Financing SMEs in Cambodia: Why do Banks Find it so Difficult?
Financing SMEs in Cambodia: Why do Banks Find it so Difficult?

Report of a study commissioned by Mekong Project Development Facility (MPDF)

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EXECUTIVE SUMMARY

Introduction

The objectives of this study on barriers to SME Lending in Cambodia commissioned by MPDF are to 1) identify specific barriers inhibiting banks from extending long- and medium-term loans to locally-owned small and medium enterprises (SMEs) and 2) determine what can be done to promote more efficient lending to the SME market. The fieldwork for this study was conducted in Phnom Penh over a two-week period in June 2002. The research team interviewed 12 banks that were or would be important lenders to the SME sector.

Overview of the Banking Sector in Cambodia

For 2000, Cambodia’s bank loan portfolios represented only 7.6% of its GDP. For 2001, the loan-to-capital ratio was 1.5 while the loans-total liabilities ratio was only 36% (representing only 33% of total bank assets). Compared to international standards, Cambodia’s banks perform limited bank intermediation and have relatively small loan portfolios.

A large amount of the banks’ funds is deposited with the National Bank of Cambodia, the country’s regulatory authority (NBC). The reasons for this are: 1) the need to satisfy the NBC’s high mandatory liquidity requirement, 2) the need to satisfy NBC’s 10% “capital requirement,” and 3) an opportunity to earn relative low-risk returns.

There is an almost total absence of medium- and long-term lending to SMEs. For 2001, only 1% of total loans to SMEs was for two-year terms, 29% was for 1-2 year terms and 70% was for terms of less than one year. Analysis of bank lending policies shows that in most cases, banks will simply not extend loans longer than 24 months. Very rarely are loans extended for longer terms on a case-by-case basis.

Generally, lenders prefer to provide working capital (short-term) rather than fixed capital financing (medium- or long-term). Lenders also prefer immovable assets (land and buildings) in Phnom Penh or other major cities over movable assets (equipment and machinery) as collateral. In addition, lenders prefer to lend to individual borrowers rather than corporations. This preference is most likely due to the lack of audited, accurate and reliable information on SME applicants and the current practice where immovable assets are usually registered in the individual’s name rather than in the corporation’s name.

The research found that the “all-in” lending rate in Cambodia is approximately 30% per annum, with average micro-finance institutions charging higher rates. For the 12 banks interviewed, the average weighted “all-in” lending rate for one-year loans was 19.2%,
with two banks charging 28.5% while one bank charges 13% on such loans. There was less variation in lending rates to SMEs; however the average lending rate to SMEs was higher than the general average lending rate. The weighted “all-in” lending rate to SMEs was 22.8%, nearly 4% higher than the overall lending rate of 19.2%. The profitability spread for lending to SMEs, that is the gap between rates to depositors and rates to borrowers was 18.9%. This is 3.4 % point higher than the profitability spread for general lending of 15.5%.

Findings Related to Barriers to SME-Lending

The SME demand for medium- and long-term financing is relatively high, however banks are reluctant to extend such term loans to SMEs. The reasons for banks’ reluctance to extend term loans to SMEs include the banks’: 1) perception that the current legal system is unable to protect their interests; 2) relatively high funding costs—high bank rates on deposits; 3) shortage of access to long-term capital; 4) inability to conduct accurate due diligence and the current unavailability of information (such as corporate records and audited financial information) on loan applicants; 5) need to meet the NBC’s high liquidity ratio—deposits cannot be deployed as loans; and 6) inability to assess, manage and price risks associated with term loans due to lack of experience and skills.

Recommendations

The study identified eight policy-oriented recommendations to resolve obstacles to term lending to SMEs in Cambodia:

1. Creation of a commercial court to effectively and efficiently address the needs and requirements of lending;
2. Amend or repeal the existing law on customer confidentiality to allow banks to share information on borrowers’ liabilities in order to promote accurate due diligence on loan applicants;
3. The National Bank of Cambodia could be more flexible in setting its liquidity ratio;
4. Establish an asset registry to improve banks’ due diligence, encourage use of movable assets as collateral to enable specialized lending activities such as leasing and equipment financing;
5. Provide focused training to banks to increase their skills in risk assessment and management of term loans;
6. Develop local business consulting services that can provide services to SMEs;
7. Develop specialized asset-based financing institutions such as leasing companies; and
8. Revoke the current 15% withholding tax on interest payments.
Update

During the six-month period after the fieldwork for this study was completed, some of the leading lenders in Cambodia substantially reduced interest rates on loans to SMEs; more recent “all-in” lending rates for established borrowers were reduced to 15% - 17.5%, compared to 19.2% - 22.8% in June 2002. This is largely due to lower funding costs and increased competition. One bank increased its credit/lending bank personnel by 35% and another bank extended equipment financing to a local company. Of substantial importance is the NBC’s relaxation of its liquidity ratio requirement from 100% to 80%.

The changes that occurred in the short period after this study was undertaken indicate that Cambodia’s banking sector is and will continue to undergo positive changes in the future.
1 INTRODUCTION

The Mekong Project Development Facility (MPDF) is a multi-donor program for Vietnam, Cambodia and Laos managed by the International Finance Corporation (IFC). Its mandate is to support the development of the domestic private sector in the three countries. MPDF does this by providing assistance to local private companies to improve their operations and prepare sound investment projects, strengthening the capacity of local support institutions that provide essential business services to small & medium enterprises (SMEs), and undertaking research and policy dialogue to generally improve the business environment for private enterprises.

In implementing its mandate in the Kingdom of Cambodia (Cambodia), MPDF has identified SMEs’ difficulty in obtaining bank financing for long-term investment projects as a critical obstacle to their development.

1.1 Background and Objectives

To assist MPDF better serve SMEs, and in light of recent plans from both the government and the aid community to reform the financial sector in Cambodia, MPDF commissioned this study in June 2002 to answer two critical questions:

1) What are the specific barriers inhibiting banks from extending long-term loans to locally-owned SMEs in Cambodia?

2) What can be done to promote a more efficient loan to SMEs market in Cambodia?

MPDF envisions using the analysis and recommendations made in this study by:

1) Directly addressing certain constraints and issues identified by conducting focused training and implementing other appropriate measures MPDF deems appropriate; and

2) Sharing the study’s results with relevant Cambodian government ministries and officials, banking institutions and other relevant stakeholders in order to engage them in policy formulation to address the identified issues and constraints.

1.2 Field Research

The research team consisted of the author and three MPDF staff members. The team conducted the fieldwork for this study in Phnom Penh over a two-week period in June 2002. The author and MPDF staff conducted approximately forty (40) interviews with senior management and credit/lending staff of banks in Cambodia, bank regulators, commercial lawyers and prospective foreign financial investors.

Interviews with banks were conducted at three levels: general managers, credit managers and credit/lending officers. Of the 17 operating banks in Cambodia at the time the
fieldwork was conducted, the team interviewed the following twelve (12) banks that were, or are potentially, important lenders to SMEs in Cambodia:

- ACLEDA Bank Ltd.
- Advanced Bank of Asia Ltd.
- Cambodian Commercial Bank
- Cambodian Public Bank
- Canadia Bank Ltd.
- Foreign Trade Bank of Cambodia Ltd.
- Maybank
- Mekong Bank
- Peng Heng SME Bank Ltd.
- Rural Development Bank
- Singapore Banking Corporation
- Union Commercial Bank Plc.
2 THE BANKING SECTOR IN CAMBODIA: AN OVERVIEW

2.1 SME Loan Weightings

The November 1999 Law on Banking and Financial Institutions increased the minimum registered capital requirement for commercial banks from US$5 million to 50 billion Khmer Riels (approximately US$13 million). Prakas B 700-39 on Banks’ Minimum Capital required that the US$13 million registered capital be satisfied by December 31, 2001. By mid-2002, the total capitalization of the twelve banks surveyed was US$127.5 million. As of the end of 2001, these twelve banks’ total asset was US$573 million, and their total deposit was US$385 million.

At the end of 2001, the loan portfolio of the twelve banks totaled US$190 million. During interviews, eleven banks were asked to indicate the percentage of their lending to SMEs (by volume). The following figures were given:

<table>
<thead>
<tr>
<th>Number of Banks</th>
<th>Percentage of Loan Portfolio to SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>100%</td>
</tr>
<tr>
<td>2</td>
<td>90%</td>
</tr>
<tr>
<td>1</td>
<td>72%</td>
</tr>
<tr>
<td>1</td>
<td>30%</td>
</tr>
</tbody>
</table>

The aggregate percentage of loans to SMEs by these eleven banks in 2001 was 85%, which indicates that total loans to SMEs in 2001 were US$162 million (85% of US$190 million). According to the banks’ forecast, their total loan portfolio by the end of 2002 would increase from US$190 million to US$271 million, a 43% increase. This substantial increase can be attributed to the need to meet the mandated increase in bank capital (of approximately US$50 million) and the country’s rapidly increasing deposit rate.

This expected increase in loan portfolio will not be evenly distributed to the SME sector, however, because the larger share of additional lending is expected to originate from those banks with lower proportions of lending to SMEs in their total loan portfolios. The estimated total lending to the SME sector by the end of 2002 was US$222 million, which represents a very large increase of 39% from 2001, but less than the 43% increase in total lending expected for 2002. The weighted proportion of lending to SMEs was expected to drop to 82% for 2002, from 85% for 2001.

2.2 Under-Lending

Various IFI technical reviews indicate that Cambodia has one of the lowest rate of banking intermediation in the world. A study by the Asian Development Bank (ADB) based on data from the end of 2000 found that total loans from Cambodia’s banking

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1 A Prakas is a regulation issued by ministerial authority.

2 Figures for the Rural Development Bank are excluded because it is a state-owned bank that performs on-lending of donor funds.
sector of US$249 million represented only 7.6% of the country’s GDP. The same study noted that “compared with other countries, Cambodia’s banking system [has] a paucity of loans. A typical commercial bank in other countries has a portfolio of commercial loans … as much as 5 to 10 times its capital or about five to ten times the pro forma ratio of Cambodian banks.”

The ADB study also found that by the end of 2001, the loan-to-capital ratio of Cambodian banks had, if anything, declined. The loan-to-capital ratio for the eleven banks surveyed is 1.5 (capital of US$127 million against total loans of US$190 million). The principal reason for the decline in the ratio was that the commercial banks had a one-off increase in capital to satisfy a requirement from the National Bank of Cambodia (NBC).

Another indicator of Cambodia’s low “lending preference” is the loans-to-total liabilities ratio. The eleven banks surveyed had substantial deposit growth in 2001 and 2002; however their loans-to-total liabilities ratio was only 36% in 2001. On average, loans constituted only 33% of total bank assets (see Figure 1 below).

![Figure 1: Loans-to-Total Assets](image)

Source: Survey work for this Study conducted in Phnom Penh, June 2002.

Such a low lending ratio has a negative impact on SME funding in Cambodia. A mere US$162 million in loans to Cambodia’s SMEs in Year 2001 and an estimated US$222 million in loans for Year 2002 is inadequate to grow the SME sector. The issue to be addressed is whether banks in Cambodia are simply disinclined to lend to SMEs or whether banks are encountering practical obstacles, despite having an appetite to lend to the SME sector (discussed Section 2.6 below).

### 2.3 How Most Liabilities are Deployed

The options available for deployment of liabilities are relatively limited. There is currently no money market in Cambodia in which short- or long-term financial instruments can be issued or traded, either in foreign or local currency. Consumer

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mortgages and lease financing (the potential for which is discussed later in this report) are also not yet available.

To a large extent, banks in Cambodia are placing their deposits with the NBC. This is the result of three factors: 1) the need to satisfy the NBC’s mandatory liquidity ratio (discussed in further detail below), 2) the need to satisfy the NBC’s 10% “capital guarantee” requirement, and 3) the opportunity to earn relatively low-risk returns. Certain banks, primarily branches of foreign banks, are able to place some of their deposits with their head office or other offshore financial institutions. The amount that can be placed with head offices is restricted by the NBC’s 2001 Prakas which controls on lending to related entities. Placing deposits with offshore institutions is not a good option for local banks, as the interest rates they give for deposits are too high for this to be feasible.

The most onerous requirement on commercial banks that curtails lending is the NBC’s liquidity ratio. Cambodia is not unique in setting a mandatory liquidity ratio; all fractional reserve banking systems impose liquidity requirements on deposit-taking institutions in order to ensure that commercial banks maintain sufficient liquid assets to meet possible withdrawal demands of their depositors. However, the liquidity ratio set by the NBC is exceptionally high compared to international standards.

Cambodia’s high liquidity ratio most likely reflects the NBC’s view that foreign currency deposits are inherently unstable and subject to “event risk-related” mass withdrawals. There is justification for this view. For example, the political crisis of July 1997 prompted near panic withdrawals and overseas remittances at Cambodia’s commercial banks causing many banks to suffer liquidity shortfalls. Another justification for the high liquidity ratio is that in Cambodia’s highly dollarized financial system, the NBC cannot function as a “lender of last resort” to ensure liquidity during periods of distress.

Notwithstanding the above justification, the current liquidity requirement is excessively high and is a major obstacle to banks’ lending activities, particularly in relations to long-term lending activities.

2.4 Near Total Absence of Medium- and Long-Term Lending

One of the key focus of this study is the availability of medium- and long-term bank financing for the SME sector in Cambodia. Rather than needing short-term working capital for receivables and inventory, SMEs generally require medium- and long-term financing to acquire additional fixed assets to expand their business activities.

The research team’s examination of loans to SMEs in Cambodia shows that 70% of the loans were for terms of one year or less, 29% of the loans were for terms of one to two years, and only 1% of the loans were for terms of over two years (see Figure 2 below). Applying this result to the estimated total loans to SMEs for the Year 2002 (US$222 million), SME funding according to loan term shows:

- Financing of one year or less: US$155 million
- Financing of 1 to 2 years: US$64 million

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4 Please see Appendix 1 for the NBC’s method of calculation for liquidity ratio.

12
Financing of 2 years or more: US$2.2 million

While these figures are only indicative of the nature of SME funding in Cambodia and are subject to further qualification, it is still accurate to conclude that there is inadequate medium- and long-term financing for the SME sector in Cambodia.

![Figure 2: Weighted Share of Lending to SMEs by Term](image)

Source: Interviews conducted with banks in Phnom Penh, June 2002.

2.5 Lending Policies of Cambodian Commercial Banks

Generally, a bank’s lending policy should reflect the bank’s: 1) perception of the lending risks; 2) ability to manage risks; and 3) the acceptable return for risks taken (risk/reward ratio).

A bank’s lending policy itself may explain the paucity of medium- and long-term lending to SMEs in Cambodia. In terms of the “supply side” issues that limit lending to SMEs in Cambodia, the analysis focuses on four aspects of bank lending policies: 1) loan terms, 2) loan by purpose and type, 3) type of collateral and 4) type of borrowing entity.

2.5.1 Policies on Term

Out of ten banks surveyed, seven will simply not extend loans with terms greater than 24 months. Only three banks were prepared to extend loans with terms up to 36 months. No bank surveyed was willing to extend loans with terms of 3-5 years. Notwithstanding these set lending policies, some banks have extended medium- and long-term loans on an exceptional basis. Below is a list of such exceptional lending cases:

<table>
<thead>
<tr>
<th>Up to 9 months</th>
<th>Up to 12 months</th>
<th>Up to 24 months</th>
<th>Up to 36 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 banks</td>
<td>2 banks</td>
<td>3 banks</td>
<td>3 banks</td>
</tr>
</tbody>
</table>

5 This part of our report analyzes responses from ten banks—the Rural Development Bank and one other bank are excluded from this analysis.
2.5.2 Policies on Loan Purpose and Type

Half of the banks interviewed only finance working capital, while the other five are willing to finance borrowers’ needs for either working capital or fixed assets. However, there is a strong preference to finance borrowers’ working capital needs rather than fixed capital financing needs. One bank branch credit manager said: “Loans are intended to finance activities that provide funds for liquidation quickly. Most borrowers are businesses seeking quick turnover.”

2.5.3 Policies on Type of Collateral

Lending on collateral is the general practice of bank financing in Cambodia. However, different banks evaluate collateral differently as indicated below:

<table>
<thead>
<tr>
<th>Collateral accepted, however are assigned little or no value/no collateral required</th>
<th>Only land/building are accepted as collateral</th>
<th>Land/building and equipment accepted as collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 banks</td>
<td>4 banks</td>
<td>3 banks</td>
</tr>
</tbody>
</table>

According to their policies, all banks require collateral for loans. The collateral is typically immovable property such as land or building. This practice may reflect the country’s current legal system that provides for the registration of a security interest in immovable property. On a much rarer basis, banks accept movable property (equipment) as collateral; only in exceptional circumstances will banks require no collateral. The following comments by bank officers reflect these lending policies and practices:

“Generally we only accept land and buildings, [al]though we have in some cases taken equipment as collateral. Collateral is always required for individuals: houses in Phnom Penh or select provincial capitals only. The loan value is 30% - 50% of the value of the collateral given.”

“We do not take equipment as collateral because it cannot be registered.”

“We accept flats, villas and raw land [as collateral]. Land and buildings [accepted are only those] in Phnom Penh and city centers. Machinery can be included when lending to a factory operation. [Loan value is 40% of the value of the collateral given.]”

“We take land, buildings and machinery [as collateral]. But even when we take property, we assign it no value in the credit-risk process. It is not a reliable second way out. Our risk assessment is based on the assumption of ‘clean’ lending.”

“Collateral is most important in Cambodia and is always required. [Loans are extended at 30% of the value of the collateral given.] [We accept] land and building in Phnom Penh, Siem Reap and Kompong Cham only. We do not accept equipment; only immovable property.”

“Collateral is only a second way out. [Loans extended are] 30% - 60% of [the value of] land, house or building [given as collateral]. We also accept factory equipment.”
“Collateral is hard to recover, even at 30%. A large part of our lending is on a ‘clean’ basis.”

“[We accept] mortgages on land and building, but not [on] equipment because there is no law to protect for equipment. We also take parental guarantees (from overseas parents).”

“Borrowers are more inclined to repay if they provide collateral. We take land and buildings in cities. Loan value is 50% of the value of the collateral given.”

2.5.4 Policies on Type of Borrowing Entity

The most active lenders in Cambodia are those that lend predominantly to individuals or to individuals/corporations and place a heavy emphasis on immovable property as collateral. Banks that lend only or predominantly to corporations tend to be foreign-owned banks targeting subsidiaries of their international clients.

<table>
<thead>
<tr>
<th>Lend only or predominantly to individuals</th>
<th>Lend to individuals and corporations</th>
<th>Lend only or predominantly to corporations</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 banks</td>
<td>4 banks</td>
<td>3 banks</td>
</tr>
</tbody>
</table>

The following comments by bank credit officers reflect these lending policies and practices:

“We lend to both individuals and companies, but normally to individuals or company representatives. The individual comes to apply and collateral is in the individual’s name, not the company’s. Financial statements of companies are not reliable or [not] available.”

“In Cambodia, many limited companies belong to the head of a family, and land title and personal housing are in the individual’s name. When we examine the corporation’s Articles of Association, 90% of [the company’s] shares belong to the individual.”

“Businesses normally last only two years as entrepreneurs are forced to change business lines. This is why we lend to individuals rather than to companies. Even if a company is properly registered, the collateral is owned by the individual. In Cambodia, property rarely belongs to the company.”
“We lend to corporations or individuals, but we prefer [lending to] corporations. Corporations have more people involved in the decision [making process], and therefore are more prudent.”

“We prefer companies. Now, fewer than 10% of [our] borrowers are individuals. We are increasingly lending to companies, but we make a principal sign a personal guarantee.”

Due to Cambodia’s current lack of laws governing relationship between shareholders, directors, management and third parties, individual directors or owners usually own immovable property such as land and buildings that may be taken as collateral while the company owns movable assets such as equipment, machinery, account receivable, trademarks, licenses and etc.

As for equipment and machinery, it is difficult to prove ownership without a registration system. Many “company” contracts are executed in the name of a shareholder or director. In such cases, the shareholder or director can contend that the equipment or contract is owned by them and only used by the company. As banks look for immovable asset as collateral, they lend predominantly to the individual persons holding title to the immovable assets.

This author’s view is that Cambodia’s current ambiguity or deficiency on corporate governance can be managed to a large extent by the banks drafting the loan documents. Banks can and should take the initiative to reduce or eliminate ambiguity or eliminate risks through documentation.

2.6 Demand for Medium- and Long-Term Loans

The research team also examined the “demand-side” for medium- and long-term borrowing by SMEs in Cambodia. However, because this study focuses on banks, the information and understanding of the SMEs’ demand for medium and long-term loans comes indirectly from inferences from bank officers’ comments or from banks’ assessments rather than from SMEs themselves.

The following comments by bank representatives indicate that the “demand-side” for medium- and long-term loans by SMEs in Cambodia is reasonably strong:

“Demand is strong. But we refuse 50% of applications because there is not sufficient collateral provided or [because of] other problems.”

“Loan demand is strong but well-qualified borrowers are in short supply.”

“Approximately 50% of loan applicants ask for medium- or long-term financing, but we offer them only short-term loans of up to one year.”

“It will be difficult to find customers for 3 - 5 year loans. Currently, investors are not investing long-term. People are waiting for results of the Year 2003 Elections.”

“Long-term borrowers can not accept our interest rates. We seldom offer long-term loans.”
Another indicator of SMEs’ reasonably strong demand for medium- and long-term loans is the notably high frequency of roll-overs and extensions of short-term loans. We were told by one bank that 60% of its one-year loans were extended, usually for further 6 month terms.

However, it is important to note that the high interest rates charged by banks may price out many SME businesses looking for bank credit. As such, it is difficult to assess the real demand for medium- and long-term financing at this point.

2.7 Interest Rates and Loan Pricing

Bank lending rates in Cambodia are quoted on a monthly simple interest rate basis. The general rates are between 1% to 2% per month. A flat service fee ranging from 0.5% to 2% of the loan value is collected at the point of draw-down. These rates produce an “all-in” lending rate of approximately 30% per annum. Micro-finance institutions charge even higher “all-in” interest rates.

For the twelve banks interviewed, the average “all-in” lending rate for one-year loans was 19.19% per annum (see Figure 3 below). Two banks charged the highest “all-in” rate of 28.5% while one bank charged the lowest rate of 13% per annum.

The considerable variance in the interest rates charged by commercial banks in Cambodia can largely be attributed to two factors: 1) different funding costs for individual banks, and 2) different market segmentation (higher rates would indicate that the bank was targeting a higher risk market). These two factors may be inter-related. That is, due to higher funding costs, a bank may need to charge higher lending rates in order to obtain an acceptable profit, and thus focuses on higher-risk borrowers.
2.7.1 Higher SME Lending Rates

There is less variation in lending rates to the SME sector than to general lending rates. However, the average lending rate to SMEs is higher than the average general lending rates. In calculating lending rates to SMEs on a weighted basis (using actual volume of SME loans), we found that the weighted average “all-in” lending rate to SMEs was 22.81%. This reflects the dominance of the highest priced lenders in the SME lending market (see Figure 4 below).

![Figure 4: Weighted Average SME Lending Rate](image)

Source: Interviews conducted with banks in Phnom Penh, June 2002.

2.7.2 Funding Costs

With respect to funding costs, the banks’ three-month deposit rates are used as indicative of their funding costs (see Figure 5 below). The funding costs range from 6% to 1.5% with foreign banks offering lower deposit rates. The average funding cost for the twelve banks interviewed was 3.65%.

![Figure 5: Three-Month Deposit Rates (for US Dollars)](image)

Source: Interviews conducted with banks in Phnom Penh, June 2002.

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6 Two of the banks interviewed do not have three-month deposit rates because they are specialized banks involved in equity or quasi-equity funding. For this analysis, interest rates of 4.5% and 5.0% were assigned to them, which reflects market rates offered by comparable banks.
A bank’s profit is determined by the “gross spread” between its funding costs and lending fees and rates. Operating costs (including loan loss provisions) are deducted from the “gross spread.” For the twelve banks interviewed, the highest spread is 24.5% while the lowest is 8.55%. The average gross spread is 15.54% (see Figure 6 below).

![Figure 6: Gross Spread between 'All in' Interest Rates and Funding Costs (for US Dollars)](image)

Source: Interviews conducted with banks in Phnom Penh, June 2002.

2.7.3 Profitability of Lending to SMEs

Published financial records of Cambodia’s most active lenders show that SME lending is a profitable endeavor for those banks. The profitability of lending to SMEs becomes clearer when pricing on a weighted average basis is considered (see Figure 7 below). On a weighted average basis, the SME lending spread widens to 18.94%, which is 3.4 percentage points above the average spread of 15.54%. The spread analyzed in this section refers to short-term loans, rather than medium- or long-term loans.

![Figure 7: Weighted Average of SME Lending Spread vs. Average Lending Spread (short-term Loans)](image)

Source: Interviews conducted with banks in Phnom Penh, June 2002.

The question arises that if lending to SMEs is so profitable, why are banks not more willing to do so? Some of the reasons for this unwillingness are discussed in detail in section 3 below.
### 2.8 Cases of Medium- and Long-Term SME Lending in Cambodia

The twelve banks interviewed provided the research team with descriptions of their medium- and long-term loans to SMEs:

<table>
<thead>
<tr>
<th>Borrower/Project</th>
<th>Size of Loan and Term</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotel in Siem Reap</td>
<td>US$150,000</td>
<td>Collateral is a villa; reduced from loan request of US$500,000</td>
</tr>
<tr>
<td>Hotel in Phnom Penh</td>
<td>US$2 million; 4-year loan</td>
<td>Borrower is a Korean company; interest at concessionary rate of 15.6%</td>
</tr>
<tr>
<td>Restaurant expansion</td>
<td>US$20,000; 3-year loan</td>
<td>Customer required loan to purchase an adjoining building for US$80,000; building was collateral</td>
</tr>
<tr>
<td>Infrastructure – jetty construction in Sihanoukville</td>
<td>US$2 million; now paid down to US$300,000</td>
<td>Borrower is a construction company requiring equipment financing</td>
</tr>
<tr>
<td>Garment factory machinery</td>
<td>US$500,000; 3-year loan</td>
<td>Building and equipment were collateral</td>
</tr>
<tr>
<td>Hotel</td>
<td>US$300,000</td>
<td>Building was collateral</td>
</tr>
<tr>
<td>Expansion of backpacker hotel in Phnom Penh</td>
<td>US$150,000; 2-year loan</td>
<td>Loan was amortized; building was collateral</td>
</tr>
<tr>
<td>Fishmeal factory equipment in Kompong Cham</td>
<td>US$200,000; 3-year loan</td>
<td>Land and machinery were collateral</td>
</tr>
<tr>
<td>Garment cleaning machine</td>
<td>US$100,000; 5-year loan</td>
<td>Defaulted; machinery collateral was seized by other creditors</td>
</tr>
<tr>
<td>Rice milling machine in Takeo province</td>
<td>US$20,000; 5-year loan</td>
<td>Defaulted; Vietnam changed policy to accept only un-milled rice imports; unable to sell on Chinese-made machinery</td>
</tr>
<tr>
<td>Water project</td>
<td>US$5,000; 5-year loan</td>
<td>Rural Development Bank on-lending donor funds</td>
</tr>
</tbody>
</table>

The first thing worth noting is just how few medium- and long-term loans have been extended by the surveyed banks—just 11 loans in total. This further supports the general perception that medium- and long-term lending to SMEs in Cambodia is not particularly common.

There has been a concentration of loans for hotel projects. This is most likely due to the fact that hotel projects can provide immoveable assets as collateral, regardless of the exceptionally high risks of accepting an uncompleted project as collateral. The largest loan of US$2 million was only recently advanced.

In the table above, two loans were extended to borrowers in the garment industry. In one case where the collateral was equipment, after the borrower defaulted on the loan, the bank was unable to establish priority over other creditors in litigation because the security
interest was not and could not be registered. Another two loans were extended to borrowers in the agricultural sector. In one loan where the collateral was rice milling equipment, after the borrower defaulted on the loan, the bank relinquished its claim because the used Chinese machinery had little or no market value and seizing the machinery would have threatened the livelihood of some villagers.
3 BARRIERS TO SME LENDING BY BANKS IN CAMBODIA

There is clearly a disparity between the meager supply of medium- and long-term loans to SMEs and the relatively strong demand for bank credit from SMEs in Cambodia. The Terms of Reference (TOR) for this study had identified a number of potential barriers to bank lending to SMEs. The research team explored these identified barriers and found that some were more relevant than others; additional barriers not originally identified were also discovered. All of the relevant barriers are discussed in this section.

3.1 Existing Laws are Inadequate to Protect Lenders’ Interests

All of the banks interviewed cited Cambodia’s weak legal system and its consequent inability to protect lenders’ interests as the critical obstacle to their lending activities (short- or long-term lending to SMEs or other borrowers). Legal inadequacy is particularly noticed with respect to loan financing for machinery and equipment in which such machinery and equipment are to serve as collateral. A report by IFC on leasing (dated November 15, 2000) stated that “under the current Cambodian Contract Law, a lessor, lender, or other creditor would have to physically possess the equipment (a ‘possessory pledge’) for the pledge to be valid.”

The current Cambodian legislative system does not provide any method for registering or perfecting security interests in movable property. A secured transaction law that establishes procedures and institutions to register security interest in moveable property is being drafted and is currently before the Ministry of Commerce. However, its adoption and implementation appear to be some time away.

Lenders believe that they cannot establish priority over other creditors, even on the machinery and equipment that they had financed. This lack of confidence is based on the few litigation cases where lenders’ contract claim over equipment and machinery was not recognized. In one case, a bank was actually admonished by the Court for having taken movable parts as collateral. The courts’ position has been that, in the absence of a specific law or edict on the matter, all of the debtor’s assets, except for immovable property properly secured under the Land Law or movable property properly secured (i.e. possession) under the Contract Law would be allocated to creditors on a first-come-first-serve basis. This means that the creditor who obtains a court judgment first will have first access to the assets.

Important gaps in Cambodia’s legal system relating to bank lending arise from the Land Law (2001), Contract Law (1988), an absence of a company law, and to a lesser degree, the absence of a bankruptcy law.

3.1.1 Land Law (2001)

The Land Law allows three types of security interests to be created: Mortgage (hypoteque), Pledge (Gage) and Antichrese (type of “gage” with no real Common Law equivalent) [Title V, Art. 192 b 225]. It also allows for registration of “security” interests in land (i.e. long-term leases, easements, concessions and etc.) and the creation of security in such secondary interests in land (Article 197). However, these three
security interests are only briefly covered and leave many issues to interpretations by courts. Regulations need to be issued to provide clarity on these matters.

The existence and registration of the secondary interests in land, and the ability for lenders to take a registered security interest in such secondary interests are crucial for lenders. This whole system must be set out in regulations to be implemented as the law only mentions the possibility of its existence. It does not appear that any such regulations are planned at present.

The Land Law also recognizes long-term lease as interests in land (Part 4, Articles 106-113). This is a fundamental change in Cambodian law, which previously only held that leases were personal contractual rights. This means that lenders can take a security interest in the lease because the lease is an interest in land – a very important right when the investor is a foreign entity. However, this section of the law requires elaboration and further explanation in a Sub-Decree. In addition, the system for registration of long-term leases and registration of security interest in such leases needs to be detailed and set in place by regulation.

The Land Law appears to allow for ownership of buildings (by foreigners or Cambodians) separate from the land (Article 8). This is important for any leaseholder who wishes to finance building of a structure on the leased land. However, regulations are needed to clarify and implement this provision.

The draft Civil Code, drafted by Japanese experts with the Ministry of Justice, also sets out various security interests in immovable property. The draft Civil Code also contains provisions on taking and enforcing security interests in movable property.

3.1.2 Contract Law (1988)

Section III of the Contract Law covers pledges of movable property. However, it requires possession of the collateral and states that the secured party cannot become owner of the collateral without court action, which can be extremely burdensome (see section 4.2 below). Possession by lender serves as the de facto registration system.

3.1.3 Company Law (absent)

Currently, there is no law setting out rules of corporate governance and rules governing the relationship between shareholders, directors, managers and third parties. The effect of this gap is that it is very difficult for banks to obtain certainty related to corporate governance such as board and shareholder approvals, authorized signatories and etc. There is also considerable ambiguity in other more substantive issues such as rules on mergers, rules for liquidation, rules relating to shareholder and director liability for fraud and other tortuous or criminal acts.

Furthermore, from a practical and procedural perspective, companies are required to use standard Ministry of Commerce statutes. These statutes create, from the outset, an unworkable structure which most companies have to violate in order to operate and which most banks would refuse to lend to. The Government may not be aware of the serious
negative effect this requirement has on lending to corporate entities and on the taking of company-owned collateral by banks.

3.1.4 Bankruptcy Law (absent)

Another reason why banks worry about lending to corporate entities is the facility for a company with debt to liquidate without paying its creditors, transfer or hide its assets and re-establish under another name. There is no legal guidance regarding the hierarchy of creditors secured and unsecured outside of the Land Law’s rules relating to security in immovable property. This issue has considerable negative influence in Cambodian business dealings. For example, if a bank takes a security in land, but unknown to the bank, the buyer never paid in full for the land, the issue arises as to whether or not the seller has a statutory or automatic lien over the land, even if unregistered, that is superior to the bank’s registered security. There are similar issues relating to construction liens and tax liens. Courts have ruled inconsistently on these issues and banks rightly feel nervous in such a legal climate.

3.2 The Judicial System Does Not Adequately Protect Lenders’ Interests

The current court system in Cambodia poses a structural impediment to financing. Each province and municipality has only one lower court called the “court of first instance.” All matters (civil, criminal and commercial) are decided by this court. Normally, a judge hears and rules on all cases. A litigant can appeal the court of first instance’s decision to the Appeals Court and can subsequently appeal the Appeal Courts’ decision to the Supreme Court. There is only one Appeals Court for the whole country, located within the Ministry of Justice. Grounds for appeal can simply be dissatisfaction with the judgment.

The current legal system’s small and fixed number of courts and judges is unable to keep up with the large and growing number of cases. In addition, the current public perception is that court decisions and judgments are erratic and unpredictable. Legal arguments and reasoning are of secondary importance to bribery and corruption.

Against this backlog and perception of unpredictability, a litigant will likely find that unofficial payments to court officials can achieve two goals: 1) place the litigant’s case at the head of a long queue; and 2) influence the court’s ruling. The judicial process is perceived to be “for sale to the highest bidder,” and in the case of loan default, the banks are often the “highest bidder.” Often, however, the value of their claim over collateral, when added to the official and unofficial costs incurred in the judicial process, fall short of the debt owed to the bank. Banks, then, will likely do their best to avoid going to court by not lending to borrowers perceived to be even somewhat risky.

According to interviewed banks, another major problems facing the current judicial system is the lack of relevant and detailed laws and highly inconsistent court procedures. There is no law dictating the procedure that the court should use in adjudicating commercial or civil cases. Thus, a solution to this critical problem would be the adoption and implementation of a law on civil procedure. Such a law is reportedly under consideration at the Council of Ministers. Courts currently apply the criminal procedure
code by analogy (and inconsistently) to commercial cases. A civil procedures law needs to be adopted and implemented.

In addition, Decree No. 51 of the “Law on Procedures for Implementation of Civil Judgments” (1992) is out of date (i.e. an auction must be timed by candle burning) and cannot be applied easily to lenders foreclosure cases.

Finally, enforcement of a judgment is uncertain. It may be that commercial judgments are more often enforced than a criminal decision. However, the period and unrestricted basis for appeals (an appeal can be filed simply because the losing party is dissatisfied with the outcome) often thwart prompt and effective enforcement of a decision.

3.3 Bank Staff are Inadequately Trained to Analyze and Manage Risks of Long-term Lending to SMEs

The research team found that staff of the banks interviewed are inadequately trained to analyze, assess and manage risks associated with medium- and long-term loans to the SME sector. Although the banks did not raise this as an obstacle to their lending to SMEs, the bank staff’s poor training is undoubtedly an important obstacle to more SME lending.

At the most active SME lending bank, the due diligence process comprises of attempts to establish the applicant’s monthly or annual net cash flow (gross cash revenue less gross cash expenses). Little or no effort is made to understand the applicant’s operating cycle and attendant risks. In general, it is sufficient that the applicant’s net cash flow indicates his ability to service the debt and that the loan is secured by collateral (which is virtually always personal property). It is viewed that security of the loan with personal property is a strong incentive for the borrower to repay the loan.

To be successful, long-term lending for fixed asset investments requires a more considered appreciation of the borrower’s business activities, attendant risks and a better understanding of ways to mitigate those risks. Collateral should, in most cases, be equipment related to the business, rather than personal property, and should be evaluated as a real second or third repayment recourse if the borrower subsequently proves unable to service the loan.

For example, in the above case of a defaulted medium-term loan issued to an agricultural project, the lender simply accepted the borrower’s projections and assumptions and did not perform any critical due diligence. The lender did not structure any effective risk-mitigating measures or viable second way out. This method of lending fairly reflects the process of lending to SMEs by most banks in Cambodia.

It should be noted that, prior to the mandatory bank capital increases of 2001, most banks in Cambodia were both capital and liquidity constrained. As a result, they were able to deploy all of their lending resources only through short-term loans, and thus bank lending prior to 2001 tended to exclude long-term loans. Against this background, banks have not had to analyze or structure long-term lending until very recently. As a consequence, there is little, if any, experience in analyzing and structuring medium- and long-term loans in Cambodia. Without such experience or focused training by experienced lenders, commercial banks in Cambodia have not yet acquired the necessary skills to analyze and manage risks.
To address this lack of experience and skill shortage, MPDF has begun to offer training courses to bank lending/credit staff and also has provided direct business plan guidance to the SME sector. These MPDF initiatives have been helpful; however as these initiatives are new and recent, they have not yet alleviated the case that commercial banks in Cambodia are generally still reluctant to extend long-term loans to SMEs.

### 3.4 Banks Do Not Know How to Price Risks, thus Charge Higher Interest Rates Than is Appropriate

Commercial banks in Cambodia have difficulty pricing loan risks. As a result, they may be charging higher rates of interest than is appropriate. At present, there is insufficient data (and few actual loan cases) upon which banks can precisely calculate the probability of loan default and price the risks of long-term loans. The adoption of such a systematic approach on pricing loan risks in Cambodia may occur in the next several years or longer in the future. In general, the most active lending banks appear to have adopted an opportunistic approach on interest rates pricing and are charging the highest interest rates that the market can withstand.

Differentiated risk analysis also appears to be largely absent in Cambodia’s banking sector. The most active banks have largely adopted an actuarial or portfolio approach in which high interest-bearing revenues are used to absorb loan losses and still leave a substantial profit. Little effort is made to carefully control and manage individual lending risks in ways that would justify a lower case-by-case lending rate. Other lenders, particularly branches of foreign banks that have relatively stronger risk management skills, are more inclined to structure credit and manage risks on a case-by-case basis. As a consequence, foreign banks are able to offer lower lending rates (and are occasionally doing so), however their participation in the local loan market (particularly in the SME sector) is relatively small.

The typically high lending rates for the SME sector reduce the cumulative number of business projects that can be financed. The high cost of capital (through high loan pricing) raises the required rate of return on projects. For example, fewer companies and projects would be viable at the real borrowing rates of 18-20% than at the real borrowing rates of 12-15% for medium- and long-term loans. Therefore, any increase in lending to the SME sector, particularly for medium- to long-term fixed asset investments, is heavily dependent on a reduction in current lending rates.

### 3.5 SMEs are Unable to Approach Banks Outside of Major Cities

It is unlikely that SMEs are unable to approach banks in Cambodia’s major cities, but it is highly probable that they are not able to approach banks in smaller towns and provinces due to the dearth of bank branches and offices at these locations. ACLEDA Bank, a micro-finance and small-scale industry bank, has the largest branch network in Cambodia. With over 750 staff and 50 branches, ACLEDA Bank is still only able to cover 14 of Cambodia’s 21 provinces. Canadia Bank has the next largest branch network with 10 branches. All other banks have branches only in Phnom Penh, and in some cases, a branch in Siem Reap. Given this lack of a national bank branch network, some SMEs may find it difficult to approach banks for financing in certain areas of the country.
It is also worth noting that banks without local offices and staff to monitor borrowers and loans are less likely to accept the risk of lending to SMEs in distant locations. The research team found that several banks accept only collateral located in major cities or those located in Phnom Penh alone.

3.6 Incentive Structures Within Banks are Not Designed to Motivate Credit Officers to Make Long-term Loans to SMEs

Only one bank interviewed has implemented an incentive scheme for credit officers to bring in new loan bookings. The scheme was introduced by a relatively new bank that is trying to increase its portfolio. This bank has instituted a successful promotion program of scheduled visits to markets and companies to solicit new loan business. Under the scheme, lending officers who introduces a customer borrowing over US$20,000 gets a salary increase of US$40 for each transaction, up to a maximum of US$400. After reaching the maximum salary increase, the incentive is paid by periodic bonus.

Other commercial banks in Cambodia are generally cautious about offering incentives to lending officers because it is sometimes the practice in Cambodia for borrowers pay “gratuities” to credit officers.

3.7 SMEs Do Not Meet Banks’ Minimum Lending Criteria

It is true that many, if not most, SME loan applicants do not meet the minimum criteria set by banks. As one interviewee said: “Loan demand is strong, but well qualified borrowers are in short supply.” However, there are readily available solutions to this obstacle.

The two main factors contributing to SMEs’ inability to meet bank criteria are: 1) the banks’ minimum lending criteria, and 2) the banks’ limited ability to perform accurate due diligence on SMEs and monitor loans extended.

3.7.1 Meeting Lenders’ Criteria

As in other developing countries, the quality and availability of financial information on SME borrowers in Cambodia ranges from minimally acceptable to wholly non-existent. Many SMEs conduct their business on a cash basis, so any attempt to verify their turnover is virtually impossible. Banks cannot be expected to extend long-term loans to SME borrowers who lack adequate proof of financial continuity or viability.

Since 1999, registered companies in Cambodia have been required to prepare and maintain annual financial reports. However, of the more than 7,000 companies registered with the Ministry of Commerce, less than 110 are believed to be producing or maintaining annual financial reports. The new Accounting Law (2002) requires an annual audit for all companies; regulations implementing this law, however, have not yet been passed.

Most banks in Cambodia require collateral for loans. However, each bank’s valuation of collateral as a risk mitigation varies. In general, the most active lending banks have
defined acceptable collateral quite strictly—land and building (including flats and villas) owned by individuals in major cities. SMEs seeking medium- to long-term loans to finance investments in fixed assets will frequently not meet this highly restrictive list of acceptable collateral. As such, banks are required to accept the financed assets themselves as collateral (lending on a “clean” basis), or banks would be required to start accepting other forms of collateral. A solution to this problem would be an asset-based financing approach such as leasing. This is discussed in greater detail in section 5.7.

3.7.2 Lack of Ability to Perform Due Diligence

If produced, financial reports for SMEs are rarely audited. Even if they are audited, the thoroughness of such audits are questionable. As such, independent third-party verifications of the SMEs’ liabilities are usually unavailable.

A law on customer confidentiality enacted in the mid-1990s prohibits the disclosure of customer information which causes restrictions on the exchange of information between banks. Currently, customer information can be shared between banks only with the client’s written approval. No private entity or government agency has established a credit bureau or database to compile information on customers’ debts or liabilities, especially on their bank borrowings. This absence of information and data on a borrower’s debts and liabilities renders the monitoring of medium- and long-term loans highly problematic.

3.8 Bank Procedures Are Perceived to be Too Complicated by Some SMEs

Foreign banks, using credit assessment processes designed by their head offices, will typically require borrowers to provide documentation such as business plans, forecasts, industry and competitor information. Such information are typically not required by local banks. Local SMEs undoubtedly find these requirements burdensome when applying for a loan.

For the most active local bank lenders to SMEs in Cambodia, the most onerous lending procedure is the due diligence and registration of collateral. These banks will generally visit the borrower’s premises and inspect the collateral being provided. Borrowers must execute loan documents and provide evidence of the company’s registration and licenses while the registration of the security interest over the collateral itself is handled by the bank. Complications usually arise when title to the collateral is unclear or is encumbered, or when the borrower has other legal problems with the collateral.

Although the documentation required can be somewhat intimidating for first-time borrowers, it is fairly basic and relatively simple compared to international practices. These lending procedures are complicated only when compared to the “no documentation process” of the informal credit market.

3.9 The Informal Credit Market is More Efficient and Many SMEs Prefer It

According to one bank officer whose relatives borrow in the “street market,” lenders in this informal credit market are liquid and have begun offering rates comparable to the highest rates offered by banks. The competitive pressure felt by banks from the informal credit market is a new phenomenon, and one would expect it to be relatively temporary.
By offering “no documentation” loans, the informal market is taking higher risks. If the risk profile of borrowers improve to make the informal credit market viable, it is expected that banks, which conduct due diligence and require documentation, to lower their lending rates to attract borrowers from the “street market.” At present, however, there is no evidence that this is occurring.

In theory, there should be little direct competition between the informal credit market and banks for customers because they should be serving distinctly different clientele. The current level of competition between banks and the informal credit market suggests that the loan market is temporarily adjusting to new supply-demand factors.

3.10 Banks Do Not Have Adequate Access to Long-term Capital

Deposits raised by banks are virtually all short-term (of one year or less), with most deposits of six months or less. Since these deposits are overwhelmingly denominated in US dollars, they are susceptible to mass withdrawal under certain conditions such as political unrest. The NBC’s extremely conservative liquidity ratio guideline of 100% (100% of time deposits with less than one month remaining) is a definite constraint on long-term lending by banks.

Prior to the capital increase requirements at the end of 2001 (from US$5 million to US$13 million), the NBC’s liquidity ratio constraint and the very thin shareholder’s capital level virtually prohibited long-term lending from a prudent asset-liabilities management perspective. Severely constrained in long-term lending from a funding perspective, local banks have had little reason to adopt long-term lending strategies, procedures, or capabilities. Although this constraint has been relieved to some extent by recent mandatory increases in shareholders’ capital, the legacy of short-term oriented lending attitudes and policies remains.

3.11 SMEs Do Not Have Demand for Long-term Capital at Current Interest Rates

The research team found that borrowers are approaching banks for medium- and long-term credit, but banks are normally declining to extend credit on this basis. Some bank managers maintain, with reason, that few borrowers are interested in long-term financing because of its high costs. This view is certainly correct for many potential borrowers and the high real cost of debt financing in Cambodia is curtailing investments and loan demand. The correct approach to this weakness in demand for credit, then, would be to increase the supply of capital at lower real interest rates.

3.12 Banks Prefer to Lend to Individuals Rather Than Corporations

The practice of lending to individuals rather than corporate entities is seen in the traditional approach to risk management practiced by local banks. This approach entails conducting minimal due diligence on a borrower’s business and risks, and rather placing emphasis on a borrower’s personal character, credit record and particularly his/her collateral. Also, the type of collateral commonly accepted by banks—land, buildings, houses—is most often held in the names of individuals.
This traditional approach to lending is an impediment to medium- and long-term financing of fixed asset investments. A bank should approach and evaluate such financing in the context of the business’ and the corporate entity’s risks, of which the investment will be an integral part. Cash flow to repay the loan (usually the ongoing business’ products) should be clearly identified. Adopting such a lending approach would require that the corporate entity be the owner of the financed fixed assets and be the borrowing entity. If additional collateral were needed, the individual entrepreneur could then be asked to pledge personal assets to the bank.

3.13 Shortage of Lending Officers in Banks

The research team found a surprising lack of lending staff in Cambodia’s commercial banks. For several banks, only two or three individuals are responsible for all of the bank’s lending activity. Even for the most active lender that has ten branches, only 20 of its staff are dedicated to lending activities. For several other banks, lending is just another duty among a staff member’s many other functions.

This under-staffing of the credit and lending function is undoubtedly impairing banks’ ability to analyze, structure and monitor all but the most standard credit risks. It prevents banks from structuring and arranging more complex medium- and long-term loans to SMEs.

As a result, an SMEs must be well-prepared with documentation before approaching prospective lenders. A carefully designed and structured proposal by the SME applicant will facilitate efficient and positive loan processing. MPDF’s assistance to individual SMEs in this area would be particularly effective and useful.

3.14 Absence of Specialized Lenders and Perceived Higher Risks of Lending Against Machinery

With the exception of a few specialized micro-finance institutions and the “street market”, lending in Cambodia is largely conducted by commercial banks whose lending approach could be characterized as “generalist.” Currently, there are no banks, department within banks, or special purpose finance companies (such as leasing companies) that specialize in equipment financing. Equipment financing involves special risks and requires focused management and specialized knowledge. This lack of specialization is another barrier to medium- and long-term financing for the SME sector in Cambodia.

In the asset financing market, specialized services and resources such as those of auditors, appraisers, auction markets and specialized equipment dealers play an important role in assisting banks to assess, control and manage risks. Risk management techniques require the ability to correctly evaluate projects and equipment from both financial and technical perspectives and the ability to repossess and dispose of the equipment outside of the local market. These abilities are largely absent in Cambodia. Therefore, in order to prudently undertake this kind of financing activity, commercial banks would have to develop such specialized resources internally. No bank in Cambodia has yet done so.

It is also worth noting that banks in Cambodia generally perceive lending against machinery and equipment to pose unacceptable high risks. The risks include:
• Difficulty in appraising and liquidating the machinery and equipment, particularly when specialized and/or second-hand equipment is involved;

• Frequent failure of end-users/borrowers to maintain the equipment properly; and

• Difficulty in maintaining control over the equipment.

3.15 Withholding Tax on Offshore Funding

Cambodia’s tax law imposes a 15% withholding tax on payments of interest to depositors. The law seems to make no distinction between interest payments made on funds borrowed from offshore financial institutions (including head offices of foreign banks) by banks or bank branches in Cambodia.

This taxation policy deviates from international practice and constitutes a significant impediment to the acquisition of long-term funding by Cambodian financial institutions. Given the liquidity constraints already mentioned, access to new sources of long-term funds could be a crucial factor in increasing the supply of long-term financing for SMEs.

Cost is a key constraint on the demand for credit by the SME sector in Cambodia, and it is therefore critical that new sources of relatively low cost long-term funding be found. The 15% withholding tax requirement places additional and unnecessary burden on borrowers, and reduces demand for bank credit.

3.16 Summary of Obstacles

The Table below summarizes the various obstacles to lending to the SME sector in Cambodia. It also indicates the perceived scale of each obstacle’s impact (large, medium or small), whether the obstacle is specific to the SME sector, and the extent to which the barriers were mentioned by the banks surveyed in this study.
### Summary of Obstacles to Lending to SMEs in Cambodia

<table>
<thead>
<tr>
<th>Obstacle</th>
<th>Scale of Impact</th>
<th>Specific to the SME Sector?</th>
<th>Cited by banks surveyed</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMEs do not meet banks’ minimum lending criteria</td>
<td>Large</td>
<td>Yes</td>
<td>All banks</td>
</tr>
<tr>
<td>Absence of specialized lenders, particularly in equipment financing</td>
<td>Large</td>
<td>Yes</td>
<td>All banks</td>
</tr>
<tr>
<td>Lending against machinery and equipment perceived to pose unacceptable risks</td>
<td>Large</td>
<td>Yes</td>
<td>All banks</td>
</tr>
<tr>
<td>Bank staff inadequately trained to analyze/manage risks of long-term lending to SMEs</td>
<td>Large</td>
<td>Yes</td>
<td>50% of all banks</td>
</tr>
<tr>
<td>Existing laws are inadequate to protect lenders’ interests</td>
<td>Large</td>
<td>No</td>
<td>All banks</td>
</tr>
<tr>
<td>Judicial system does not adequately protect lenders’ interests</td>
<td>Large</td>
<td>No</td>
<td>All banks</td>
</tr>
<tr>
<td>Banks do not have adequate access to long-term capital</td>
<td>Large</td>
<td>No</td>
<td>All banks</td>
</tr>
<tr>
<td>Shortage of lending officers in banks</td>
<td>Large</td>
<td>No</td>
<td>All banks</td>
</tr>
<tr>
<td>Withholding tax on offshore funding</td>
<td>Large</td>
<td>No</td>
<td>30% of all banks</td>
</tr>
<tr>
<td>Some SMEs are unable to approach banks</td>
<td>Medium</td>
<td>Yes</td>
<td>No banks</td>
</tr>
<tr>
<td>Banks’ preference to lend to individuals rather than corporations</td>
<td>Medium</td>
<td>Yes</td>
<td>50% of all banks</td>
</tr>
<tr>
<td>Banks do not know how to price risks, thus charge higher rates than appropriate</td>
<td>Medium</td>
<td>No</td>
<td>No banks</td>
</tr>
<tr>
<td>SMEs do not have demand for long-term capital at current interest rates</td>
<td>Small</td>
<td>Yes</td>
<td>75% of all banks</td>
</tr>
<tr>
<td>Informal credit market is more efficient and SMEs prefer it over banks</td>
<td>Small</td>
<td>Yes</td>
<td>25% of all banks</td>
</tr>
<tr>
<td>Bank procedures are too complicated</td>
<td>Small</td>
<td>No</td>
<td>No banks</td>
</tr>
<tr>
<td>Incentives within banks do not motivate credit officers to extend long-term loans</td>
<td>Small</td>
<td>No</td>
<td>No banks</td>
</tr>
</tbody>
</table>
4 CONCLUSION: EIGHT RECOMMENDATIONS

This final section provides eight policy-oriented recommendations on how to address and overcome the obstacles to lending to the SME sector in Cambodia that have been identified. The goal is to provide recommendations to resolve general bank lending inhibitors as well as those inhibitors specific to lending to SMEs.

4.1 A Commercial Court Needs to be Created

Cambodia’s current judicial process is both costly and unreliable and is in urgent need of improvement. One remedy would be to create a commercial court for the adjudication of only commercial claims and disputes, particularly those relating to contract and debt obligations. Such a court could have a magistrate who verifies a case’s facts and applies statutes and laws, rather than a judge who interprets law. Decisions of this court should be binding and final with no right of appeal. The court should also be empowered with enforcement authority on its rulings. Ideally, a new commercial court should be established in each province and principal municipality.

Unless fundamental issues such as a lack of laws and regulations relating to secured lending, procedural laws for efficient adjudication of a dispute and court personnel issues are resolved, any new commercial court will encounter the same problems facing the current judicial system. Perhaps a small pool of expert commercial judges could be found. A number of interviewees commented that Cambodia’s pre-1975 commercial court system (a legacy of the French colonial system) was both efficient and effective. Perhaps a similar system could be established.

4.2 Banks Should be Permitted to Provide Information on Borrowers’ Liabilities to Appropriate Third-parties

The banks’ current difficulty in conducting effective due diligence on borrowers increases the lenders’ real and perceived lending risks, particularly those relating to medium- and long-term loans. The existing law on customer confidentiality should be amended to permit commercial banks in Cambodia to provide appropriate third-parties with information on borrowers’ liabilities without the need to obtain prior approval from the relevant client. The client should be notified of the request and provision of information to third-parties, but his/her approval should not be required.

A private or public entity such as the Bankers’ Association7 or the NBC could be authorized to compile data on customers’ liabilities, particularly those relating to loans with banks. The confidentiality of customers’ information can still be maintained by assigning each borrower an identification number. Reporting of customers’ borrowing records to the proposed system by commercial banks should be mandatory.

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7The Association of Banks in Cambodia (ABC) began as an informal body in the mid-1990s, however was not recognized by the NBC until December 2001.
4.3 The NBC Should be Flexible in Its Liquidity Ratio Requirements

The NBC’s current high liquidity ratio requirement effectively acts to inhibit long-term bank lending in Cambodia. The NBC should differentiate between banks that have strong parents and offshore sources of liquidity and others that do not when setting liquidity requirements for commercial banks.

The NBC should also consider working with leading local banks to encourage lending, particularly term lending. Furthermore, the NBC could establish a long-term loan refinancing facility for commercial banks lending to SMEs for productive purposes. The refinance rate should be low in order to encourage borrowers and lenders to participate.

4.4 A Prakas or Sub-Decree Establishing an Asset Registry Should be Issued

Currently, commercial banks are reluctant to accept machinery, equipment or any other movable asset as collateral, thereby thwarting lending for fixed asset investments. In order for asset financing to burgeon in Cambodia, there must be a remedy to creditor’s current inability to enforce their rights against secured “movable assets.” However, it should be noted that much of the machinery and equipment used as collateral is second-hand and some may even be wholly obsolete. Even with a limited re-sale market for many types of industrial equipment, this type of financing collateral will play a limited, but nevertheless important, role in SME lending activity in Cambodia.

Given the importance of this barrier to greater lending to SMEs, waiting for the adoption of a secured transaction law does not appear to be a viable option, and a quicker solution is needed. One possible remedy would be a Prakas Ministerial Guideline or Sub-Decree from the Prime Minister’s Office establishing an asset registry. A Prakas or Sub-decree interprets and explains the law and can establish a responsible authority (perhaps the Ministry of Commerce) where creditors can register their security interests in movable assets.

Some commentators believe that the existing Contract Law is an adequate and highly desirable basis for this initiative. This author believes that linking financing rights and responsibilities to the Contract Law rather than a more specific (and more limiting) special purpose law such as the proposed leasing law will give the contracting parties more flexibility in their financial transactions. It will allow lenders to tailor-fashion solutions to each transaction’s different degree of risks.

The current Contract Law requires possession of the asset by the secured party and requires court decision for transfer of the ownership of the asset following a default. Only another law, passed by the National Assembly, can amend an existing law. However, as a Prakas or Sub-decree interprets and explains the law, it is possible that a Prakas be written to interpret “possession” as meaning physical possession of the title or registration document, not physical possession of the asset. Furthermore, it could be interpreted that where the asset is intangible, “possession” means assignment of the contract or other rights. Finally, the

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8 A Sub-Decree can be issued by the Office of the Prime Minister and is subject to approval by the Council of Ministers.
9 The current Contract Law is actually “Decree No. 38, Concerning Contracts and Matters Relating to Contracts” (November 1988). According to the Ministry of Economy and Finance, a complete contract law is anticipated at the end of 2003.
regulation could interpret the law to mean that court decisions are only required where the asset is physically possessed, as opposed to possession of the title/registration documents or assignment of contract rights.

In order to achieve a prompt solution to this obstacle to SME lending, it is recommended this issue be taken up with the Private Sector Working Group on Law and Good Governance to present this initiative to the relevant government ministries.

4.5 Focused Training to Increase Banks’ Ability to Analyze and Mitigate Risk

Currently, banks in Cambodia prefer to lend to individuals rather than to corporate entities. This barrier to SME lending can be overcome with focused training for bank staff (such as the training courses already being provided by MPDF). The training should focus on cash flow-oriented lending, analysis of business risks (particularly operating cycle risk analysis) and mitigation of risks related to lending to SMEs.

Training or assistance to the SME sector on financial record-keeping and maintenance of company records and accounts will also help the SMEs better present themselves to banks as credible borrowers.

4.6 Development of Local Consulting Services that Can Provide Assistance to SMEs that MPDF is Currently Providing

The SME sector in Cambodia does not maintain or have sufficient information (quality and type of information) necessary for banks to make a credit decision. As such, there is an opportunity (currently being filled by MPDF and a few NGOs) to assist SMEs in formulating business and financial plans. The SME sector is generally disinclined to pay for such advice; however this disinclination can be overcome when the service results in financing.

Cambodia’s SME sector may be able to support a significant expansion of financial advisory services if a firm linked to potential financing were established. Furthermore, greater transparency and professionalism in borrowers’ financial record could, in turn, generate increased bank lending resulting in “a virtuous cycle.” In addition to undertaking this work directly, MPDF could support the growth of local business development services companies to take on this role.

4.7 Develop Specialized Asset-based Financing Institutions

Many commercial banks perceive that lending against machinery and equipment present additional unacceptable risks (above the reluctance to accept movable assets as collateral). In conducting this study, the research team frequently heard about the difficulties encountered by commercial banks (non-specialized lending institutions) in managing asset-based lending risks. The risks and difficulties cited are very real for such institutions, as asset-based financing requires specialized skills and risk management abilities.

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10 One interviewee cited an example of a business management advisory services company in Shanghai that was established by the local government and the Bank of Shanghai. The company helps SME clients become bankable creditors and also provides partial guarantees for loans with the Bank of Shanghai funds. The company is self-funded by fees from such advisory services to SMEs.
One solution would be the development of more specialized asset-based financing institutions in Cambodia such as leasing companies. As Article 2 of Cambodia’s Banking Law defines leasing as a banking activity, this provision can be used to facilitate the beginning of leasing activities by certain commercial banks. It should be noted that for local banks to enter the leasing business or engage in long-term financing, they will most likely be required to import knowledge and expertise from offshore specialized leasing companies. The most feasible model for such an arrangement would probably be a non-equity cooperation between overseas leasing firms and Cambodian commercial banks.

4.8 Withholding Tax on Interest Payments to Depositors Should be Revoked

Finally, the current 15% withholding tax is an important obstacle where long-term funding comes from offshore sources. Where banks borrow from offshore, the withholding tax increases their cost of financing. This extra cost will be passed on to borrowers in the form of higher interest rates. To help reduce the rates and to promote the inflow of capital to the financial sector such withholding tax should be waived or revoked for funding between financial institutions, including non-banks.
Appendix 1: NBC’s Liquidity Ratio Requirement and Calculation

In Cambodia’s highly dollarized banking system (over 90% of bank deposits are in US dollars), the NBC explicitly disavows any role as a “lender of last resort” for commercial banks operating in Cambodia.

Liquidity Ratio Requirement by the NBC

Banks must maintain a liquidity ratio of 100%. The calculation should be based on the banks’ monthly financial accounting statements. The numerator and denominator are derived as follows:

**Numerator**

1. Treasury balance (lender’s position), when debit items exceed credit items:

   **Debit items:**
   - cash and gold
   - deposits with NBC
   - deposits with banks
   - portion of lending to banks and financial institutions with less than one month remaining

   **Credit items:**
   - credit balances on sight in accounts maintained with NBC, banks, or other financial institutions
   - borrowings from NBC and banks with not more than one month to run.

2. Portion of lending with less than one month remaining
3. Treasury bills with less than one month remaining

**Denominator**

1. Treasury balance (borrower’s position), when credit items exceed debit items (see above);
2. 80% of the portion of fixed deposits and CDs with less than one month remaining;
3. 50% of the portion of fixed deposits and CDs with less than one month remaining;
4. 50% of savings deposits; and
5. 60% of demand deposits.
Appendix 2: Lending Activities Update  
As of End of Year 2002

After the first draft of this report was completed in August 2002, the following events occurred:

1. **Lower Lending Rates**

   During the second half of 2002, interest rates charged on loans to SMEs by the leading lenders were substantially reduced. The “all-in” lending rates for established borrowers was reduced from 19.19% - 22.81% to 15% - 17.5%. This is a highly positive development for the SME sector and serves as a remedy to one of the constraints we had identified in our report (the prohibitively high cost of debt financing for SMEs).

2. **Increased Competition/Activity Amongst Lenders**

   Bankers stated that their lowering of lending rates was, for the most part, a response to competitive pressure. Customers were demanding lower rates because they had been solicited for or know of other lenders prepared to offer lower rates. Another reason for the lowering rates was that the banks’ cost of funding decreased (due to lower interest rates on deposits).

   One lender informed us that it had recently added seven lending officers to its lending operation. This represents an increase of 35% in its credit/lending staff. Such change will likely continue (although probably not at the same rapid pace and magnitude), and are positive for borrowers, the SME sector and the banking sector.

3. **A New Bank**

   In the Fall 2002, a new, full-service commercial bank named Vattanac Bank was established. The bank is a Cambodian bank and plans to actively lend to domestic SMEs. Such new competition in SME lending should be welcomed.

4. **NBC Relaxes its Liquidity Ratio**

   Another factor contributing to the lowering of lending rates was that the NBC reduced its liquidity ratio from 100% to 80%. At the time of the field research, the liquidity ratio requirement was 100% and was identified by all banks as a constraint on lending. Responding to appeals by the banking community, on September 13, 2002 the NBC lowered the liquidity ratio requirement.

   An NBC staff remarked that the NBC is prepared to reduce the liquidity ratio requirement even further. This is in conformity with the recommendation set forth in this paper and is highly welcomed by the banking community.

   **NBC Promises to Reduce Solvency Ratio**

   An NBC representative further informed us that the NBC expects to reduce the solvency ratio (risk weighted capital adequacy) in 2003. The solvency ratio has been a constraint for some
lenders. The current solvency ratio requirement is 20% and was set in 1999 in the aftermath of the Asian financial crisis. This requirement is excessive when compared to the Basel Accord’s minimum requirement of 8% and is significantly above the requirements of other Central Banks in neighboring countries.

Under the current system, banks that deposit funds with other financial institutions (excluding the NBC), are required to have “risk weighting” capital which can often be 100% of the amount deposited. This study had noted the banks’ under-lending position, and this author believe that the solvency ratio requirement remains an important constraint on bank lending activities.

5. **One Bank Has Begun Lease Financing**

It was reported that a specialized equipment financing company recently entered into a cooperative agreement with a local company whereby the bank is to provide medium-term equipment financing under selective criteria and conditions.

This leasing scheme and cooperative arrangement is in line with this report’s recommendation. This start-up business is operating under a variety of constraints and difficulties—the subject of other recommendations in this paper—that remain largely unresolved. Nevertheless, this initiative is to be lauded and should serve as a model for other banks and specialized companies.