh] 18 Jan. 2010. Print.

market volatility resulted in a curtailing of foreign direct investment and a very competitive race to procure funding from limited sources. Hence, the economic crisis has fervently shaken the Cambodian microfinance sector, exposing many of the pre-existing weaknesses and ensuing challenges outlined below.

The industry has however shown strong signs of recovery over the first half of 2010.

Box 1: Cambodia's Microfinance Amid the Global Financial Crisis – A Concerted Initiative

In August 2009, CMA, NBC, IFC and EU co-organized the *National Conference on Cambodia's Microfinance Amid the Global Financial Crisis* at the Phnom Penh Hotel, in Phnom Penh. Together, 500 participants discussed the roles and responsibilities of different stakeholders, namely MFIs, regulators, and government authorities, in promoting financial inclusion, consumer protection while further developing the Cambodia's financial sector. They shared effective practices on responsible lending and debt collection and non performing loan (NPL) management. They also discussed strategies in raising public and local authorities' awareness on the benefits of microfinance and its contributions to the development of Cambodia's financial sector and ultimately the national economy.

3. 2 Sector Weaknesses

Multiple Loans

The prevalence of multiple lending, whereby an individual has taken out loans from more than one MFI, has reached a strenuous point. Some clients have taken out as many as 4 to 5 loans which they are unable or unwilling to pay back. These unfavourable cases leave the respective MFIs to resort to suboptimal actions, including selling the clients' collateral, writing off the outstanding loan as nonperforming, restructuring or rescheduling the loan, or bringing the client to court. The

root causes of this mounting problem are presented below:

Lack of a thorough preliminary credit assessment

Currently, loan officers provide loans without conducting detailed assessments of clients' credit history. Loan officers may lack proper capacity building and training or may feel pressure to reach a loan quota in order to earn commission or favourable opinion from their branch managers.

Box 2: Healthy Competition Workshop Focuses on Tackling Multiple Loans, Sihanoukville, Cambodia

On December 3rd and 4th, 2009 CMA organized the third annual *Healthy Competition Workshop* in Sihanoukville, presided over by Mr. Kim Vada, Deputy General Director of the NBC, and 150 participants from NBC, MEF, RDB, ACLEDA Bank, CMA, 19 MFIs and 9 registered NGOs. The objective of the workshop was to discuss strategies to strengthen the Cambodian microfinance industry. The two-day workshop focused primarily on multiple loans as requested by the majority of participants. Together they shared individual cases of multiple loans and outlined the perceived root causes of the problem at hand. They also relayed thoughts on how to improve capacity building for MFI staff and strengthen relationships with potential competitors who operate within the same communities. The workshop adjourned with CMA and its members drafting an MOU on healthy competition, which will suggest alternative solutions to dealing with the existing cases of multiple loans and the precautionary steps needed to prevent future such cases. The MOU will be agreed upon and signed by all CEO members in the next CEO meeting.

Weak credit-reporting system

The Cambodian financial sector is equipped with a dismal and incipient Credit Information Sharing System (CIS). It is based on a single database owned by the NBC, which MFIs have very limited access to, and is not user-friendly. Furthermore, the system provides only negative information and consumer rights regarding data are not properly addressed.

Issuing of multiple land titles by local authorities

The Ministry of Land Management recently issued a Land Law to manage the issuing of land titles by local authorities. Loosely enforced, multiple land titles for the same land lot to villagers continue to be issued in return for kickback pay and constituent support. Clients often provide these duplicate land titles as collateral for their loans to multiple MFIs.

3. Challenges for the Future

Mission Drift

Currently, much ambiguity exists concerning the actual social impact Cambodian MFIs have on their clients due to the high costs of conducting impact assessments. On one hand, the commercialisation of MFIs has raised the concern that Cambodian MFIs are increasingly derailing from their social mission. ACLEDA Bank is the most widely-cited case, starting as a NGO, then burgeoning into a commercial bank in 2000 and currently providing medium-sized and large loans to a wide range of customers⁸. On the other, advocates of continued commercialisation argue that the incorporation of MFIs and a more acute definition of target clients are natural steps during expanding operations, and are ultimately beneficial to society. Regardless, striking a balance between the different objectives of an MFI is fundamental

⁸ Sanae, Ito. "Cambodian Microfinance: A Case of Successful Commercialization?" *Forum of International Development Studies*. Sep. 2008: 19-33.

in creating sustainable growth for Cambodia's microfinance sector.

Lack of Product Diversification

Credit is the primary financial product offered by MFIs and is offered mainly to small businesses and individuals, with very limited group lending options. Given this saturated credit culture, the current number of savings accounts is relatively low as illustrated by the number of active savers vis-à-vis the number of borrowers, 126,099 and 878,559 respectively. Currently only 4 MFIs (AMK, HKL, Amret and Sathapanahave) successfully been granted licenses to collect deposits from the public due to legal and budgetary setbacks; however several applications are currently being processed. The potential number of savers is however tremendous and its impact could be even more significant as it may likely decrease MFI dependence on foreign direct investment for loan portfolio financing. Recognizing this high potential, the ADB launched a technical assistance for the Royal Government of Cambodia to help address these issues. The resulting national survey concluded that "of the total potential savings of \$350,680 [from a survey pool of 801 households], 67% is stored in gold, jewellery and/or cash."⁹ According to additional investigation by the survey team, Cambodians have a high propensity to save, rural and urban populations alike.

Limited credit

Credit is reserved predominantly for entrepreneurial activities while credit earmarked for consumption, such as paying school fees and medical bills, payment services, money transfers, or insurance services is very limited. Moreover, current credit options are not tailored to the majority of clients' lifestyles and financial preferences. For example, 80% of Cambodians live in the provinces and work in the agriculture sector

⁹ Chandrarot, Ph.D., Kang and Liv Dannel. "National Survey on Saving Needs and Opportunities for Poor Households in Cambodia." *Asia Development Bank and Cambodia Institute of Development Study*. March 2007.

whose performance is linked to variable seasonal crop yields, making income yields uneven and unpredictable. Although only monthly basic loans are available, Cambodians prefer to make payments annual basic, whereby both principal and interest are paid at the end of the annual cycle.

4. Opportunities

Though extremely challenging, the aforementioned challenges present opportunities for Cambodia's microfinance industry to reinvest in its mission so as to ensure the sustainable delivery of financial services to their clients.

4.1 Developments in Cambodia's Economic Environment

Credit Bureau

On May 12th 2008, the NBC signed a MOU with the IFC wherein it was appointed to conduct a feasibility study for establishing and operating a "for profit" credit reporting company to serve both the financial and nonfinancial sectors¹⁰. The methodology used to assess the demand for a better reporting system was a series of in-person interviews with sector stakeholders, including representatives from the NBC, ADB, IMF, CMA, and MFIs. The responses were a nearly unanimous support for a "for profit" credit bureau, as it would include both positive and negative information of the client and would be used by both the banking and microfinance sectors. However, the installation of such a system presents a daunting task in terms of legality and financial viability: the existing legal framework will take time to amend while the initial projected capital required to install the credit bureau amounts to approximately 2 million USD. Nevertheless, the NBC recognizes the inefficiency of the current CIS and is taking the steps necessary

¹⁰ "Country Assessment Report and Preliminary Technical Assessment of Data Providers / Users in Respect of Cambodia". *International Finance Corporation*. July 2008.

to implement a comprehensive credit bureau by the end of 2010.

Cambodian Stock Exchange Market (CAMEX)

With limited long-term domestic investment opportunities, Cambodia's national economy is tied to the supply of foreign direct investments which in turn rides on the fluctuations of the global economy. In response to this unfavourable dependency, the MEF has worked with Korea Exchange to launch a Cambodian securities market¹¹ by the end of 2010. Although many doubt the Cambodian economic environment's level of sophistication to successfully execute the new stock exchange, the MEF is optimistic that this will create more opportunities for companies, including MFIs, to raise capital. Seeking to procure new sources of funding, MFIs will first observe the selective few companies who have expressed interest in listing initial public offerings on CAMEX.

4.2 Developments Specific to Cambodia's Microfinance Sector

The microfinance sector's future in Cambodia rests on its ability to sustain the sector operations. Therefore, all stakeholders have the responsibility to coordinate and collaborate with each other on specific objectives and tasks so that MFIs, clients, and investors can together afford the success it has experienced up-to-date.

Product Diversification

Savings Mobilization

Current figures suggest that the sector could highly benefit from savings mobilization initiatives as deposits encompass both a demand-led and supply-driven model by offering clients an alternative savings channel while generating a domestic source of financing. In 2005 the Asian Development Bank (ADB) launched a technical assistance (TA) for the Royal Government of Cambodia

¹¹ Postlewaite, Susan. "Coming Soon: A Cambodian Stock Exchange." *BusinessWeek*. 25 Oct. 2007.

(RGC) to address the lack of a savings product. As a component of the TA, the ADB in partnership with the Cambodia Institute of Development Study (CIDS) conducted a national study on the saving habits of poor people in rural and urban Cambodia and identified two significant trends on saving habits in Cambodia¹². First, most rural Cambodians store their savings in gold, land, livestock, or simply under their pillows, all of which are subject to theft or devaluation. Second, many have expressed interest in securing their disposable income in savings accounts, however most lack access or are uninformed of the available savings products and their respective benefits.

On December 13th 2007, recognizing the importance of savings mobilization and the foreseen benefits of voluntary deposit services for the Cambodian microfinance sector, the NBC issued the PRAKAS on Licensing of Microfinance Deposit Taking Institutions which authorizes qualified MFIs to collect deposits from the public. Although the strict requirements and conditions outlined in

Box 3: “It’s Our Money We’re Talking About” – Media Campaign to Mobilise Savings

In 2008, the ADB partnered with CMA and 3 MFIs to produce “It’s Our Money We’re Talking About”, a thirty-minute video spot on savings mobilization. The segment features anecdotes of current MFI clients most of whom stored their savings in gold, land, and livestock. The video concludes with an interview with a NBC senior representative who presents the role of MFIs and savings. Although lack of funding stopped the documentary short from having airtime, it may be used as an effective promotional tool to mobilize savings amongst MFI clients in the future.

¹² Chandararot, Kang Ph.D. and Liv Dannet. “National Survey on Saving Needs and Opportunities for Poor Households in Cambodia.” *Asian Development Bank and Cambodia Institute of Development Study*. March 2007.

the edict have made applying for a deposit-taking license a lengthy process, including minimum length of sound operation and capital requirement, they are necessary to ensure depositor protection. Today 4 MFIs, including Amret, SATHAPHANA, AMK, and HKL hold a deposit-taking license.

License-holding MFIs have indeed experienced a marked increase in their deposit balances compared to their counterparts unequipped with a savings license: deposit balances have more than doubled for both Amret and SATHAPANA, both of which were granted deposit licenses from the NBC in early 2008, from 3,522 Million KHR to 12,209 Million KHR and 5,609 Million KHR to 12,738 Million KHR, respectively. The surge in domestic capital is timely as foreign investment has curtailed significantly. In addition, MFIs are no longer subjected to foreign exchange rates making the cost of borrowing more affordable.

Microinsurance

Microinsurance is nascent to Cambodia’s microfinance sector, and regulation is currently being drafted by the MEF. Since 2007, VisionFund Cambodia and CHC have experimented by rolling out microinsurance pilot projects. Currently Vision Fund has over 360,000 micro life insurance clients, three times higher than its credit clients, and has paid claims to 509 beneficiaries of deceased family members amounting to 53,401 USD. CHC has 7,080 micro life insurance clients and has paid claims to 5 clients amounting to 2,003.54 USD¹³.

Mobile Banking

Mobile banking is the newest addition to the product catalogue, attracting much attention from both the banking and microfinance sectors. WING, a subsidiary of the Australia and New Zealand Banking Group (ANZ) is the first company to introduce mobile banking. The product is now available in all of

¹³ *Vision Fund and CHC Micro-insurance Report*, Oct 2009.

Cambodia's 24 provinces, targeting unbanked customers and allowing them to save, make purchases, transfer money to both WING and non-WING users, all through mobile phones¹⁴. WING has partnered with VisionFund by enabling it to disburse loans and collect payments electronically. The MFI also sees the opportunity to provide their customers with financial information, such as market data, via their phones. A successful execution of this partnership is likely to catalyse other MFIs to incorporate mobile banking into their operations.

Merging

Cambodia's maturing and increasingly competitive finance industry has stimulated discussion about consolidation in the microfinance sector. Today, operating and capital financing costs are the two biggest hurdles expending MFIs. Some regions are experiencing an oversaturation of MFIs, with the ration of MFIs to population having reached a point where MFIs are facing increasingly unfair competition.

Merging would create economies of scale for the sector, limit the cases of multiple loans, and expend less for operations overall. Economic analysts and MFI stakeholders foresee that merging will take place only in the distant future as they favour an organic growth rather than prematurely taking on a project.

5. CMA's Outlook on the Sector

The first half of 2010 has already brought major microfinance stakeholders together to elaborate on sector strategies which will help overcome the effects of the global financial crisis. CMA members have also agreed and signed on CMA's 3-year business plan. CMA will remain as a neutral moderator to serve the interests of all MFIs and clients. Acknowledging that some solutions may require longer strides, the sector will use interim steps in the meantime. Hereby, as the Cambodian microfinance sector moves forward, CMA is optimistic that the current challenges will be viewed as opportunities to reinforce the sector.

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¹⁴ Firpor, Janine. "Mobile Banking Takes WING in Cambodia." *The World Bank: Private Sector Development Blog*. 27 Feb. 2009.