

# Why are Cambodian Banks Reluctant to Lend to SMEs?\*

**The Mekong Private Sector Development Facility (MPDF)<sup>1</sup> summarises a study on Financing SMEs in Cambodia: Why do Banks Find it so Difficult?**

One of the most frequently mentioned constraints that slows the growth of the private sector in Cambodia is the lack of access to medium- and long-term financing (loans with a repayment period of two to five years). This problem is particularly acute for small and medium-sized enterprises (SMEs), which make up the largest part of the private sector. Only one percent of all loans made to SMEs are for more than two years.

The issue is not that lending to SMEs is unprofitable. On the contrary, lending to SMEs is more profitable for commercial banks than lending to the general credit market. Research by the MPDF, on which this summary is based, shows that banks earn more from lending to SMEs than they do from lending to other types of borrowers such as large enterprises. The weighted average SME lending spread for the 12 banks surveyed out of a total of 17, is 18.9 percent, compared to the general average spread of 15.5 percent.

Despite the potential profits to be made from SME lending, banks are reluctant to provide medium- and long-term loans because they consider the legal and the judicial system inadequate to protect their interests. For example, the absence of a Bankruptcy Law makes it easy for companies to liquidate their assets without paying their creditors. Also, while the current Land Law recognises the legal rights of those with long-term leases, and of those who lend money based on such leases, it does not provide enough guarantee to enable a lender to take over a long-term lease should a borrower default. This means that if a bank finances an investment project based on a long-term lease, its interest in the land is not secured. Consequently, lenders are reluctant to provide financing to SMEs who lease, rather than own, land.

The law that protects borrowers' privacy is another constraint because it means that lenders have no way of checking the credit worthiness of prospective borrow-

ers. In many countries it is normal practice for banks to share information about borrowers and some have established credit bureaus where lenders can check potential borrowers' credit history.

In addition to concerns about the lack of protection offered to them by existing laws, lenders are also constrained from making medium and long-term loans because they lack confidence in the fairness of the judicial system. When banks bring cases to court, they often find themselves having to pay numerous official and unofficial fees, which can cost a bank a significant percentage of the value of its loan. Moreover, because the judicial system is perceived to be 'for sale to the highest bidder,' the outcome of cases is highly unpredictable.

In conjunction with the legal and judicial issues that contribute to the lack of medium- and long-term financing for SMEs, is weakness in the credit market itself. On the supply side, bank staff do not have the skills necessary to analyse, assess and manage the risks associated with medium and long-term loans. For example, they do not know how to price risk appropriately or how to protect the bank from unforeseen risks. All of these uncertainties lead bank staff to compensate by setting high interest rates, making the cost of borrowing too expensive for many SMEs.

On the demand side, SME borrowers often lack expertise in convincing banks to lend them money and this also discourages banks from making medium- and long-term loans. Few SMEs maintain the minimally acceptable financial records that banks need to assess risk, and many SMEs maintain no records at all. This lack of records means that banks often have no way of assessing the viability of businesses. Consequently, they raise interest rates and lend only to borrowers who have adequate collateral. Not only is collateral required, but the only collateral that most banks will accept is land and buildings in major cities — something which many SMEs simply cannot provide.

To help resolve the legal and judicial problems that bar SMEs from securing adequate financing, new commercial laws should be enacted and old ones amended such as the law that protects borrowers' privacy. In order to adjudicate business conflicts as efficiently as possible, a commercial court should also be set up separately from the criminal court system. Because it may take some time to establish a commercial court, it is suggested that an arbitration system could be set up now to allow disputing parties to resolve their differences without going to court.

Market related problems could be reduced by providing training to bank staff that would increase their skills in assessing risk and setting appropriate interest rates. This could be supplemented by encouraging the establishment of local consulting services that would help SMEs prepare effective business plans. The establishment of specialised financial institutions such as leasing

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\* This article is based on the MPDF study, *Financing SMEs in Cambodia: Why do Banks Find it so Difficult?* (May 2003). For more information on the study, contact Mr. Hor Soneath, Business Development Officer for Research and Policy Dialogue, Telephone: (855)-023-210 922. Email: shor@ifc.org.

companies, supported by the passing of suitable laws such as Secured Transaction Law, could also help by giving lenders clear rights to any moveable assets they finance should borrowers default.

If recommendations such as these are followed (and MPDF is actively working on some of them with relevant partners), banks would be much more likely to provide medium- and long-term financing to SMEs—financing that they badly need to expand and modernise their operations. As is now beginning to be recognised, SMEs are Cambodia's best hope for economic growth and job creation.

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## From Planning to Action...

### Lessons Learned

Research undertaken on resource management committees in Kompong Phluk and Koh Sralao highlights how community-based management can evolve at a local level. Villagers are concerned about their forests and fishing areas, along with other community-level problems. Resource management committees see their work as enhancing community livelihoods, and they are willing to experiment with a range of strategies.

Villagers also perceive tangible results from this work: a few less crab traps stolen per year; denser forests; less farmland encroachment; and increased co-operation amongst villagers.

*We know that the resource management committee will help us. They have taught us about mangrove replanting and about protecting our resources. There are more crabs this year near the mangroves, and we now understand the relationship between mangroves and a healthier fishery (a fisher 2003).*

Although there is no baseline data to supplement villagers' perceptions of increased resources, what is important, at this point, is that villagers believe in this type of work.

Another important factor for the success of these two resource management committees is support from the Commune Council. Leadership, including the willingness to take risks, is also seen as critical to garnering the support of the local community. Both resource management committee leaders are respected within their village, and tend to be more influential within their community. Without such determination, commitment and support, these resource management committees could not be as successful.

Resource management committees have had the flexibility to address issues as they have arisen in the community. Neither committee is strictly bound by their mandate, recognising that they have the ability to problem solve around different community issues, whether this be environmental or social. For example, villagers

### Endnote

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recently hauled cement and other materials for the construction of a pagoda hall, used as a meeting place for different community events, up a steep hill in Koh Sralao upon request of the resource management committee. Resource management, in a way, is a vehicle for committees to address and problem-solve a range of community-level issues!

Legislation is being drafted to support community-level initiatives, however, a critical question remains: how can policy best be implemented to serve the interests of villagers, especially for those who do not separate their resources by sector (e.g., forest, fishery)? Further investigation is required to assess how different community-based policies identified in a range of legislation and programmes (e.g., community fisheries sub-decree, community forestry sub-decree, protected areas law, land law, local governance programmes, etc.) can best support village-level work, rather than lead to fragmentation via the creation of multiple committees doing similar work. As has been shown by experiences in Kompong Phluk and Koh Sralao, community-based management can emerge in many ways. Finding flexible approaches that support creative learning and problem-solving opportunities represents an important challenge for local resource management and development.

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