

# BUSINESS ISSUES BULLETIN

CAMBODIA

No. 1, November 2003



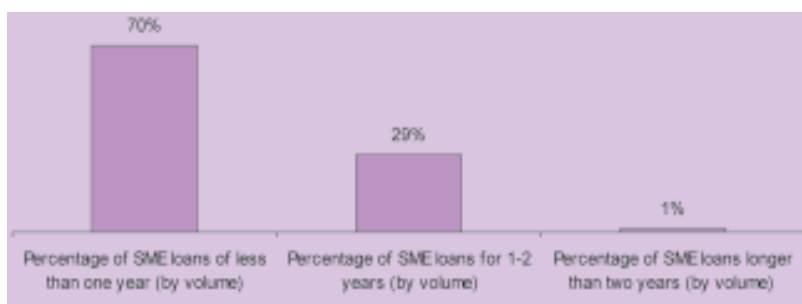
## A REVIEW OF CONSTRAINTS TO SME FINANCING

*The owners of small and medium enterprises in Cambodia consider the lack of affordable long-term financing one of the greatest obstacles to their growth. MPDF investigated why banks and other financial institutions are reluctant to make long-term loans at affordable rates, and how to overcome this barrier to economic growth. We interviewed bank regulators, commercial lawyers, and 12 out of a total of 17 banks.<sup>1</sup>*

With 92% of all Cambodian jobs created by the private sector, and the private sector comprised primarily of small and medium-sized enterprises (SMEs), most would agree that economic growth depends on SMEs.<sup>2</sup> However, important as they are to the economy, SMEs face considerable obstacles that constrain their growth. One of the most frequently mentioned constraints is the lack of access to finance. The total loan portfolio for 11 out of the 12 banks<sup>3</sup> that MPDF surveyed was US\$190 million, representing only 5.9% of GDP.<sup>4</sup> Although 85% of this amount was lent to SMEs, very little of that was for long-term loans. As

Figure 1 indicates, only a tiny fraction of loans made to SMEs are for more than two years. The issue here is not so much a shortage of banks available to make loans (although this is certainly an issue in some parts of the country), rather, it is that a variety of barriers discourage banks from lending to SMEs, and in particular for lending long term.

Figure 1: A comparison of lending to SMEs by term (weighted)



Source: Harner, M. Stephen (2003) "Financing SMEs in Cambodia: Why Do Banks Find it so Difficult?" Mekong Private Sector Development Facility, p. 15.

### Barriers that result from the legal system

Barriers related to the legal system include insufficient protection of lenders' interests under existing laws, the absence of relevant commercial laws, and lenders' lack of confidence in the judicial system. While the absence of relevant commercial laws and the complexity of existing ones are causes for concern, how cases are handled by the courts contributes to mistrust of the judicial system. According to bank directors interviewed by MPDF, "justice is seen to be for sale to the highest bidder."<sup>5</sup>

<sup>1</sup> Harner, M. Stephen (2003). "Financing SMEs in Cambodia: Why Do Banks Find it so Difficult?" Phnom Penh: Mekong Private Sector Development Facility.

<sup>2</sup> Asia Development Bank's Private Sector Assessment Report, First draft, May 2003, Phnom Penh, p. 32

<sup>3</sup> Data from the state-owned Rural Development Bank is not included since it only performs on-lending of donor funds.

<sup>4</sup> Total loan portfolio for the whole banking system was US\$242.30 million, representing only 7.5% of GDP. Nominal GDP in 2001 was US\$3,234 million. Source: Sok Hach and Acharya, Sarthi (2002) "Cambodia's Annual Economic Review-2002" Phnom Penh: Cambodia Development Resource Institute, p. 86.

<sup>5</sup> Harner, M. Stephen (2003)



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, and exposure to different opinions held by various stakeholders on the topic.

This bulletin is published with support from the Mekong Private Sector Development Facility (MPDF), a multi-donor funded initiative managed by the International Finance Corporation (IFC), the private-sector arm of the World Bank Group.

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 IFC.

*The Government is improving the banking system by: (1) encouraging competition through re-licensing and re-capitalization of banks, (2) helping to find cheap and stable sources of funds, such as concessionary loans to the Rural Development Bank, and (3) requiring banks to standardize their chart of accounts (how and when they report on their accounts).*

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

*The legislation that could encourage long-term lending relates to company law, commercial arbitration, bankruptcy law, a commercial court, contract law, and secured transaction law. The legislation concerning the first two are already at the National Assembly, while the bankruptcy law is still with the Council of Ministers. Regarding other legislation on the list, we are still waiting for final modifications from legal experts.*

H.E. Mao Thora, Secretary General for Technical Affairs, Ministry of Commerce

Because they do not consider their interests well protected by the law and by the court system, banks are reluctant to lend to SMEs. And when they do lend, banks consider it necessary to charge high interest rates (see Figure 2). Banks are also unwilling to make the larger, and longer-term loans that SMEs need to finance expansion and the purchase of new equipment. The combination of the high cost of borrowing and the lack of long-term financing are serious constraints to SME growth in Cambodia.

### Barriers that result from SMEs and banks

There are several other barriers besides those of the law and the court system. First, the poor quality of financial records maintained by many SMEs makes it impossible for banks to judge whether a company is credit-worthy. Second, few bank staff have extensive experience in assessing and managing risk. Third, banks lack the funds needed to make medium- and long-term loans.

*The lack of financing limits both my ability to increase investments in assets and my ability to increase production levels even when assets are increased. For example, some time ago I saw the potential for saving costs if I had a production plant close to corn farms in Sampov Loun in Battambang. However, I had to wait for two years before I could secure a loan of \$300,000 to set up another factory in Sampov Loun. Now that I have a plant there, I still face financial difficulties because my working capital is not sufficient to buy all the corn available (60,000 - 80,000 tons).*

Mr. Kuch Tech Srun, Owner of a corn processing business

The absence of reliable financial information on SMEs and the limited capacity of bank staff to assess SME borrowers are mutually reinforcing problems. With potential borrowers unable to provide trustworthy financial records, bank staff consider financial information much less important than whether a borrower has adequate collateral. Because borrowers almost always secure loans with collateral, bank staff have little experience analyzing financial records and assessing risk. Conversely, because bank staff lack analysis and risk assessment experience, they cannot capably assess financial records, even if borrowers can provide them. These shortcomings on the part of both borrowers and lenders increase the risks to lenders, prompting lenders to charge high interest rates.

Figure 2: Lending Rates for One-year Loans



*Note:* In a survey of the interest rates offered by twelve Cambodian banks in 2002, the average "all-in" lending rate for one-year loans was 19% per year.

*Source:* Harner, M. Stephen (2003)



*I do not necessarily agree that high interest rates are related to the difficulties that bank staff have in analyzing financial statements.*

*Interest rates are based on:*

- the bank's cost of funds
- the bank's operating expenses
- inflation
- estimation of loan losses
- expected profits

*Regarding why banks make many more short-term than long-term loans, this is because the sources of capital that banks use are also short-term.*

Mrs. So Phonnary, ACLEDA Bank

*Because companies don't maintain reliable financial statements, banks have no choice but to require collateral. Banks lend short-term because they have to keep their liquidity ratio very high (30% to 40% of total deposits). If there was a mechanism to provide liquidity to banks, perhaps banks could afford to offer longer-term loans to SMEs.*

Mr. Sar Kim Lomouth  
Canada Bank

*Lack of confidence in the legal system is not that significant. Also, statistics on short-term loans are not necessarily correct from a practical perspective, since banks lend long term by offering overdrafts that go on from year to year. Of course, these must be re-approved annually.*

Mr. C.K. Choy  
Vattanac Bank

### **A lack of borrowers contributes to high interest rates**



Because few SMEs can afford the high cost of borrowing, the pool of eligible borrowers in Cambodia is small. This creates a vicious cycle. With few potential borrowers, banks cannot achieve the economies of scale in lending that would allow them to offer lower interest rates. This too contributes to the high cost of borrowing, which in turn discourages SMEs from seeking loans. Hence, the cycle

continues. Looking at all of these constraints, it appears difficult to break the vicious cycle and make medium and long-term financing both profitable for lenders, and affordable for borrowers. Concerted efforts by everyone concerned, including the government, to implement the following recommendations could significantly increase the amount of term loans available to SMEs.

### ***Pass business-oriented legislation***

There is an urgent need to improve and enact new laws and regulations related to the commercial sector. These include contract law, company law, bankruptcy law, and law on secured transactions.

### ***Establish a commercial court***

Cambodia could benefit from an independent and capable court that specializes in commercial cases. Such a court would have the expertise needed to verify a case's facts and apply relevant statutes and laws. Decisions would be made by judges who are knowledgeable about commercial transactions and law. This would be better than today's practice of trying commercial cases in courts set up for criminal cases. This in turn could increase banks' confidence in seeking and obtaining a fair resolution to disputes, thereby reducing one of the main constraints to lending.

*I believe that a commercial court will become operational within two years. The groundwork is being prepared now. The exam to recruit judges for the commercial court will be held soon so that when the necessary legal, administrative and institutional requirements are completed, we will have judges trained and ready to start their work.*

H.E. Mao Thora  
Secretary General for Technical Affairs,  
Ministry of Commerce

*To be successful a commercial court will need clear procedures to ensure that its work is transparent, independent, and trials proceed rapidly. This can be achieved only if the government has a strong commitment to carry out legal and judicial reforms.*

Mr. Bun Youdy  
Legal Expert  
Secretary General of the  
Bar Association of the  
Kingdom of Cambodia

### ***Require businesses to register and have their financial records audited***

Government could improve SME financing by enforcing the law that requires all businesses to register and to have their financial records audited. This would improve the quality of the financial records available to banks, and make it easier for banks to determine whether potential borrowers are likely to repay their loans.

### ***Train bank staff in financial assessment skills***

General training, and training tailored to the needs of individual banks, could enhance the skills of banking staff to assess and manage risk. Training could also help bank staff improve their ability to market loans.

## **Reference Information**

The full report, "*Financing SMEs in Cambodia: Why do Banks Find it so Difficult?*" which was published as MPDF's Private Sector Discussion Paper Number 14 in May 2003, may be requested from MPDF's Phnom Penh office at No. 113, Norodom Blvd., Phnom Penh.

### **Feedback**

What are your views? We welcome your comments and feedback. If you would like to comment on this Bulletin, suggest topics for future issues or request additional copies, please fill in this form and send it to: (or directly contact us at the address below).

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