Regulation and Supervision of Microfinance in Cambodia

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Introduction

After a civil war in Cambodia, micro-finance operation was retrieved at the end of 1980, and has been strongly grown since late 1990s. However, at that time, most of micro finances were under the project of INGO and NGO.

Between 1994 and 1996 the Decentralized Rural Credit Committee helped to bring operators and the authorities closer together and to allow the later to better understand the concrete problem faced by decentralized financial systems. This jointly run organization, having ceased to exist the National Bank of Cambodia, assumed the responsibility for supervising this sector through its Bureau for the Supervision of Decentralized Bank Systems set up in 1997 within the Department of Banking Supervision. The Credit Committee for Rural Development has been created for the purpose of formulating strategies to improve the efficiency of rural credit and to support the institutional strengthening and promoting private sectors. In order to have a positive development of microfinance, the government has tried to issue a number of policies through several authorities. Having a legal framework for sound supervision and regulation on microfinance and the role of Credit Committee for Rural Development are important for development of microfinance. Since 1998, this Bureau has actively helped to introduce regulations specific to micro finance institutions.

The National Bank has a role to coordinate these by making a system for microfinance operators to transform into microfinance institutions, recognized and licensed by the National Bank of Cambodia. Therefore, fund can be preceded from the rural development banks, commercial banks, or local financial institutions and international finance institutions.

The institutionalization is necessary at that time because local credit sources are important by not depending on outside sources for fund any more. The government has established rural development banks, under the supervision from the sponsored partners such as ADB and the party involved such as Ministry of Economy and Finance. Its purpose is to improve the development of rural agro-economic activities.

Royal Government of Cambodia supported the expansion of rural credit and saving through cooperating with the licensed microfinance institutions and commercial banks. Improving rural development banks was the key to provide refinancing to microfinance operators in order for them to provide long-term loans to rural people with sustainability. By strengthening microfinance institutions, the government would create financial laws and regulations through the National Bank at the end 1999.

With regard to this, “Good governance is important when applied for formal microfinance institutions because the issues may result in potential transfer pricing and transparency. Both local non-government and international non-government should transform themselves into commercial forms in order to enhance governance and ownership”.

A law on banking and financial institutions has been promulgated in and the law would provide a legal framework for organizations and operations of all types of banking sector, including microfinance institutions. The supervisor of microfinance requires the same commercial bank such as their capital adequacy ratio and minimum reserve for microfinance institutions.

With the advice from its partner, the National Bank has been issued the regulations, circulations or announcements to monitor and gain more control of the finance sector. All organizations giving credit must register with the government and all organizations over a certain size must become licensed. The registration and licensing are determined according to the level of loan portfolio outstanding, saving mobilized, number of clients and geographic coverage. A license allows a microfinance institution to conduct credit activities and accept saving from the publics. Moreover, to promote microfinance institutions, the bank has issued regulations on capital guarantee that shall be permanently deposited with certainty.

The government also leaves the operators free to set their interest rates. Furthermore, the demand of rural zones is high and there is no real downward pressure on the rates. Moreover, the policy of the National Bank of Cambodia has been a support, in line with its concerns and responsibilities for preserving the integrity of the financial system, promoting public confidence in the financial system, protecting deposits, preventing fraud, and encouraging best management practices.

Banking System

The banking system in Cambodia was completely destroyed in the year 1975 and in fact, there were absence of financial services from 1975 to early 1979. A mono-banking system was established in 1979 with NBC playing the role of both central and commercial bank through a network of provincial branches. Under the mono-banking system, the NBC financed state-owned enterprises provided big loans as well as small loans to needy farmers based on mutual guarantees, through twenty provincial branches all over the country. With the privatization of the banking sector in 1990 and the cessation of the NBC as a commercial bank, the needy borrowers/enterprises were deprived of accessing financial services. However, in some areas in the country, the provision of small financial assistance was taken over by non-licensed credit providers. After the adoption of the law on Banking and Financial Institutions at the end of 1999, the NBC launched a banking system restructuring program by requiring all banks to apply for re-licensing. Further in 2000, the NBC started to issue regulations on the classification of MFIs into three categories according to the level of their operations and revise regulations in order to transform NGOs into registered and licensed MFIs as per their scope of operations. At the end of 2005, the Cambodian 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 one is state-owned and 3 are private owned, 16 licensed MFIs and 24 registered micro operators operating in the rural areas. Today the institution has classified the banking sector into three types such as Commercial Bank, Specialized Bank and Micro Finance Institution. These criteria of classification depend on the minimum capital requirement and operational services.

Prudential Regulations

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. Regulation refers to the set of government rules that apply to microfinance. Supervision is the process of enforcing compliance with those rules. Prudential regulation and supervision are designed to avoid a banking crisis and maintain the integrity of the payments system; protect depositors; and encourage financial sector competition and efficiency. Microfinance providers that take deposits need "prudential" regulation. This type of regulation protects their financial soundness to prevent them from losing small depositors' money and damaging confidence in the financial system. Some instruments are used in prudential regulation, each of which is designed with a specific purpose and it include requirements for minimum capital, capital adequacy requirement, liquidity requirements, risk concentrations, limits on loan to related parties and legal reserve requirement.

1. Licensing Requirements:

The purpose of licensing Micro Finance Institution is to ensure adequate capitalization and sound management that satisfies the requirement of regulation. A licensed MFI shall only conduct banking operations such as credit services and savings in their operating area. An MFI license is valid for a period of three years, from approval date and it shall pay a fee of KHR 50,000 for a license. Licensing is compulsory for all micro finance institutions, if they meet one of the following conditions:

a. For those engaged in credit: Their loan portfolio outstanding is equal to or greater than KHR 1,000 million, or they have 1,000 borrowers or more.
b. For those engaged in savings mobilizations: the savings mobilized from general public amount KHR 100 million or more, or the number of their depositors is 1,000 or more.

2. Registered Requirements:

The purpose of registered Micro Finance Operator with National Bank of Cambodia is compulsory for non-governmental organizations, associations and other entities engaged in microfinance, if they meet one of the following conditions:

a. For those engaged in credit: their loan portfolio outstanding is equal to or greater than KHR 100 millions.
b. For those engaged in saving mobilization: the savings mobilized from the general public amount to KHR 1 million or more, or the number of their depositors is more than 100 or more.

The National Bank of Cambodia shall deliver a certificate of registration to micro finance operators that present official request for registration, meets the set standards and criteria. This certificate can be withdrawn and the registration cancelled if the operators do not comply with conditions set by the National Bank of Cambodia.

3. Minimum Capital Requirements:

It is the lowest amount of capital that owners can bring to the equity account of an MFI seeking a license. There are some kinds of investors who are willing and able to invest in MFIs but they may not be able to come up with the amount capital required for a normal MFI license. During the institutionalization of MFI in Cambodia, most of major shareholders came from oversea or non governmental organization in their project and some part from the staff of MFI. In Cambodia an MFI license shall be incorporated as a limited liability company or a cooperative. It must have a minimum registered capital of KHR 250 million and registrants with no operating history must pay up 100 percent of registered capital into an account with NBC prior to commencement of operations. A licensed MFI must have business plan over the next three years. Furthermore, capital contributors holding 5 percent or more of capital voting rights of the institution must provide minimum information to NBC.

4. Capital Adequacy Requirements:

The underlying rationale for capital-based supervision is that MFI will be less likely to fail or take on excessive risk if their owners are forced to place more of their own money at risk. In effect, the more capital backing a MFI's activities, the more its stockholders will likely exercise quality control over the MFI's operation. However, there are limits on how much capital regulators can demand from MFIs. These provisions require deposit-taking institutions to maintain a minimum fixed amount of capital and prevent the ratio of equity capital to total assets from falling below a prescribed level. These rules encourage responsible behavior by the institution's owners because their equity capital will be reduced first by losses. A licensed MFI shall maintain a capital adequacy ratio (CAR) of at least 20 percent between eligible capital which it includes core capital and hybrid capital instruments and its weighted risks. Eligible capital will include, core capital Tier I, and hybrid capital instruments such as non refundable subsidies (public grants), public guarantee funds to cover risks on credit to the clientele, and perpetual subordinated debts (elements of Tier II capital).

5. Reserve Requirements:

Many countries require MFIs to maintain reserve equal to percentage of certain type of deposits. These reserve may be a useful tool of monetary policy, but they amount to a tax on saving, and can squeeze out small deposits by raising the minimum deposit size that MFIs can handle profitably. All licensed MFI shall deposit 5 percent of its deposits into its account maintained with the National Bank of Cambodia. The reserve requirement shall be maintained as deposit in the institution's account with the National bank of Cambodia. It will be calculated on the basis of the deposits outstanding at the end of each month, as reporting in financial reports.

6. Liquidity Requirements:

Many MFIs establish their liquidity needs based on experience. Through the mechanisms of liquidity ratios and reserve requirements, and by ensuring that the National Bank of Cambodia regulations which is a supervisory authority guarantees that institutions maintain adequate liquidity.

Liquidity risk refers to cash flow problems when assets cannot be liquidated easily and when there is no access to liquidity pools. Delayed loan repayments or grant receipts can severely limit the institution's ability to respond favourably to credit demand or withdrawals of deposits. If liquidity shortages restrict lending operations, the incentive for borrowers to repay their loans may be weakened. Since small savers tend to make frequent withdrawals and deposits, managing liquidity becomes difficult. Licensed MFIs shall at all times maintain a liquidity ratio of at least 100 percent. This ratio will be calculated as : numerator such as cash on hand, plus deposits with National Bank of Cambodia, plus deposits with the banks, minus the amount owed to the National Bank of Cambodia and banks, plus portion of loan outstanding maturing in less than one month and its denominator such as 25 percent of voluntary saving , excluding the compulsory saving.

7. The classification of and provisioning for bad and doubtful debts:

Credit risk refers to the danger of late or non-repayment of loans. Despite the often-observed high repayment rates in microfinance, the use of collateral substitutes combined with weak contract enforcement power creates considerable risk. Repayment incentives mainly derive from the promise of access to subsequent loans. However, these conditions may not be enough to ensure repayment, particularly when access to repeat loans appears threatened, for instance by liquidity shortfalls, economic crises, high dependency on donor funds, or when the methodology employed produces conflicting incentives, as in group lending when a few group members default. Default risks are highly correlated when loans are granted to a relatively homogeneous clientele in terms of geographical proximity and/or market segment. Micro loan portfolios typically lack diversification, primarily comprising short-term working capital loans. They can be adversely affected by an externality such as drought or flooding.

MFI must organize their internal accounting information system in such a way that they are able at any time to provide the National Bank of Cambodia with information of classification and provision of the loan to clients. MFI shall classify their loan outstanding into the four classes such as standard, sub-standard, doubtful and loss. The mandatory minimum level of specific provisioning, it depends on the classification concerned such as substandard 10 percent, doubtful 30 percent and lost 100 percent. The credit classification was classified standard credit when good financial condition and punctual payment of principal and interest, sub-standard credit when some payments of principal and or interest are overdue by 30 days or more, doubtful credit when some payment of principle and or interest are overdue such as 60 days or more in the case of a loan with an original term of one year or less than one year or 180 days or more in the case of a loan with an original term more than one year and loss credit when some payments of principal and or interest are overdue such as 90 days or more in the case of a loan with an original term of one year or less than one year or 360 days or more in the case of a loan with an original term more than one year. The specific provision shall be recorded in the accounts and charge the profit and loss account in the month in which the need is identified. The profit and loss account shall be recorded with accrual basis for its interest to clients.

8. Loans to related parties:

Loan to related parties is defined any person holding directly or indirectly at least 10 percent of capital or voting rights, any company of which the covered entity directly or indirectly hold at least 10 percent of the capital or voting rights, any individual who participates in the administration, direction, management, or internal control, and the external auditors.

Loans and overdraft to related parties must be made under normal conditions of duration, interest rate, collateral and repayment schedule. Normal conditions are understood as the condition that would be made to other non-related customer in similar circumstances. The total weighted outstanding of loans to related parties will in no case be superior to 10 percent of the MFI’s net worth. The calculations to related parties shall not include the MFI’s placements with head office or mother company.

<u>Prudential Supervision</u>

Supervisory activities are confined to those of prudential regulation. Supervision includes frequent that allows short-term commercial monitoring because risks and financial borrowing to manage temporary liquidity position change constantly in financial problems. In order to ensure soundness and sustainability, National Bank of Cambodia conducts its work both onsite and offsite to monitor the MFIs. NBC has elements of supervisions such as:

- To check board of directors and management team oversights on MFI

- To check the availability of MFI's policies and procedures
- To check the internal control system of MFI
- To check the management information systems of MFI

NBC tries to understand MFIs activities and it has assess the managing risk of MFIs through planning, scheduling, defining the supervision activities and it make report after they found during the onsite inspection.

NBC has its offsite inspection through monthly reports for licensed MFIs such as:

- Balance Sheet
- Income Statement
- Off-Balance Sheet
- Break down of deposits
- Loan Breakdown by category
- Loan Breakdown by currency
- Deposit Breakdown by currency
- Loan Classification, Provisioning and Delinquency Ratio
- List of Loans to Insiders and Related Parties
- Capital Adequacy Ratio for Microfinance Institutions
- Liquidity Ratio for Microfinance Institutions
- Microfinance Institutions Network Information
- Calculation of Foreign Currency Exposure

In addition, All MFIs must adopt chart of accounts and disclosure requirements for implementation and compliance by all MFIs licenced by the NBC.

Conclusions

The present study concluded that there was a good regulation and supervision by National Bank of Cambodia to Micro Finance Institutions. This shows that the Micro Finance Institution has positively gone inside the framework of rule of law for the development of the economics in Cambodia. Necessary supportive environment must be maintained by the Royal Government of Cambodia. Today Cambodia is proud of the expansions of MFIs with involvement of regulators from different sections of society. Thus, the role of MFIs played by this sector in economic development of Cambodia is well recognized.

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