Financing SMEs in Cambodia: Why Do Banks Find it So Difficult?[1]

Dr Keith Carpenter, with assistance from OUCH Chandarany, discusses a 2003 Mekong Project Development Facility (MPDF) paper on bank lending in Cambodia.*

A CDR article in 2003[2] summarised the MPDF paper. The present article looks at the MPDF study from a practical banking perspective to offer an alternative view on the lack of bank lending in Cambodia, while conceding that significant institutional changes are also required. This article concludes that a key reason for a lack of lending to small and medium enterprises (SMEs) is within the control of banks.

The MPDF paper gives a comprehensive overview of the issues facing banks and SMEs in Cambodia. It suggests 15 reasons why banks do not lend to SMEs and makes eight recommendations, mostly related to the need to change institutional conditions. The recommendations, if implemented, would help banks to finance SMEs in the longer term. Based on the results presented in the MPDF study, this article argues that banks do not lend to SMEs in Cambodia primarily because banks do not see lending as their main focus, not simply because of any institutional weaknesses in Cambodia. This outcome probably results from a perception by banks that they can make sufficient income from their other (non-lending) activities without needing to be involved in SME lending.

This lack of focus on lending by Cambodian banks is very clearly demonstrated by an issue noted in the MPDF study: a shortage of bank lending officers (§3.13, p. 32). Some banks had only two or three people to cover lending, and these people often had other additional duties. In most economies, lending is the key function of banks and a major source of their income, yet in Cambodia banks do not appear to devote the resources required to generate loan assets and hence lending income. Banking is about lending, and lending requires risk assessments in order to charge appropriately for the credit risk that a bank takes on to its balance sheet as a result of making loans.

A recent informal survey of some of the larger banks in Phnom Penh on changes in the number of their lending or credit officers since 2002 revealed an increase in credit staff. There had also been an increase in lending activity. These increases may indicate that a more positive attitude towards lending is now emerging in banks.

Study Results

The MPDF study identifies 15 problems that constrain lending to SMEs. For the purposes of the analysis in this article, the issues have been categorised into five types:

1. Legal: requires a new law or legal framework.
2. Administrative: requires a change in the way an existing law is administered, rather than a new law.
3. Market: a result of the way the Cambodian financial system is organised or operates.
4. Credit policy: a policy or procedure that would be followed by most well-managed banks internationally in their approach to lending.
5. Bank: matters that are directly under the influence of local banks.

This article argues that the fifth category, matters within the control of local banks, is the main constraint on bank lending in Cambodia.

The problems identified by the MPDF, using the above categories, are listed in the following table.

Table 1: Reasons for Lack of Bank Lending to SMEs

No	Issue	Type
3.1	Inadequate laws	Legal
3.2	Weak judicial system	Administrative
3.3	Inadequately trained bank staff	Bank
3.4	Inappropriate risk pricing by banks	Credit policy
3.5	Banks accessible only in major centres	Bank
3.6	Incentive structure in banks	Credit policy
3.7	Bank's minimum lending criteria	Credit policy
3.8	Bank's lending processes	Credit policy
3.9	"Informal" credit market more efficient	Market/bank
3.10	Shortage of long-term funding	Administrative
3.11	High cost of long-term borrowing	Market
3.12	Preference to lend to individuals	Credit policy
3.13	Shortage of lending officers	Bank
3.14	Lack of specialised lending institutions	Market
3.15	Withholding tax on offshore funds	Administrative

The key problems within the power of the banks to change are: "bank staff are inadequately trained to analyse

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and manage risks of long-term lending to SMEs" (§3.3, p. 27) and "shortage of lending officers in banks" (§3.13, p. 32). Another issue within the control of banks is: "SMEs are unable to approach banks outside of major cities" (§3.5, p.28). While this latter point is a constraint on lending, it is a lesser constraint than the initial two. Banks presumably do not operate outside the major cities because they do not perceive a necessity to do so. This suggests that banks can gather sufficient deposits in the main population centres to fund their existing lending needs and that they do not see a market for their lending in the smaller centres, with the result that they do not expand their services to those centres.

A comment on a point listed above as a credit policy issue is appropriate. A lack of an incentive structure in Cambodian banks is thought to discourage credit officers from actively making loans. This is highly unlikely to be a constraint. Most well–managed banks would not provide business volume incentives for credit officers. Long experience suggests that paying credit officers an incentive according to the volume of loans that they write or approve is a sure way for a bank to get itself into lending difficulties.

The recommendations of the MPDF study can be similarly categorised using the list above.

Table 2: Recommendations of MPDF Study

No.	Recommendation	Type
4.1	Commercial court	Legal
4.2	Amend privacy legislation	Legal
4.3	Liquidity requirements	Administrative
4.4	Asset registry	Administrative
4.5	Risk training	Bank
4.6	Consulting services	Market
4.7	Specialised lending institutions	Market
4.8	Withholding tax	Administrative

The only recommendation within the power of the banks to change relates to training staff in risk assessment. This relates to the finding on inadequately trained bank staff. If banks are to increase their lending volumes, they will need to improve their risk assessment skills, and this is a matter that banks can control, as the study clearly states.

Lending margins in Cambodia are extremely high by international standards; the study suggests funding costs of up to 6 percent per annum and lending rates of around 19 per cent, which translates into a lending margin of about 13 per cent. Such a margin should be more than sufficient to cover all lending costs, provide a reasonable profit margin and provide an adequate loan loss reserve. Inadequate lending margins are unlikely to be the main reason for a lack of lending by banks to SMEs.

The Business of Banking

Banks are financial intermediaries; they borrow funds from economic agents with surplus funds and lend these funds to other economic agents needing to finance their activities. Banks charge the borrowers a fee for providing this service. This fee covers (1) the costs of collecting the funds from those with surplus funds, (2) the transaction costs involved in lending, (3) a margin to cover any losses if the borrower does not repay the loan and (4) a profit for the bank for risking its capital. The bank attracts deposits from those with surplus funds by undertaking to repay any deposits on demand, so that depositors are always assured of immediate access to their funds. Banks manage their balance sheets so that they are always able to meet any call on their funds on demand. To fail to repay depositors on demand would immediately cause a bank's source of funds to dry up, and the bank would go out of business.

A key problem with lending is that some borrowers may not meet their interest payment obligations or may not repay what they borrow. Such behaviour leads to lending-related losses by banks which must be met out of the bank's own funds, i.e. its income or capital, not from depositors' funds. To overcome such adverse behaviour by borrowers, successful banks develop a high degree of skill in "risk assessment". As a result, they know from experience and customer analysis which customers are likely to meet their borrowing obligations and which are likely to have problems. Associated with this approach is differential pricing for risk; potential customers assessed as having a higher risk of default should be charged a higher interest rate to compensate the bank for the greater probability of sustaining a loan loss. Most of this higher lending margin will go into a loan loss reserve to meet losses arising from lending.

The key concept in risk assessment is "Know your customer". A bank or any financial intermediary that takes the time and effort to know its customers and to understand the customers' businesses will be in a much better position to assess the risks involved in lending to a particular customer. "Know your customer" is more than understanding a customer's financial position. As important as that is, it also involves building a relationship with the customer so the bank can understand the way the business operates. Acquiring this customer knowledge takes time, but it is a necessary prerequisite for profitable lending, as successful banking relationships are ongoing long-term relationships that benefit both parties.

One finding of the study (§3.9, p. 30) notes that borrowers prefer to deal with the informal lending market because it is more efficient. Apparently, the informal market is also able to compete with the banks on pricing. This suggests that the informal market is much better at knowing the customer than banks, which is why customers prefer to deal in that market. The informal market is a form of financial intermediation, and it will also make a risk assessment of potential borrowers.

The informal market would be expected to deal with customers who have a higher risk profile than those of bank customers, as the informal market would not usually take formal security over a borrower's assets. The fact that the informal market can compete with banks on price suggests that banks have not been using their competitive advantage to compete with this market; i.e. banks have not been making the effort to know their customers, so it is not surprising that the informal lending market has been more successful in attracting customers.

The Cambodian banking market is not unique in having to operate under adverse institutional circumstances, as other banking markets in the past, and no doubt in the present, have suffered under the same constraints. Similar constraints have not prevented the development of vibrant and successful bank lending markets. Banks in such markets have worked within the constraints they face and focussed their energies on perfecting their risk assessment techniques through knowing their customers.

Conclusion

The key problem with bank lending in Cambodia is not the institutional conditions under which banks operate, but rather the way in which banks approach the lending market. Banks require a radically different approach to lending. They need to:

1. make the resource investment required to know their customers;
2. use this knowledge to assess the risk involved; and then
3. price loans for the risks involved.

These steps are within the control of banks. The other changes proposed by the MPDF study will make it easier for banks to lend to SMEs, but such changes will not be sufficient unless banks themselves make the investment of effort required to seek out profitable lending opportunities.

The recent informal survey by CDRI referred to above may indicate a positive change in Cambodian banks' attitude to lending. It may take some time before this change becomes apparent in the banking market but it does suggest that banks are beginning to place more emphasis on lending as one of their key activities.

Endnotes

1. MPDF (Mekong Project Development Facility), *Private Sector Discussions, Number 14, Financing SMEs in Cambodia: Why do Banks Find it so Difficult?*, May 2003.
2. "Why Are Cambodian Banks Reluctant to Lend to SMEs?", *Cambodia Development Review*, Volume 7, Issue 3 (Phnom Penh: CDRI, July–September 2003), , pp. 11–12.

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is therefore primarily developed as a research tool with this trade-off in mind. The results in terms of NPV can be read by policy makers, but specific skills in growth modelling and environmental economics are needed to modify the model and interpret the reliability of new results and their application to policy recommendations.

The model could in the future be further developed into a planning tool for sustainable natural resource utilisation. The complexity of modelling sustainable yields in natural ecosystems, however, points to the importance of linking natural resource management initiatives to capacity building of Cambodian natural resource planners and researchers. This way, more reliable national data on potential yields at different locations can be developed, and natural resource planners can develop their own models based on solid research, including indirect values that they identify and prioritise.

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