The Development of Micro Finance in Cambodia

Dr. Kang Chandararot, a researcher at CDRI, provides a short analysis of some of the key issues affecting micro finance in Cambodia.

The micro finance system in Cambodia was established at the beginning of the 1990s with the help of micro credit promoters and external aid.[1] In 1990, micro credit was mainly extended by GRET (Group de Recherches et d'Echanges Technologiques). The amount set aside was US$100,000, to serve round 4,000 people.[2] After the general elections in 1993, Cambodia had an internationally recognised government; consequently, additional foreign support was available, and a number of micro finance providers emerged. The number of (national and international) organisations providing micro credit exceeded 30 in 1994 and 55 in 2001. The loans outstanding up to February 2002 were about US $38 million, borrowed by 449,100 clients. At the same time, savings from 211,981 depositors in micro finance institutions amounted to about US$4 million.[3] Micro finance operations are countrywide, spanning across all the 24 provinces. The biggest institution is ACLEDA, providing 58 percent of the total loans outstanding up to February 2002. ACLEDA is presently operational in 14 provinces.

A new national institution, the National Rural Development Bank, was established to promote micro finance in early 1998. It has been assigned the task of co-ordinating finance and refinancing all micro finance institutions and commercial banks that have the intention to support rural economic activities. Parallel to this, the National Bank of Cambodia has enacted a Law on Banking and Institutions, to govern and license micro finance institutions. This law has been created to provide opportunities to national and international financial organisations and credit providers, to undertake micro finance activities as well as link micro finance activities to the formal banking system.

Despite this systematic and co-ordinated effort, the credit needs of the rural poor are not being met. Up to February 2002, only 23 percent of the total number of families in rural areas had access to institutional finance. And, according to some, there is a shortage of up to US $ 120 million in credit available to this sector. In the final analysis, the needs of the rural poor can only be addressed if, either the present institutions are able to access additional finance, or new institutions begin to provide micro credit. This paper will examine these two issues in turn.

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Accessing Additional Finance

For all practical purposes, micro finance institutions have three options in financing additional credit:

- through the savings of depositors, or/and
- through borrowing from other institutions, or/and
- through extra capital from shareholders and donors.

Thus far, savings with micro finance institutions are small. The average saving per member (up to December 2001) was just US$19, while the average loan per member reached US$81. The proportion of credit financed by savings was on average only 23 percent. The highest ratio between savings and credit was registered at 95 percent with the institution USG, while ACLEDA, by far the biggest institution, achieved a figure of just 10 percent. On this evidence, it would seem that credit is predominantly financed by loans from other institutions and/or from shareholders, and not from savings.

In terms of gaining additional credit The Rural Development Bank (RDB) is deemed the most important institution. But according to the requirements of the Asian Development Bank (ADB) - where RDB's credit capital is found – the RDB can serve only those institutions that are licensed by the National Bank of Cambodia (NBC). There are just two licensed micro finance institutions, E.M.T. and HATHA KAKSEKAR. As a result, only about US$1 million out of the US $20 million credit made available by the ADB, has been transferred by the RDB to users through its two (licensed) partners. This source of financing credit is very restricted if the present stipulation of the NBC and the ADB continues to be enforced.

Most of the micro credit lending institutions (including ACLEDA, which is a specialised bank) rely on the third option; i.e. credit from shareholders and donors. Conditions, however, apply here as well. Firstly, interest has to be paid, and second, an institution has to prove its "financial viability". If an institution does not prove to be financially viable over a reasonable period, it loses the trust of the shareholders, and hence the credit-supply as well. So, how can financial viability be achieved?

Financial viability depends on the lending institution and its clients. The institution has to design and monitor the entire process: the organisational structure, management and administration, and business policies. These elements determine the interest rate to be charged per loan, as the interest has to cover the operating costs of the institution. These include the costs of funds, risks, and expenses related to expanding the business. These costs determine the so-called *minimum rate of interest. The lending institution is financially viable only if the interest rate it charges is equal to or higher than this minimum rate.*

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Despite the wages of staff being low, the operating expenses in Cambodia are high. This is due to poor infrastructure in rural areas, high costs of communication, high credit risks, and high costs of funds from donors and shareholders.[4] For example, E.M.T. has fixed the annual interest rate at 48 percent, which breaks down to operating costs (31 percent), cost of funds (15 percent), and cost of business expansion (2 percent). [5] The interest rates for loans, in riel, range from 3-5 percent per month, and in dollars, from 2-4 percent. This was an example from one institution. It is not necessary that all institutions will have their costs covered within 48 percent per annum.

Next, covering costs by setting adequately high interest rates does not necessarily mean that financial viability will be realised. This would be realised only if the borrowers also agree to borrow at that rate and are able to pay the money back. *This is possible only if clients feel they can benefit from the credit despite the interest rate*. Thus, a minimum profit from the venture for which the money has been borrowed has to be ensured, to pay the minimum interest rate. The logical question then is what determines this profit? In every economic activity, there are output prices and input costs. In order to make a profit, prices must be maintained at a certain (minimum) level, and the costs should be contained within a (maximum) ceiling. Could the market and production conditions permit assurance of a profit?

More credit could be provided if commercial banks expand their services to rural areas. At present, commercial banks concentrate their business in urban areas, reasoning that operating in rural areas is a "high risk" venture.

In Cambodia there are three main factors suppressing output prices:

- *Low purchasing power*: Most micro credit clients work in agriculture and small enterprises. Products emerging from their activities are mainly meant for domestic markets, where the number of purchasers is small. Next, the demand for these products stems mainly from the low-income classes whose purchasing power is generally low.[6] This low demand limits the ability of the producers to command a high price for their produce.
- *Role of middlemen*:[7] Middlemen have an important influence in setting prices. Goods are produced in rural areas, while they are often sold in urban areas, and this opens the door for middlemen. Due to poor infrastructure linking the production areas to the market and the poor communication and transport system, only a small number of middlemen are able to operate; creating a near-monopoly situation. The situation is complicated by the procedures related to obtaining licenses for being middlemen, for which they have to incur costs. The smaller number of middlemen narrows the channel to the market for the producers (clients of micro credit). Consequently, they (the latter) are at a disadvantage *vis a vis* the middlemen. [8] The scope to reap sufficient profit, therefore, is small.
- *Competition*: Liberalisation of markets in ASEAN member states, especially for agricultural products, has forced Cambodian farmers (or rural people), who actually represent the main clients of micro credit, to face stiff competition against producers from abroad. The prices of imported products (especially from the agricultural sector) are lower than the ones domestically produced because of better production conditions prevailing there. The price of domestic products has to be kept low for domestic producers to stay in the market. In the recent past, data has shown that the food price index has been negative for some time. [9]

These three factors, affecting price levels, make the poor unsure about borrowing money, since they are not confident about making a profit. The situation is in fact worse, since production conditions too, are adverse - technology is rudimentary and management skills are low. In addition, costs associated with dealing with the authorities are high. Each of these pushes the production costs yet higher. [10]

It is clear that, in the present market and production conditions, clients of micro credit face huge difficulties in realising a profit large enough to cover interest rates set by the micro credit institutions. The high risk incurred by the borrower is transferred to the lender as well since defaults in repayments can and do occur, which in turn makes the whole micro credit a business risky investment. The fact that the poor borrow money, despite the high risk, could be explained because *it is the only chance people have as opposed to remaining poor*. Statistical data showing a relatively high repayment rate, between 94-98 percent (with the exception of CCB with 86 percent and KFA with 88 percent), may not mean that borrowers are better off. More studies on the internal economics of the borrowers may be essential before firm conclusions are drawn. Nevertheless, the conditions are not present for shareholders and donors to invest additional capital in micro credit institutions.

The Expansion of Commercial Banks into Micro Credit

More credit could be provided if commercial banks expand their services to rural areas. At present, commercial banks concentrate their business in urban areas, reasoning that operating in rural areas is a "high risk" venture. What is the high risk?

High risk, here, can originate from risk due to poverty and risk due to low profit in contrast to the investment. Perennial poverty adversely influences the ability to manage a loan. Poor people could use the credit in unproductive ways; for example for covering immediate costs like medical bills, funeral and wedding fees or even paying for food. Poverty can also affect the willingness and ability to repay.

Even if the risk due to poverty is discounted, commercial banks still foresee risk in extending credit to the rural people. For example, there is risk due to low profit on investment. It has been described that production and market conditions limit the ability of the poor to benefit from credit: the probability of the profit rate being less than the interest rate cannot be ruled out. Therefore commercial banks continue to provide credit at relatively low interest rates in urban areas, where there is less risk, instead of venturing into rural areas. As of April 2002, based on data collected by the NBC from 17 commercial banks (including Foreign Trade Bank of Cambodia), the average interest rate for 12 months credit, in riels was 21.30 percent, while in dollars, 17.14 percent. [11] The lending, however, was for low risk ventures in urban areas.

In order to get additional credit for micro credit activities, through expansion of commercial bank's services, conditions that ensure high profitability on investment must be met. How this can be achieved will be explicated in the next article in this series.

Summing Up

Micro finance in Cambodia can be an important tool in alleviating poverty but only if certain conditions are met. The institutions need to provide more credit and this has to be financed from somewhere. The licensing conditions of the NBC combined with the credit conditions of the ADB limit the amount of capital available to micro credit institutions. This certainly needs to be addressed through negotiation. It could be financed by encouraging the poor to save more. But this presupposes that the poor have money to save, and this occurs only if their investments make a sufficient profit. Other institutions and commercial banks could provide micro credit but are unwilling to do so due to unfavourable conditions, which makes lending a high-risk proposition in rural areas. The risk to the commercial banks and indeed all credit institutions is a risk transferred from the poor when and if they take out a loan. The rural poor face many difficulties economically. They are unable to get good prices for their products due to the bargaining position of middlemen and the local preference for imported goods. The roads are in a bad condition and communication can be problematic. They have little or no modern technology. These all need to be addressed before they feel confident that borrowing money is more an opportunity rather than a risk. Finally, credit institutions must ensure they charge the lowest possible interest rates.

Policy Recommendations

In light of the issues mentioned above, some policy recommendations can be drawn and need to be acted upon to improve the micro finance system in Cambodia.

1. To hold regular and open discussions between RDB, NBC, ADB, micro finance institutions and representatives from borrowers;
2. To set up a team or body to ensure that the prevailing interest rate is the same as the minimum interest rate required;
3. *To not target micro credit on the poor per se, but to target those people who do not have access to credit from commercial banks or whose applications have been rejected due to the size of their businesses (considered too small).* This will enable broader expansion of micro finance to the whole country, both rural and urban areas. The funds will also be used more productively.
4. To raise import duties on goods that are in competition with those produced by the poor (clients of micro credit). This is the 'infant industry argument', and it would reduce the external pressure on prices.
5. To make it easier for the poor to access markets. For example, laws can be enacted concerning monopolies and trade regulation. If the ability of middlemen to monopolise access to markets and thereby control on prices is reduced, the opportunity for the poor to obtain a better price for their products is correspondingly increased.
6. To improve the infrastructure, especially the roads, so that transportation costs can be reduced;
7. To reform the administration so that the costs caused by bureaucracy and administration will decrease;
8. To target training and education in order to develop the capacity of the poor. Their ability to make optimal use of credit, in the process, will be improved.

Endnotes

1. vg Snab (1985)
2. By interview (13.11.2001) with H.E. Son Koun Thor, Chairman and chief executive officer of Rural Development Bank.
3. Working paper (2002) of NBC and RDB obtained by interview (10.06.02) with H.E. Son Koun Thor.
4. An additional 7% interest is charged; 3% is the so-called country risk (the risk of lending to Cambodia) plus 4% LIBOR (London Inter Bank Offer Rate).
5. The Second Commission of the Senate (2002): Minutes of Forum Discussion on Micro Credit in Cambodia.
6. People from high-income classes prefer goods from abroad.
7. The term also refers to women who play this role in Cambodia.
8. This can be confirmed by a case study conducted in Koh Dach (Kandal Province), 02.04.2002.
9. See CDRI: Flash Report on the Cambodian Economy, monthly.
10. This can be verified by two case studies on brick making in Battambang and a Vegetable plantation in Kandal, conducted in 18.01.2002 and 14.01.2002, respectively.
11. Data document of NBC (2002).

References

Bousso, P./Daubert, P. etc. (1997): The micro-economic impact of rural credit in Cambodia. GRET, Phnom Penh.

Continued on Page 11