

## **Carping Critics and the Microfinance Conundrum: Cambodia's need for microfinance reform**



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**Does the discussion in Advisory Note-1 on this subject mean all is well with Cambodian microfinance: It does not.** Countrywide data shows that microfinance in Cambodia has grown very fast with the ten largest microfinance institutions (MFIs) registering portfolio growth rates of around 25% per year over an extended period of time while borrower numbers have grown at around 9% per year over the past decade. This discrepancy between portfolio and borrower growth rates has resulted from a strong push to increase average loan sizes with microfinance field staff encouraged to re-finance loans and provide additional funds often within 4-5 months of disbursing the previous loan. As a result, the average outstanding loan amongst borrowers covered by the M-CRIL survey was \$6,200 in early 2023. This amount is more than three times the country's \$1,765 GDP per capita in 2022 but since loan tenures have extended to 3-4 years, in terms of loan servicing capacity, it is roughly equivalent to the GDP per capita level in that year. Given that microfinance borrowers, though not the poorest households in the country, still have average earnings much less than the GDP per capita, this is nevertheless a substantial burden. It compares with average loan sizes of the order of 20% to 30% GDP per capita in the Philippines, Bangladesh, India and elsewhere in Asia.

**The issue of repayment stress and coercive recovery tactics by some MFIs and their staff:** In the course of the M-CRIL study, we found that 24% of microfinance clients report repayment stress and have to adopt coping strategies at one point or another. These strategies include temporary borrowing from friends and relatives or borrowing from the high interest informal money market. In around 2% of cases, this can also result in the sale of parcels of land and in around 10% of stress cases in the sale of high value assets like motorcycles, appliances or agricultural equipment. The sale of land has been highlighted by some media reports as resulting in landlessness but while the M-CRIL survey found a reduction in landholdings of the order of 20% for those who sold land, no cases of landlessness were reported either by the sample households or amongst their communities. Of greater concern, are reports of MFI field staff of some MFIs using coercive loan recovery tactics like "reporting to the police" or threats of and, in a few cases, actual sale of land pledged as loan collateral. This is a situation that Cambodia's MFIs need to take seriously and review their staff incentive systems as well as undertake strong disciplinary measures to rein in staff behaviour.

**And "astonishingly a few polite recommendations"** (to paraphrase the comment on our study by one carping critic of international microfinance):

**First, the issue of loan size:** The growth of the loan size is a major factor; it is attributed by some MFI managements to the need to control operating expenses in the context of the 18%

interest rate ceiling on MFI loans imposed by the regulator, National Bank of Cambodia (NBC). Another critical factor is the use of land as collateral for backing up the relentlessly increasing loan size. Here M-CRIL has two recommendations. First, that the central bank should back up its concern about interest rates with a much more knowledgeable approach to understanding the cost of loan intermediation to the poor – the 62% of borrowers with outstanding loans less than \$3,000 – so that a more caring pricing regime becomes the norm rather than increasing loan size as a knee-jerk reaction to the price ceiling. A process of this type has worked well in other countries (such as India) and microfinance operating expense ratios have fallen to 6-8% with interest rates to borrowers of the order of 15%, well below the interest rate ceiling in Cambodia.

**Second, collateralised lending to microfinance clients:** There is no reason why MFIs that lend to the poor (if not the poorest) should take high value land parcels worth \$20,000 and more as collateral for loans of \$2,000 to \$3,000 (since sub-division of titles is a cumbersome process). International microfinance was launched as, and is still, largely based on uncollateralised lending. Yet, Cambodian microfinance has drifted into collateralised lending even for micro-loans. If Cambodia's MFIs must provide loans in excess of \$3,000, these larger loans could be collateralised; those with loans of well over \$3,000, in any case, are usually those with better income opportunities than the poor and are, therefore, less likely to suffer distress if loan repayment becomes difficult.

**A better definition of microfinance and institutional reform:** Even better would be to split current microfinance operations into microfinance lending by MFIs while larger small enterprise and housing loans are provided by finance companies as separate entities. This will enable traditional microfinance to support relatively poor borrowers while larger borrowers are served by a better trained cohort of credit officers who make more knowledgeable decisions based on careful credit scoring and similar techniques. The current MFI intermediation that uses the same processes for loans below and above the \$3,000 cut off suggested here falls between two stools and serves neither group appropriately. Again, it is the central bank along with MFI managements that need to take a hand in creating a separate category of finance companies while limiting MFIs to loans of \$3,000 (or less if the NBC, in consultation with Cambodia's MFIs, considers it appropriate).

**Finally, client welfare requires support for distressed clients:** The fate of those who still suffer distress at least partly due to their MFI borrowings needs to be kept in mind. Published accounting information from the largest MFIs over the past 8-10 years shows annual returns on equity (RoE) of the order of 12-15% for a few while others consistently register 25-30% RoE's. Even those at the lower end of the range still have substantial returns in absolute terms, around \$10-20 million each. A small proportion of this could be set aside, say 5% of profits, to provide direct support to families in distress (carefully vetted to avoid giving other borrowers the impression that easy money is available). The number of genuinely distressed borrowers is small but the welfare effects of supporting them would be large. What's more, it would demonstrate to the world that Cambodian microfinance has a heart after all; the international media's efforts could then be more usefully deployed in understanding the

complexity of people's lives and the multifarious causes of distress rather than superficial reporting that runs the risk of destroying the whole framework of micro-lending to the detriment of many poor (if not the poorest) households.

**Sanjay Sinha**, Team Leader for the Cambodia Microfinance Impact Assessment Study,  
with the field survey ably supervised and data analysis led by Ratika Kathuria,  
Sengdy Khiev was the field supervisor in Cambodia;  
data monitors and analysts were Arpana Gone, Rejoice Parackal and Shwetangi Raj.  
Financial research was by Charlene M Samuel.