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The case of PRASAC: Transformation of a credit programme into an MFI

Presented by

Johann-Friedrich Ramm
PCA Credit Adviser

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1. History of PRASAC as rural rehabilitation/development programme

PRASAC (Programme de Réhabilitation et d'Appui au Secteur Agricole du Cambodge) was launched in early 1995 as a rural rehabilitation programme in six provinces in Southern Cambodia after a period of 20 years of civil war and destruction. Around 50% of the national population of around 12,4 million live in these six provinces in the upper part of the Mekong Delta. The European Union has committed Euro 40 million each for phase I (1/1995 until 4/1999) and phase II (5/1999 until 12/2003).

PRASAC's executing agencies are the three Ministries of Agriculture, Fisheries & Forestry, Rural Development and Water Resources & Metereology and the Rural Development Bank (since March 2000). Around 600 public servants mainly from the Ministries of Agriculture, Fisheries & Forestry and Rural Development were seconded to PRASAC. Implementation of PRASAC started as three separate programmes, managed by different consulting companies, each covering two neighbouring provinces. In February 1998, all three programmes were merged and programme execution has been steered and supported since then by a Project Management Unit in Phnom Penh.

PRASAC envisaged "providing water for domestic purposes and for maintaining livestock to the rural households, in this way supplying basic means to improve agricultural productivity with self-sufficiency on family level. Breaking the cycle of rural indebtedness caused by unfair interest rates, the project would render lending services on village level with interest rates compatible to the farmers' capacity for repayment" (PRASAC I Financing Agreement, annex A, p.2).

PRASAC consists of the following six main components:

(1) **Domestic water supply** by way of constructing wells and water catchment tanks for drinking water and village ponds for livestock and gardening during the dry season.

(2) Rehabilitation and construction of **irrigation** systems to increase rice production as well as organisational support to water management and maintenance of irrigation systems.

(3) **Support to rice production** for achieving self-sufficiency by introducing irrigation, new agricultural techniques and improved seed quality. Upon achievement of rice self-sufficiency in the target areas, interventions are focusing on intensification and diversification of agricultural production, processing and marketing.

(4) **Rural credit** and **promotion of micro-enterprises.** Rural credit interventions focused on encouraging financial intermediation by co-operative village banks at village-level by way of technical and financial support. In addition, loans were granted to the village banks. The Credit Programme of PRASAC carried out both functions.

    Interventions to promote micro-enterprises focused on technical and business training and access to credit through the Credit Programme in order to facilitate the creation of supplementary employment opportunities in the rural society (e.g. processing of food products, repair services, and agricultural support services).

(5) **Village-based community development** with an initial focus on establishing and strengthening of Village Development Committees that steer and co-ordinate village-level development.

(6) **Institutional strengthening** of provincial departments and authorities in the six provinces through training of all personnel made available for project purposes.

In line with the Financing Agreement for the second phase, PRASAC has been shifting since mid 1999 from rural rehabilitation towards rural development with emphasis given to capacity building and programme sustainability. Provincial and component development strategies were developed in close consultation with the executing agencies in mid 2000 in order to ensure that the development impact of key interventions can be sustained beyond 2003 by the following variety of approaches:

☞ Assumption of responsibilty by provincial departments and authorities facilitated by handing over of equipment and reintegrated (seconded) staff trained by PRASAC.

☞ Handing over ownership of small-scale infrastructural facilities, such as well, tertiary roads and irrigation canals, to village-based associations for operation and maintenance.

☞ Privatisation of the Credit Programme and selected other market oriented operations, like well drilling, road construction and car repair, by incorporating private companies or co-operative societies.

☞ Mobilisation of other donors that may want to support specific development interventions for which they may recruit staff trained by PRASAC.

A strategic re-orientation (or ‘exit strategy’) has been developed for the Credit Programme in mid 2000 so as to ensure long-term access to affordable credit by the rural population (i.e. long-term financial sustainability of the loan portfolio) at the conclusion of PRASAC in December 2003. It called for the separation of the Credit Programme into the following two operations:

(1) A financially sustainable credit operation that will be either transferred to an existing MFI or transformed into on a newly created MFI based on the assessment that only the ‘financial services’ (and not the co-operative village bank) methodology can succeed within a limited time period. The second option of creating a new MFI was considered to better ensure synergies with the development support of PRASAC in the agricultural and micro-enterprises sectors, whereas the first option of transfer to an already established MFI was considered less risky and preferable option from a sectoral viewpoint due to:

   ☞ Technical feasibility without the time intensive challenges of ‘building’ a senior management team and the search for a foreign strategic investor.

   ☞ Sectoral considerations of creating a larger and more competitive MFI (benefiting from economies of scale) that could compete with ACLEDA, the market leader, on a more equal footing.

(2) A village bank support system financed and managed by PRASAC’s ‘Community Development component’ because of the potential contribution of co-operative village banks to community development in terms of:

☞ Creation of self-help capacity in limited financial intermediation.

☞ Enhanced literacy in simple bookkeeping and financial management.

☞ Increased capacity in community mobilisation, management and solidarity.

The stakeholders of PRASAC adopted the strategic re-orientation of the Credit Programme in October 2000, and voted for the option of its transformation into a newly created MFI within the remaining period of PRASAC.

2. Services provided by PRASAC Credit Programme

The objectives of PRASAC Credit Programme during phase I has been the establishment of 150-200 ‘village cash facilities’ per province in order to enable 50 to 60.000 families to get out of the cycle of indebtedness caused by excessive money lending practices. Accordingly, availability of credit was perceived helping families to balance food shortages between the harvesting seasons and to improve productivity through purchase of fertilizer and optimisation of non-irrigated (rain-fed) production.

Following a co-operative village bank methodology, PRASAC Credit Programme has been providing the following two main services until mid 2000:

(1) **To establish and strengthen co-operative village banks** (called Savings & Credit Associations) in villages where PRASAC had already helped established Village Development Committees.

Credit staff facilitated the **establishment** of co-operative village banks as follows:

☞ With support by the Village Development Committees, villagers were encouraged to form guarantor groups of 5 to 10 household representatives. Each guarantor group had to select a group leader. Each member had to save a weekly amount between Riel 500 to 2.000 (15 to 50 US cents) as decided by the group for at least seven weeks to demonstrate savings capacity and related organisational skills as pre-condition for establishing a co-operative village bank.

☞ The members of between 5 to 15 guarantor groups then formed a village bank. At the constituent meeting, they voted for the chairman, accountant and cashier of the village bank and decided on the by-laws of the village bank (sample by-laws were proposed by PRASAC).

☞ The members of the village bank committee were trained in how to:

(a) Operate the village bank accounting system that comprises general ledger, cashbook, loan book and saver’s book.
(b) Manage small (internal) loans for emergency and other purposes.
(c) Access (external) loans from PRASAC Credit Programme.
(d) Perform other tasks, like conduct of meetings for members, preparation of minutes, update of membership lists and so forth.

Credit staff was **strengthening** co-operative village banks technically and financially as follows:

- ☞ Regular checks whether the manual bookkeeping system (comprising general ledger, cash book, loan book, and savers books) were correctly filed in and updated regularly. If not, corresponding training on-the-job was delivered.
- ☞ Advice in loan management on request by village bank committees.
- ☞ Allocation of financial support in the form of high rebates (40% of total interest paid until June 1999, 25% until April 2000, 15% until December 2000 and 8% thereafter) for timely repayment of (external) loans granted by PRASAC Credit Programme in order to build up the capital of the village banks.

(2) **To lend to village banks** whereby village bank committees carried out most loan management tasks, such as application, pre-appraisal, disbursement to members, monitoring and collection. The role of the credit staff was pretty much limited to the administration of credit funds without close contact to individual borrowers. The village banks were not only handling group loans from PRASAC Credit Programme, but also individual loans to its members. As a consequence of the attractive financial support offered in the case of timely loan repayment, on-time loan repayment rates remained high between 90 to 100%.

The credit staff initially concentrated on the establishment and strengthening of co-operative village banks and gradually shifted attention to lending operations with village banks. Individual loans to micro-entrepreneurs without involvement of village banks were introduced gradually in late 1999.

As part of the strategic re-orientation of the Credit Programme that started in mid 2000, 22% of credit staff was transferred to PRASAC's 'Community Development component' in May 2001 to strengthen village banks. Since then, the Credit Programme has been concentrating fully on lending operations by offering two key loan products, as outlined in chapter 6, section 4.

3. Rationale for the transformation decision

The decision to transform PRASAC Credit Programme into a licensed private sector MFI was triggered by the assessment that the co-operative village bank methodology has not worked well in the majority of villages within the limited time given for reasons caused by Cambodia's past 20 years of civil war:

- ☞ Trust among villagers is often limited to the closest circle of the own family.
- ☞ Village communities are not 'rooted' due to significant migration caused by civil war. Village self-help capabilities are therefore limited.
- ☞ Very low literacy levels of villagers (47% for farmers and 22% for housewives according to a nation-wide UNESCO survey in 1999) caused by Cambodia's recent history reduce significantly the number of villagers that are capable of managing a co-operative village bank. The choice among literate villagers is therefore limited so that personal characteristics (e.g. honesty and commitment to co-operative principles) do only play a minor role, if at all.
- ☞ People prefer newly gained personal freedom and resist co-operative structure that may remind them of the recent socialist systems of the Khmer Rouge (1975-1979) and the Vietnamese period (1979-1989).

In conclusion, the co-operative village bank methodology did not work successfully in most villages within a few years only. The original objective of PRASAC (PRASAC II Financing Agreement, p. 20) has been the evolution of the co-operative banking system from village to district level where all village banks within a district would form a district credit union. However, the creation of 20 and more viable district credit unions was considered impossible within the remaining 3,5 years of PRASAC and given the development status of most village banks in mid 2000.

Most other Cambodian MFIs had made the same experience. EMT has experimented three years before abandoning its co-operative village bank methodology in 1994. Therefore, it was proposed to abandon the strategy of focusing on co-operative village banks with the ultimate objective of supporting them in forming credit unions at district level. However, PRASAC kept its commitment to further strengthen the village banks with development potential under its Community Development component.

Apart from 777 established co-operative village banks, PRASAC Credit Programme consisted of the following elements of a credit organisation as of May 2000:

- Outstanding loan portfolio of $1,7 million of which 98% was lent to village banks and 2% directly to micro entrepreneurs.
- Access liquidity of $1,1 million in cash and bank accounts.
- 27 credit offices in the six target provinces as part of the structure of PRASAC with motorcycles for all credit officers.
- Around 160 credit staff of which around 15% had acquired some previous banking experience at provincial branches of the central bank.
- Computerised accounting system and MIS (using a customised Standard Runtime Edition of FAO MicroBanker DOS version).

Given the above, the proposal to change from a co-operative village bank to a ‘financial services’ methodology by either transferring most elements of the Credit Programme (i.e. loan portfolio, liquidity reserves and qualified credit staff) to an already established MFI or by transforming the Credit Programme into a MFI was self-evident. Only these two options offered a reasonable chance to ensure sustainable access to affordable credit for the target rural communities and micro-enterprises beyond 2003.

The new regulatory framework for micro-finance has greatly facilitated the decision-making process of PRASAC’s stakeholders since it clearly encourages “the entry of privately licensed MFIs and commercial banks” (National Bank of Cambodia, p.1) into the rural credit and savings sector. It has supported the understanding that the role of government is to set the regulatory framework and to leave micro-finance operations to the private (and/or co-operative) sector.

Noteworthy is that the separation of micro-finance functions from the remaining rural development functions of PRASAC has not created any trade-off in pursuing its development purpose and objectives because:

- The development purpose of PRASAC is to support rural development with the objective of increasing the living standards of the rural population. PRASAC’s broad definition of target group leaves PCA sufficient flexibility in defining its target clientele.

- ☞ The development objective of PRASAC Credit Programme is identical with the mission of PCA "to create sustainable access to financial services (at reasonable rates) for rural communities and micro-enterprises".

4. Operational changes as part of transformation

Upon the decision for transformation in October 2000, a MFI 'enabling' working environment was been created as fast as feasible within the framework of PRASAC's Financing Agreement. As a result, the recently established PRASAC Credit Association (PCA) already operates like an MFI, apart from personnel management that is still handled by PRASAC until May 2002. This chapter first outlines the essence of the transformation process and then refers to the strategic orientation and necessary changes of key operational issues.

4.1. Essence of the transformation process

The transformation constitutes a profound change for the credit staff and the new management team to be mastered in a short span of three years. Its main elements are as follows:

(1) Introduction of **micro-finance best practise** comprising the:

- ☞ Elimination of subsidised lending operations with village banks by reducing rebate payments to a level that is justified as a commission for clearly defined performance-based (i.e. loan recovery) activities that assist in the delivery and recovery of group loans and thereby reduces transaction costs for PCA.
- ☞ Reform of the group loan delivery mechanism by redefining the exact functions of the credit officer and the village bank representatives for each step of the group loan management cycle. Among others, the credit officer has to interview each loan applicant at his/her house or business premise and monitor regularly all loans by keeping in contact with all borrowers instead of dealing only with the village bank representatives.
- ☞ Introduction of an alternative group loan delivery mechanism in the form of informal village associations that consist of several guarantor group. This group loan delivery mechanism is based on the solidarity group methodology. It constitutes the most efficient approach for expanding group lending into new rural areas by avoiding high costs required for the establishment of co-operative village banks.
- ☞ Introduction of banking practise for business loan management and corresponding staff capacity building related to loan appraisal techniques, particularly the preparation and analysis of cash-flow projections.

(2) Introduction and/or improvement of **all management systems** required by a licensed MFI, as outlined in the next chapter.

(3) Establishment of **managerial sustainability** by recruiting selected senior staff and carrying out a comprehensive training programme, as outlined in the next chapter. Noteworthy is that the speed of the 'learning curve' of the new management team

as well as all staff constitutes the key time constraint in the whole transformation process.

(4) **Two-step institutionalisation** of the Credit Programme into PCA and PCA into PRASAC MFI Ltd., as outlined in the eighth chapter.

(5) Obtaining the **license** to operate as a MFI, as outlined in the eighth chapter.

4.2. Target clientele

'Medium and very poor' village households and micro enterprises constitute the two key client target groups of PCA. PCA is targeting the former for group loans that finance income-generating activities and the latter for individual investment and working capital loans. The two key client target groups are defined as follows:

- ☞ 'Medium and very poor' village households constitute on average between 50 to 70% of a village population. At least one person of such household is working in the semi-subsistence village economy by employing some productive assets of the household, such as land, tools, livestock and so forth. Cash income is mainly generated from the purchase of surplus rice or other food items (i.e. not consumed by the household), but also from trading or service activities. The projected cash income determines the debt capacity of a household in taking out a group loan.

- ☞ Micro-enterprises that produce (or offer services) predominantly for a market. The large majority of them are non-registered sole proprietorships where family members help out in the running of the business. They are mainly located in market places in or nearby district and provincial centres. PCA is financing up to 70% of investment or working capital costs in the cash of a positive cash flow during the whole loan period. The minimum 30% self-contribution by the micro-entrepreneur, that can be mobilised in terms of fixed assets, inventory and labour, is necessary to ensure both his/her business commitment and financial viability.

PCA is supporting all legal economic activities of its clients that are part of, or linked to the rural economy in order to help increase the income of its clients and thereby stimulate economic growth and the transformation of the rural economy. Its outreach and outstanding portfolio as of end of 2001 are summarised as follows:

<table>
<tr><td rowspan="2">Outreach
(active borrowers)</td><td colspan="2">group loan borrowers</td><td colspan="2">individual loan borrowers</td><td>total borrowers</td></tr>
<tr><td colspan="2">37.552</td><td colspan="2">6.217</td><td>43.769</td></tr>
<tr><td rowspan="2">Outstanding
Portfolio</td><td colspan="2">group loan portfolio</td><td colspan="2">individual loan portfolio</td><td>total portfolio</td></tr>
<tr><td colspan="2">$2.059.000</td><td colspan="2">$1.496.000</td><td>$3.555.000</td></tr>
<tr><td>average loan size</td><td colspan="2">$55</td><td colspan="2">$241</td><td>$81</td></tr>
<tr><td rowspan="2">portfolio per
sector</td><td>rice production</td><td colspan="2">agriculture excl. rice</td><td>services/trade</td><td>manufacturing</td></tr>
<tr><td>$1.907.000</td><td colspan="2">$420.000</td><td>$1.082.000</td><td>$146.000</td></tr>
</table>

On the basis of the current exchange rate of 1$ to 3.900 Riel

4.3. Products and key lending strategies

PCA aims at offering a voluntary savings product in the form of a savings book on a pilot basis in three to four selected branches by early 2003. It is currently offering the following two key loan products:

(1) Group loans denominated in Riel with increasing loan ceilings for group loan borrower per loan cycle; i.e. up to $62 for the first cycle, $87 for the second cycle and $125 for the third and consecutive cycles. Other loan conditions are:

- ☞ Loan term between from 4 to 10 months.
- ☞ Interest rates range from 42 to 48% p.a. on a declining basis, depending on the performance of the village banks and village associations that function as group loan delivery mechanisms.
- ☞ Single repayment of principal and interest for rice or other agricultural production as loan purpose.
- ☞ Peer pressure (i.e. no group members receives a new loan in the case of an outstanding loan from the previous cycle) as substitute for physical collateral.

(2) Individual loans denominated in Riel for micro-entrepreneurs based on a cash-flow analysis, a business plan and physical collateral with an initial loan ceiling up to $1.250 and a repeat loan ceiling of up to $2.500. Other loan conditions are:

- ☞ Loan size up to 70% of the investment and/or working capital costs of the business activity proposed.
- ☞ Loan terms between from 4 to 24 months with a possible grace period up to 4 months.
- ☞ Interest rates from 36 to 42% p.a. on a declining basis, depending on the loan size and soundness of business plan.
- ☞ Repayment schedule according due to the cash-flow projection.
- ☞ Business plan in PCA standard format as part of loan application.
- ☞ Hard collateral required, preferably land titles.

Character-based group lending to ‘medium poor and poor’ village households is organised via the following two group loan delivery mechanisms with identical lending conditions and procedures:

(1) Informal village associations that comprise several guarantor groups of 5 to 10 household representatives. The group leaders and the chair and vice chair of the village association assist PCA in group loan management and receive 8% commission (of total interest paid) in the case of on-time repayment.

(2) Co-operative village banks that comprise several guarantor groups of 5 to 10 household representatives. Apart from accessing PCA group loans, they engage in village-level financial intermediation. Village banks are also paid 8% commission (of total interest paid) in the case of on-time repayment.

PCA applies the following key operational lending strategies:

(1) To minimise PCA’s group loan transaction costs by:

- ⇒ Offering one standard group loan product to reach efficiencies and simplicity.
- ⇒ Involving villagers to the degree feasible in the loan management cycle, such as the preparation of group loan applications, preliminary loan appraisal focusing on the creditworthiness of the members concerned, loan monitoring and loan collection.
- ⇒ Applying peer pressure and joint liability as substitute for physical collateral.

⇒ Minimising travelling costs by selecting new villages that are either close to branch offices or villages already served.

(2) To reduce clients' group loan transaction costs by:

⇒ Offering group loans at a lower interest rate in the case of an excellent loan repayment track record by the village banks and village associations.

⇒ Strengthening the managerial capacity of village banks (by PRASAC) and village associations so that they would qualify for reduced group lending rates.

⇒ Further reducing unit operation costs of PCA that would allow further reductions of group lending rates.

(3) To lend in a prudent manner to minimise potential losses for both PCA and its clients by:

For group loans:

⇒ Lending to village households according to their loan repayment capacity, i.e. their capacity to use credit effectively for increasing their cash-flow.

⇒ Increasing the group loan ceilings gradually with increasing loan cycles and corresponding better client track records.

⇒ Allowing a household only one membership in a guarantor group because a household constitutes the smallest economic entity.

⇒ Granting only one group loan at the time to a member of a guarantor group.

For individual loans:

⇒ Assessing the business activity in necessary detail to arrive at a high probability a positive cash flow during the entire loan period and a financially better off situation for the micro-entrepreneur compared to the time of loan application.

⇒ Take appropriate types of collateral that (a) help strengthening the loan repayment morale of the client and (b) maintain a market value and could be realised with minimum efforts, if required.

4.4. Branch network and staffing patterns

PCA has currently 12 branches with 16 sub-branches that are operating in 34 districts of the six target provinces of PRASAC. Current total branch staff amounts to 99 comprising 12 branch managers, 12 MicroBanker tellers and 75 credit officers. One cashier per branch will be soon recruited. The branch manager is responsible for all branch operations having full managerial authority within the operational policies, procedures and targets set by head office.

Each branch is set up as full profit centre (via transfer price) and is operating the MicroBanker system that produces all daily updated loan portfolio (and future savings mobilisation) transactions. The branch reports its operations weekly by sending zip disks of all MicroBanker files by road transport to head office. The branch submits monthly to the head office a standardised progress report plus all MicroBanker files, including a monthly trial balance.

Most branches have one or more sub-branches where credit officers cannot easily visit clients within a day due to remoteness or bad road network. Credit officers usually stay at sub-branches during the week. The sub-branches are equipped with safe deposits where limited cash amounts may be stored during the week. At changing intervals, one of the credit officers will assume the function of cashier on a part-time basis.

4.5. Key performance criteria

After the full separation of the accounting systems of PCA and PRASAC and the corresponding upgrading of the MIS, PCA is calculating the below key performance criteria on a monthly basis for PCA and each of its 12 branches since January 2002. Efficiency and profitability criteria for 2000 can have an error margin of 10-15% because not all operating expenses of PRASAC were broken down per individual component. Costs of long-term TA were not considered.

PCA performance criteria	31.12.2000	31.12.2001	31.12.2002
Asset Composition			
Net loans outstanding	98%	76%	82%
Liquidity (cash & bank)	2%	21%	14%
Fixed assets	not accounted for	3%	4%
Quality of loan portfolio			
1) Portfolio At Risk	1%	4,5%	7%
2) On-time Repayment for all loans	97%	89%	90%
3) Annual Loan Loss	0%	4%	2,5%
Efficiency cost ratios			
1) Operating cost ratio	24,9%	26,1%	24%
2) Administrative cost ratio	24,3%	19,4%	18,2%
3) Salary (& incentives) cost ratio	13,2%	10,6%	9,9%
Productivity ratios per credit officer			
1) Outstanding loan portfolio	$ 31.795	$ 47.436	$ 44.615
2) Number of Active Borrowers	332	589	500
Profitability/Self-Sufficiency ratios			
1) Adjusted Return On Assets	0,9%	1,1%	3%
2) Operational Self-Sufficiency	137%	150%	170%
3) Financial Self-Sufficiency	101%	106%	125%
Capital adequacy ratio	98%	127%	115%

Noteworthy is that loan classification and provisioning procedures have been changed significantly in late 2001 in order to comply with new supervision requirements. They became much stricter than before. Furthermore, quality in loan portfolio dropped significantly during 2001 mainly caused by the biggest flooding disaster since 40 years in late 2000. These two events largely explain why the operating cost ratio increased from 2000 to 2001, whereas the other cost ratios decreased.

5. Management systems and HRD required for transformation

Upgrading of existing management systems and introduction of new ones are required to meet all licensing and supervisory requirements and attain professional management systems for competing successfully in the micro-finance market as a key player. This chapter shortly mentions the main activities required for putting key management systems in place.

The features for professional treasury system are not yet planned since it does not constitute an urgent priority for PCA due to its continued access to credit funds from PRASAC until end of 2003. Furthermore, PCA management has recognised the need for professional risk management as a tool for portfolio policies, but an detailed action plan on how to set up risk management systems remains to be done.

Re-training of all staff to adopt new credit practise and to learn new skills for mastering new products and increased responsibilities is another key requirement for successful transformation. Noteworthy is the training on-the-job of a management team that will be capable of leading the MFI when technical assistance will be phased out. This chapter shortly outlines the main training and capacity building activities carried out.

5.1. Standardisation of procedures

As a result of the start of the Credit Programme as three separate operations with different loan management systems and procedures until February 1998, different credit practises were put in place that could be phased out only gradually. Standardising of procedures has been of particular importance as follows:

- Introduction of the FAO MicroBanker system for the MIS and accounting system already by the end of 1998 as the consequence of merging three credit programmes with different software applications for accounting and MIS.
- Reform and detailed operational procedures for the two group loan delivery mechanisms as a result of the consequence of changing a co-operative village bank to a ‘financial services’ methodology.
- Review of all lending policies and procedures (that are currently compiled in a credit manual) because of the need to introduce micro-finance ‘best practise’.
- Current development of HRD policies and procedures as a consequence of the planned operational autonomy of PCA in handling personnel management as of May 2002.

5.2. Accounting and MIS

The accounting system and MIS that has been upgraded over the past year by:

- Adopting the Chart of Accounts requested by the central bank for licensed MFIs.
- Producing complete financial statements (upon full separation of PCA’s accounting system from that of PRASAC) comprising a balance sheet, a profit & loss statement and a cash-flow statement.

- Establishing each branch as a full profit centre with transfer pricing for fund utilisation and head office service charges.
- Producing key performance criteria for portfolio quality, staff productivity and efficiency, profitability and operational self-sufficiency and capital adequacy on a monthly basis for PCA and each of its 12 branches.

Further MIS upgrading required includes:

- Change from the MicroBanker DOS version to the new MicroBanker Windows version because the latter (a) has additional functionalities and features, (b) is more user friendly, and (c) will be displace the DOS version in the medium-term vis-à-vis future programming support.
- Calculation of inputs for the planned performance-based salary system.
- Calculation of monthly depreciation of fixed assets.
- Adaptation to the introduction of new products, particularly savings mobilisation.

5.3. Internal control systems

As first priority, a standardised internal audit system has been introduced in 2001 that enables a three-person audit team to audit a branch office, the branch staff and up to 30 sample clients with one week only. All branches are currently audited on a quarterly basis, however, auditing of at least every 6 weeks is envisaged when additional auditors can been recruited. An audit system for head office operations remains to be developed.

Internal control systems are already sufficient when it comes to financial transactions recorded by the MicroBanker system. However, internal control systems need to be strengthened by a variety of measures starting with the enforcement of consistent and standardised loan management procedures, especially loan monitoring, across the branch network as well as stricter control on branch administrative costs.

It is therefore planned to improve reporting systems at head office and branch level encompassing more formalised reporting at branch level and better quality reports. Some reporting by credit officers need to be formalised based on a review of the branch monitoring and staff supervision systems. Quality of reports will be enhanced by (a) standardising report formats and (b) training branch managers in filling in correctly report formats.

5.4. Staff performance-based salary and incentive system

A performance-based salary system is perceived as the key instrument to instil a 'client-oriented' business attitude among the staff if complemented by corresponding training. With PCA's autonomy in personnel management and the de-linking from the salary system of PRASAC scheduled for May 2002, a staff performance-based salary and incentive system is being finalised that consists of the following key elements:

- Base salary component with several grades for different positions. Each grade has several steps that account for years of experience and qualification.
- Performance-based salary component that is adjusted annually based on staff performance over the past year in terms of selected standard productivity criteria

and/or contribution to profit. Performance above (or below) standard productivity parameters will lead to a higher (or lower) performance-based salary component for the following year.

- ☞ Annual allocations from net profit to a staff provident fund that is fed by fixed monthly salary contributions. It strengthens the equity basis of PCA since it is paid out only in case of retirement age, disability or death.
- ☞ Annual performance-based bonus up to 1,5 monthly salaries paid out from net profit.
- ☞ Annual bonus for head office managers and branch managers as a percentage of net annual profit granted as non-tradable staff 'options/shares'.
- ☞ A health insurance package for all staff that may be combined with a life insurance package, if feasible.
- ☞ Educational incentives for selected staff in the form of co-financing tuition fees for specific training courses or university studies related to their work assignments.

The above package is based on the principle that PCA cannot risk its long-term financial self-sufficiency, but need to motivate qualified staff to stay and not be attracted by higher salaries offered by international NGOs or UN organisations. The risk is minimised if fixed salary costs are kept under control by linking an increasing share of the salary and most incentives to net profits.

5.5. Comprehensive staff training programme

Staff training comprises formal training courses on various topics conducted in-house or sub-contracted to training institutions, informal workshops, generic management training for the new management team, practical training on-the-job and exposure visits for senior staff to successful MFIs in Cambodia and abroad.

Re-training of credit staff started in mid 2000 with two customised training courses on "Introduction to Micro-Finance (40 hours)" and "Basic accounting for MFIs (80 hours)", occasional workshops at branch level and monthly workshop-cum-meetings with all branch managers and senior head office staff. Generic management training (on staff supervision, conflict resolution, decision-making, conduct of meetings, report writing and so forth) is offered to branch managers and senior head office staff in two-day sessions on a monthly basis.

Another important issue is to develop in-house training capacity in all loan management and accounting related topics required for all branch staff, with priority given to the induction training of new recruits. Selected branch managers and senior head office staff form the training faculty that is delivering all in-house training courses and workshops.

6. Institutionalisation and licensing process as part of transformation

This chapter shortly outlines the institutionalisation of the Credit Programme and the subsequent licensing process of the newly created legal entity as an essential and final part of the transformation.

6.1. Institutionalisation of PRASAC Credit Programme

Institutionalisation is here defined as the creation of an interim and a final legal entity under Cambodian law. As first step in the institutionalisation of the Credit Programme, PCA is currently be established legally as an association that is seeking registration as a (non-lisensed) MFI by the central bank.

The Credit Programme has been 'transformed' into PCA as follws:

- Full separation of PCA's accounting system from that of PRASAC and preparation of financial statements according to the chart of accounts requested for MFIs.
- Transfer of fixed assets from PRASAC to PCA at the book value as of 1.1.2002.
- Physical separation of head office and most branch offices from PRASAC office.
- Establishment of a near complete Cambodian management team.
- Three-year business plan of PCA as an important player in the micro-finance sector.
- Achievement of full operational self-sufficiency during 2001.
- Legal registration of PCA as association under Cambodian law.

Institutionalisation of the Credit Programme will be completed with the incorporation of a limited liability company in the name of PRASAC MFI Ltd. However, this requires the identification of appropriate shareholders, particularly the identification of at least one foreign strategic shareholder that will take a 20% share. This constitutes a challenge because the European Union cannot modify its role from donor to shareholder, as it is the case with other transformed credit programmes (e.g. EMT). Noteworthy is that the newly created MFI will depend on strategic guidance from an experienced investor for quite some years to come.

Therefore, PCA has first to build up a good track record with favourable performance criteria over a couple of months before it can attract a foreign strategic shareholder. As a pre-condition, professional management systems and sufficiently trained staff need to be in place as soon as possible as part of the technical aspects of transformation (see the chapter above). A rating of PCA by a recognised rating agency as well as a pro-active investor search is planned for early 2003

Apart from a foreign strategic investor, micro business and farmers associations, the staff association, the staff provident fund, and possibly an association of the best performing village banks will be the other shareholders of PRASAC MFI Ltd. PCA will have to register legally its staff association and the planned staff provident fund. It may have to assist clients to form micro business and farmers associations so as to qualify them as eligible shareholders.

Once incorporated, all assets of PCA need to be transferred to the new company and the ownership transfer of the PRASAC credit funds need to be resolved. It is proposed that the European Union will transfer ownership of the PRASAC credit funds to the Royal Government of Cambodia on the condition that they are made available to PRASAC MFI Ltd. as sub-ordinated debt for micro-finance services to rural communities and micro-enterprises.

6.2. Licensing process

PCA will file its license application in January 2003 upon meeting all licensing requirements, apart from the legal requirement of being incorporated as a limited liability company. PCA will then comply with all NBC reporting requirements for a licensed MFI and expects to obtain the license latest with the incorporation of PRASAC MFI Ltd.

7. Lessons learnt to date

PCA requires the necessary operational autonomy from PRASAC to develop into a professional MFI as soon as possible. This is because financial self-sufficient micro-finance operations and subsidised rural development interventions require quite different organisational structures and salary systems for the following reasons:

- PCA requires a head office - branch structure, whereas PRASAC's structure is similar to the provincial structure of its executing agencies where extension staff are stationed at district level.
- Client-orientation is much better ensured if the financial performance of institutions depends directly on the quality of services offered. Service quality is often poor if staff is providing 'beneficiaries' with subsidised services.
- High staff motivation is difficult to achieve without a performance-based salary system. PCA is therefore introducing a performance-based salary system that is mainly linked to profit. However, it would be very difficult for PRASAC to introduce a transparent and objective performance-based salary system since its staff are delivering many intangible development services.
- Employment of (seconded) public servants by a MFI creates potential conflicts of interest. It is therefore important for PCA to set a deadline for its staff to abandon their status as public servants if they want to pursue a career in micro-finance.

The success of separating the micro-finance functions from PRASAC's other functions is already evident since the Credit Programme already achieved full operational self-sufficiency during 2000. This indicates the successful start of the transformation process. Furthermore, it leaves more financial resources for PRASAC's rural development functions starting from May 2002 when financial support to PCA will be limited to credit funds and subsidies for training and technical assistance.

PRASAC's successful separation of micro-finance from rural development functions also supports commonly accepted 'best-practise' by recommending separate credit/micro-finance projects that support already existing MFI rather than to launch credit/micro-finance activities as integrated component of rural development projects. This opinion is shared by the final report of PRASAC I (p. 28) and the European Commission (document COM/98/0527, p. 6).

8. Challenges and Opportunities

Key challenges of the transformation of PRASAC Credit Programme are as follows:

- ‘Building’ of a top management team that can lead a large MFI in the Cambodian context in two years time only. This includes the shift from a ‘bureaucratic’ to a ‘pro-active’ performance driven management attitude.
- Speedy upgrading of all management systems to professional standards. This also includes the proper reform of the group loan delivery mechanisms so that credit staff assume full control over loan management.
- Identification of a strategic foreign investor of good reputation that may constitute the single most serious constraint in transforming PCA into PRASAC MFI Ltd. Presently, it is difficult to find strategic investors in Cambodia that would meet the requirements for ‘good’ governance. Furthermore, there are some NGOs that are also transforming currently their micro-finance operations into private sector MFIs and are seeking foreign investors.
- Effective marketing of PCA’s corporate identity so that its clients, provincial and local politicians and the general public at large start perceiving PCA as a Cambodian MFI with long-term ambitions to offer micro-finance services at affordable rates and not as a time limited operation supported by donor grants.
- Continued dialogue with the executing agencies to maintain support for the transformation process at every step. All stakeholders must understand that it is the best approach to (a) achieve sustainable access to credit for the rural communities and micro-enterprises, and (b) comply with the new regulatory framework for micro-finance.
- Building up sufficient financial reserves to cope with potential loan losses that could be caused by the external threats of:
  - (a) Flooding disasters as experienced end of 2000.
  - (b) Political instability in the wake of the upcoming national elections in 2003.
  - (a) Overwhelming competitive pressure by the market leader that could use its financial leverage to reduce significantly the financial margins of PCA.
  - (b) ‘Bad’ practise (e.g. subsidised lending or loan write-offs across the board) by micro-finance operators that may affect the loan repayment morale of PCA’s clients.

Successful transformation will open up the following outstanding opportunities for PCA:

- To establish itself as the largest MFI (after ACLEDA that is a specialised bank) thanks due to the generous allocation of credit funds from PRASAC.
- To benefit from business opportunities developed by PRASAC in the agricultural and micro business sectors. Lending risks can be reduced significant, if PRASAC or other partner institutions can provide technical and marketing support to clients.
- To have clients with a generally high loan repayment morale.

☞ To expand operations supported by an enabling regulatory framework and good prospects that the business environment is likely to improve further with increasing political stability.

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