A Review of SME Financing Activities in Cambodia[1]

Background and Objectives of the Study

The Cambodian government has adopted policy measures to support and promote small and medium scale enterprises (SMEs). This is because the sector is considered critical to boosting and maintaining growth momentum in the country's economy given its dominant stake in terms of the number of firms and its potential to generate employment (SME Sub-committee 2005).

Guided by the government's Rectangular Strategy in which the promotion of SMEs is a cornerstone of private sector development, the SME Sub-committee was created to formulate, in collaboration with development partners, the SME Development Framework as the road map to guide the setting up of SMEs[2] nationwide. The objective of this framework is to promote SME development through (i) improving regulatory and legal framework, (ii) facilitating access to finance, (iii) diversifying and coordinating SME support activities, and (iv) harmonising policy.

This report focuses on SME access to finance. It specifically aims to review the limitations of SME financing programmes, particularly since the inception of the SME Development Framework in 2005. The rest of this paper is organised as follows. Proposed actions within the SME Development Framework to improve SME access to finance are outlined in section two. Section three presents a brief literature review on constraints to SME financing and an overview of the situation of SME financing and limitations in Cambodia. Section four describes the progress towards improving SME financing within the SME Development Framework. The conclusion is presented and recommendations to smooth the way for SME development are drawn in section five.

SME Development Framework Proposed Actions for Improved SME Access to Finance

To improve SME access to finance for working capital and investment, the SME Development Framework addresses four main issues:

- **Collateral and land titling**: Secured Transactions Law is expected to enable banks to use movable assets as collateral; expediting and reducing the costs of land titling are considered essential to improving the use of land as collateral.
- **Leasing finance**[3]: Absence of specific legal framework for SME leasing finance prevents banks and financial institutions from operating leasing facilities for SMEs.
- **Credit information sharing**: High risk lending environment in Cambodia is significantly linked with the absence of a formal credit information sharing system, inducing banks to use collateral to reduce the risk of asymmetric information. An improved system is expected to encourage all banks to join the voluntary credit information system.
- **Simplified accounting**: Simplified financial reporting systems and guidelines developed by the National Accounting Council (NAC) enable SMEs to better record and provide comprehensive information required by banks. Training and dissemination programmes for SMEs are conducted by the Ministry of Economy and Finance (MEF).

To enhance the dialogue between government and the private sector, the Working Group on Manufacturing and SME was established to work with the SME Sub-committee. Coordinated by the SME Secretariat[4], the sub-committee and the working group share the same work plan in which SMEs' insufficient collateral and limited capacity to prepare a feasible business plan are the key issues addressed to improve SME access to finance. Thus, the proposed activities of the SME Secretariat are to set up an SME and bank forum, train SME operators on financial management and business planning, diversify financial instruments and design a range of simplified finance and accounting systems for SMEs.

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[2] The SME Development Framework categorises enterprises by the number of full-time employees (micro: <10; small: 10-50; medium: 51-100), or assets excluding land (micro: <USD50,000; small: USD50,000-250,000; medium: USD250,000-500,000).

[3] Leasing finance enables an enterprise to hire and eventually purchase essential equipment, i.e. fixed assets.

[4] The SME Secretariat was established by the SME Sub-committee to provide an inter-ministerial coordinating mechanism to implement the SME Development Framework and its "road map" for promoting SME development.

Table 1: Annual Interest Rates (%) on USD Loans

	2005	2006	2007	2008	2009
Banks	16.20	16.37	15.83	16.08	15.56
MFIs	31.75	30.70	28.10	29.18	27.39

Source: NBC (2009) cited in Sohn (2010)

Overview of the Financial Sector, SME Financing and Limitations

Literature Review

The complicated bank procedures, high interest rates and restrictions imposed by short term loans[5] that characterise the financial sector in developing economies such as Cambodia could result from banks hedging against potential risks due to information asymmetries (Beck & Asli 2006; Beck 2007). Alternatively, banks ration (limit) the amount of credit extended at a certain interest rate with fixed collateral requirements and repayment terms (Petrick 2004).

In Cambodia, Oum *et al.* (2011) argue that the absence of a guarantee scheme and mechanism to reduce risk to banks has led to approximately 96 percent of applications for bank and micro-finance (MFI) loans being collateral-based. This confirms that banks use collateral requirements to ration credit to SMEs; just over one quarter of the firms surveyed in the study (*ibid.*) reported that they could not expand their business due to insufficient financing. It is clear then that despite efforts made by government, access to finance remains a key constraint to SME development.

Situation in Cambodia

Over the period 2005 to 2009, average annual interest rates were around 16 percent on loans and 5 percent on deposits; however, the interest rates charged on USD loans by MFIs were almost double those levied by banks (Table 1). The risk of borrowers' uncertain credit rating and financial institutions' pursuit of profit are the two main reasons explaining these disparate interest rates in Cambodia.

Domestic commercial banks provide only 1 percent of working capital and 1.7 percent of investment capital to SMEs (IFC 2010). This is chiefly because Cambodian financial institutions lack the capacity to collect credit information (Sohn 2010; Harner 2003), the banking sector is mainly accessible in urban areas with 62 percent of bank branches located in Phnom Penh, and less than 8 percent of the total population use financial services and products from banks and MFIs (*ibid.*). These figures imply that limited penetration and outreach is still a gap in the country's banking sector.

Even though a number of commercial banks and MFIs have schemes to provide loans to SMEs, they continue to target their services and products to more lucrative business transactions with multinational corporations (Sohn 2010). Without reliable information on borrowers, banks impose stringent conditions on SME loans to reduce the risk resulting from uncertainty about their creditworthiness. Banks and MFIs still require SMEs to put up their land title as collateral as well as meet the following conditions:

- Be a formal sector (registered) enterprise – provide copies of ID card, patent, licence
- Use loan for business start-up or expansion
- Submit business plan and financial records
- Have management skills or experience: borrowers with no business experience are unlikely to get loans or be able to provide financial records
- Hold 20 percent of the whole investment capital
- Provide collateral (land title, not movable asset)

The pilot web-based Credit Information (sharing) System (CIS), launched in Cambodia in 2006, has yet to be expanded given its limited applicability in Cambodia's banking sector (Sohn 2010). The CIS holds mainly negative information about borrowers, but banks need both negative and positive information for a more comprehensive assessment of borrowers' creditworthiness. Another pitfall of the current CIS in Cambodia is that membership is voluntary. Moreover, the credit rating system has not been activated due to limited information on SMEs' financial records, making it difficult for banks and financial institutions to develop a viable credit model for SMEs. Compulsory membership of the Credit Bureau would be an effective option to improve CIS practices. When the Credit Bureau is fully functional, it will facilitate a credit guarantee scheme to be implemented by the government and international development partners.

The Asian Development Bank (ADB) and the MEF have recently agreed on a USD25 million credit guarantee fund to launch a risk-sharing facility (RSF) called the Microfinance Risk Participation Programme. Under this scheme, 50 percent of the loans that participating MFIs and banks extend to SMEs will be guaranteed by the Programme and the remaining risk will be carried by the MFIs and

[5] Small businesses can only borrow credit in the short term; more favourable longer term loans at more competitive interest rates are monopolised by big business.

banks[6]. Loans, however, will still be subject to the standard documentation required by participating MFIs and banks because borrowers' capacity to prepare proper financial statements and business plans is considered to be a determinant of successful RSFs in other developing countries.

Revisiting SME Development Framework

Significant progress has been achieved by the government towards improving SME financing within the SME Development Framework, as summarised below:

- A simplified financial reporting template for SMEs has been issued by the National Accounting Council which also provides a training programme for accounting professionals and SMEs.
- New annual tax declaration forms and guidelines for filing tax returns have been issued by the Tax Department.
- Secured Transaction Law was enacted in 2007 in an attempt to establish an effective mechanism for collateral-based loans.
- Law on Financial Leasing was approved in 2009 to create an enabling framework for banks to provide financial leasing services to SMEs with limited collateral.
- The *Prakas* on the Utilisation and Protection of Credit Information was issued by the National Bank of Cambodia. With this *prakas* in place, commercial and specialised banks are authorised to conduct financial leasing business under the Law on Financial Leasing.

However, a large proportion (around 72 percent) of Cambodian enterprises are family businesses with one to three employees/workers (NIS 2009). Of 505,134 enterprises, around 3.5 percent were registered at the Ministry of Commerce in 2011 (NIS 2012). This means the majority of enterprises are in the informal sector, effectively preventing them from accessing finance because banks and MFIs require SMEs to have legal status to be eligible to apply for a loan. The primary reason for SMEs maintaining their informal status is the perception that standard accounting practices are complicated and unnecessary (IFC 2010). Besides this, some SMEs intend to keep informal financial records which allow them to conceal their real profits and revenues from the tax authorities so as to reduce their tax liability[7].

Although most SMEs (both registered and unregistered) prepare a monthly profit and loss statement, they do not use a standard format because they find formal financial records complicated or even unnecessary (IFC 2010; Figure 1). Formal financial records are a standard bank requirement without which SMEs are unable to access credit from financial institutions. As well as conforming to this, SMEs must conform to other standard logistic procedures, particularly collateral requirements, which have so far impeded SME access to finance.

SMEs have difficulty accessing finance to cover the costs of hiring essential equipment such as office computers, machinery and vehicles because Cambodian banks' and MFIs' financial products and services reportedly do not cover loans for leasing (IFC 2011). Through financial leasing SMEs could finance the hire and eventual ownership of equipment. Over a fixed time-frame the lessee makes periodical payments (principle amount plus interest) that eventually cover the cost of the asset itself. The benefits of leasing are that it (i) does not require financial records or collateral, (ii) finances the purchase of much needed fixed assets, and (iii) counters the probability of fund diversions, compared to working capital that could be sold off. In other words, for entrepreneurs who cannot meet the normal collateral requirements of banks, leasing offers an alternative form of finance. Therefore, leasing could ensure long term benefits to the SME sector.

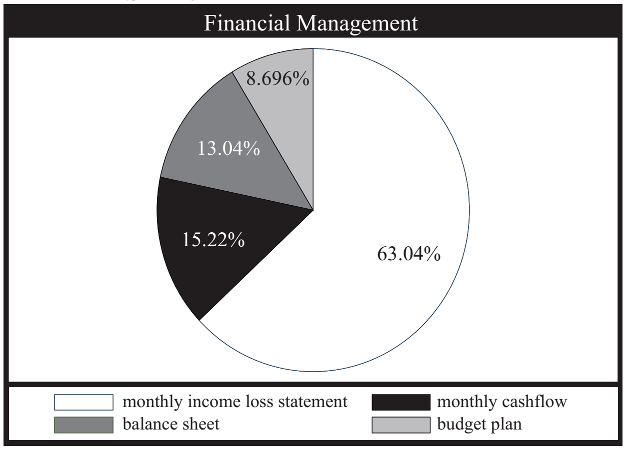
Conclusions and Recommendations

SME financing has improved to some extent since the inception of the SME Development Framework, but progress on the four key issues hindering SME access to finance identified by the SME Sub-committee has been slow. Land is still the common collateral demanded by all financial institutions and we have found no concrete evidence to suggest that banks or MFIs accept movable assets as collateral. The Credit Information System is still far from being institutionalised due to its limited applicability and voluntary membership as well as the lack of soft and hard infrastructure. SME leasing finance is still negligible even though the Law on Leasing has been in place since 2009. Lastly, a significant proportion of SMEs do not prepare formal financial records despite the fact that the NAC has developed a simplified accounting template for them.

[6] No further details of this project are available; this information is based on the Law on National Budget 2011 (Article 13) and anecdotal evidence from MEF.

[7] Interviews with credit officials at the Rural Development Bank and SME secretariat in May 2011

Figure 1: Financial Management of 120 Surveyed SMEs



Source: Tong (2011)

The main barriers to SMEs' ability to access finance that stem from their bad practices are the lack of accounting standards and informal status. The government has already addressed these issues in the SME Development Framework by adopting a phased plan and strategy, so there is need for additional commitment to encourage more enterprises to adopt formal status through registration and standardising their management systems and financial records. This is the first priority for the government in responding to the demand-side factors that hinder SME access to finance. Specific measures to encourage SMEs to adopt formal status and management systems are beyond the scope of this report.

To fully institutionalise the credit guarantee system for SMEs, the government should develop essential infrastructure, both hard—a national credit bureau in charge of collecting and managing credit-rating information throughout the country, and financial support from the government to guarantee funds, and soft— legal frameworks and human resources for the implementation of a credit guarantee scheme for SMEs. As SMEs in Cambodia become corporatised with a standard financial management system, and financial institutions have increased knowledge of financial markets, the mismatch in the demand and supply of funding for SMEs will gradually reduce.

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