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THE CURRENT STATE OF THE MICROFINANCE INDUSTRY AND THE LEGAL ISSUES AND CHALLENGES OF MICROFINANCE INSTITUTIONS IN CAMBODIA

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ABSTRACT

This working paper explores and details the continual progression of the financial and banking sectors of Cambodia, which continue to shape international perception of investment in the country, starting from the era of civil unrest which destroyed the country's social and economic infrastructure. It identifies and discusses the three distinct phases of the evolution of microfinance in Cambodia; start-up, institutionalization, and commercialization. In terms of legal issues of the microfinance industry, the Law on Banking and Financial Institutions established the minimum capital requirement for commercial banks, specialized banks, and microfinance institutions (MFIs) at $13 million, forcing several banks, which did not meet this sum, to close. Due to the country's cash economy, funds for lending are sourced from grant aids, foreign and local borrowings, and savings. With 15 commercial banks, 4 specialized banks, 16 MFIs, and 90 NGOs operating, Cambodia accounts for having one of the most developed microfinance industries in the world. To develop an effective industry, the microfinance sector must serve the needs of low income households, micro and small enterprises; MFIs must equally strengthen institutional capacity to improve current operations and reach financial sustainability.

1. Introduction

Cambodia still suffers from the legacy of 20 years of civil unrest that occurred between 1970 and 1990. During this period, a significant number of educated Cambodians fled the country and government structures of the country were not fully operational, if they existed at all. The social and economic infrastructure of the country was virtually destroyed by the Khmer Rouge. Today, Cambodia is one of the poorest countries in the region: 36 percent of its 13.4 million citizens live below the national poverty line.

Following the Paris Peace Accords of 1991, funds started flooding into the country for reconstruction. In the challenging post-conflict context of Cambodia, microfinance was one area where donors achieved remarkable success in close partnership with private sectors, civil society, and the government. In fact, the accomplishments of microfinance in the country serve as an emerging model for institutional governance, transparency, and public-sector regulation of a privately operated industry. Cambodia microfinance institutions have now attracted foreign investors, which are playing an important role in shaping international perception of the investment climate in the country.

The financial and banking sectors were destroyed by the Khmer Rouge regime, which abolished money for a number of years. In the 1990s, Cambodia's banking sector went from a mono-banking to a two-tier banking system that separated the functions of the central bank from commercial banks. The Royal Government of Cambodia (RGC) introduced banking regulations in 1999 and a bank restructuring program in 2000. As a result, many banks were liquidated (32 institutions were consolidated into 19). Today, 17 banks remain in operation, including one state-owned commercial bank, three foreign bank branches, 10 local banks, and three specialized banks (one of which is state-owned). These banks – with one notable exception (ACLEDA Bank) – are highly liquid, conservative, and serve a narrow elite clientele.

2. Evolution of Cambodian Microfinance

In just one decade, microfinance evolved from a series of small, isolated initiatives into what is arguably the most sophisticated part of the national financial sector. In 2004, the main suppliers of pro-poor financial services, such as ACLEDA Bank, licensed MFIs, and registered non-governmental organizations (NGOs), served closed to 400,000 borrowers –eight times more than in 1995. This evolution was marked by three phases that

reflected changes in the approach and behavior of financial service providers, the government, and the donor community.

A. 1990-1995: Start-up Phase

The start-up phase began in the early 1990s, when multilateral and bilateral donors and international NGOs began financing projects to deliver credit to poor micro entrepreneurs. At that time there was a vacuum of functioning institutions, as well as government oversight, in the financial sector. International NGOs such as the Group de Recherche et d'Etudes Technologiques (GRET), Catholic Relief Services (CRS), and World Vision, together with some early donors such as the United Nations Children's Fund (UNICEF), the International Labour Organization (ILO), the United Nations Development (UNDP), Agence Française Développement (AFD), and the US Agency for International Development (USAID), played a significant role in launching the first microfinance programs in the country.

Most of these early initiatives were financed as credit components within integrated rural development programs. They utilized a wide range of microcredit delivery methodologies, from individual loans to solidarity groups, village banks, and self-help groups. Early on, a few of these actors demonstrated services for poor people.

B. 1995-1999: Institutionalization Phase

This phase was characterized by the separation of credit components from integrated program structures and the institutionalization of NGO microfinance activities. The primary objective of this phase was to achieve financial sustainability of microfinance providers. The supporters of microfinance in Cambodia started meeting regularly in these years to share information, align objectives, and define a common vision for the sector. NGOs formed their own forum while the Cambodia Committee for Rural Development (CCRD), a government body funded by donors, provided a platform for broader discussion. During this period, the government also created the Rural Development Bank (RDB), a wholesale leader to emerging MFIs.

On the policy front, the International Monetary Fund (IMF) and the Asia Development Bank (ADB) supported the RGC to formulate a comprehensive macroeconomic and structural reform program, including financial system modernization and corresponding legislation. The Central Banking and Financial Institutions of 1999 created a legal framework for a broad range of financial service companies, with appropriate mechanisms for licensing, regulation, and supervision. Given these changes, the emerging microfinance community encouraged the CCRD to allow the National Bank of Cambodia (NBC) to assume responsibility for regulating and supervising microfinance.

C. 1999-Present: Commercialization Phase

The success of NGOs in providing credit to poor and largely rural populations encouraged the NBC to issue regulations which establish a special license for MFIs and a registry for NGOs. The issuance of new Prakas (regulations) in 2000 and 2002 marketed a move toward the commercialization of microfinance and its integration into the formal financial system of Cambodia.

The vision of integrating microfinance into the regulated financial system arose out of a consultative process led by the RGC, the NBC, and leading MFIs. In October 2000, the industry leader, ACLEDA, transformed from NGO into a specialized microfinance bank with the support of its founding donors and new institutional investors. ACLEDA bank's transformation provided an important precedent for other financial providers. During this phase, socially responsible investors and development finance institutions (DFIs) replaced the donors that had financed the start-up and institutionalization of NGOs which, up until this stage, had served as their primary funding and advisory partners. Nine of the leading NGOs subsequently transformed into licensed institutions with the assistance of their original donors and new investors (which provided capital and governance).

3. Current State of Microfinance Industry in Cambodia

As of June 2006, the banking system is composed of:

- 15 commercial banks, of which 12 are locally incorporated and 3 are foreign branch banks
- 4 Specialized banks, of which 1 is state-owned and 3 are private-owned
- 16 licensed MFIs and 24 registered micro operators operating in rural areas

A. Commercial Banks

There were 30 commercial banks until 2000 including the Rural Development Bank, all under the supervision of the NBC. The banking sector contained many small banks, which were operating marginally. Most of the banks, however, were not viable.

The activities of commercial banks remained concentrated in the city and focused on big transactions of commercial nature, real estate and multinational corporations. Poor people living in rural areas did not have access to loans or saving with commercial banks. The commercial banks had neither resources nor the possibility to expand their

limited range of rural services because microfinance operation, especially rural microfinance, requires high cost and is hardly profitable.

After the adoption of the law on Banking and Financial Institutions at the end of 1999, the NBC launched a banking system restructuring program that required all banks to apply for re-licensing. As a result, 16 commercial banks were successively eliminated from the banking system and currently, there are new banks and MFIs coming into the system. The banking system is now developing its network to provide financial services all over country.

B. NGOs Operating in Microfinance

There were about 90 NGOs supplying credit in the rural areas, seven of which play a significant role. International NGOs established local NGOs in order to set up an organization on a continual basis. Many local NGOs are supported by international NGOs which provide management guidance and financial support for institutional building and credit for revolving funds.

At the end of 2000 all NGOs had a total loan outstanding of USD 29 million and a total saving of USD 1.5 million. The total number of borrowers was 147,000 in 20 towns and provinces, representing 18% of the total number of the Cambodian population. Women borrowers represented 80% of total loans (NBC Source).

Most NGOs provide loans to group members of the same occupation or type of business. In these cases there were few opportunities for loan diversification. Loans are usually provides on a six-month cycle basis. Most of the smaller NGO credit operators have compulsory saving requirements where members control group savings and use them to lend among themselves.

C. Traders, Moneylenders, Relatives and Friends

Similar to loans from formal and non-formal institutions, loans from informal sources are commonly used for agricultural production and investment in business. They are also important for covering sickness in the family and other purposes.

Interest rates on loans from informal sources are extremely variable, ranging from interest-free (on many loans from relatives and friends) to 20 percent per month and higher (than those from traders and moneylenders). Despite high interest rates, borrowers continue to use informal services for a variety of reasons, including ease of the loans, flexibility in repayments, personal relationship, and lack of alternatives to access the formal loans.

D. Microfinance Institutions (MFIs)

In 2000, NBC started to issue and revise regulations in order to transform NGOs into registered and licensed MFIs according to their scope of operations. After having received license and registration certificates, these institutions have been regulated and supervised by NBC. Since 2000, certain NGOs have only been licensed and others have only been registered. By the end of June 2006, there were 16 licensed MFIs and 24 registered as rural credit operators. Among these institutions, the majority of them were transformed from NGOs, while others remained as local private companies.

The newly transformed MFIs have continued their culture of lending in form of solidarity groups where lending does not require collateral. Lending to individuals requires collateral when there is no trustworthy guarantor. For local private MFIs, the majority of loans have been lent to individual clients with required collateral. Licensed MFIs and registered NGOs accumulated a total of loan outstanding of KHR 275 billion (USD 66.83 million) by the end of June 2006 (NBC source).

4. Legal Issues and Challenges of Microfinance Industry in Cambodia

A. Legal and Regulatory Environment

In 1999, the Law on Banking and Financial Institutions was passed, establishing a minimum capital requirement for Commercial banks, specialized banks and Microfinance Institutions. In 2002, 15 commercial banks were closed for failing to meet the $13 million minimum capital requirement and having inadequate governance. Currently, there are 15 commercial banks, 4 specialized banks and 16 MFIs operating. According to the CGAP microfinance donor review, Cambodia has one of the most developed microfinance industries in the world. Organizations exceeding the specified number of clients, portfolio or voluntary savings are required to license as an MFI. The law provides for two structures for MFIs – limited liability company or cooperative; laws governing cooperatives have yet to be introduced and as such, a suitable legal form for credit unions has yet to be introduced. MFIs pay company tax and report monthly to the NBC, showing their compliance with the ratios and regulations. In particular, capital adequacy ratio of 20%, minimum liquidity requirement of 100% and loan loss provisioning.

B. NGOs Operating in Microfinance

The savings deposit of NGO Operators is at risk because management and staff of most NGOs have limited knowledge of how to run savings and credit schemes. Many NGOs have neither operations nor savings and credit policies that are clear to their schemes; there is an urgent need for appropriate supervision. The smaller indigenous NGOs are in

locations which are difficult to reach, and their financial activities may be too small to warrant the costs of supervision.

C. Microfinance Institutions

The sources of funds for lending are mostly grant aids and borrowings from abroad, local borrowings, and in smaller proportion from savings. This demonstrates the weakness in savings mobilization (which results in a lack of savings mobilization strategy) and the meager awareness of the poor people of financial services (the thought of being poor and methods of saving).

The operation of MFIs is limited under regulation issued by the NBC, meaning that only credit providing services and saving mobilization can be obtained from their group member or in the area of operation. Therefore, MFIs need many services and banking operations, such as remittance, saving deposit, service transfer.

Management information systems (MIS) play a crucial role in improving the management and operation of MFIs. The quality of software and systems present varies considerably, with some MFIs unable to access integrated accounting and loan portfolio systems, while others have very expensive and effective systems.

D. Lending Environment

Cambodia is a cash economy, with approximately 25% of small business finance coming from loans from family and friends (33% for micro-enterprises and 16% for large firms). Commercial banks provide only 1% of the working capital of medium enterprises and 96% of those who do not have a loan have never applied for one. In the World Bank study, small and medium enterprises identified lack of access to credit as a major constraint.

The situation is somewhat different among MFIs. Micro-entrepreneurs have access to financial services through ACLEDA, 16 licensed MFIs, 52 registered MFIs and many small subsidized schemes. ACLEDA is now a commercial bank lending up to $70,000 per client, while most MFIs focus on micro-loans with a few institutions offering up to $10,000 loans. Subsistence farmers, those in remote rural areas and people with disabilities, AIDS and other challenges still lack access to finance.

For Commercial banks, the lack of a credit registry or system for mortgaging property, makes the available collateral for large loans difficult to standardize and enforce. Further, creditors lack rights, access to information sharing or laws relating to collateral. Lending is a risky business with creditors reliant in a weak rule of law to enforce the loan conditions. Microfinance Institutions excel in this area due to their experience with non-

collateralized loans or informal collateral. However, the loan size required by small and medium entrepreneurs often exceeds the loan limit of MFIs.

E. Savings Environment

Public confidence in savings has been undermined by historical events prior to the bank restructuring program, including the abolition of the currency during Khmer rouge, formerly high inflation and emergence of unsound banks during the late 90s. Likewise, microfinance funding made available during the 90s focused on a credit, rather than a savings culture. While this situation improved when microfinance institutions became licensed to mobilize savings from the public, MFIs still mobilize on average 4.5% of their portfolio from savings (ACLEDA being an exception with 60% and CREDIT with 14%). 0.15% of Cambodia's domestic savings is still being mobilized by MFIs which are funded by grants and certain loans.

5. The RGC Policy in microfinance sector

In 1999-2000, the RGC and the Asian Development Bank (ADB) worked together to create a long-term developing strategy for the financial sector in Cambodia. The result was the Financial Sector Development Plan for 2001-2010 (former FSB 2001-10), promulgated by the RGC, and since then has served to guide the efforts of the RGC, stakeholders in Cambodia's financial sector, and the donor community in supporting the development of the financial sector in Cambodia. The RGC adopted the FSDP 2001-10 in a plenary session of the Cabinet meeting chaired by the Prime Minister on 24 August 2001. It was the Government's ground-breaking initiative for financial sector development.

The FSDP 2001-10:

- Set out a long-term vision and development strategy for the financial sector over from 2001-2010; and
- Aimed to develop a sound market-based financial system to support resource mobilization and broad-based sustainable economic growth.

To achieve the vision, the FSDP 2001-10 specified ten principles as the Government's long-term strategy for financial sector development. Under the guidance of the long-term strategy, the FSDP 2001-10 detailed sector development strategy and policy reform agenda. As originally designed, the development strategy of the FSB 2001-10 was to be a rolling plan, needing continuous updating to reflect the RGC's achievements, as well as the changing socioeconomic environment.

The FSDP 2001-10 identified rural finance as a critical sector requiring development and support. It was recognized that the banking system had not been able to address the demand for finance, from the poor, to smoothen consumption, build assets and develop micro-enterprises. This had been expressed by the most obvious manifestations of poverty, such as insufficient household income, lack of productive assets and inaccessibility of affordable financial services.

The United Nations Forum, in early November 2005, called "International Year of Micro-Credit 2005", for building financial sector was established in order to encourage the micro-credit and microfinance projects towards the poverty eradication in the Least Developing Countries and Developing Countries. In January 2006, Samdech HUN SEN, Prime Minister of the Royal Government of Cambodia (RGC), announced said year as the year of Microfinance, at the National Conference on "Cambodia Microfinance".

The sound management of financial system boosts the national economic development and access to it will especially benefit to the poor. For this reason, governments in developing countries have made serious strides to developing the microfinance sector to give hope to poor people, particularly women, by helping to build businesses, revitalizing communities, and creating jobs for lifting millions of people out of poverty. In this sense, microfinance has become a powerful tool to use in reaching the Millennium Goals, particularly those relating to promoting children's education, improving health outcomes for women and children, and empowering women when these households have increased earnings and their living can be sustained. Besides this, microfinance had also been important in contributing financial support to micro enterprises, small and medium enterprises, which, in turn, has been an effective tool in basic economic development and poverty reduction.

The Royal Government of Cambodia had been acting an important role for developing microfinance sector in Cambodia through the preparation of Macro Economic Policy in purpose of low inflation and low interest rate, giving poor people the ability to use micro-credit services. The Ministry of Economy and Finance had cooperated with the concerned institutions to carry out effectively «The Vision and Financial Sector Development Plan for 2001-2010», which attract and mobilize financial resources for serving production demand and supporting an economic growth. Within this, rural finance participates in the development of microfinance sector in order to create viable, pro-poor and effective rural financial system, enabling the poor to enhance their rural incomes. Moreover, the National Bank of Cambodia (NBC) prepared law and other regulations for providing license to Banks and Microfinance Institutions, and for ensuring the provision of financial services with effectiveness and sustainability. The Ministry of Economy and Finance (MEF) has its role and duty to attract and mobilize the financial resources from

International Financial Institutions and other donor countries to develop microfinance sector in Cambodia.

MEF has created microfinance and SMEs financing division at the financial industry department to coordinate and facilitate the task in the area of microfinance and financing for SMEs with relevant institutions/ministries. This division has the following duties:

- To take part in preparing strategic policy and strategy for development micro-finance and financing small and medium enterprise in cooperation with related institution in order to implement with high efficiency with national policy.
- To take part and cooperate with National Bank of Cambodia and related institution in monitoring the implementation of national policy in the field of micro-finance through national vision and planning for financial development of Royal Government of Cambodia for 2001-2010.
- To take part in coordinating and monitoring the implementation of SMEs framework in line with policy and strategy of the Royal Government of Cambodia.
- To coordinate and cooperate with national unit and related institution in the preparation of legal framework for exploitation with collateral and land registration and registered system for movable property and real estate in order to support SMEs with bank financing and financial institution.
- To take part in the development and implementation support program for bank and other financial institution for assessing collateral with high efficiency in order to assure that SMEs to have full capacity to borrow money from financial institution.
- To take part and cooperate in the creation of task forces in order to determinate which financial institution (Non-bank) can meet the micro-financial institution requirement, in the future.
- To prepare and support strategy for creating financial institution (non-bank) and to strengthen branch in order to exploit in the rural areas.
- To coordinate, develop and implement a plan to mobilize local financial resource such as commercial bank and other financial institution, so that they take part in supporting micro-finance institution and SMEs.
- To take part in developing and implementing training program and capacity building for micro-finance institution which provide financing to SMEs in cooperation with training banking institute MPDF, CIB and other institute with support fund from international financial institution.
- To take part and cooperate with relevant institutions to mobilize bilateral and multilateral donors such as French Agency for Development(AFD), KFW, ADB, WB and IMF and other resource for supporting micro-finance institution commercial bank and providing loan to SMEs.

- To coordinate and implement credit project for microfinance development and SMEs which receive financing from government and from international finance institutions in order to ensure using this credit in line with strategy and national policy of Royal Government of Cambodia.
- To control operational activity of microfinance and financing SMEs directly in order - to report this activity to leader of ministry of economy and finance.
- To fulfill other functions of the ministry.

The Rural Development Bank (RDB), was established by the Royal Government of Cambodia in referring to Sub-degree No. 01 ANK.BK, dated 21 April 1998. RDB is a specialized bank under guardianship of MEF and under technical supervision of NBC. RDB's main duty as a whole sale bank is to provide financing and refinancing to licensed commercial and specialized banks and Micro Finance Institutions (MFIs), which has activity to support rural economic.

The Royal Government had amended the Sub-degree on membership and conduct of Credit Committee for Rural Development (CCRD) through Sub-degree No. 67 ANK.BK dated 4 May 2005 and has amended his CCRD in 2005. This committee has participated members from (1) Ministry of Economy and Finance (chairman), (2) National Bank of Cambodia (vice-chairman), (3) Ministry of Agriculture Forestry and Fisheries(MAFF), (4) Ministry of Rural Development, (5) Ministry of Women's Affairs, (6) Council of Ministers, (7) Supreme National Economic Council, (8) Rural Development Bank, Association Bank of Cambodia, (10) Cambodian Microfinance Association, (11) Communities Agricultural Development, and (12) Director of Financial Industry Department (FID) of MEF as secretary. CCRD has its main role and duty to prepare the National policy frameworks and strategy in microfinance sector for rural development in order to submit to the Government for reviewing and deciding. CCRD has secretariat under management of financial industry department.

1. Prepare and approve strategic framework and national policy in the Micro-finance sector for rural development.
2. Promote and monitor the implementation of strategy and national policy in the Micro-finance sector with high efficiency.
3. Coordinate the use and implementation of credit projects for development in the Micro-finance sector, which received financing from Royal Government of Cambodia, national and international financial institutions, donor countries and other credit resources in order to ensure that the use of such credit in line with strategy and national policy which determinates.
4. Monitor the provision of credit or sources of fund of institutions or micro-finance operators which received license or registered at the National Bank of Cambodia as well as other operators which operate micro-finance without registered at the

National Bank of Cambodia in order to ensure high efficiency and sustainability of financing on this sector.

5. Arrange program and action plan in order to develop in the Micro-finance sector including the mobilization of oversea donation in the form of bilateral and multi-lateral for rural credit demand as well as to promote national financial institutions for supporting to the development of rural credit in Cambodia.
6. Participate in capacity building of the microfinance institutions and competency of microfinance operators through the arrangement national and international seminars and seeking donations to strengthen this sector.
7. Fulfill the other functions that this committee has aware the necessary things in term of promoting the development of the Micro-finance sector in Cambodia.

The Law on Banking and Financial Institution was adopted by the national assembly of Cambodia in 1999. Based on this Law, the National Bank of Cambodia has released some regulations related to microfinance sector as follow:

1- Prakas on the licensing of Microfinance Institutions
2- Prakas on the Calculation of Interest Rate on Microfinance Institutions
3- Prakas on the Maintenance of Reserve Requirement for Microfinance Institutions
4- Prakas on Reporting requirement fro registered NGOs and Microfinance Institutions
5- Prakas on Liquidity Ratio Applicable to Licensed Microfinance Institutions
6- Prakas on Registration and Licensing of Microfinance Institutions
7- Prakas on Loan Classification and Provisioning Applicable to Specialized Banks for Rural Credit and Licensed Microfinance Institutions

Prakas on Adoption and Implementation of Chart of Accounts for Microfinance institutions.

The following are the summary of these regulations:

- Criteria for licensing and registration: the Identification of permanent shareholding, in particular the influential shareholders holding 20% or more of the capital.
- Requirement for being licensed: NGOs having loan outstanding of KHR 1,000 million or more on 1,000 borrowers or more.
- Minimum paid-up capital: KHR250 million, compared to KHR 50 billion for commercial banks.
- Liquidity ratio: 100% compared to 50% for commercial banks
- Solvency ration: 20% compared to 15% for commercial banks
- Capital guarantee: 5% compared to 10% for commercial banks
- Reserve requirement: 5% compared to 8% for commercial banks

- Calculation of interest rate shall be based on the remaining balance of credit.
- Reporting requirement: monthly for licensed MFIs and quarterly for registered NGOs.
- Reporting: Asset and liability statement, profit and loss statement, statement of deposit and loan classified currency and by types, loan classification, and branch network.
- Introduction of uniform chart of account of NBC into the system (MIS).
- Annual license fee: KHR 1 million for each MFIs with no fee for branch, the purpose of promoting the expansion of branch network to reach poor people in remote rural areas.
- No fee for registered NGOs.

6. Cambodian Microfinance Association

Cambodia Microfinance Association (CMA) was established in January 2004 by 7 MFIs as CEB, AMRET, HKL, Maxima, Seilanithih, CREDO and PCA and on 18th October 2004, CMA formally registered at the Ministry of Interior as a non-governmental organization. The purpose of it is to ensure the prosperity and sustainability of microfinance sector in Cambodia.

According to the banking law in Cambodia (Chapter 22, Article 72) there is only scope for one professional association related to banking services permitted in Cambodia. The National Bank of Cambodia (NBC) has approved that CMA can operate as a sub-division of the Association of Banking in Cambodia (ABC) in accordance to the law. Currently, CMA is being formalized. As a sub-division, CMA is an institutional member of the ABC and can directly negotiate with NBC on relevant microfinance matters.

Since 2004, CMA General Secretariat is comprised of a general secretary and a secretary. The general secretary is a part time volunteer and Secretary is a full time staff that support fund members. The general secretariat operates from a rented office space in one of the member institutions. In the mid of year 2006, CMA has independent office at Mekong Bank compound first floor and has been two full time staff for operation as a general secretary and a admin/financial officer that supported fund by AFD and membership fee.

In the past two years, CMA has grown from a membership association serving 7 members in 2004, to serving 11 members in 2005 and to serving 13 members in 2006.

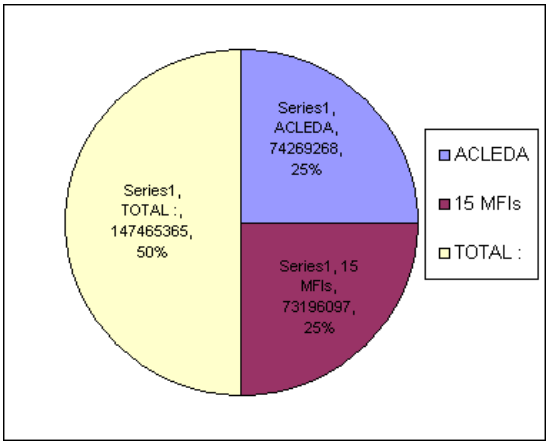
The Microfinance Sector in Cambodia

As of Sept. 2005, the microfinance sector in Cambodia was led by ACLEDA Bank, followed by 14 licensed MFIs, and 23 NGOs registered with the NBC. The registered NGOs vary in terms of outreach, capacity, and commitment to sustainability; and only a few currently possess the resources to become licensed MFIs. In addition, a number of smaller NGOs and other community-based organizations currently provide microfinance services, including an estimated 60 NGOs that are not registered, and a few mutual and savings associations in their early stages.[1]

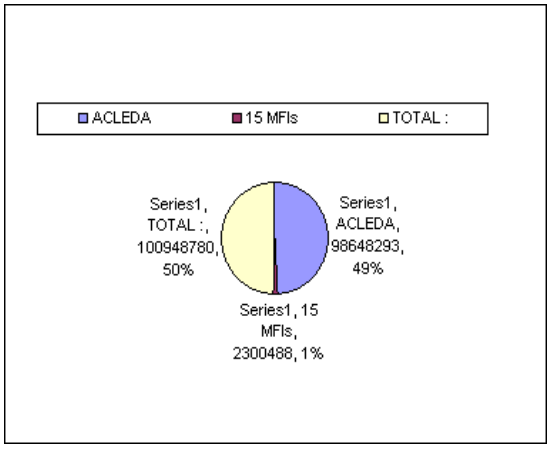
As of September 2006, according to quarterly data collected by the Cambodia Microfinance Association (CMA), ACLEDA Ltd, and 14 licensed microfinance institutions operate in 22 out of 24 of Cambodia's provinces. The only two provinces where there is no microfinance activity are Mondolkiri and Ratanikiri.

The total loan portfolio represented by the leading commercial bank and 14 licensed microfinance institutions and one registered non-government organization (that submit data to CMA on a quarterly basis). Shown is the loan portfolio of ACLEDA that included the small and medium size.

Loan Outstanding -September 2006



Deposit Balance-September 2006



The Cambodian microfinance sector can be categorized as a competitive market with a diverse range of institutional models and lending methodologies that serve the needs of low income households and micro and small enterprises, including farmers. As Cambodia's market grows more competitive, increasingly microfinance operators (including banks, licensed microfinance institutions, and registered non-government

[1] In 1999, under the laws on banking and financial institutions, the government of Cambodia adopted a two-tier system for supervising microfinance. A 'Prakas' (i.e. government decree), on microfinance regulation was enacted in 2000, and implemented by the National Bank of Cambodia. MFIs with a portfolio over 100 million KHR (24,000 USD) only need to be registered with NBC, while MFIs with a portfolio over 1 billion KHR (240,000 USD) need to be licensed, as limited liability company or as a cooperative. [1] The term "microfinance operators" refers to both licensed microfinance institutions and registered non-governmental organizations that offer microfinance services.[1] Refer to Planet Finance Rating of Seilanithih, Page 2. (www.planetfinance.com)

organizations) are looking for innovative ways to compete including the development of new financial products.

In particular, MFIs in Cambodia are exploring offering voluntary savings[2] and new services such as micro-insurance. Additionally, some MFIs are strengthening their institutional capacity to improve their current operations and reach financial sustainability.

Some pressing issues facing microfinance operators include: a strong concern that clients are over-indebted and there is no credit information system in place to track clients that is accessible to microfinance operators; increasing competition that is leading to what is perceived as members as "unethical" competition strategies[3], some aspects of the business and enabling environment that constrain microfinance in Cambodia[4]; limited access to commercial capital to finance growth and expansion; as well as the limited supply of high quality training and technical assistance opportunities to assist microfinance operators to improve their operations and build their capacity for expansion and transformation.

Vision: Cambodia residents have received financial service on time through a sustainability financial system.

Mission: To facilitate microfinance operators in operation and strengthen communication with authorities, national-International donors, creditors and investors.

The Role of CMA: CMA members demonstrate a strong sense of purpose and have very specific reasons that they joined this association. Many joined CMA because they want CMA to play a role in the broader sector. For example,

- To be one, strong voice representing the microfinance sector when negotiating and dialoguing with government agencies;
- To represent the microfinance sector and coordinate with government and donor agencies and other stakeholders including potential funders and investors; CMA can be the "point of contact."
- To improve awareness about microfinance in the country and among policy makers.
- CMA members also feel that the association offers them opportunities to improve their current work in microfinance. For example,
- To facilitate or provide training and to identify international resources persons that can offer technical assistance or awareness of best practices;

[2] According to the CGAP Country Level Effectiveness and Accountability Review (2005), the development of savings services has lagged behind credit. As of June 2004, the combined deposits of MFIs and registered NGOs represented less than 5% of lending portfolios. Page 6.

[3] During the CMA Organizational Needs Assessment (2005), MFI operators cited examples, such as, credit agents marketing directly to the clients of other MFI operators as "unethical" strategies.

[4] For some specific examples, refer to CGAP Clear Report (2005) and CMA Organizational Needs Assessment, Page 13 (2005).

- To provide a forum to discuss current issues that affect the sector in a timely fashion -- such as competition strategies, client over-indebtedness, fostering a savings culture.
- To foster sharing and learning among MFIs and document best practices in Cambodia;
- To produce research in areas of importance to its members;
- To assist members to settle/mediate conflicts and foster sharing and coordination among members;
- To provide opportunities to learn new skills as a professional association.

Most donors consulted during this process believe that CMA's main role in the sector is to represent the interests of microfinance institutions and negotiate and lobby the government on their behalf. One voice that represents the microfinance sector may be a driving force to make improvements in the current business and enabling environment and also safeguard and protect the progress made to date in the policy and regulatory arenas.

Specific Goal and Strategies (2006-2008)

The CMA business plan is grounded in a thorough understanding of its current organizational capacity. The strategies and activities that CMA plans build off CMA's strengths and opportunities and minimize the weaknesses and threats that CMA faces.

By the end of 2008, CMA's specific goals will be to:

1. Become a full-fledged association with a solid governance and organizational structure that responds to CMA's needs
2. Expand membership and satisfy members with core services offered by CMA
3. Have key government agencies adopt policies or regulations that improve the enabling environment for microfinance
4. Increase number of domestic, regional and international stakeholders view CMA as the point of contact or the "hub" for microfinance in Cambodia
5. Operate a Research and Technical Service Center
6. Diversify sources of funding, including an increase percentage of revenue generated from membership dues, sale of publications and the provision of fee-based technical services.

7. CREDIT Microfinance Institution

CREDIT MFI is a Cambodian limited liability company with three shareholders: World Relief US owns 74% of shares, World Relief Canada 17% and World Hope International 9%. In May 2004, CREDIT was licensed by the National Bank of Cambodia as a microfinance institution (CREDIT MFI).

CREDIT's main activity is the provision of quality financial services according to client need. CREDIT has a range of savings and loans products developed to meet these needs, including:

- Business, consumption and agricultural loans – paid by declining balance
- Agriculture loans – paid at the end of cycle
- Dollar loans for individual and solidarity group borrowers
- Riel loans for individual, solidarity and community bank borrowers
- Compulsory savings
- Voluntary savings.

CREDIT's strategy attempts to reach two goals:

1. Effectively position CREDIT within the market place where it has a comparative operating advantage and there is strong market demand so that CREDIT can gain market share and increase the possibility of long term sustainability in a context of rising cost of funds and declining interest rates to customers. This niche could possibly be the small scale entrepreneurs market, individual loans of $1000 to $10,000 using semi-secure collateral.
2. Effectively provide financial and transformational services to target high risk and vulnerable populations such as very poor people, people living with HIV/AIDS and victims of trafficking. This could be achieved through the creation of a specialized division, which would focus on developing appropriate financial services whether or not they are sustainable.

Vision: Cambodians, especially the poor have the opportunity to develop their livelihoods and experience full and productive lives.

Mission: CREDIT will be a leading MFI in providing trusted financial services to small and micro entrepreneurs including the poor and vulnerable through excellent service, positive relationships, and a strong sustainable institution.

> *"The vision and mission both have a focus on the poor and on entrepreneurs more generally in recognition that CREDIT works with a range of entrepreneurs. CREDIT also seeks to have transformational impact through relationships with and between clients, enabling entrepreneurs to experience full and productive lives. This relational aspect is also present in the way financial services are provided – through service excellence. To ensure these services can be provided both now*

and in the future, financial services will be provided through a sustainable institution."

The following values underpin CREDIT's activities:

Motivation:

~ Christ's love and God's call to serve the poor.

Organizational Values:

~ Sustainability
~ Customer Focused
~ Transparency and accountability
~ Excellent Financial Systems
~ Strong Internal Controls
~ Zero Tolerance of Fraud
~ Efficiency
~ Strong portfolio quality
~ Maximizing Outreach

Values in regards to clients:

~ Commitment to the poor and upholding their dignity
~ Responsive to clients needs
~ Belief in the God-given Potential of the Clients
~ Clients are Business Partners not Beneficiaries
~ Clients are Responsible to Fulfill their Obligations
~ Non-Discriminating
~ Encourage women entrepreneurs

Values in regards to service:

~ Respectful
~ Friendly
~ Compassionate
~ Honest

Values in regards to business:

~ Flexible
~ Fast
~ Leading
~ Trustworthy

Legal Structure: CREDIT was originally formed under the agreement of World Relief with the Ministry of Foreign Affairs. The organization became a Private Limited Liability Company in response to the requirement of the Banking and Financial Institutions Act (2000) for organizations with a portfolio and clients above the stated threshold to become licensed MFIs. The company has three shareholders; World Relief US has 74% of voting rights, World Relief Canada 17% and World Hope International 9%. The shareholders all share the same vision of building sustainable institutions.

The total share number is 1,000 shares. One share gives the right of one voice in a resolution of the Company. World Relief U.S. owns 740 shares from number 0001 to 0740 being equal to the equivalent of $370,000 (total paid up capital being $500,000. The share division was based on donated equity, program to date. The shareholders have signed a Memorandum of Understanding stating that they will make decisions by consensus.

The license allows CREDIT to mobilize savings and to provide loans to customers. The license excludes leasing, derivatives, dealing in gold, precious metals or commodities, checking accounts, swap or forward dealings in foreign currencies.

Shareholder Legal Responsibilities: As outlined in CREDIT's Articles of Association (a standard provided by the Ministry of Commerce according to Cambodian Law), the shareholders have the following responsibilities:

- Appointing and dismissing the Board of Directors.
- Agreeing on a change of the central office location if it is moved outside of Phnom Penh.
- Agreeing to a change in shareholding proportion, cessation or addition of shareholders.
- Buying and selling of real estate.
- Borrowing on behalf of the company.
- Nominating external auditors every 3 years.

Prudential Ratios: In conforming to the requirements of Article 15 and 16 of the Government Regulations relating to the implementation of the Law on Banking and Financial Institutions CREDIT will maintain a liquidity ratio of more than 100% and Capital Adequacy Ratio of more than 20%.

Liquidity Ratio: CREDIT complies with the Government Regulations relating to Microfinance Institutions and easily maintains a liquidity ratio of more than 100%.

The NBC's Liquidity Ratio primarily focuses on available funds to cover voluntary savings. Being a small proportion of the assets, CREDIT easily meets the ratio.

Capital Adequacy Ratio: CREDIT reports monthly to the NBC on its fulfillment of the requirements of Article 15 of the Government Regulation, to maintain a minimum liquidity ratio of 20%. CREDIT easily reaches the required Capital Adequacy Ratio.

Risk Management: CREDIT complies with Article 43.1 of the Law on Banking and Financial Institutions "verifying that the limits lay down for risks, in particular counterparty, exchange-rate, interest rate and other market risks are strictly observed." CREDIT's shareholders are responsible for ensuring CREDIT fully complies with these regulations and will take corrective action to ensure compliance. CREDIT has a number of risk management strategies, which the internal audit team monitors. Importantly,

every staff member is trained to consider risk and the management review and evaluate all risks on an ongoing basis.

Audit Committee: CREDIT has a team of five internal auditors who work for the audit committee of the Board of Directors and report quarterly to the Board of Directors. The purpose of the audit is to detect and prevent fraud and irregularities and act as an independent review of operating activities. The independence and the neutrality of the Internal Audit team are preserved through reporting directly to the Board of Directors. The internal auditors work program focuses on the operating activity and accounting procedure. They conduct spot checks, verify loan write off, check staff compliance with the policy and recommend ways of improving internal controls. More specifically they check that:

- CREDIT's policies and regulations are being complied with
- Income and expenditure are properly accounted for
- Profit and Loss, Balance Sheet and Portfolio reports are accurate
- Accounting documents are kept correctly
- Branch finances and operations are effectively managed and controlled
- Cash is adequately protected from losses
- Compliance with loan write-off policy.

The internal auditor reports to the monthly Executive Committee meeting where they verify that accounting and financial information is disclosed. The auditors provide reports on the regular activity of the internal audit, to the Directors (with copies to the relevant staff) and report independently to the CREDIT Board.

Key achievement: As of October 2006, CREDIT had a portfolio outstanding of US$ 3,729,196 servicing 10,651 clients through community bank, solidarity group and individual loans. CREDIT had 11,636 savings clients through its compulsory and voluntary savings accounts. To date CREDIT has made 76,625 loans to 45,294 clients. The long term loan recovery rate is a high 99% and client retention rate is 77%.

In end of 2005 CGAP awarded CREDIT with a merit award for financial transparency; CREDIT is also listed on the Mix market with five stars for maximum financial disclosure.

In the same year, MCRIL Rating Agency gave CREDIT an A- rating for financial performance. MCRIL commented on the

> "excellent capital adequacy, good performance on profitability and sustainability and good portfolio quality' and 'Governance is in the hands of an international NGO capable of providing technical and financial support; in management and operations there are qualified technical and management staff, a good loan appraisal system and an MIS generating critical reports".
>
> *MCRIL Rating Assessment, June 2005*

95% of CREDIT's clients are women and 90% of clients live outside Phnom Penh in Cambodia's rural areas, where the majority of Cambodia's poor are living.

The key to CREDIT's success is its client oriented services, which seek to provide financial services according to need. By offering a range of products, CREDIT is able to meet clients' individual needs. CREDIT has social and financial goals, and covers all its operating costs from interest income.

Future Plan: CREDIT plans to expand outreach to more clients and to lower interest rates in order to enable clients to increase the profitability of their enterprises. The institution is continually improving in efficiency, outreach and capacity. This is demonstrated through the localization of board and management, high portfolio quality (portfolio at risk 30 days is 3%).

8. DAI/Cambodia MSME Project

Development Alternatives, Inc. (DAI) is an organization that has registered as Non Governmental Organization in Cambodia. This organization has gotten fund from US Agency for International Development (USAID) to implement a project, which calls Cambodia MSME Project.

The project has been active since October 2005. It focuses on four provinces in Cambodia, including Kampong Cham, Kratie, Prey Veng and Svay Rieng. The project identified five value chains for implementing such as swine, fish, roof and floor tile, agricultural machinery, and cashew value chain with significant potential for positive impact in terms of market growth, revenue generation, job creation and increased opportunities for women.

The project has chosen three value chains to implement, including pig, fish, tile value chain and the rest is going to implement in year 2.

There are four components in this project in order to achieve the project goal. Firstly, improved performance of enterprises in target value chains is upgrading value chain competitiveness by building knowledge and skill of MSME. Secondly, enhanced capacity of value chain firms and service providers to support value chain competitiveness is improving the capacity of providers of both stand-alone and embedded services and linking these providers with MSME customers. Thirdly, improved access to finance is fostering the "bankability" of MSME and promoting new and more appropriate financial products for enterprises within target value chains. Fourthly, improved business environment is building institutional and inter-firm trust, improving the capacity of MSME to encourage in local policy advocacy and talk to government, fostering the development of provincial business association, and making the local business environment more conducive for MSME growth.

MSME's Constraints to Access to Financial Products:

- Lack of information on financial products
- Lack of collateral
- High interest rate on loan products
- Pay much expenditure on processing loan procedures
- No habit to have bookkeeping on income and expenditure
- Loan products are not flexible in repayment method for MSME's business
- Agricultural sector is not target for financial institution
- No long term loan for MSME to buy machineries and other equipments
- Cultural pressure

Financial Institutions' Constraints:

- Spend much capital investment
- High operational cost
- Microfinance Institutions are difficult to find financial sources with lower expenses
- Lack of credit information system
- Government get tax from deposit (saving and fixed deposit)

9. Priorities for 2006-2015: Microfinance

The FSDS 2006-15 has revised the delineation of the sector in the FSDP 2006-10 as "Rural Finance", to become more inclusive, and considers the sector as "Microfinance". This encourages the diversification of risks and growth of diverse products, as well becoming more inclusive for those in urban areas.

Since 2001, the microfinance sector has shown remarkable dynamism, with admirable results for a sector in its present stage of development. This has been due in no small part to the RGC's willingness to allow the commercialization of microfinance in the country, with a private sector approach supported, where necessary, by the Government and the donor community. The continued development of a supportive network by the Government and donors, whilst allowing the private sector freedom to act within the legal and regulatory framework, should support additional rapid growth.

Inter linkage and integration of the microfinance sector with the commercial banking sector continues as a major priority. In the long run, the commercial banking sector is the only reliable source of extensive liquidity which can meet the demands of the microfinance sector. Furthermore, there is a trade-off for the banking sector. The more successful the microfinance sector's clients are, the more likely they will eventually graduate into customers for the banks.

The microfinance sector's future development should be considered on three levels: the Macro level, the Meso level and the Micro level. Furthermore, developments should not be time-bound or time-constrained, but should be prioritized and sequenced, based upon expected impacts and absorptive capacities.

Macro level (Government and regulatory authorities):

- Support continued development of capacities at NBC for effective regulation and supervision of the microfinance sector. The sector's requirements are, in many ways, different from those of the commercial banking sector, since the requirements for support are more extensive.
- Agreement upon common reporting standards is required to establish sound financial performance analysis and enable the support of the sector's growth, as well as to inform the public via monthly bulletins.
- There are structural risks associated with the MFIs, in terms of governance, ownership, and the small size of some MFIs. There is a need to study these issues to try to resolve the weaknesses.
- There is a need for assistance to identify and define microfinance markets throughout Cambodia, and this is an area in which the MEF should provide significant support. There needs to be improved statistical analysis and market definitions, geographically, sectorally, in size and in scope. There is also a requirement to define and elaborate on the scope of alternative financing sources at the local levels (ROSCAs, moneylenders, family, friends, village banks, cooperatives, etc.). This will inform MFIs, and provide the basis for product development, for policies and, for the Government, the potential identification of incentives to promote development. Furthermore, it would enable all participants in the sector to continue to re-evaluate systematic risk on the basis of concentration of assets. For example, if the concentration of assets in the Agricultural sector became too high, a drought could threaten many of the gains achieved along with many of the assets of those who could not afford to lose them. It would provide the foundation of support for the sector upon which policies, product development, regulation and commercialization can be based. MEF is ideally placed to lead such studies.

Meso level (Technical support level):

- There is a priority need to establish a training facility which can provide off and on the job training for all levels within the microfinance sector. The training facility, wherever established, should include a governing council for microfinance capacity building (to include the MFIs, both licensed and registered), in order to ensure that it meets the needs of the sector. It will develop off the job training courses and develop increasing outreach capabilities to support the establishment

of training management systems for effective on the job training at MFIs and beyond. This would include training of trainers; work task analysis; needs assessment; training planning, budgeting and on the job delivery; appraisal methodologies; management succession training; and training recording systems. The training facility would operate as an integral, responsive part of the microfinance sector, funded by sustainable pricing of services.

- A further priority is to improve the provision of management information systems (MIS) for MFIs. The quality of software and systems presently varies considerably, with some MFIs unable to access integrated accounting and loan portfolio systems, while others have very expensive and effective systems. Minimum standards for MIS in Cambodia need to be established, particularly when improved common reporting standards are introduced. This may call for the holding of national licenses by Meso or Macro level organizations on behalf of the MFIs, in order to ensure minimum quality of support to those organizations. Any MIS must integrate the accounting and portfolio management functions for MFIs, and must provide the possibility for networking of Head Office, branch and sub-branch information transfer. At a minimum, the MIS must be able to feature the following activities:
    - Accounting
    - Loan Portfolio Management
    - Savings Portfolio Management
    - Client Management
    - Customized Report Production

Other features, such as payroll management, share management, palmtop entry, etc. would be plus factors. This would require the establishment of local capabilities in troubleshooting the software and systems to avoid the present requirement of call software experts from other countries, if there is a problem.

- It is important to develop a wholesale market for loan financing, operated within the private sector and linking the MFIs with the commercial banking sector. At the moment, MFIs have difficulty in accessing credit in riel. Credit is invariably provided in US dollars. A money / interbank market should not only link the microfinance and banking sectors, but should also provide flexibility in the currency in which loans are provided (see Non-Bank Finance: Financial Markets, chapter V). Additionally, linkages should be extended via measures enabling the banks to obtain experience of lending to, and working with, MFIs. This requires a less collateral-based approach to lending and the development of more cash flow/accounts analysis-based thinking. The projects to be funded should not be considered wholly upon the protection afforded by hard collateral. Risk

assessment should look at past performance and future potential performance, and risk premiums attached if and where necessary. Potential for interim guarantee measure to enable such experience to be gained will be considered. These issues are discussed further in the context of payment systems (above and Foundations of Finance, chapter II) and money / interbank markets (Non-Bank Finance, chapter IV)

- The recent and welcome establishment of the Cambodian Microfinance Association (CMA) provides an opportunity for improved representation in the sector. CMA may be developed to disseminate improved policy options, to improve dialogue, advocacy, research and information exchange. The key to CMA's success will be to select the correct mix of products to be developed over time, with an eye on ensuring that CMA does not become overburdened or try to overextend itself.
- There is a requirement to build a local MFI ratings capacity, based upon commercial ratings support and linked to a credit information exchange. The information exchange should include both positive and negative information. If customers are to graduate to the commercial banking system, they will need to have established an accessible, good credit history. A credit information system is being established for the commercial banking sector. There should be one, along the same lines, for the microfinance sector.

Micro level (Retail):

- There is a requirement to provide support to strengthen retail institutions, particularly those below the level of Licensed MFIs, with the provision of intermittent technical assistance.
- Based upon research and statistical analysis conducted at the Macro level, a need may arise to assist other forms of microfinance institutions (non-registered, community based, etc.), and to ensure that where needs are being met by such ad hoc organizations, those needs continue to be met. The greater the variety and flexibility in the system, the stronger it will be.

Further links should be created between NGOs dealing with the destitute and MFIs. This will allow destitute people to become non-destitute, via NGO support, and to ease into the microfinance sector.