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Urban Land Titles, Formal Credit and SME Investment

Brett Ballard and Phim Runsinarith discuss the potential relationship between land titling, affordable credit and small and medium enterprise (SME) investment in three urban areas of Cambodia.*

This article discusses the potential relationship between land titling, affordable credit and small and medium enterprise (SME)¹ investments in three urban areas of Cambodia. Data gathered in late 2005 in conjunction with CDRI's urban land titling baseline survey suggest that SMEs are a potentially important source of employment in Phnom Penh, Siem Reap and Serei Saophoan (Banteay Meanchey). The employment impact of land titles therefore may be significant to the extent that they stimulate increased SME investments in new start-ups and expansions by promoting a more secure sense of tenure and aiding access to more affordable credit.

The assumptions and predictions about the expected benefits of land titling programmes are primarily based on property rights theories that link investment incentives to secure tenure. The basic argument is that people are more likely to invest in economically productive activities when they are confident that they, or their heirs, will enjoy the benefits of such investments (Brandao and Feder 1996; Barzel 1997). In regard to poverty reduction, de Soto (2000) has also argued that the poor in developing countries possess substantial assets, albeit in the form of "dead capital"² that cannot easily be used for investment. Governments should therefore provide property ownership in the form of legal titles, which the poor can then use as collateral to secure credit for investments in housing improvements, SMEs or other productive activities.

According to these arguments, the use of formal land titles to govern land tenure must be understood as part of a market-based approach to urban development that takes place within a broad arena of formal institutions.

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A SME producing steel doors and windows on street 271, Phnom Penh

These institutions include formal credit arrangements and well-regulated real estate markets (e.g., land use master plans, enforced zoning) that underpin any robust business environment (Payne et al. 2007).

The urban land titling baseline survey was conducted in October–December 2005. In Phnom Penh municipality, 1663 households were surveyed in three of four urban districts and all three peri-urban districts.³ Of these, 439 (28.4 percent) reported owning 470 SMEs, about 1.09

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SMEs per owner. In Siem Reap district, 536 households were interviewed in the urban commune of Sala Kamraeuk and the peri-urban commune of Siem Reap. Of these, 164 households reported owning a total of 192 SMEs, which

means that about 30.6 percent of the survey households operate an average of 1.17 SMEs. In and around Serei Saophoan town, 507 households were interviewed in the three communes of Kompong Svay, Preah Ponlea and Ou Ambel, where 241 households reported operating a total of 285 SMEs, an average of 1.18 SMEs per owner.

Table 1 shows that in all three urban areas, SME employment has increased since the businesses were initiated. In Phnom Penh, employment increased from 2.38 at the time of start-up to a current average of 3.13 employees, while in Siem Reap, employment has increased even more, from 3.42 to 3.78 per business. In Serei Saophoan, it has increased from 2.35 to 2.69. Given the definition of SMEs based on the number of employees, almost all the SMEs covered in the survey were in fact small businesses, while only a few could be considered medium. Assuming that the survey sample is representative of the general population, it would appear that the potential employment impact of SME development is significant.

It is therefore important to consider how these small businesses have been financed. Table 2 shows that in Phnom Penh, 91.9 percent of all sources of finance were "own sources". Siem Reap and Serei Saophoan had similarly high percentages of "own sources" financing at 86.1 percent and 85.0 percent respectively. In all three areas, informal moneylenders seemed to play almost no role in financing SMEs, while only a small number of loans were reported from commercial banks.

These observations raise the question of why so many small business owners continue to rely on own sources and family to finance business start-ups as well as to maintain or expand businesses. In a previous study, Kang (2005) concluded that a well-developed banking system may not be necessary for starting new businesses despite the conventional wisdom of traditional development economics. The security of contracts associated with borrowing from formal institutions may be offset by high levels of personal trust associated with informal

Table 2: Sources of Business and Livelihood Expenditures

Location	Own Sources		Family		Moneylender		Private Bank		Other		Total
	No	%									
Phnom Penh	440	91.9	29	6.1	1	0.2	4	0.8	5	1.0	479
Siem Reap	167	86.1	16	8.2	0	0	9	4.6	2	1.0	194
Serei Sophoan	256	85.0	26	8.6	0	0	7	2.3	12	4.1	301

borrowing.

Another possible factor is that investors may be unsure of or lack confidence in the viability of their venture. In Phnom Penh, for example, more than 81 percent of SME respondents who said that they were not seeking loans indicated that they either "strongly agreed" or "somewhat agreed" with the reason that expected profit from the business would not be higher than the interest on the loan. In Siem Reap, the figure was 75.5 percent.

Kang found that 70.1 percent of 648 surveyed SMEs ranked a lack of capital as the most significant constraint on business expansion, regardless of the location, size or type of enterprise. As the lack of capital seemed to be associated with an "insufficient accumulation of profit", Kang views the development of a sound banking system and legal security of contract as key components for solving these kinds of investment problems. In this sense, there is general agreement that better access to formal credit could and should play a larger role in financing capital investments.

In start-ups and expansion, collateral requirements are a constraint. Indeed, Kang found that 52 percent of 137 SMEs that sought a bank loan were refused, and of these, 60 percent were refused because of a lack of collateral. In the urban land titling study, among the Phnom Penh SMEs, 44.2 percent indicated that they "strongly agreed" or "somewhat agreed" that collateral requirements inhibited them from seeking commercial loans. About 30.5 percent also indicated that they "strongly agreed" or "somewhat agreed" that they had been refused a loan because of a lack of collateral. In Siem Reap, 45.1 percent indicated they strongly agreed or somewhat that collateral requirements prevented them seeking commercial loans.

This situation seems to be changing. According to recent discussions with bank officials, the number of loan applications and approvals has increased dramatically over the past year, especially for business expansions, including SMEs. According to anecdotal evidence, investors are still reluctant to borrow from commercial

banks for business start-ups because they are not willing to take loans when they are unsure of the returns on the investment. As a result, business start-ups continue to rely

Table 1: SME Employment, by Location

Location	No. of households	Permanent Workers		Daily Labour		Family Members		Total	
		Start	Current	Start	Current	Start	Current	Start	Current
Phnom Penh	436	239	310	59	125	739	929	1037	1364
Siem Reap	162	53	87	148	160	353	365	554	612
Serei Sophoan	241	53	92	36	46	477	511	566	649

primarily on own sources as well as on family and friends. However, once the business is up and running and owners see a steady and predictable flow of returns, they appear more willing to obtain loans from commercial banks to expand their businesses.

Such shifts in attitude about borrowing from commercial banks appear to be relatively recent. As the business climate in Cambodia improves and investors develop more trust in the banking sector, it is likely that the trend toward increased demand for credit for a variety of purposes will continue. Since commercial banks require “hard” land titles to secure such loans, it is quite likely that land titles will contribute to increased consumer and business borrowing. It is important to note, however, that such an increase probably could not be solely attributable to land titles; rather, such growth would represent the merging of several additional factors to form a virtuous cycle of development and growth. These would include business experience and skill (i.e., entrepreneurship), political stability and security, banks that want to lend and know how to do so (i.e., credit supply) and people’s institutional trust in banks. The development of credit markets and the business sector both seem to rely on many of the same factors regarding institutional trust. Once these factors are in place and functioning more efficiently, they will enable entrepreneurs to predict returns on investments with greater accuracy and reliability.

Other evidence from the urban land titling survey appears at first glance to support the observation that shifts may be occurring in attitudes toward borrowing from commercial banks. Table 3 summarises business-related loans and their sources. In Phnom Penh, of the 502 loans reported between the national election of 2003 and the end of 2005, 180 were for business start-ups, operations or expansions, 35.6 percent. In Siem Reap, 38.5 percent of all loans were for business-related purposes, while in

Serei Saophoan it was 33.8 percent. Of particular interest is the fact that Aceda Bank accounted for 41.1 percent of the business loans in Phnom Penh, while in Siem Reap it accounted for 48.0 percent. In Serei Saophoan, it was lower at 36.7 percent. When the micro-finance institutions (MFIs) are included, formal lending institutions appear to play a prominent role in financing business activities.

As the overall number of loans from all sources has increased steadily each year in all three urban areas, so has the number of loans from formal sources (i.e., MFIs and commercial banks). In Phnom Penh, the share of loans from the formal sector has increased from 37.5 percent in 2003 to 41.7 percent in 2005. However, even though the number of loans has increased each year in Siem Reap and Serei Saophoan, the share of loans from the formal sector has declined. In Siem Reap, the formal sector share of loans decreased from 54.1 percent in 2003 to 47 percent in 2005, even though the number of loans almost doubled.

There is, however, a seeming discrepancy in the data concerning business-related credit (Table 3) and SME financing (Table 2). The data concerning business loans suggest an increasing amount of borrowing from the formal sector, while the SME data show an almost negligible role of the formal sector in financing SME start-ups, operations or expansions. There are several possible explanations for this seeming discrepancy.

First, the data for all loans include all business-related activities, both small and large, some of which probably employ more than 10 individuals, while the SME data refer almost entirely to small enterprises that employ fewer than five individuals. It is more likely that larger businesses would require larger amounts of capital and would be more inclined to borrow from formal institutions. Larger businesses might also be better able to afford higher interest rates charged by commercial banks as well as to meet their strict repayment schedules than would SMEs.

Second, the data concerning credit cover only the period between the national election of 2003 and the end of 2005, while the data for SMEs cover the entire period since 1980. It should be kept in mind that even in the early 2000s, the banking sector was not much involved in loan activity. For example, a 2003 Mekong Project Development Facility paper suggested 15 reasons that banks had not been lending to SMEs until then.

Table 3: Loan Sources for Business-Related Activities

	Relative	Friend	Moneylender	NGO	MFI	Aceda	Total
Phnom Penh	147	32	97	23	27	172*	502*
Start-up	9	3	10	5	7	23	60
Inputs/Ops	14	2	4	2	1	16	40
Expansion	14	4	15	5	7	35	80
Siem Reap	49	7	37	5	26	71	195
Start-up	3	0	2	0	5	10	20
Inputs/Ops	4	0	4	0	2	6	16
Expansion	0	1	6	1	8	23	39
Serei Saophoan	23	5	54	7	15	41	145
Start-up	3	1	7	0	0	4	15
Inputs/Ops	3	0	6	1	4	4	18
Expansion	1	0	5	0	0	10	16

* This figure includes 1 loan from Canadia Bank.

Carpenter and Ouch (2006) argue that one of the main reasons for sluggish lending then was that banks did not want to lend. Since 61.8 percent of SMEs in Phnom Penh and 64.6 percent in Siem Reap were started before 2003, nearly all financing would have had to come from own or family sources.

A third, and perhaps more important, factor is that almost all reported loans from the commercial sector were from Aceda Bank, which has a branch presence throughout the country. In fact, only one loan was reported from Canadia Bank. Aceda's history as a micro-finance NGO whose lending practices are motivated by social objectives distinguish it from other commercial banks in Cambodia. If we take Aceda out of the formal banking sector, we see that other commercial banks have not been lending at all for any purposes, including business activities. As a result, except for the small number of loans reported from MFIs, most business activities are still being financed through informal sources, including moneylenders. The picture then looks very similar to that of SMEs concerning financing (i.e., mostly own sources and family, who generally provide interest-free loans with no collateral requirements). The only exception is borrowing from moneylenders who do charge interest. As SME operators appear to be concerned about interest rates relative to potential returns, they will avoid borrowing from moneylenders, while at least some larger businesses appear more willing to do so.

It appears then that, despite the anecdotal evidence concerning a shift in credit activity involving the formal banking sector, there is still a long way to go before SME investors fully embrace the traditional commercial sector and vice versa. Although the difficulties associated with collateral requirements may be substantially resolved with land titles, the data clearly suggest that SME investors also perceive other constraints in obtaining loans. As discussed above, business profitability relative to interest rates is especially important. Even Aceda's interest rates on small loans were still very high in 2004–2005.⁴ This suggests that while land titles may indeed improve access to commercial loans by providing collateral, other constraints must also be addressed for the effects of land titles to be fully realised. Land titles are probably necessary, but they not sufficient to stimulate increased investment in SME start-ups and expansions.

Conclusion

Although the credit data suggest that people have increased their borrowing from the commercial sector during 2003–2005 for a variety of purposes, including business, it may be too early to conclude that the propensity to borrow more from the formal sector is now expanding to SMEs. One reason for this is that reported commercial borrowing between 2003 and 2005 was solely limited to Aceda, which has a laudable albeit somewhat different

mission than other commercial banks. Nevertheless, anecdotal evidence suggests that such borrowing from at least one commercial bank has been increasing since the time of the survey at the end of 2005, beginning with increased borrowing for SME expansion. This is due to the fact that ANZ Royal Bank—a significant new entrant to the banking market—appears quite willing and able to lend to a wide range of clientele, including SMEs. Such borrowing may eventually also be used for start-ups, depending on the pace of developing institutional trust and the maintenance of a favourable business climate.

Since SMEs clearly represent important sources of employment, any increase in the number of SMEs or expansion in the size of current SMEs is likely to have an important impact on overall employment. Land titles are likely to play an important catalytic role by providing investors with a sense of secure tenure and providing collateral with which to access formal loans for start-ups and expansion. This hypothesis will be tested in the follow-up study to the baseline survey.

Endnotes

1. In one study (Kang 2005), enterprises were divided into three categories: micro (one to two workers), small (three to five workers) and medium (10 to 100 workers).
2. "They have houses but not titles, crops but not deeds, businesses but not statutes of incorporation" (de Soto 2000: 7).
3. The survey did not include the district of 7 Makara.
4. See annual reports at www.acedabank.com.kh.

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