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Making Microfinance Work for the Poor: Key Principles

Microfinance is the supply of loans, savings and other basic financial services to the poor. Recent debates in the Cambodian media about microfinance indicate the growing interest in the subject among those concerned with helping poor people have better access to finance.

This issue of the Business Issues Bulletin *discusses the pros and cons of microfinance, focusing on the* Key Principles of Microfinance *developed by the Consultative Group to Assist the Poor (CGAP).*[1] *The Principles draw from global experience in microfinance over the last three decades, and were endorsed by the Group of Eight (G8), who underscored how access to financial services by the poor can contribute to poverty reduction.*[2] *This bulletin highlights six of the 11 key principles that are most relevant to Cambodia, and includes viewpoints from a range of stakeholders.*

Microfinance is a powerful tool to fight poverty

Poor people are often overlooked by mainstream financial intermediaries such as commercial banks, yet, like everyone else, they need basic financial services, including credit, savings, insurance and transfers. Microfinance includes a wide range of services that can help poor households diversify sources of earnings, plan future expenses, take advantage of economic opportunities, and prepare better for sudden crises; from a developmental perspective, microfinance allows poor households to move from everyday survival to planning for the future. Evidence shows that, given the means, poor people will invest in a wide range of assets: better nutrition, improved health, access to schooling, a better roof on their homes and expansion of small businesses. [3]

Microfinance plays a critical role in improving the livelihoods of the poor in Cambodia. With low interest rate loans, they are able to make a profit and send their children to school. As of September 2005, there were 480,000 households receiving loans from microfinance institutions.

Mr. Bun Mony, Chairman of the Board of Directors, Cambodian Microfinance Association

In Cambodia, microfinance is a relatively new phenomenon. Credit is the most common financial service; very few deposit and insurance services are available to poor clients. During the early 1990s, community development programs of donor agencies and non-governmental organizations (NGOs) started offering microcredit; by the early 2000s, a number of these microcredit projects had successfully transformed into full-fledged, profit-oriented microfinance institutions (MFIs) offering a wide range of financial services. ACLEDA, which started out as a microfinance operator, is today one of the country's largest commercial banks.

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The *Business Issues Bulletin* provides those interested in business issues with a short summary and analysis of a particular topic affecting the business environment in Cambodia. Also included are opinons on topic from a number of relevant stakeholders.

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The statements and opinions presented here are only meant to provide additional reference material and do not reflect the official opinion of the Mekong Private Sector Development Facility or of IFC.

1 CGAP is a consortium of 31 public and private donors and a clearinghouse for microfinance. *The Key Principles of Microfinance* are available on the CGAP website at www.cgap.org/keyprinciples.html.

2 The group of the world's leading industrialized countries includes the United States of America, Canada, the United Kingdom, France, Germany, Italy, Japan, and Russia.

3 See Donor Brief No. 9: Microfinance and the Millennium Development Goals, http://www.cgap.org/docs/DonorBrief_09.pdf.

This remarkable growth reflects the strong demand for microfinance services in Cambodia. Given the absence of a functional financial market, particularly in rural areas, microfinance is often the only alternative to moneylenders who charge interest rates as high as 10% per month (120% per year),[4] which can easily entrap poor people in a vicious cycle of poverty. MFIs, on the other hand, charge more competitive interest rates that average 3% per month (36% per year).[5]

There is ample anecdotal evidence of how owners of micro and small enterprises in Cambodia have made use of microcredit to turn their entrepreneurial ideas into successful businesses, thus improving their livelihoods.

I am a charcoal seller. I buy charcoal from Kampong Speu to sell in Phnom Penh. In terms of costs, I borrow 400,000 Riels from an MFI at an interest rate of 3.5% per month and spend 300,000 Riels on the charcoal. I go to sell in Phnom Penh 13 times a month, and each time I make a profit of 50,000 Riels, which amounts to a total profit of 650,000 Riels per month. So I think the interest rate is reasonable. The local moneylender charges an interest rate of 15% per month – if I borrowed from the moneylender my profits would be lower.

Mrs Nhem Sarom, Charcoal Seller, Samroang Tong District, Kampong Speu

I am a farmer in Kandal province. I grow rice on one hectare of land. I borrow 460,000 Riels from an MFI that charges me a monthly interest rate of 3.5%. I spend about one million Riels every four months, in which time I can realize sales of 2 million Riels. If there is no drought, I can cover my interest and even earn some money. If there is drought, then I gain nothing. Regardless, the interest rate of the MFI is much lower than that of the moneylender, who charges 10% per month.

Rice Farmer, Khsach Kandal District, Kandal

Some critics say that since there has not been a study looking at the connection between microfinance and poverty reduction in Cambodia to date, the poverty reduction impact is unclear. These types of studies, however, are typically very expensive and time-consuming, and it is questionable whether such studies are needed in every country. As MFIs in Cambodia become more rigorous in monitoring their social performance and client satisfaction, the "proof of poverty impact' will likely become more evident with time.

Another question often raised is the reach of microfinance and whether or not it helps the "poorest of the poor." MFIs' strong emphasis on sustainability requires them to target the "entrepreneurial poor" who are perceived as less risky clientele. Microfinance skeptics may argue that extremely poor people or those living in remote, rural areas remain outside the reach of MFIs, and are therefore forced to resort to local moneylenders. In reality, most MFIs in Cambodia share an equal commitment to sustainability and deep poverty outreach; they seek to maintain a diverse portfolio of clients, mixing people with different poverty profiles.

Interest rate ceilings hurt poor people by making it harder for them to get credit

Interest rates (and the question of interest rate ceilings) are often raised by microfinance critics, who argue that interest rates of 3% per month (36% per annum) are "cutthroat" and too high for poor borrowers to be able to pay back their debts. Microfinance has been called by some "a revenue spinner, a tool of control.".[6] In fact, a number of politicians and development practitioners have recommended that the government impose interest rate ceilings on microcredit to protect poor people.

The current interest rate is still high. Rural people find it difficult to make a high profit. For example, with US$100 working capital, it is rare that a business generates revenue as high as US$130 to US$140 per month. High interest rates prevent those in the agricultural sector from making any profit.

Mr. Chor Leng Huong, Deputy Director General, Rural Development Bank

Decades of international experience, however, shows that interest rate ceilings can be more harmful than helpful. For microfinance institutions, it is much more costly to make many small loans than to process fewer, larger ones. Since the due diligence required to assess the creditworthiness of potential borrowers is costly and time-consuming, capping interest rates would adversely affect the sustainability of microfinance providers. MFIs would thus have to move towards larger clients, resulting in poor people having a harder time accessing much-needed financial services.

There are five factors affecting the interest rates that banks

[4] Oum Sothea and Sok Hach, *Cambodia Economic Watch,* EIC, Issue 1, Oct 2004, p. 30

[5] Ibid.

[6] Rosanna Barbero, Director of Women's Agenda for Change (WAC), quoted in an interview by Caroline Green in "Microfinance: who's helping whom?" *Phnom Penh Post,* Issue 11/14 May 24 – June 6, 2002

and MFIs in Cambodia charge their clients.[7] These include:

- Cost of funds
- Operational costs
- Risk (of default)
- Inflation
- Profit margin

Given these factors, an interest rate of 36% per year is not unreasonable – it reflects the variety and degree of costs that MFIs incur in making loans and the premiums associated with lending to many potentially high-risk borrowers. MFIs must charge interest rates that allow them to cover these costs and to continue offering microfinance services to poor clients on a sustainable basis.

Ultimately, the market should determine interest rates for microcredit, coupled with consumer protection measures such as mandatory standardized disclosure on total loan costs and financial management training programs in MFIs. The high repayment rates and repeat borrowing of microfinance customers in Cambodia at present suggest that the loans are affordable, and that the opportunity cost of forgoing access to credit may be higher.

If the government sets interest rate ceilings, it would not be sustainable in practice since the source of funds for microfinance is mainly from international loans that charge high interest rates. In a free market economy, the price is set by the market. If we set the price, then there will be market distortion. Ultimately, interest rate ceilings would adversely affect consumers.

H.E. Dr. Sum Sannisith, Secretary General, National Bank of Cambodia

The impact of an interest cap would be a catastrophe for the microfinance industry – it would collapse. No MFI could continue fulfilling its mission. The MFIs would target only the better-off clients and the poor would have to go back to moneylenders. This, in turn, will hurt the economy as a whole.

Mr. Tom Von Weissenberg, Management Advisor, Prasac MFI

Financial sustainability is necessary to reach significant numbers of poor people

Another argument for letting the market determine interest rates is that microfinance must pay for itself if it is to reach very large numbers of poor people. Unless microfinance providers charge enough to cover their costs, their pool of capital for lending will always be constrained by scarce and uncertain subsidies from donor and governments. The reach of microfinance will remain limited and poor people will still find it difficult to access credit. Allowing the market interest rate to prevail would help MFIs provide quality services on a permanent basis, enable the supply for credit to meet demand, and improve the likelihood that loans go to those who need them.

While there is no reliable data about the aggregate demand for microcredit in Cambodia, the current supply is thought to be US$58 million per year.[8] Some estimates suggest that over 50% of demand is unmet.[9] To meet this large demand, strong MFIs that have significant capacity for growth are needed; this cannot be achieved if MFIs lowered their interest rates.

The cost of funds is high because Cambodia is a high-risk country. Our cost of funds is 10.5%, inflation ranges from 4% to 5% per annum, operational cost is 14%, the loan loss provision rate is 5%, and we need to make profit. Given these high costs, an MFI cannot lower its interest rates. If it did so, it would lose money and would be unable to access additional international loans from investors. Thus, an MFI charges the current interest rate for its own sustainability.

Mr. In Channy, General Manager, ACLEDA Bank Plc.

The sustainability of microfinance is important. The collapse of microfinance would destroy public confidence in the banking system.

H.E. Dr. Sum Sannisith, Secretary General, National Bank of Cambodia

The government's role is as an enabler, not as a direct provider of financial services

International experience shows that governments around the world do not do a good job of lending to the poor. For example, in the 1980s, the government of India introduced a variety of subsidized targeted lending programs, including one called the Integrated Rural Development Program (IRDP). The program suffered from three major problems common to subsidized lending programs: diversion of funding to the better-off clients, low payment rates, and dependence on significant subsidies. The loan recovery rate on IDRP loans was between 10-55%. By contrast, leading MFIs in India who offered loans at unsubsidized interest rates of 20-40% per annum had

[7] Oum Sothea and Sok Hach, *Cambodia Economic Watch,* EIC, Issue 1, Oct 2004.

[8] According to the National Bank of Cambodia (NBC), the value of total loans outstanding as of June 30, 2005 for 11 MFIs and 31 NGOs was 180,232.57 million Riels (approximately US$45.06 million), and ACLEDA Bank's microbusiness loan portfolio was US$13 million.

[9] In Channy, Letter to Editor, *Phnom Penh Post,* Issue 13/14, July 2 – 15, 2004.

repayment rates of almost 100 % during the same time period.[10]

In government-led lending programs, short-term political considerations often tempt politicians to offer microcredit without much regard for the creditworthiness of potential borrowers, which leads to hastily-made and risky loans. Also, due to the fear of losing political support, officials are reluctant to collect interest and loans. The end result is often a higher rate of loan default and losses, which ultimately depletes the amount of capital available for lending. This jeopardizes the sustainability of government-led microfinance programs and ultimately limits poor people's access to finance.

As past experience demonstrates, the government has never succeeded in operating microfinance. The reason for the failure was that weak management led to corruption.

Mr. Bun Mony, Chairman of the Board of Directors, Cambodian Microfinance Association

The most important role for the government is to establish a supportive policy environment that stimulates the development of financial services while also protecting poor people's savings. Appropriate activities include maintaining macroeconomic stability, creating a good business environment, avoiding interest rate caps, establishing a legal framework, and ensuring supervision for the transparency and governance of MFIs. The government should also promote competition among MFIs and other lenders so that market forces stabilize interest rate levels that are both more accessible to poor people and sustainable for MFIs.

Currently, a large proportion of deposits in commercial banks remains unused. It would be better if some part of commercial bank savings were used to provide microcredit.

Mr. Chor Leng Huong, Deputy Director General, Rural Development Bank

There is room for the government to take Cambodia off of the high-risk country list. To reduce the country risk, more work needs to be done to further stabilize economic growth. The country needs to promote good governance, which means transparency is needed.

Mr. In Channy, General Manager, ACLEDA Bank Plc.

In a free market, the government should encourage competition among MFIs. Restoring trust in the banking system is important to ensure an increase in savings that in turn leads to a lower cost of funds. The government should provide tax incentives, especially by reducing withholding tax. The government should also encourage the donor community to provide loans to MFIs at competitive interest rates.

Mr. Huot Ieng Tong, General Manager, HATHAR KASEKAR LIMITED

Microfinance works best when institutions measure and disclose their performance

Microfinance institutions, like other businesses, should be held accountable for the results of their actions, and reporting is a necessary tool to ensure accountability. MFIs in Cambodia do currently adhere to international good practice – they are supervised by the National Bank of Cambodia, and are required to produce accurate, timely reports on their financial performance (e.g. loan repayment and cost recovery). Disclosure not only helps stakeholders to judge the costs and benefits of microfinance, but also helps MFIs to improve their performance.

Microfinance is not always the answer

Though microfinance has successfully helped alleviate poverty for many around the world, it is important to remember that microcredit is not a panacea, and may not be appropriate for everyone or every situation. Placing unrealistic expectations on microfinance is counterproductive. For example, the destitute and hungry, who have no income or means of repayment, may need other forms of support before they can make use of loans. In many cases, small seed capital grants, infrastructure improvement, employment programs, vocational training, and other non-financial services may be more appropriate tools for poverty alleviation. Wherever possible, such non-financial services should combine with incentives to build savings. Microfinance should *complement,* and not substitute for, other development interventions.

Conclusion

The *Key Principles of Microfinance* seek to help governments, donors, development practitioners and other interested parties avoid the pitfalls of microfinance practices – such as government-run programs, subsidized lending, and interest rate caps – which often run counter to their good intentions and actually exclude poor people, particularly in rural areas, from having access to needed credit. These *Key Principles* encourages a more effective and efficient allocation of credit, that enables poor people to turn their business ideas into actions, plan better for the future and ultimately improve their well-being.

[10] CGAP (2004), *Interest Rate Ceiling and Microfinance: The Story So Far,* Occasional Report No. 9, Sept 2004, p. 5.

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