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Cambodia financial inclusion:

Still investable?

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Cambodia's financial inclusion sector has got quite some media coverage in the past months (and years). In essence the media coverage boils down to the (ir)responsible lending practices and over borrowing (over-indebtedness) risk. This is due to the high growth of the sector and the increasing risk of clients taking more debt.

DEVELOPMENTS

Cambodian financial inclusion/microfinance roots go back to the 90's when, in aftermath of the 20 years civil unrest, the United Nations peacekeeping program was established as to recover the country and to support financial sector development. Prior to the 90s, the microfinance model was unknown while the banking sector was immature in the country. Partly because the entire professional and intellectual class of Cambodia was murdered by the Khmer Rouge and because of a scorched earth policy to anything resembling capitalism. With support of the international community the industry made its first steps in financial inclusion/microfinance which resulted in a total Micro Finance Institutions (MFI) loan book of around USD 3 million in 1995, provided to 50.000 borrowers and no depositors. At that time the country's population stood at 10.6 million, of which almost 50% were considered to be poor, with a Gross Domestic Product (GDP) per capita of USD 323.

Since that time the microfinance industry with capital support (debt and equity) from international and local markets grew towards a more professional sector. However, the sector is still faced with "microfinance high growth diseases".

The microfinance industry's relatively high growth rate can be explained by low starting base point, literarily starting from scratch, as well as the role the industry has played in fulfilling the banking sector gap. This is well pictured in the citizens sentiment that shows that only 17% of adult Cambodians use universal banks while 52% use services of the MFIs. In addition, the population growth as well as improved financial literacy have added to the industry growth as well as tripled GDP growth in the past three decades.

Currently, Cambodian MFIs provide loans to more than 2.3 million clients, while having more than 1 million depositors, in a country with 16.2 million (GDP per capita USD 1,512) inhabitants, of whom around 14% is considered poor. In recent years, competition between MFIs has become more intense due to the increasing number of MFIs in the country and the inflow of available resources. 80 MFIs operate in the country, including seven microfinance deposit-taking institutions.

Over the last 10 years the sector has shown an annual growth of over 30%, following larger inflow of capital and the regulator's approval of MFIs to take deposits. In fact as result of the deposit taking activities, borrowing from international sources dropped 50%. This, together with improving efficiency, has impacted funding costs of MFIs to decrease, and according to MixMarket has been halved in the past 20 years to the current level of around 6% (USD).

These expenses reflect the more difficult operating environment (think about political, regulatory, social, economic and other risks) in this case in Cambodia, compared to more economically developed countries. And even though the interest rate is capped at 18%, the average portfolio yield of the MFIs in Cambodia stood at 20.5%.

Operating expenses (especially labour costs) are one of the key drivers of determining the interest rates charged by MFIs. Microfinance business in Cambodia, but also worldwide, is (still) a labour-intensive sector and personnel costs are rather high. Making and recovering small, tiny loans is costly on a per unit basis compared to larger volume loans. Most of the loan takers are located in rural areas, which are hard and time consuming to reach. For the Cambodian MFIs average operating expenses were close to 11% in 2018.

	Cambodia	East Asia and the Pacific
Average Interest Margin	14.6%	26.7%
Average Operational Expenses	10.9%	23.5%
Average Loan loss Expenses	0.7%	1.9%
Average Operating Margin	3.0%	1.3%

The microfinance industry is flagged as an industry with high repayments rate. This still holds for Cambodia as well, and based on sampled MFIs, loan losses expenses add on average 0.7% to the interest rate structure.

Cambodia's microfinance sector can be considered to be pretty concentrated with high competition, with the top ten MFIs commanding 95% of market share in loans and 100% of market share in microfinance deposits. In spite of strong growth in the sector and increased competition overall, portfolio quality has been maintained with aggregate non-performing loans (NPLs) of 2%, which is considered relatively low. However, this low level of the NPLs needs to be viewed with caution given the high growth rates that can mask portfolio quality issues.

At the same time such intensified competition coupled with improved efficiency has resulted in lower interest rates to clients and more diversified products offered by MFIs, particularly in individual loans. Early 2000 the MFIs charged interest rates as high as 35% which decreased to below 20%. One of the other key contributor to this in Cambodia has been the interest rate cap (18%) that has been introduced in 2017. Although some still perceive this as high, it in fact reflects current market efficiency.

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RESPONSE TO THE GROWTH

When viewed in a global context, the country is still perceived to be well below investment grade and relatively high risk. Rating agencies rank the banking industry in Cambodia on the lower end of its peers in Asia citing lax bank regulation and passive supervision, overcapacity and lack of depositor confidence.

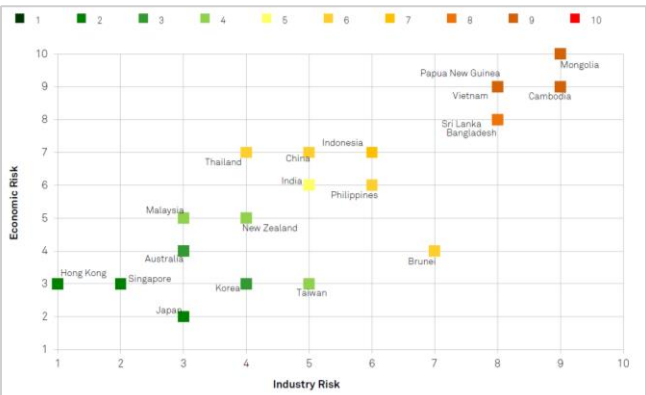
The industry wide high growth rates pushed the regulator, the National Bank of Cambodia (NBC), to enhance microfinance industry regulation. This resulted in the establishment of a credit bureau. Today all regulated MFIs are required to report to the credit bureau as to verify client data prior to any loan disbursement. Furthermore, the NBC has recently taken steps to raise the minimum capital requirement for MFIs and regulated banks in addition to adding minimum liquidity requirements (via the liquidity coverage ratio) for deposit-taking MFIs as to boost the sector in its effort to put a brake on sector growth.

At the same time the sector wide initiative such as the Cambodian Microfinance Association (CMA) have acted as to contain the problem of the industry high growth by imposing Lending Guidelines on MFIs to stop predatory practices. They also carry “bite” as they: a) have now become quasi-covenants for MFIs since many lenders will not finance them unless they are LG-compliant; and b) they are treated as core criteria for SMART Campaign stipulations specific to Cambodia.

The Lending Guidelines use traditional indicators for gauging over-indebtedness, such as multiple borrowing and loan-to-income ratios; in addition loan refinancing is being used as well (e.g. taking out new - and usually larger - loans to refinance existing loans that have not yet matured).

One third of the Cambodia’s regulated MFIs have signed on to the global Smart Campaign initiative, pledging to adopt consumer-protection principles, such as providing mechanisms for redress. Moreover, a plentiful of the MFIs that have singed the principals has got certification from the Smart Campaign confirming that they do actually adhere those in daily practice.

Asia-Pacific: Banking industry country risk assessments
(BICRA-groups: lowest to highest risk)



Source: S&P Global Ratings, 22 November 2018

In parallel with the microfinance industry growth, the country as a whole has made decent progress as the GDP growth in the past 30 years mounted for 7.6% per year on average, on the back reforms taken, as observed by the IMF (Dec 2018). However, the Cambodian (rating “B”), highly dollarized, economy is still marked by pockets of vulnerability in growth, and external liquidity owing to the country's underdeveloped and narrow economic profile. Agriculture, which contributes 30% to the country's GDP but employs more than 70% of the labour force, suffers from output volatility and does not have a developed downstream processing industry. The country's industry is centred around the low value-added garment, textile and tourism industry.

Financial Inclusion and the Social Development Goals (SDGs)

The SDGs comprise an ambitious 17 goals. And while the SDGs do not explicitly target financial inclusion, greater access to financial services is a key enabler for many of them. SDG 1 (ending extreme poverty) for instance explicitly mentions the importance of access to financial services and is closely linked to SDG 8 (promoting economic growth) and SDG 9 (sustainable industrialization). On the other hand, financial inclusion of farmers can lead to bigger investments in the planting season, resulting in higher yields - and hence progress towards the realization of SDG 2. Financial inclusion institutions also often explicitly target women and hence promote gender equality (SDG 5). In addition, we see more and more microfinance products linked to issues around water & sanitation, contributing to SDG 6.

OVER-INDEBTEDNESS

Over-indebtedness is generally regarded to be one of the most serious problems of the financial inclusion sector. The SMART Campaign, a global initiative to enhance client protection in microfinance, states that “*many within the sector have seen an overemphasis on the supply side, which can have the effect of microfinance institutions not adequately knowing their clients’ repayment capacities.*”

In financial inclusion, the global issue of over-indebtedness has surfaced in many countries, such as Nicaragua, Morocco, Ghana, Bosnia and Pakistan, but most prominently in India. Most of those countries have reacted on similar grounds as Cambodia (i.e. strengthening sector regulation and oversight and improving market level credit risk management, via credit bureaus).

It is good to note that 80% of clients in the Cambodian microfinance sector are unique (i.e. have loans from only one lender). However, cautiousness is needed in the light of elevated growth rates in spite of low levels of financial inclusion and a nascent banking sector in Cambodia.

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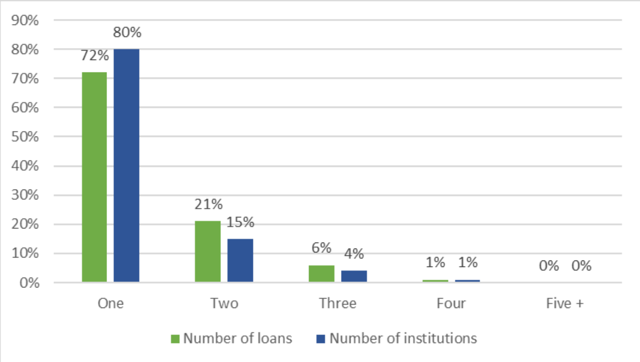
Multiple borrowing distribution



Source: CBC data

Contrary to the experience of overheating microfinance markets in other parts of the world, Cambodia does not have high levels of multiple borrowing; 28% according to the Credit Bureau data.

However, if you take a look at the *potential* client base of MFIs it is safe to say that the market saturation is almost there. To arrive at this conclusion, we have the following assumptions:

- total population of 16,3 million;
- around 77% of the population (that is poor and rural) is a potential MFI client;
- 75% of those will actually take a loan.

Figure 3: Pro-forma market penetration Cambodia

Cambodian population as of 2018	16.3 million
% of poor and rural population	77%
#of poor and rural population	12.5 million
average family size	4
# of poor families	3.1 million
% of families with MFI client profile	75%
# of potential MFI clients (market size)	2.3 million
# of MFI clients end 2018 / penetration	2.3 million

Source: World Bank, 2018

However, World Bank says that still just a bit more than 20% of adults have a bank account versus 90% of banked adults in the developed world. Anyhow, cautions and good understanding of the Cambodian market lending dynamics as well as on multiple loans and consequent borrowing over clients repayment capacity is needed. Major microfinance investment vehicles (MIVs) have invested on average 8.4% of their respective portfolios in Cambodia supporting financial inclusion sector. In addition, development financial institutions like IFC and FMO alongside to capital have provided considerable technical assistance to the sector supporting sector professionalization.

KEY TAKEAWAYS AND ACHIEVEMENTS

MFIs seem to be one of the key tools for Cambodia in the effort to increase financial inclusion and national prosperity. World Bank has pronounced importance of the financial inclusion sector for the country's economic growth and its contribution to a reduction in poverty levels from 47% to 14% in just seven years' time. Number of financially excluded is nevertheless still consider to be relatively high given that some 80% of adults are considered to be unbanked.

While Cambodia still has an underdeveloped financial sector according to global indicators it has demonstrated a noteworthy reforms effort in this area. The regulatory environment has been improving while number of investable financial institutions increases.

Though there has been a problem with sector-wide over-indebtedness the regulator and industry association are proactively confronting the issue by strengthening MFIs lending guidelines.

The interest rates charged are considered to be on a higher end, when compared to the developed markets but this is justifiable given the MFIs current business model. An opportunity for interest rates decrease to a certain extent depends on MFIs efficiency. Can they make use of new tech developments?

From an investment perspective we see a further professionalisation of the financial inclusion sector in Cambodia. Certain financial inclusion players are still considered to be investable given sound financial infrastructure and number of unbanked, however, selection of the right MFI is critical using criteria for responsible lending and saturation.

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