Microfinance Alert in Cambodia:
How significant is individual lending?

M-CRIL advisory on loan sizes in Cambodia – 3

In August 2019, a Cambodian NGO, LICADHO (Cambodian League for the Promotion and Defence of Human Rights) published a damning report on the conduct of Cambodian MFIs towards their borrowers. The report, titled: **COLLATERAL DAMAGE: Land loss and abuses in Cambodia's microfinance sector**[1], accuses Cambodian MFIs of reckless lending by offering loans to clients who could not afford to repay them and then pressurising the clients into repaying loans through "coercive land sales or other unethical measures".

In **Note 1**, we summarised the contents of the LICADHO report and reviewed **the evidence for the allegations made and the likely scale of the problem.** We noted the high leverage (large loan size relative to average incomes) of microfinance clients in Cambodia, particularly for some of the largest MFIs who are increasingly lending to individual borrowers. We also noted that with the qualitative research seeking out only those clients with stories of distress, our estimate of the scale of the problem is that such clients are likely to be a very very small percentage (0.27%) of total microfinance borrowers. Nevertheless, even if a small number of borrowers are affected (around one in 370), that is still too many. And the aim is to bring this down to zero. The question is how? In **Note 2,** we considered

- **The action that MFIs and the international community need to take to mitigate and prevent the abuses alleged by the LICADHO report**.

The mission of microfinance is widely understood to be to enable low income families to improve their lives. **If, in any part of the world, microfinance results in the loss of livelihoods or becomes a cause of distress or abuse even for a single borrower it is a matter of very serious concern.** Indeed, if microfinance loans are pushed onto low income households beyond reasonable limits (at high levels of leverage), resulting in a loss of livelihoods or in various forms of abuse, it could be termed a violation of human rights (as suggested by the LICADHO document).

In practice, therefore, MFIs should be concerned if
- (i) there is any overselling of loans by their field staff
- (ii) their loan conditions/collateral conditions result in a loss of land, out-migration, child labour or a decline in the quality of food consumed by over-indebted borrowers.

For this purpose, in **Note 2** we suggested a two-pronged approach

First, that MFIs should establish Livelihood Restitution Teams to determine and support those of their borrowers in genuine distress

[1] http://www.licadho-cambodia.org/reports/files/228Report_Collateral_Damage_LICADHO_STT_Eing_07082019.pdf

Second, that there should be a more sensitive policy of loan rescheduling and write-off of loans outstanding with those in genuine distress than is currently the case.

Note 3: This is the third note in the series; here we consider some of the feedback received on the first two notes and seek to address it. The following are the key points that have been made

(a) Default by a small number of borrowers is an inevitable consequence of the risk inherent in any form of lending; trying to eliminate risk will only result in stalling the activity altogether and denying credit to the overwhelming majority of borrowers who are, in fact, able to use it productively. Livelihood restitution for those in distress is a good idea but it is a task better suited to NGOs/social workers than to MFIs.

(b) A large proportion of the microfinance borrowers in Cambodia have quite small loans and the average hides both this large proportion as well as the fact that the larger loans are made to MSMEs (the "missing middle") not otherwise served by the financial sector; some MFI practitioners argue that, to this extent, even the larger loans serve a socially useful purpose and the average microfinance loan size in Cambodia should not be compared with that in other countries.

M-CRIL's view

(a) It is apparent that risk is an inherent part of lending (or borrowing) and some part of this will result in failure; the key is for lenders to work on minimising that failure. The critical measures needed to minimise failure are

(i) realistic rather than aggressive targets for growth so that field officers have the time and inclination to source credit-worthy clients and undertake well informed appraisals

(ii) programmes of "livelihood restitution" that identify genuinely distressed borrowers (as opposed to wilful defaulters) and work with them to reschedule and/or refinance loans at the same time as facilitating linkages and other support services to enable the restoration of livelihood activities endangered by severe climate or other adverse conditions; in the extreme, loans may need to be written off – as pointed out in Note 2, write off ratios in Cambodia are currently extremely low, which provides the cushion necessary to enable this type of "generosity". This is a specialist enterprise support activity rather than a social intervention; undertaking it needs both financial skills and micro-enterprise experience – a different set of skills from those of social workers or even of typical loan officers; sensitive MFI managements will need to set up appropriately skilled teams to deal with it.

(b) A disaggregation of loan size in Cambodia is presented in **Table 2**. This is based on group and individual loan information obtained from the annual reports of 14 of the largest MFIs in the country. Based on M-CRIL's deep knowledge of Cambodian microfinance this analysis assumes that small loans are provided through group processes while individual lending is only worthwhile for larger loan sizes that exceed $1,500. **Disaggregated data for the 69 MFIs** that are members of CMA (Cambodia Microfinance Association) but not included in this analysis **is not available**. As a result, roughly 12.5% of borrowers and 16.5% of the MFI portfolio is excluded from the analysis in the table. However, the included MFIs cover a sufficient proportion – around 85% – of Cambodian microfinance for us to reach workable conclusions.

Table 2 Cambodian MFI portfolios by type of lending process

Largest 14 micro-lenders, 31 December 2018*	**Borrowers** number		**Portfolio**		**Average outstanding loan**
Lending process	'000	% of total	US$ million	% of total	US$
Group loans	722	32.2%	313.7	4.6%	434
Individual loans	1,522	67.8%	6,529.3	95.4%	4,290
Total for largest 14	**2,244**	**100%**	**6,843.0**	**100%**	**3,050**
Other 69 MFIs, June 2019	318		1,355.2		4,266

The table shows that over two-thirds of microfinance loans in Cambodia are now provided as individual loans. Such loans are "secured" by both individual guarantors and physical collateral – usually agricultural land, residential property or business premises. The remaining one-third are subject to group guarantees in theory but (contrary to international practice) are still secured by physical collateral in Cambodia. Most significantly, the

- Average outstanding **group loan** is $434 – in relation to the analysis in **Figure 1** of **Note 1** this is 29% of per capita income – still significantly higher than the 9-18% of per capita income in other Asian countries with large microfinance sectors but manageable as a level of indebtedness for group borrowers – usually amongst the poorest in the community.
- Average outstanding **individual loan**, however, is nearly $4,300; **just under 3 times per capita income** in Cambodia. The argument of some microfinance leaders that individual lending finances the "missing middle" is partly borne out by this except when one considers the number of loans around this average figure; 1.5 million loans of this magnitude amounts to $6.5 billion outstanding in a country with a GDP under $24 billion and population of just 16.5 million.
  - As indicated above, we do not have specific information on the 69 smaller MFIs in Cambodia. Nevertheless, it is well known that virtually all have switched to individual lending. The estimated average outstanding loan size of these 69 MFIs (using the cumulative numbers in **Table 2**) is almost the same as that for individual loans from the largest 14 for which we do have information. Therefore, we assume that these are all individual loans with large loan sizes and the total number of large individual **loan accounts** from MFIs then amounts to 1.8 million.
  - Given the well known phenomenon of multiple borrowing in Cambodia (as in other countries) we estimate multiple loans to be of the order of 30-40% of loan accounts and therefore, calculate that there are roughly 1.3 million MSME clients – covering 35% of the 3.7 million households in the country.
  - In a low income country like Cambodia, 35% of households dependent largely on MSMEs is quite plausible. However, this means that the average outstanding loan size for such clients increases to $6,000 or 4 times per capita income for the **entire set of MSME borrowers**.
  - It is the sheer numbers over which this average outstanding loan is spread that makes the figure of $6,000 (4 times per capita income) seem excessive and unsustainable. Given the well known practice of cross-financing loans across MFIs before their term is complete, there are elements in this of a form of "ponzi" scheme – the system only works so long as more and more money continues to be pumped into the system by international investors and lenders, enabling the cross financing referred to above and **continuously pushing up the loan size**.

- But what happens when international investors/lenders are satiated and find other more remunerative investments perhaps in other countries? There is clearly some cause for concern from their perspective as well as that of the borrowers who stand to lose their collateral and their livelihoods if there is such a turn of events and loan sizes, on the one hand, and the number of borrowers, on the other, have to be reduced suddenly. In this situation, **it will no longer be possible to borrow from one MFI to pay another leading to widespread borrower default** and perhaps even the collapse of some micro-lenders.

Is there a solution?

It is difficult to see a solution in a situation where most MFIs continue to record 20-30% returns on equity (and more in a few cases) and where these are increasingly owned by financially powerful east Asian banks. Technically, the whole sector needs to moderate its growth projections (simultaneously to avoid imbalances between MFIs) and reduce the phenomenon of cross financing to enable a "soft landing". In practice it is unlikely that this will happen despite all the efforts of CMA, ADA and the group of investors supporting the "Lending Guidelines" and despite warnings such as that contained in this note. Experience from all countries that have had major microfinance crises – India, Bosnia, Nicaragua, Pakistan, Morocco – shows that ultimately MFI managements and investors only learn lessons when stark examples of failure appear before them. As a well-wisher of the Cambodia microfinance sector and a believer in the development potential of microfinance for supporting low income households, M-CRIL hopes that the example of loss necessary to instil discipline will not be too extreme.

In the meantime, a suggestion for the regulator (National Bank of Cambodia): In case this is not being done already, it would be productive to undertake regular analyses of the microfinance portfolio in the country both as a trend from one year to the next and as a cross-section (between MFIs) to determine at a macro-level what contribution there is by the sector to track the pattern of access to credit for the poorest sections of the population and what increase there is in the MSME (or individual) loan portfolio of the sector. Most important, is to curb the practice of refinancing of loans across MFIs – lending by MFI B to client X before she has fully repaid her loan to MFI A – to reduce unproductive growth in loan sizes. Ensuring that one loan is fully repaid before another loan is made to the same borrower is prudent since it enables both client and lender to determine that the borrower herself has the capacity to repay a loan of one size before offering her a much larger loan. M-CRIL would be happy to discuss this with the regulator.

M-CRIL is a responsible development research and analytics firm with around two decades of experience in Cambodia and a substantial record of analytics in international microfinance including client protection assessment and certification as well as microfinance ratings, programme evaluations and focused management training and capacity building support for MFIs.