

Microfinance as a Tool for Poverty Reduction

Current State and Future Prospect

By empowering the rural poor to move out of the poverty trap, microfinance can accelerate the speed of poverty reduction. Further development of microfinance depends heavily on macroeconomic stability, good infrastructure in rural areas, and a regulatory environment to promote microfinance services such as saving deposits.

Development of financial services is important in the process of economic development. Many economic research papers have proved the link between economic growth and the depth of financial intermediary. However, in developing countries, financial services tend to be underdeveloped.

Rural areas, in particular, are underserved. Rural households face limited access to formal financial services. Consequently, many have no choice but to utilise informal services which are generally extremely expensive, even exploitive.

The development of financial services in rural areas is important to promote rural development, and thus economic growth. In this context, the development of microfinance needs to be undertaken immediately.

Definition of Microfinance

Microfinance is used to refer to financial services for poor and low income people. According to Prakas number B7-02-49 issued by the National Bank of Cambodia (NBC), microfinance is defined as "the delivery of financial services such as loans and deposits to the poor and low-income households, and to micro-enterprises".

Microfinance may include several services such as credit, savings, payment transfer, and insurance. However, in many countries credit is the most common financial service in rural areas. Consequently, micro-credit is often used to refer to micro-finance.

Another term that is often used interchangeably with microfinance is rural finance. As most of the poor live in rural areas, microfinance and rural finance are like two sides of the same coin.

Why Microfinance?

Why do we need microfinance? In short, we need microfinance because commercial banks tend to be concentrated in urban areas and they tend to serve clients who are relatively better off. The poor in rural areas are unable to access any financial services, allowing microfinance to play a leading role.

In Cambodia, with the exception of ACLEDA Bank, the operation of commercial banks are limited to Phnom Penh city and some provincial capitals such as Siem Reap and Sihanoukville. Hence, there is a strong need for microfinance in rural areas.

How does Microfinance Contribute to Poverty Reduction?

Since the poor in rural areas do not have access to any formal financial services, there is a large excess demand for such services. Lack of capital is among the most binding constraints for rural businesses. It is commonly noted that the poor are trapped in extreme poverty by exploitive informal credit. Thus, providing a secure cheap source of funding to the rural poor can empower them to move out of the poverty trap.

"For Cambodia, the number of people living on less than one dollar per day has declined from 36% in 1998 to only 28% in 2005... However, we are not satisfied with this, and we remain committed to further reducing this number. To achieve this objective, the microfinance sector should be the priority... Thus, to attract more attention to this sector, I would proudly announce 2006 as the Year of Microfinance in Cambodia", Prime Minister Hun Sen's Opening Address at the National Conference on Cambodian Microfinance.

The role of microfinance in poverty reduction is well documented. For example, the Consultative Group to Assist the Poor (CGAP) found that in India, half of SHARE clients have graduated out of poverty. Likewise, in El Salvador, the weekly income of FINCA clients increased on average by 145 percent.

Notwithstanding the important role of microfinance in poverty reduction, the United Nations suggested microfinance as a tool to fight poverty and achieve the Millennium Development Goal (MDG). It went further to declare 2005 the Year of Microfinance. The government of Cambodia followed suit by declaring 2006 as the Year of Microfinance.

Box 1: Prakas Issued by the NBC for MFIs to Implement

No.	Prakas No	Date	On
1	B700-06	Jan 11, 2000	Licensing of MFIs
2	B7.01-115	Aug 14, 2001	Calculation of Interest Rate
3	B7-02-45	Feb 25, 2002	Reserve Requirement
4	B7-02-47	Feb 25, 2002	Reporting Requirement
5	B7-0-48	Feb 25, 2002	Liquidity Ratio of Licensed MFIs
6	B7-02-49	Feb 25, 2002	Registration and Licensing of MFIs
7	B7-02-186	Sep 13, 2002	Loan Classification and Provisioning
8	B7-02-189	Feb 25, 2002	Implementation of Chart of Accounts

Source: Tal Nay Im (2006), "Role of the National Bank of Cambodia and Regulation for Microfinance", presented at Microfinance conference, January 11-13, 2006

History of Microfinance

The history of microfinance in Cambodia is quite recent. It started around the early 1990s. Small-scale loans were provided together with humanitarian aid to refugees living along the Thai border. According to the NBC, there were about 90 NGOs offering microfinance services. Lending was done as group loans where members have to guarantee each other.

After the Paris Peace settlement, NGOs kept on providing financial services to the rural poor. Among the early main players are the Agence Française de Développement (AFD), Groupe de Recherche et d'Echanges Technologiques (GRET), United States Agency for International Development (USAID), European Union (EU) etc.

In 2000, with the banking system reform program in place, the law on banking and financial institutions promulgated at the end of 1999, and with the inactivity and risks related to unsupervised NGO financial services, the NBC decided to issue a number of regulations to transform NGOs into microfinance institutions under NBC supervision. As of December 2005, eight prakas have been issued by the NBC for microfinance institutions (MFIs) to implement (see box 1).

Among the prakas issued by the NBC, were prakas number B7-02-49 on the registration and licensing of microfinance institutions. According to the prakas, microfinance operators that meet a certain scale must register with the NBC. Those with a larger scale must apply for licenses from the NBC or reduce their scale of activity. Registered MFIs and licensed MFIs must report to the NBC on a regular basis.

As of December 2005, there are 16 licensed MFIs and 24 registered MFIs in operation. The number is expected to keep on increasing together with the activity expansion of non-registered NGOs.

In the process of formalization, microfinance has been commercialised. Microfinance is no longer humanitarian aid; it is a business. Nev-

ertheless, commercialisation does not mean that microfinance ceases to be a tool to fight poverty. On the contrary, commercialisation is expected to accelerate the speed of poverty reduction.

So far, the Royal Government of Cambodia has been playing a very critical role in the development of microfinance. With technical assistance from the Asian Development Bank (ADB), the Government issued The Financial Sector Blueprint for 2001-2010 in August 2001. The establishment of the Credit Committee for Rural Development (CCRD) in 1995 and Rural Development Bank (RDB) in 1998 was an important step in the development of the microfinance sector. In addition, with support from the NBC, the Cambodian Microfinance Association (CMA) was founded in January 2004.

Outreach

Microfinance is a dynamic sector in Cambodia. All aspects of the sector have seen remarkable progress. As of September 2005, microfinance institutions are serving 371,054 borrowers compared to 291,453 in 1999. The number would increase to more than 480,000 if a commercial bank deeply involved in microfinance, ACLEDA Bank, is included.

The size of outstanding loans has been increasing at a faster pace from US\$18 million US\$50 million during the 1999-2005 period. ACLEDA Bank loans have more than tripled from US\$26 million in 2002 to US\$91 million in September 2005. Deposit services have also seen a remarkable expansion. Total deposits have doubled from US\$1 million in 1999 to US\$2.3 million in 2005.

Limited Access to Loans

Though the sector has gone through remarkable improvements, many issues still need to be solved. Other services besides credit such as micro-insurance hardly exist. Deposits only amount to about five percent of

outstanding loans. Microfinance institutions still depend heavily on external funding sources.

In addition, microfinance has not been able to serve the poorest of the poor who need it the most. The very poor generally cannot take out any formal loans since they neither have collateral nor the ability to join any borrowing group.

Even with some improvements, interest rates on loans are still high compared to that of neighboring countries. Rates are also high compared to the Return on Investment rate (ROI) in rural areas such as rice farming and husbandry.

High Interest Rates

So far, interest rates on loans have been following a downward trend. Monthly interest rates have decreased from about 5 percent to an average of 3 percent to 3.5 percent. In addition, according to CMA, effective interest rates have been declining from about 10 percent per month to about 3 percent to 3.5 percent per month.

The sharp decline is due in part by the change in calculation method from "flat rate" to "declining balance". The declining balance method was required by Prakas number B7-01-115 on Calculation of Interest Rates issued on August 14, 2001 by the NBC.

It is also worth noting, that interest rates on informal loans have also declined due to competition from microfinance institutions. Therefore, even those who are not able to take any loans from MFIs can also enjoy indirect benefits through enhancing competition.

Table 1: Average Cost of MFIs in Cambodia

Item	Cost (%)
Operating Cost	18 ~ 20
Cost of Fund	6 ~ 8
Loan Loss	2 ~ 3
Inflation	3 ~ 4
Total	29 ~ 35

Source: CMA (2006), "Interest Rate"

Even with the decline in the past decade, interest rates on loans are still high compared to international standards and business profitability in rural areas. For example, paddy cultivation and cow raising both have a return on investment rate (ROI) of about 100 percent on average. Therefore, a 36 percent payment of interest rate would mean one third of total return.

Why are Interest Rates so High?

There are many reasons behind high interest rates on loans. Generally speaking, interest rates tend to be higher in microfinance than that of commercial banks. This is due to the high unit cost of operations associated with small loans.

Furthermore, the fact that microfinance institutions operate in rural areas where infrastructure is poor and energy costs are relatively high also contributes to high operating costs. Low population density and large covered areas also increase the cost of operations in microfinancing 'doorstep' banking.

Therefore, one issue facing microfinance is the nature of its trade which is to serve clients in rural areas with relatively small loans per client. Nevertheless, a large part of the problem is due to a lack of local sources of funding for microfinance institutions.

Currently, microfinance institutions are depending heavily on external funding. Most MFIs borrow from abroad paying on average interest rates of around 10 percent to 12 percent per annum including withholding tax on payment. The interest rate charge is much higher than the London Inter Bank Offer Rate (LIBOR) due to high country risk premium. Banks in other countries with lower country risks enjoy lower interest rates.

MFIs have not been successful in shifting to local funding sources. With the exception of ACLEDA Bank, which is a commercial bank, savings amount to only 5 percent of MFIs' loans. Most of the savings are compulsory savings. Many MFIs have tried to

mobilise voluntary savings but none have been quite successful.

Lack of trust in microfinance institutions is the main reason behind this failure. Past experience has caused mistrust in financial institutions in Cambodia. It takes time for trust to be gradually restored. More importantly, the concept of microfinance is still relatively new for most Cambodians, therefore they need time to learn about the system. Significantly, the term "microfinance institution" is difficult for rural Cambodians to understand and many microfinance institutions have abortively tried to use the term "rural bank" instead.

MFIs have also been unable to utilise commercial banks' excess deposits. According to the NBC, commercial banks' total deposits exceed total outstanding loans by US\$400 million much larger than the US\$80 million funding deficit of MFIs and ACLEDA Bank (see Figure 1). However, even with some initiatives by donors, such as IFC-MPDF and USAID, to transfer the excess deposits from commercial banks to microfinance institutions, none has been realised. As a result, Cambodia still has to pay millions of dollars per annum to foreign investors.

In addition to high operating costs and high costs of funds, currency depreciation put an additional burden

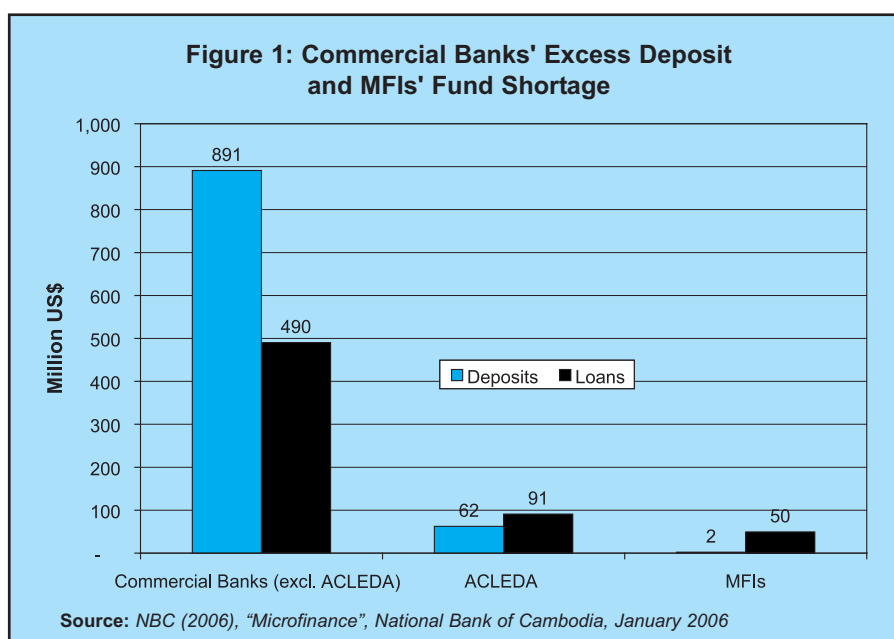
on the already high interest rates on loans as MFIs need to hedge against the currency mismatch. Consequently, interest rates on Riel denominated loans are generally set at about 0.5 percent higher than that of dollar denominated loans. This means an additional six percent per annum.

Besides, inflation can also contribute to high interest rates as it is taken into account when MFIs set interest rates on loans. Thus, given the same real effective interest rates, inflation is added up in nominal interest rates. Borrower, therefore, must pay the cost of inflation under high nominal interest rates.

How to Lower Interest Rates?

As interest rates on loans are set by adding up all costs with profit margins, to lower interest rates, each cost must be reduced. In addition, we must ensure a healthy market structure through fair competition so that profit margins are set at a reasonable level.

There are five determinants of interest rates on loans; cost of funds (including tax), operating costs, loan loss provision, currency depreciation, and inflation. According to CMA, operating costs and cost of funds are the largest costs followed by inflation and loan loss. On average, operating costs amount to 18 to 20 percent of the



outstanding portfolio (see Table 1). Cost of funds amount to 6 to 8 percent of the outstanding portfolio. Thus, reducing the two costs would have the largest possible effect.

Operating costs generally decline along with years of operation due to the learning-by-doing effect and economy of scale. A study by M-CRIL and CGAP found operating costs to decline significantly along with the years of operation both abroad and in Cambodia.

A case study of an MFI, CEB, has found evidence of such an increase in efficiency. The loan portfolio per credit officers increased from US\$16,712 to US\$69,042 from 2001-2005. The number of active borrowers per credit officers increased from 75 to 122.

However, improvement of efficiency and productivity will come to a halt after a certain period of time. Thus, to further reduce operating costs, we need to reduce the cost of doing business associated with poor infrastructure, high energy costs etc.

To reduce the current cost of funds, the most effective way is to mobilise local savings. To MFIs, local savings would not only reduce the cost of funds, but also provide some hedging against liquidity risks incurred with over-dependency on few creditors. Finding a way to channel excess deposit from commercial banks to MFIs is also an alternative.

Further reduction of interest rates on loans can also be achieved by sustaining macroeconomic stability. Keeping a low inflation rate and a stable exchange rate is an important task. Consequently, rising inflation in the last two years is a concern.

Future Prospect

The future prospect of microfinance in Cambodia is bright. Microfinance will keep on expanding its cover area. ACLEDA Bank, the largest player, is planning to expand its cover area to the provinces of Rattanakiri and Mondulakiri making it the first bank in Cambodia to have a branch network

covering all provinces and towns.

In the long run, interest rates on loans will further decline due to improving efficiency, better infrastructure, and increasing local savings. However, the pace of decline will depend on Government support in providing a better infrastructure network, reducing the cost of doing business such as corruption and bureaucracy, and sustaining macroeconomic stability. It also depends on the government's ability to play its role in monitoring fair competition among players.

In the short run, the decline of interest rates would be minute as improvement in efficiency is slowing down with the number of years of operation. In addition, infrastructure rehabilitation can only be achieved gradually over a long time span.

Other services beside loans and savings will develop gradually. Some MFIs, such as AMK, have started some services such as life insurance. However, the pace of development will depend on the ability of the NBC to work as a regulatory institution.

MFIs are expected to keep on performing well in the coming years. Even though return on investment might decline due to enhanced competition, it is expected to remain at a healthy rate. Portfolio at risk (PAR) is expected to stay under control as MFIs learn from their past experience.

However, microfinance institutions may not be able to serve the very poor in the near future due to excess demand. Furthermore, provid-

ing credit to the very poor with no other supporting measures such as technical training etc. stands a high chance of failure.

Conclusion

Microfinance can contribute to poverty reduction by empowering people to start up a business and move out of the poverty trap. In Cambodia, the microfinance sector has progressed strongly in the last decade.

However, there are still many challenges such as high interest rates on loans, inability of the poor to receive any microfinance services, and underdevelopment of other services besides loans.

Nonetheless, microfinance is expected to keep growing. Interest rates are expected to keep declining even with a slower rate than until now. Several microfinance services such as micro-insurance are being developed. MFIs will be able to sustain their healthy performance in the coming years.

The pace of interest rate reduction will depend heavily on the Government's ability to provide macroeconomic stability and better infrastructure, deal with corruption and bureaucracy, and provide a fair playing ground to MFIs. Likewise, development of other microfinance services besides loans will depend on the ability of the NBC in performing its role as a regulatory institution.

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Box 2: Policies to Reduce Interest Rates on Loans

Interest Rate Determinant	Recommended Policy
Cost of Fund	Credit Insurance Scheme Infrastructure Rehabilitation Macroeconomic Stability
Operating Cost	Infrastructure Rehabilitation
Loan Loss	
Currency Depreciation	Macroeconomic Stability
Inflation	Macroeconomic Stability
Profit Margin	Fair Competition

Source: Author, based on various sources