



National Bank of Cambodia

Microfinance of Cambodia

2007

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Executive Summary

The Kingdom of Cambodia is a democratic monarchy with multi-political parties and a population of 13.8 millions, among which 85% live in rural areas. Females represent 53% of the total population. The majority of the people are Buddhists. Recent economic development has gone through three distinct periods: emerging from scratch, Asian financial crisis and internal conflict and peace and security. During the last period Cambodia has made good progress.

The Cambodia banking system started in the early 1990s when the government launched the economic reform program from a centrally planned to a free market economy. Reform programs have been introduced and good progress has been achieved in regulating and supervising banks and microfinance institutions.

Most rural financial operators in Cambodia have been transformed from non-government organizations (NGOs) that were involved with humanitarian work amongst refugees in the Thai border. After Paris Peace Accord in October 1991, the refugees had returned home.

With the passage of time, NGOs have redefined their roles in terms of interventions in the microfinance development process. NGOs have been involved in virtually every sector of the economy including micro credit programs and savings. Micro credit is the most active service due to banking services of commercial banks being limited in urban areas, and rural people are unable to receive such services, especially loans from the banks. Main practical rural financial services are individual loans, group loans and savings from members.

In response to the huge need for microfinance services, many Microfinance Institutions (MFIs) have engaged in providing these kind of services. In 2006, Cambodian microfinance has grown remarkably. This growth significantly contributes to economic development and poverty alleviation. With its credit and savings services, MFIs help people, especially the poor to relieve their family burdens and improve their livelihood to some extent. Currently there are 17 licensed microfinance institutions, 26 registered rural credit operators and around 60 NGOs freely operating in the whole country.

The Royal Government of Cambodia has committed to the development of rural finance since it is a key ingredient for sustainable economic development, particularly rural development, and for alleviation of poverty. In addition, the government has announced 2006 as a year of microfinance of Cambodia and it always supports the development of this sector through the introduction of policies and creates a favorable environment for further growth.

The government is also considering giving priority to the agricultural sector development in order to improve people's living standard and to reduce poverty. Today, the government is putting even more effort into building up an adequate legal framework, infrastructure, and investment incentives for the agro-industrial sector; farmers training in theory, practice, and technology transfer.

To implement law on banking and financial institutions and improve financial services in rural areas, NGO suppliers of financial services need to be licensed as MFIs by the National Bank of Cambodia (NBC). The main objective of regulating MFIs is not to

restrict their activities but to promote them. Licensing is required for MFIs to collect savings from their members and from the public, acquire long term borrowing from foreign and local organizations and employ these funds to provide loans in rural areas.

An MFI must be registered and incorporated as a legal entity such as a company, cooperative or have a legal status according to the law. An MFI must obtain a license from NBC upon application with the required documents.

With microfinance, the NBC is confronted with conflicting targets. On the one hand, microfinance, as with all other financial activities, must be regulated to avoid incompetence, and in some cases dishonesty, which can undermine the system. On the other hand, if regulation is too harsh, and in particular if the capital requirement is too high, microfinance might exhibit the same behaviour as banks, flee from rural areas and concentrate their activities in major cities. Therefore, the NBC has released a set of regulations according the size of MFIs.

For the first time in 2000, the NBC issued regulations on the classification of MFIs, classifying all MFIs into three categories according to the level of their operations with different criteria for being licensed and registered. The obstacle preventing NGOs from being transformed into MFIs is ownership. In the beginning, it was difficult to identify the shareholder because funds used by NGOs to operate microfinance had been granted by international donors. But at the end staff association had been established as the owner of those funds, opening the way for NGOs to transform into MFIs.

The biggest MFIs must be licensed by the NBC. The regulations to be complied with by them are very similar to those to be complied by the commercial banks, except the minimum capital required is substantially lower. The medium-sized MFIs must only be registered by the NBC and are subjected to lighter regulations and in particular reports to be sent to the NBC are simplified. The smallest MFIs can operate freely with no requirement to be regulated and supervised due to high operating costs.

The regulations issued by the NBC include criteria for licensing and registration, minimum capital requirement, solvency ratio, liquidity ratio, uniform chart of accounts, reporting requirements, and interest calculation. These regulations are consistent with the scope of work of MFIs and support them in expanding their activities in an appropriate manner.

In terms of supervision and regulation, the NBC is responsible for maintaining integrity and a sound banking and financial system in order to encourage public confidence, to protect depositors from fraud and encourage good governance. To do this, a complete set of criteria have been issued such as licensing and registration procedures; minimum capital requirement; solvency ratio; liquidity ratio; uniform chart of accounts; reporting requirement etc. and furthermore, the NBC also conducts off-site and on-site supervision on a regular basis in order to ensure that all MFIs are operating in a professional and prudential manners.

The financial sector, both banking and rural finance, is a major element of the financial system of the country and sound supervision and regulation of banks and financial institution is essential. Attention must be paid not only to banks but also other components of the financial system such as rural financial institution providing funds for

small and micro enterprises. In order to create a conducive rural finance policy environment, governments need to understand core financial sector stability issues and be aware of different response options.

1- Background

The Kingdom of Cambodia is a democratic monarchy with multi-political parties and is one of the ASEAN members, with an area of 181,035 km² and a total population of about 13.8 millions (2005), of which 85% live in rural areas and 15% live in urban areas, and a population density of 74 persons per square kilometres (2004). Cambodia shares a border with Thailand to the west, with Vietnam to the east and the south and with Lao PDR to the north. Of the population, females represent 53%. The population have been classified into three different ranges of age: Below 14 years old 39%, from 15 to 59 years old 55.1% and above 60 years old 5.9%. Life expectancy is 57.87 and 64.14 for male and female, respectively. The annual natural growth rate is 1.81%. The vast majority of the people are Buddhist (85%) and the remaining 15% are Muslim and others.

Three distinct periods of progress have been seen in recent economic development. The first was from 1979 when it emerged from almost 4 years of genocide. Everything had to start from scratch. Even in conditions of international isolation, the country was rebuilt and reached a stable stage but scarcities and legacies still remain especially in terms of skilled manpower shortages. The second was from 1993 to 1997, when the country was suddenly overwhelmed by two unrelated crises, the Asian financial crisis and internal conflict. The third started from 1998 till now, which is the period of peace, stability and uninterrupted growth and progress. Cambodia has made important progress in ensuring peace and security, rebuilding institutions, establishing a stable macroeconomic environment, and putting in place a liberal investment regime.

Notwithstanding these achievements, much remains to be done. The annual growth rate at the end of 2006 was 10.5% and GDP per capita was US\$500. Recent economic growth mostly centred on the garment industry and tourism is urban focused with limited linkage to the rural economy where 90 per cent of the poor people live. Agriculture is the largest employment sector of the country's economy. Over three quarters of the total population work in agricultural businesses.

Poverty levels in Cambodia have registered a significant decline since 1993, which is mainly through widespread economic growth. The incidence of poverty in a 2004 survey was estimated at about one third of the population, ranging from 5 percent in Phnom Penh to 39 percent in some rural areas. As compared with a survey in 1993-94, poverty fell from 39 percent to 28 percent. The gains have been widespread but not uniform.

2- Overview of the Cambodian Financial System

The Cambodian financial system is at the early stages of development. It started in the early 1990s after the government launched the economic reform program from a planned economy to a market economy. Actually the most advanced financial sectors are banking and microfinance which have been regulated and supervised properly after the adoption of the Law on Banking and Financial Institutions in November 1999. Other financial sectors such as insurance have been developed only at the end of the 90s and the capital market is yet to be developed.

The Cambodian banking system consists of the central bank, the National Bank of Cambodia, banks and MFIs. Now, there are 20 banks of which 15 are commercial banks, 5 are specialized banks and 2 are representative offices of foreign banks. Among the 15

commercial banks, 10 are locally incorporated, 2 are subsidiaries of foreign banks and 3 are foreign banks' branches. Of the locally incorporated banks, 5 are wholly foreign owned, 4 are wholly domestically owned, and one is a joint venture. Four out of 5 specialized banks are locally owned and one state owned. The majority of banks are the result of the banking reform process that has been carried out by the NBC starting from 2000 after the promulgation of the Law on Banking and Financial Institutions in November 1999. The purpose of the reform is to issue a new series of prudential regulations to set up criteria for licensing to permanent shareholders identification and strengthening the capital base. As the result, 16 banks stepped out of the system.

In addition, there are 17 licensed MFIs, 26 registered credit operators, and around 60 small unregistered NGOs operating in rural area.

The Cambodian banking system can be characterized by the following events:

- **The dollarized and cash based economy:** Due to the heavy dollarization of the Cambodian economy, about 95 percent of transactions are carried out in US dollar and on a cash basis because of the absence of an effective payment and settlement system and the lack of financial service providers all over the country.
- **The insufficiency of network and financial service providers:** Banks are concentrated in the capital city, Phnom Penh, and in major cities. Few banks have branch networks covering the whole country. This makes it difficult for people to have access to banking services and cash has been used for a large part of payment transactions. At present, 20 banks have 65 branches throughout the country. This small number shows that there are insufficient institutions to meet the need of the people.
- **The absence of inter-bank/money market:** Furthermore, there is no inter-bank/ money market or capital market in operation. The lack of money market instruments such as government securities, or other negotiable instruments are an obstacle to the development of that market.
- **The absence of the national payment system:** Commercial banks provide local money transfer services through their own networks or bilaterally or multilaterally through their accounts opened in the books of NBC, internationally through their direct correspondent relationships abroad or through their accounts with the NBC. There is no limit on the transferred amount; however the banks are required to file necessary documents from their customers to justify the purpose of the transfer. At the moment there is only a limited check clearing house managed by the NBC in its head office in Phnom Penh and in its branches in two provinces.

2-1 Central Bank: the National Bank of Cambodia

The NBC is the central bank of the country. It is governed by the Law on the Organization and Conduct of the NBC promulgated at the beginning of 1996. This Law provides NBC with an independent autonomous status to carry out its operations.

The principal mission of the NBC is to determine and direct monetary policy aimed at maintaining price stability in order to facilitate economic development. Its main duties and functions are:

- to act as the monetary authority: conduct monetary policy,
- to act as the sole issuer of national currency of the country;
- to act as the supervisory authority of the banking and financial system;
- to oversee the payment system of the country;
- to manage the international reserves of the country.

The major monetary policy objective pursued by the NBC is currency stability. To this end the major tool is active intervention in the Riel foreign exchange market. To date this policy has been successful and has delivered a stable exchange rate, lower Riel interest rates and price stability in Riel.

The goal is increasing confidence in the Riel which will, in time, increase the use of the Riel with a relative reduction in the dollarization of the economy.

Dollarization has been helpful in allowing the NBC to achieve the goal for a stable Riel exchange rate because of the relative smaller size of the Riel economy compared to the dollar economy. A fully Riel based economy would have been much larger and been more difficult to achieve the exchange rate stability that has been achieved to date.

In time reduction in relative dollarization will give the NBC more tools to pursue its core monetary policy goals.

2-2- Commercial Banks

Commercial banks are governed by the Law on Banking and Financial Institutions and can carry out the following business activities authorized by law: lending to the public with interest including leasing operations and commitment by signature, receiving non earmarked deposits from the public and the provision of means of payment.

Until 2000, there were 31 commercial banks under the supervision of the NBC. The banking system was concentrated in Phnom Penh with only six banks having branches outside the city. The banking sector contained many small banks, which were operating marginally. Most of these banks were not viable.

The activities of commercial banks remain concentrated in the city and focused on big transactions of a commercial nature, real estate and multinational corporations. Poor people living in rural areas do not have access to loans or to savings with commercial banks. The commercial banks have neither the resources nor the possibility to expand their limited range of rural services because microfinance operation especially rural microfinance is high cost and is barely profitable. Rural people have limited access to rural credit with low interest rates.

After the adoption of the Law on Banking and Financial Institutions in late 1999, the NBC launched a banking restructuring program by requiring all banks to apply for re-licensing. As a result, 16 commercial banks were successively eliminated from the banking system and there are now new banks and MFIs coming into the system. The banking system is now developing its network to provide financial services all over the country.

As at March 2007, the total assets of commercial banks are US\$ 2.2 billions of which loans are US\$ 993 million. The credit increased by 42% in 2006. Since 2004 the quality of assets has increased, non performing loans being only 6.54% as at March 2007. Such improvement can be attributed to political and macroeconomic stability, and the improvement of the soundness of the banking system.

2-3- Rural Financial System

The microfinance sector was born in Cambodia the early nineties. At first this sector was developed by NGOs after the Paris Peace Accords in 1991. At that time NGOs and donor communities had an important role to play in providing the poor with rehabilitation and reconstruction work.

The government gave first priority to its social sector development program for reducing rural poverty by using all means and resources to rehabilitate and develop the economy. Thus, the government considered the rural financial sector an important mechanism in reducing poverty and developing the economy because the rural financial sector increases and expands business and productivity by generating income that upgrades people's living standards.

However, despite economic success during the last decade, Cambodia remains the poorest country in East Asia, with an estimated annual GDP per capita in 2006 of about US\$ 510. Social indicators are poor and poverty rates are high, particularly in rural areas. The economy has a small industrial base and depends heavily on subsistence agriculture. About 80 percent of the population lives in rural areas, where production contributes about 31 percent of GDP.

Even though the banking sector is growing quickly, the country will always need to use microfinance. It is the sole means of allowing farmers to have access to credit; otherwise, they would borrow money from informal credit market, which charges very high interest rates, often around 5% to 10% per month.

It is clear that Cambodia must promote the microfinance sector, as it is essential for helping people living in rural areas to access credit with reasonable interest rates and to fund their investments.

Of the 15 commercial banks, one bank has transformed from an NGO operating microfinance into a specialized bank and at last, a commercial bank (ACLEDA Bank). ACLEDA Bank has the largest network all over the country, in the cities and in remote areas of the countryside. ACLEDA Bank provides both commercial banking and rural financial services. Other commercial banks have limited branches in Phnom Penh and major provinces such as Siem Reap, Sihanoukville, Battambang, Kampong Cham and

Banteay Meanchey, such as the Canadia Bank, which has been and is intended to provide wholesale lending to the MFIs and to small and medium enterprises with funds from the international community, KfW, IFC and USAID.

Total Loans Outstanding and Deposits of ACLEDA

| | In KHR million | | | |
|-------------------|----------------|---------|---------|------------|
| | 2002 | 2003 | 2004 | 2005 |
| Loans Outstanding | 107,689 | 160,970 | 265,298 | 410,396.72 |
| Total Deposits | 22,373 | 52,428 | 127,702 | 255,901.99 |

2-3-1- NGOs, as Micro Operators

There were about 90 NGOs supplying credit in the rural areas, seven of which play a significant role. International NGOs established local NGOs in order to establish an organization on a continuous basis. Many local NGOs are supported by international firms, which provide management guidance and financial support for institutional building and credit for revolving funds.

The following table shows the evolution, from 1996 to 2000, of NGO/MFI financial services in Cambodia.

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|------------------|-----------|-----------|----------|----------|-----------|
| Borrowers | 82,000 | 171,087 | 291,453 | 334,145 | 370,651 |
| Loan outstanding | USD 4.1 m | USD12.5 m | USD13 m | USD 23 m | USD 29 m |
| Savers | N.A. | N.A. | 103,872 | 134,350 | 147,441 |
| Saving balance | N.A. | USD 0.3 m | USD0.7 m | USD1.7 m | USD 1.5 m |

At the end of 2000 all NGOs had total loans outstanding of US\$ 29 million and total savings of US\$ 1.5million. The total number of borrowers was 147,000 in 20 towns and provinces, representing 18% of the total number of the Cambodian population. Women borrowers represented 80% of total loans.

Most NGOs provide loans to group members of the same occupation or type of business. In these cases there are few opportunities for loan diversification. Loans are usually provided on a six-month cycle basis. Most of the smaller NGO credit operators have compulsory savings requirements where members control group savings and use these savings to lend amongst themselves. The savings deposit is at risk. Management and staff of most NGOs have limited knowledge of how to run savings and credit schemes. Many NGOs have neither operations nor savings and credit policies that are clear to their clients. While NGOs must be given freedom to develop group savings and credit schemes, there is an urgent need for appropriate supervision. The smaller indigenous NGOs, however, are in locations which are difficult to reach, and their financial activities may be too small to warrant the costs of supervision.

Frequently, the credit operations of NGOs are integrated with other programs such as health, education and community development. Many of their credit programs are dependent on grants from international public and private organizations. Funds are often for a limited duration: this means credit schemes operated through NGOs are based on group solidarity either through a village banking system or direct delivery. After a few loan cycles, many groups are disbanded as members became dissatisfied with the quality of services or lost interest. Generally, rural credit and savings schemes are not viable due to the lack of savings and good savings services, excessive reliance on external financing in the form of grants or project financing, lack of professional management needed to handle saving and credit schemes, lack of an appropriate legal structure, and lack of external supervision.

2-3-2- Traders, Moneylenders, Relatives and Friends

According to the 1996 socio-economic survey in Cambodia, approximately 704,000 rural households took loans with a total value of about US\$ 120 million during 1994-1995. About 54,000 of them obtained loans from traders, 114,000 from moneylenders, 400,000 from relatives, and 114,000 from friends and neighbors. Of the remaining loans, 7,000 came from banks, 71,000 from NGOs.

Actually, although the number of loans from MFIs and NGOs has expanded considerably, loans from moneylenders, relatives and friends continue to be an important source of rural credit.

In common with loans from formal and non-formal institutions, loans from informal sources are commonly used for agricultural production and investment in business. They are also important for covering sickness in the family and for other purposes.

Interest rates on loans from informal sources are extremely variable, ranging from interest-free on many loans from relatives and friends to 10 percent per month and higher on those from traders and moneylenders. Despite high interest rates, borrowers continue to use informal services for a variety of reasons, including ease of the loans, flexibility in repayments, personal relationship, and lack of alternatives to access formal loans.

2-3-3- Microfinance Institutions

In 2000, the NBC started to issue and revise regulations in order to transform NGOs into registered and licensed MFIs according to their scope of operations. After receiving license and registration certificates, those institutions have been regulated and supervised by the NBC. Since 2002, some NGOs have been licensed and some others have been registered. By the end of 2006, there are 17 licensed MFIs and 26 registered as rural credit operators. Among those institutions, the majority of them were transformed from NGOs, while others were local private companies.

Loan Outstanding and Savings in the Microfinance

| | In KHR billion | | | | | |
|-------------|----------------|---------|---------|---------|---------|------------|
| | 2002 | 2003 | 2004 | 2005 | 2006 | March 2007 |
| N.Borrowers | 328,295 | 265,044 | 322,056 | 366,107 | 398,058 | 484,861 |
| Loans | 201.4 | 129.7 | 164.4 | 196.7 | 274.6 | 435.7 |
| N.Savers | 107,150 | 78,628 | 122,984 | 137,624 | 115,244 | 114,813 |
| Savings | 27.8 | 9.8 | 8.0 | 7.9 | 10.5 | 14.2 |

Agricultural and Rural Economy, Rural Farm and Fishing Households

The rural economy is the dominant component of the Cambodian economy, with about 80 percent of the population representing 85 percent of the total households living in rural areas engaged in agriculture. Among the rural population, about 75 percent are farmers depending on agriculture especially for subsistence and about 80 per cent are poor. The rural economy is dominated by the agriculture sector, which accounts for about one third of GDP. The agriculture sector is crop-oriented, with rice as the dominant crop.

Cambodia has two seasons: the rainy season, from April to October, and the dry season. Most farmers are used to working only during the rainy season using traditional production means (e.g., cattle is used for dragging and transportation and mainly dependent on rain fall), and crops collected are hardly sufficient for the rest of the year. Besides, there are several major issues such as property rights on land, poor infrastructure, insufficient irrigation systems, rice fields with mines, fragmented agricultural structure, and low productivity that have hindered agricultural development.

Fishing is vitally important. It supports millions of people in terms of food security, accounting for three fourths of animal protein consumption and provides invaluable revenue and employment for around 2 million people. However, the importance of the fishing sector is significantly underestimated. The household survey in 1996 revealed that 11 percent of the households took fishing as a primary occupation. The total value of annual fish catches ranges from US\$250-300 million. By the end of 2006, banks and MFIs provided total loans of US\$ 84.25 million to the agriculture sector. This increases by 88%, 27% and 81% in 2004, 2005 and 2006 respectively.

Farmers have gradually advanced from their traditional and ancestral monoculture, of rain-fed rice cultivation to agro-industrial production in cashew, peanuts, soybeans and cotton production based on modern means of production such as tractors, pumping machines, and fertilizers. Poultry, animal raising and fish farming using modern technology have provided farmers with a self-sufficient food supply. They can sell animals, poultry, and meat products that increase their income and thus improve their living standards. In addition, some rural farmers understand the advantages of small business activity and have an opportunity to access financing from MFIs or NGOs to extend their businesses and establish small enterprises that enable them to increase their incomes.

Poverty and Reduction Strategies

The major strategy for alleviation of poverty is strong and sustainable economic growth delivered through a competitive and equitable economic system that allows the benefits of growth and wealth expansion to reach the poor. For the poor commercial and competitive microfinance services are one of the key tools with civil infrastructure, particularly roads and irrigation being developed and delivered by the government.

The latest 2004 household survey finds that 35 percent of the population live below the national poverty line, down from 47 percent a decade earlier. Over more than a decade, Cambodia has consolidated peace with a plan to achieve annual economic growth of 7 percent. This can be achieved because Cambodia has embarked on a three-fold transition from civil war to peace, from one party to multi-party and from an isolated and subsistence-oriented economy to a free market economy with an open trade policy.

With peace, social order and robust economic growth, Cambodia is at the critical threshold and with more equitable growth. To accelerate progress in the lives of the Cambodian people, the government is committed to pursue strategies and actions that will:

- consider poverty reduction and gender equity concerns in all activities,
- ensure speedy reforms in all sectors, which will yield long term benefits,
- foster and facilitate equitable and sustained macroeconomic growth,
- increase real investment for growth in the productive sectors,
- optimize factor productivity- capital, labour, land, natural resources and inputs – in all sectors,
- target the most needy and least served people,
- focus on low cost activities with potentially high returns,
- promote adaptation and use of science and technology,
- stress the building of institutional and human capacity in all sectors.

3- Rural Finance Policy and Regulatory framework

3-1- Rural finance policies

Rural finance is an important ingredient for sustainable economic development, for rural development, and for alleviation of poverty. The government has announced 2006 as a year of microfinance of Cambodia. Many actors applauded this innovative approach to rural development as relevant government ministries, development partners, and other stakeholders highlight the crucial role of micro credit in contributing to the reduction of poverty. However, much more funding is needed to even partially meet the demand for rural credit. The most important challenge is to promote rural credit to be available at a lower interest rate.

Significant progress has been made towards the first Cambodian Millennium Development Goal with a commitment to halve the proportion of people living below the

national poverty line between 1993 and 2015. The government always supports the development of microfinance through the introduction of its policies and creates a favorable environment for growth in this sector, particularly the development of the institutions.

Based on this aspect, the Royal Government of Cambodia is considering giving priorities to economic development, especially in the agricultural sector in order to improve people's living standard and to reduce poverty. Today, with the efforts of the government and the assistance from national and international organizations and donor communities in the development of a legal framework, infrastructure, investment incentives for the agro-industrial sector, farmers training in theory, practice, and technology transfer, a number of farmers have acquired the ability to broaden and increase agricultural productivity and generate more income.

The FSDP 2001-10 identified rural finance as a critical sector requiring development and support. It was recognized that the banking system has not been able to address the demand for finance, from the poor, to smoothen consumption, build assets and develop micro-enterprises. This has been expressed by the most obvious manifestations of poverty, such as insufficient household income, lack of productive assets and inaccessibility of affordable financial services.

Since 2001, the microfinance sector has developed impressively: this significant success is largely the result of an overall market based approach to develop and light government intervention. Today, there are now 16 licensed MFIs, with good market performance, and an increasing number of registered MFIs. In addition, some MFIs have graduated from MFI status to bank status (as banks or specialized banks). MFIs today are involved in both credit provision and deposit taking.

Progress and Achievements Since 2001

In developing microfinance, the FSDP 2001-2010 highlighted five areas, using a phased approach:

- Implementing and enhancing rural credit policy;
- Strengthening supervision and regulation;
- Building financial infrastructure for microfinance;
- Creating institutional capacity; and
- Ensuring pro-poor orientation.

Overall, responsibilities have been divided between MEF, NBC and the Cambodia Microfinance Association (CMA), with MEF supporting policy development and funding coordination, NBC responsible for regulation and supervision, and CMA and the industry responsible for operational aspects.

Much has been achieved in relation to the Phase I activities. The Phase II activities are taking place, although at differing paces and with highly variable achievements. The anticipated activities for Phase III have not yet started, and were not due to start until 2008, but some have taken place already, thus demonstrating the dynamism of the sector.

Implementing and Enhancing Rural Credit Policy

The RGC has formed the Credit Committee for Rural Development (CCRD). Under this framework, the MEF plays a crucial role in preparing the policy framework and strategies relating to microfinance, in cooperation with NBC, the private sector and other concerned parties, while the NBC is responsible for regulation and supervision. The Rural Credit Policy is still under preparation, but, given the changes which have taken place in the sector over the intervening years, with international best practices being freely adopted by MFIs, MFIs (through the Cambodia Microfinance Association (CMA) and the CCRD are now working closely together to develop appropriate policies, within the boundaries set by international best practices.

In looking forward, microfinance in Cambodia has developed beyond consideration only of credit, and has moved into areas such as savings, insurance and other financial services for the future. Any sets of policies developed should be enabling policies for development, and the establishment of implementation policies should rest at the level of the MFIs themselves. Their governing bodies should adopt policies on the basis of market needs. There is a growing body of international best practices in microfinance, and the role of support bodies should be to disseminate such policies and encourage their adoption or adaptation to the Cambodian situation.

Reviewing and coordinating policy continues now, and is a long-term feature of sectoral development.

Strengthening Supervision and Regulation

Whilst the roles of the various bodies in supervision and regulation have been recognized, there is still considerable work to do in delineating roles and pursuing effective supervision and regulation. Cambodia has demonstrated restraint in intervening in the sector, which has directly allowed the sector to develop so well. It will therefore be as important to delineate areas in which government should not intervene, to maintain the freedom for the market to develop, as it will be to delineate and effect roles for supervision and regulation, to protect the vulnerable from exploitation.

Prudential regulations exist to protect the interests of all participants in the sector. Certainly, they provide a framework within which the microfinance sector can operate. The regulations exist in order to enable compliance with the law, and at the enterprise level, the regulations provide a framework within which by-laws and other operating methods can be framed and applied. In order that such regulations do not suffocate development, it is essential that the roles of government bodies be designed to ensure a lightness of touch in their application. Improving the application of prudential regulations is still required.

In addition, there is an urgent need to agree upon common reporting requirements, based upon prudent operations. Once common reporting systems are agreed, common performance standards will have been agreed, and these can be used as the basis for meaningful ratings, performance analyses and supervision.

Building Financial Infrastructure for Microfinance:

This is a very important, broad, but inclusive set of activities, and will be a continuing set of activities, in the future, which will be open-ended, as the sector responds to continuously-changing market realities.

The FSDP 2001-10's recommendations to establish a range of service providers assumed that the need for such services as leasing, venture capital funds and equity funds would arise, along with the development of the sector. However, this has not proven to be the case, and the products which the microfinance sector is developing are less sophisticated, but are still trying to meet the demands of a considerable market. In product terms, the microfinance sector is still trying to expand horizontally, to cover the needs of the market, before expanding vertically. Any products which are introduced should be demand-led, rather than being introduced as part of a desire to create new markets. There is also the need for additional service providers, as outlined below, such as specialized training and audit providers.

It is a priority to support development of links between the commercial banking sector and the microfinance sector. As was outlined in the FSDP 2001-10, the microfinance sector requires constant injections of liquidity to expand its activities, sustainably, into new areas. As new products are developed, further liquidity will be required to service the markets. Only the commercial banking system has a sufficient level of liquidity to satisfy anticipated demand. The sector has created 16 licensed MFIs, and they are performing well. The development of the network between the banks and the microfinance sector will now rely upon the development of mutually advantageous products and markets. The present demand by some banks for substantive collateral from the MFIs is traditional and understandable risk mitigation. Efforts must be made to overcome this blockage to further collaboration via possible imaginative substitutes to collateral (where the risks are manageable) such as guarantees, equity participation, improved risk assessment and others, which will assist in developing the linkage between banks and MFIs.

Before the development of an institutional network and legal framework for integration reaching to small farmer and community groups, there is a need to define the market and the extent of that market, with its variations, flexibilities and characteristics. This will clarify the character of the eventual, integrated structure, and so define more clearly the legal and other requirements.

Creating Institutional Capacity

Many MFIs are already profitable and sustainable, and some progress has been made in this area. The support network for those MFIs, nevertheless, requires development, and their long-term sustainability will need that support. Again, this will be a continuing set of activities, in the future, which will be open-ended, as the sector responds to continuously-changing market realities.

The intensive interventions required to build capacity via training support is still a major priority. The training support is not just required for off-the-job training, but also for the development of capacity building structures within the MFIs and systems of needs identification, skills development and management succession. This will require the

identification of a suitable institution which is prepared to expand into this field and to provide such support over the long term.

Updating and upgrading skills is a priority area which must be an ongoing feature of development, with institutional capabilities for training enhanced and deepened in line with the deepening of the financial system. As the boundaries of the financial system move outwards, so should skills development, through the development of institutional outreach capabilities in training provision.

Ensuring Pro-poor Orientation:

Once again, this will be a continuing set of activities, in the future, which will be open-ended, as the sector changes and skills and systems are developed.

As the microfinance sector has expanded and developed, so priorities have changed. For those with disabilities and those living in resource poor areas, there may be opportunities to assist through the development of local workshops, marketing networks or other business opportunities, and their sustainability must be assessed in the same way as for other potential business partners, because they are, after all, subject to the same market forces as other entrepreneurs. There should be a policy of non-exclusion of potential customers based upon personal disability or physical remoteness, and in some areas MFIs may wish to apply to government for special grant funds to assist in establishing such support mechanisms.

Similarly, there must be extra efforts made to include women within the sector, particularly those women who are heads of household. It has been consistently shown, internationally, that financial support activities targeted at women convert more readily into improved family nutrition, improved schooling and improved family health than similar support provided to men. Also, women have been shown to be more responsible in their use of financial support, and in repaying credit, than men. Poverty assessment studies could lead to more effective targeting of financial support, and more inclusion of women, based upon desired improvements in household living standards.

Research needs to be conducted on the opportunities available for introducing micro-insurance, pensions and other financial services which may be developed to provide the safety nets which existing customers of MFIs do not presently possess.

Developing Microfinance: The Next Stage

At present, as a result of rapid development, it is necessary to go deeper into the structural issues surrounding the sector, and to sequence the interventions to support the development of a well-functioning microfinance sector. Interventions to develop the Microfinance Sector will be diverse, but interdependent. There are a number of major issues which need to be addressed, and which affect the development of the sector directly.

The microfinance sector, itself, has generated its own development in Cambodia since 2001, and has moved forward in many areas. Given the proven dynamism of the sector, the character of required interventions has changed, and there is a need, now, to re-

identify, prioritize and re-schedule interventions, to reflect the developing needs of the sector.

Overall, the growth of the sector will be determined as much by internal performance factors as by external interventions. Also, the needs for intervention have changed considerably. Now, the type of intervention is of a more supportive nature to on-going activities. Expanding the scope, growth and outreach of activities will arise from introducing new skills, new perspectives and new ideas, as well as introducing additional funding.

To optimize the microfinance sector's development and performance, and to provide prudential supervision to protect the more vulnerable in society from being unduly exploited, there is a requirement for imaginative and deliberate interventions which will generate growth and create the architecture to protect the interests of all involved.

It is also essential to identify those for whom the Microfinance Sector cannot offer services. The destitute, by definition, do not have assets or potential income generating activities. They therefore have no deposits, which they could make, or income by which they might repay any loans granted to them. If loans are provided, it places the destitute in a worse position than if they had not been provided with loans, since they will be placed under pressure to repay the loans and will have debts which they never had before. The destitute can only be assisted via grants or free services to pull themselves out of their destitution and eventually enter the market for microfinance services.

In this context, key issues are:

- Funding strategy for MFIs. MFIs need to continue to develop commercial funding independent from international donors or NBC. The development of the national wholesale payment system, interbank / money market and continuing improvement in financial information will serve to support the development of increasing linkages between banks and MFIs. MFIs are often exposed to foreign exchange risks if their funding comes from outside Cambodia. As the use of the riel develops, MFIs may increasingly make loans in riel and this once again highlights the role of the banking sector in intermediation and risk management.
- Deposit taking by MFIs. Funding may come through deposit taking and this highlights the importance of appropriate regulation and supervision by NBC of banking activities by MFIs. The regulatory system should be progressive and developmental with graduated standards for institutions with different activities and which provides an incentive framework to support institutional development (for example, registered MFIs to licensed MFIs to specialized banks to banks).
- Regulatory parity. Other institutions conducting microfinance business or banking business should be treated similarly from a regulatory standpoint in order to properly address risks, reduce regulatory arbitrage and provide a level playing field. Examples include money changers, money lenders, credit cooperatives and mutual savings institutions, all of which should meet similar standards if engaging in microfinance or banking business.

Priorities for 2006-15: Microfinance

The FSDS 2006-15 has revised the delineation of the sector in the FSDP 2001-10 as “Rural Finance”, to become more inclusive, and considers the sector as “Microfinance”. This encourages the diversification of risks and growth of diverse products, as well becoming more inclusive for those in urban areas. The objective is thus a viable, pro-poor and effective microfinance system for to provide affordable financial services to enable the poor to enhance income and reduce poverty.

Since 2001, the microfinance sector has shown remarkable dynamism, with admirable results for a sector in its present stage of development. This has been due in no small part to the RGC’s willingness to allow the commercialization of microfinance in the country, with a private sector approach supported, where necessary, by the Government and the donor community. The continued development of a supportive network by the Government and donors, whilst allowing the private sector freedom to act within the legal and regulatory framework, should support additional rapid growth.

Interlinkage and integration of the microfinance sector with the commercial banking sector continues as a major priority. In the long run, the commercial banking sector is the only reliable source of extensive liquidity which can meet the demands of the microfinance sector. Furthermore, there is a trade-off for the banking sector. The more successful of the microfinance sector’s clients will eventually graduate into customers for the banks.

The microfinance sector’s future development should be considered on three levels: the Macro level, the Meso level and the Micro level. Furthermore, developments should not be time-bound or time-constrained, but should be prioritized and sequenced, based upon expected impacts and absorptive capacities.

Macro level (Government and regulatory authorities):

- Support continued development of capacities at NBC for effective regulation and supervision of the microfinance sector, while at the same time making sure that all institutions taking deposits are subject to graduated regulatory requirements and supervision based upon size and complexity of activities.
- Agreement upon common reporting standards is required to establish sound financial performance analysis and enable the support of the sector’s growth, as well as to inform the public via monthly bulletins.
- Study structural risks associated with the MFIs, in terms of governance, ownership, and the small size of some MFIs and try to resolve the weaknesses.
- Identify and define microfinance markets throughout Cambodia, and this is an area in which the MEF should provide significant support. There needs to be improved statistical analysis and market definitions, geographically, sectorally, in size and in scope. There is also a requirement to define and elaborate on the scope of alternative financing sources at the local levels (moneylenders, family, friends, village banks, cooperatives, etc.). This will inform MFIs, and provide the basis for product development, for policies and, for the Government, the potential identification of incentives to promote development as well as appropriate regulation and supervision.

- Creation of capabilities to support other forms of microfinance institutions (i.e. community-based, non-registered, etc.) to broaden the types of needs being met, and introduce greater variety and flexibility into the system.

Meso level (Technical support level):

- Establish a training facility which can provide off- and on-the-job training for all levels within the microfinance sector. The training facility should include a governing council for microfinance capacity building (to include the MFIs, both licensed and registered), in order to ensure that it meets the needs of the sector. It will develop off-the-job training courses and develop increasing outreach capabilities to support the establishment of training management systems for effective on-the-job training at MFIs and beyond. This would include training of trainers; work task analysis; needs assessment; training planning, budgeting and on-the-job delivery; appraisal methodologies; management succession training; and training recording systems. The training facility would operate as an integral, responsive part of the microfinance sector, funded by sustainable pricing of services.
- Improve the provision of management information systems (MIS) for MFIs. The quality of software and systems presently varies considerably, with some MFIs unable to access integrated accounting and loan portfolio systems, whilst others have very expensive and effective systems. Minimum standards for MIS in Cambodia need to be established, particularly when improved common reporting standards are introduced. This may call for the holding of national licences by Meso or Macro level organizations on behalf of the MFIs, in order to ensure minimum quality of support to those organizations.
- Develop a wholesale market for loan financing, operated within the private sector and linking the MFIs with the commercial banking sector. At the moment, MFIs have difficulty in accessing credit in riel. A national wholesale payment system and money / interbank market should not only link the microfinance and banking sectors, but should also provide flexibility in the currency in which loans are provided (see Non-Bank Finance, Chapter V). Additionally, linkages should be extended via measures enabling the banks to obtain experience of lending to, and working with, MFIs. This requires a less collateral-based approach to lending and the development of more cash flow/accounts analysis-based thinking. Potential for interim guarantee measures to enable such experience to be gained will be considered.
- The recent and welcome establishment of the Cambodian Microfinance Association (CMA) provides an opportunity for improved representation in the sector. CMA may be developed to disseminate improved policy options, to improve dialogue, advocacy, research and information exchange.
- Build a local MFI ratings capacity, based upon commercial ratings support and also linked to a credit information exchange. The information exchange should include both positive and negative information. If customers are to graduate to the commercial banking system, they will need to have established an accessible, good credit history. The CIS established for the commercial banking sector can be extended to the microfinance sector.

Micro level (Retail):

- Support to strengthen retail institutions, particularly those below the level of Licensed MFIs.
- Based upon research and statistical analysis conducted at the Macro level, a need may arise to assist other forms of microfinance institutions (non-registered, community based, etc.), and to ensure that where needs are being met by such ad hoc organizations, those needs continue to be met. The greater the variety and flexibility in the system, the stronger it will be.
- Further links should be created between NGOs dealing with the destitute and MFIs. This will allow destitute people who become non-destitute, via NGO support, to ease into the microfinance sector.

3-2- Regulatory framework: Regulation and Supervision

The regulations issued by the NBC include criteria for: licensing and registration; minimum capital requirement; solvency ratio; liquidity ratio; uniform chart of accounts; reporting requirements; and interest calculation. These regulations are consistent with the scope of work of the MFIs and support them in expanding their activities under an appropriate requirement.

The following are the summary of these regulations:

- Criteria for licensing and registration: The identification of permanent shareholding, in particular the influential shareholders holding 20% or more of the capital.
- Requirement for being licensed: NGOs having loan outstanding of KHR 1,000 million or more or 1,000 borrowers or more.
- Minimum paid-up capital: KHR 250 million
- Liquidity ratio : 100%, compared to 50% for commercial banks.
- Solvency ratio : 20% of net worth
- Capital guarantee : 5%, compared to 10% for commercial banks.
- Reserve requirement : 5%, compared to 8% for commercial banks.
- Calculation of interest rate shall be based on the remaining balance of credit.
- Reporting requirement: monthly for licensed MFIs and quarterly for registered NGOs.
- Reports: Asset and liability statement, profit and loss statement, statement of deposit and loan classified currency and by types, loan classification, and branch network.

- Introduction of uniform chart of accounts of the NBC into the system (MIS).
- Annual license fee: KHR 1 million for each MFI with no fee for branch, with the purpose of promoting the expansion of branch network to reach poor people in remote rural areas.
- No fee for registered NGOs.

Deposit Taking

The microfinance sector in Cambodia is at the early stage of development and therefore, deposit taking is very limited, only a restricted amount of deposits, mainly compulsory and staff savings. However, technical assistance from ADB has conducted a survey on micro savings in some potential provinces. The outcomes of the survey have shown that rural people have the willingness to save. Based on this result, the NBC will carefully prepare a regulation governing deposit taking institutions by setting up a complete set of criteria to evaluate the qualification of MFIs. Finally licenses will be given to those who meet the criteria as Deposit Taking Institution.

MFIs transforming from NGOs have continued their culture of lending in the form of solidarity groups where lending does not require collateral. Lending to individuals requires collateral when there is no trustable guarantor. For local private MFIs, the majority of loans have been lent to individual clients with the required collateral.

Since we are promoting the growth of MFIs, the requirement for opening new branches was not set, except giving prior notice to the NBC. However, once branches are allowed to collect savings and, even more, on-lend them, then the NBC needs to supervise that these savings are managed securely (requirements on buildings, environment, security, vault, transport, etc.). As with the opening of bank branches, such MFI branches need to be properly licensed.

Since MFIs have developed, the savings mobilization trend has spread. But, it is not yet at the desired levels. At the end of March 2007, MFIs had total deposits of US\$ 3.5 million, which equals to 3% of loans outstanding. To meet lending requirements, MFIs need to look for other sources of funding other than savings. Furthermore, there are many approaches and steps required to mobilize savings for reinvestment. Those approaches include the strengthening of MFIs to improve public confidence and to provide training for the poor to understand the advantages of savings. Moreover, MFIs should develop simple financial products for the poor to save.

Borrowing

There are no restrictions on where MFIs may borrow from either domestically or internationally, however, their ability to take deposits from the public is tightly restricted by regulation. The effect is that nearly all the funding for MFIs is sourced from foreign entities. Local banks, generally, will not lend to MFIs because they do not have assets that meet the banks collateralization criteria.

Branches

MFIs are actively encouraged to open branches to both increase the outreach to the poor and to increase competition. Branch growth is only limited by the overall prudential ratio applied by the NBC and the capabilities of the MFIs own management and human resources.

Foreign investment

Foreign investment is seen as a key requirement to allow the sector to expand quickly enough to meet the needs of the expanding Cambodian economy. Foreign owned MFIs or MFIs with foreign investment either debt or equity must meet the same prudential supervision requirements as domestically owned MFIs.

Disclosure of audited financial statement

Moreover, the NBC is strengthening the implementation of the uniform chart of accounts for MFIs and the disclosure requirements in accordance with international accounting standards. The NBC is strengthening the management of the MFIs as well.

Regulation and supervision

To ensure the implementation of these regulations, the NBC has to conduct offsite supervision of reports regularly received and onsite supervision. Moreover, field visits have been conducted to verify their activities when applying for a license or registration.

In addition to its supervisory activities, the NBC has encouraged MFIs to establish a professional association for microfinance which has a relationship with the bank association so that it can communicate with the NBC or other institutions to share views and to protect their interests.

However, commercial private investment in MFIs is encouraged, it can produce better performance and then convince local banks and the public to also invest and deposit (savings) in them. But then we need real ownership, and effective oversight of such investors.

To implement laws on banking and financial institutions and improve financial services in rural areas, NGO suppliers of financial services need to be licensed as MFIs by NBC. The purpose of the regulation is not to restrict their activities but to promote them. Regulation and licensing are necessary for MFIs that collect savings and deposits from their members, acquire long term borrowing from foreign and local organizations and employ these funds to provide loans in rural areas.

A MFI must be registered and incorporated as a legal entity such as a company, cooperative or have a legal status according to the law. An MFI must obtain a license from NBC on application by submitting the required documents.

For the first time in 2000, NBC issued regulations on the classification of MFIs into three categories according to the level of their operations, and created criteria for licensing and registration. The major obstacle preventing NGOs from transforming into MFIs is

ownership. In the beginning, it was difficult to identify the shareholder because funds used by NGOs to operate microfinance had been granted by international donors. To overcome this staff associations have been established as the owners of those funds, opening the way for NGOs to transform into MFIs.

The biggest MFIs must be licensed by NBC. The regulation is very similar to commercial banks, except that the capital requirement is substantially lower. The medium-sized MFIs only are registered by NBC and are subject to lighter regulation and in particular, reports sent to NBC are simplified. The smallest MFIs can operate freely with no requirement to be regulated and supervised due to high operating costs.

The banking supervisor should have appropriate powers and systems relating to: supervisory approach, supervisory techniques, supervisory reporting, corrective and remedial powers, consolidated supervision, and home-host relationships.

The NBC has been working hard to improve supervision, but much work remains to be done. Key objectives include:

- Improvement of on-site and off-site supervision techniques
- Continued capacity building at NBC and in banks.
- Development of NBC processes and information technology systems.
- NBC and judicial implementation and enforcement.

4- Innovative Rural Finance Products and Services

Since Cambodia is in the early stages of development, the development of insurance, credit line, term finance, collateral substitutes, and consumer credit will take time. Group and individual products are the most popular products of MFIs operating in Cambodia and they are very active in lending but short of liquidity at the same time, Savings products are not well-developed because NBC is in the process of building an adequate legal framework for governing deposit taking institutions in order to protect the interests of small depositors and in addition, the savings mobilization is under study by ADB.

On the other hand, as defined by law, MFIs are not allowed to offer remittance services. However, money transfer can be done through commercial banks' branches or the NBC branches throughout the country. There is no partner in providing financial services in Cambodia. There is a full competition among MFIs in this industry.

5- Delivery Methodology and Outreach

The development of the financial services sector is still in its infancy. The range of products and financial services available is still limited. This is partly due to a conservative approach to regulation to ensure the integrity and stability of the financial system as it develops. While it has meant that additional financial services have been restricted or slow to reach rural areas it has meant that there has been a high level of stability in the services delivered and there have been no events that have undermined the development of confidence in the financial sector and its institutions, particularly banks and registered financial institutions.

By the end of March 2007, licensed MFIs had total loans outstanding of US\$ 103 million. This figure does not include loans of ACLEDA to the microfinance sector. Though ACLEDA has been transformed to a commercial bank, its major operations still involve the microfinance sector and lending to registered MFIs and non-registered NGOs. The number of borrowers has increased from 250,000 to 463,890.

The sources of funds for lending are mostly aids grants and borrowings from abroad, local borrowings, and a smaller proportion from savings. This demonstrates the weakness in savings mobilization, which results from a lack of a savings mobilization strategy, and the poor understanding of the poor people of financial services as they think they are poor and do not know how to save. On the other hand, people have savings behaviour in the form of putting money in a piggy bank or under the pillow, for which there is a high risk of loss through theft or other causes.

6- Rural Finance Technology

The NBC has established procedures for licensing, regulating and monitoring MFIs. The NBC provides detailed guidance on the monitoring framework: compulsory registration and licensing conditions, loan classification and provisioning, liquidity ratio, reserve requirement and detailed reporting requirements for licensed MFIs (with registered MFIs being encouraged to provide data as much as is possible).

For licensed MFIs, the requested standard input reports consist of a full set of reports aimed at checking performance and compliance with regulatory requirements. For registered MFIs and NGOs, the requested standard input reports are limited to a number of reports aimed at collecting information on MFIs prior and during their license application period. For licensed MFIs the reporting requirement is monthly and quarterly for registered MFIs.

This framework enables the NBC to fulfil its monitoring objectives:

- Preserving integrity of financial system and avoiding disruptions
- Promoting public confidence in the financial system
- Encouraging savings mobilisation
- Protecting depositors
- Supporting best management practices and transparency
- Preventing fraud and illegal activities

To ensure the NBC can fulfil its objectives and implement the proposed monitoring framework, MFIs need to provide performance data on a regular basis. To help MFIs to provide the data in a structured and consistent way, avoiding errors and omissions, a data input and transfer system has been installed in the monitored MFIs. This manual assists the users of this input and transfer system to utilise the system.

As discussed above, while there are highly prescriptive requirements for MFIs to report to the NBC there are no such requirements on the MFIs internally. There is a wide variation of practice between MFIs on how they actually perform their credit analysis and support. One of the results of MFIs having to borrow from international sources to fund their operations is that they have been forced to meet international standards of reporting, internal management reporting and transparency that meet the demands of international

lenders, not only those of the domestic regulator.

There is no doubt that the MFIs would benefit from further development of information technology and human capital but they must be at a cost that the businesses can support or have some form of support to assist in further development.

Management, Governance and Institutional Reforms

The overall objective of the reforms contains two key elements: (1) financial stability, and (2) financial development to support economic growth and poverty reduction.

Since 1993, Cambodia has made very significant progress on the most basic foundation of economic development. Overall, governance is improving but requires continuing attention. In the microfinance sector, shareholder-owned MFIs are playing an important role in the delivery of financial services to the poor. MFIs are commercial, limited liability companies, whose ownership is in the hands of multiple shareholders, mainly private. The board members selection and at least two managers recruitment is subject to approval by the NBC, with candidates screened to be fit and proper. MFIs are required to nominate an independent auditor to conduct an annual audit. They are also required to have an internal auditor, which reports directly to the board. In terms of transparency, ACLEDA bank and two MFIs had been awarded prizes by CGAP, and two other MFIs received certificate of acknowledgement.

Many MFIs are already profitable and sustainable, and some progress has been made in this area. The support network for those MFIs requires development, and their long-term sustainability will need that support. Again, this will be a continuing set of activities, in the future, which will be open-ended, as the sector responds to continuously-changing market realities.

The intensive interventions required to build capacity via training support is still a major priority. The training support is not just required for off-the-job training, but also for the development of capacity building structures within the MFIs and systems of needs identification, skills development and management succession. This will require the identification of a suitable institution which is prepared to expand into this field and to provide such support over the long term.

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- **Regulatory parity.** Other institutions conducting microfinance business or banking business should be treated similarly from a regulatory standpoint in order to properly address risks, reduce regulatory arbitrage and provide a level playing field. Examples include money changers, money lenders, credit cooperatives and

mutual savings institutions, all of which should meet similar standards if engaging in microfinance or banking business.

In addition to those things mentioned above, and as stated earlier, the main driver demanding and forcing good governance other than the regulation and supervision of the NBC is the demands of foreign lenders and investors.

This has been highly successful in driving transparency and good businesses practices as evidenced, not only by the continued availability of foreign loans, but also the awards of prizes by CGAP to Cambodian institutions for transparency.

Human resource management and development remains a huge problem to source the people with the correct skills and training to meet the needs of a rapidly growing sector in the range of 80% per annum.

Internal systems and sophistication do vary widely as would be expected in a sector with a wide range of sizes and business models for delivering microfinance of services to a wide range of customers in a manner that is profitable to the provider. Rapid growth may place an unacceptable strain on some of the existing systems and assistance may be required to help MFIs to overcome these issues, and equally important to assist management to recognize that it is not always possible to grow a business safely without continued and often major and costly upgrades to systems and methods of doing business.

7- Critical Elements of Success

For banking regulation and supervision to be effective in supporting financial stability and financial development, a number of preconditions must be in place. These preconditions are:

- Sound and sustainable macroeconomic policies;
- Well developed public infrastructure;
- Effective market discipline; and
- Mechanisms for providing an appropriate level of systemic protection (public safety net).

7-1- Sound and Sustainable Macroeconomic Policies

Macroeconomic and monetary policy must be stable and appropriate, and supported by an effective institutional framework. In relation to policy, the key focus is on price stability, monetary stability and financial stability. In relation to macroeconomic policy, Cambodia is constrained by its dollarized economy, especially in relation to monetary policy. At the same time, use of the US dollar has also been effective in supporting macroeconomic stability.

In looking at the development of Cambodia's financial sector, the basic institutional framework is in place for safeguarding macroeconomic stability. The basic institutional framework provides the basis on which a more efficient and effective monetary policy for safeguarding macroeconomic stability can be implemented. In order for this to occur, there is a need to develop appropriate instruments and tools.

In moving forward, Cambodia will continue to be guided by relevant international experience and standards in the area of macroeconomic policy and the related institutional framework.

Beyond this, the immediate priority to set up a system for an effective and efficient monetary policy is first to improve monetary policy instruments, and second to develop a market-based monetary policy framework. As stated in the Financial Sector Development Blueprint 2001-10, the improvement of monetary policy instruments will lead to increasing competition among banks, enhancing their intermediation function. At present, the key needs are:

- **Payment system.** Unless the payment system is well developed, the effectiveness as well as the efficiency of monetary policy is not attainable. The key objective, thus, is to achieve the establishment of a payment system, which is secure and safe, and has a national dimension. In addition, it is expected to have an electronic payment system both for riel as well as for the US dollar.
- **Money / interbank / government securities market.** Financial markets serve as another important component of the macroeconomic policy framework, shaping a market-based monetary policy. The establishment especially of money / interbank markets including short-term government securities will assist flows of financial resources, and provide the central bank and government with important information and the means of macroeconomic management.

The establishment of an effective payment system and of a money / interbank market including short-term government securities paves the way not only for a market-based monetary policy, but also promotes monetary development, a medium and long term priority for Cambodia.

Monetary development and increasing the use of the riel is also supported by increasing public confidence. As confidence in the government, the financial system and financial institutions improves, and once a payment system is developed, confidence should also develop in the domestic currency. As the infrastructure is developed, government salaries and other expenditures can be paid through the payment system into bank accounts, and tax and other government revenues can be paid in riel through the banking and payment system. This can eventually be extended to all salaries once the financial system has developed sufficiently. As such confidence increases, larger denomination notes in riel could be issued to enhance the effectiveness of the riel as a means of exchange. At this point, prices could also be expressed in riel. Further, as confidence in the currency increases and use of the currency increases, the tools available for implementation of macroeconomic and monetary policy will improve.

7-2- Well Developed Public Infrastructure

Well developed public infrastructure includes:

- The system of business laws (corporate, insolvency, contract, consumer protection, private property), consistently enforced and providing fair resolution of disputes. As discussed above, the most important priorities

for Cambodia are (1) enacting laws now pending, and (2) improving enforcement and commercial dispute resolution.

- Accounting and auditing standards of international standard. As discussed above, the most important priorities for Cambodia are (1) improving human capacity in relation to financial information, and (2) developing and implementing a progressive, incentive framework for company development.
- An efficient and independent judiciary, and accounting, auditing and legal professions. As discussed above, the most important priority for Cambodia is improving contract enforcement and commercial dispute resolution.
- Regulation and supervision of other financial markets.
- Secure and efficient payment and clearing system. In the context of banking and microfinance, the development of a secure and efficient payment and clearing system is a **key objective** and an **urgent priority** for Cambodia.

7-3- Payment System

At present, Cambodia has no national wholesale electronic payment system. Rather, payments are made through cash deliveries or via a limited (though increasing) number of US dollar and Cambodian riel cheques. Importantly, however, in 2005 Cambodia enacted its first Law on Negotiable Instruments and Payment Transactions which provides a legal basis for negotiable instruments such as cheques, bills of exchange, promissory notes, and regulation of payment systems.

Cambodia's current lack of an efficient, secure, national payment and clearing system poses a major impediment to financial development: payments are insecure and difficult to make in large volumes; money / interbank markets cannot function effectively; and macroeconomic policy instruments are severely limited. These factors suggest that developing such a system would remove a number of serious impediments to financial development in Cambodia.

In looking forward, the objective is to develop a payment system and settlement system in Cambodia that is:

- National in scope;
- Secure and safe in the context of international experience and standards such as the Committee on Payment and Settlement Systems' Core Principles for Systemically Important Payment Systems; and
- Electronic.

In addition, such a payment system will cover at least the riel. A US dollar system will also be considered.

In terms of elements, the national payment system will comprise:

- Cheque clearing and settlement;
- Wholesale interbank payments;
- Money / interbank securities transactions; and
- Support for retail payments.

7-4- Public Financial Safety Net

Banking supervision is one element of an effective public financial safety net. In essence, the financial safety net is the overall system for supporting financial stability in the banking system. As such it includes a number of elements, of which banking regulation and supervision is the most important:

- Lender of last resort;
- Regulation and supervision;
- Systems for addressing problem bank resolution and insolvency; and
- Depositor protection.

First, the lender of last resort function is designed to provide emergency liquidity to solvent banks facing bank runs. Due to Cambodia's dollarized economy, it is not possible to have a lender of last resort in the true sense. As a result, this function can only be developed if at some point in time the riel increases in use sufficiently to make up a significant portion of banking assets (for example, loans) and liabilities (primarily deposits). As such, the NBC should not provide financial support to financial institutions under the present monetary circumstances. Any such support is actually a form of subsidy or government bailout and will only be undertaken with RGC approval.

Second, banking regulation and supervision is discussed below.

Third, a system for problem bank resolution and insolvency deserves attention in Cambodia before any future bank failure takes place. At the least, there is a need for a contingency plan for dealing with any future bank problems or failure. Likewise, this should be extended to considerations of bank insolvency. Cambodia will look to international guidance and experience such as the *Legal, Institutional, and Regulatory Framework to Deal with Insolvent Banks* in developing an appropriate system to address problem bank resolution and insolvency.

Fourth, depositor protection is addressed most importantly by the preceding three elements, especially banking regulation and supervision. It also may include structures such as (1) preferences for depositors in the context of insolvency; and (2) deposit insurance. Depositor protection beyond banking regulation and supervision, possibly including deposit insurance, may be considered in Cambodia in the medium term to longer term. At present, there is no consensus on whether or not Cambodia should adopt deposit insurance, but this is an issue for further consideration in future.

Within the microfinance sector the critical elements of success have been discussed earlier but in summary they include:

- no events that undermine the confidence of the public in the financial sector generally and in the microfinance in particular,
- increasing access to financial services by the poor and remote rural population,
- expanding and accelerating use of financial services by the poor and remote rural population as measured by a rapid growth in amount of loans than GDP and a more rapid growth in borrowers than population growth,
- the undisputed rule of law and good conduct in the operations of the MFIs
- a growing range of financial services available to the poor and remote rural population.

8- Constraints and Issues: How these are being addressed

A safe, efficient and effective banking sector is absolutely essential to support financial development and economic growth in Cambodia. Unsafe banks can lead to systemic financial crisis, economic collapse and massive permanent economic losses, as in the Asian financial crises in 1997-1998. Hence, the key consideration is first to address risks: the goal is to maintain financial stability by developing an effective financial safety net, focusing on (1) financial stability, (2) banking regulation and supervision, and (3) depositor protection. Likewise, to the extent that other financial institutions such as microfinance institutions, money lenders and money changers are conducting banking business and therefore raise similar risks to banks, they should likewise be addressed. As such, this section addresses not only banks and banking but also microfinance and microfinance institutions (MFIs) as well as money lenders and money changers to the extent they are conducting banking activities.

At the same time, developing banks and banking and related institutions is important to support savings and financial resource allocation. The focus here is on providing rules and incentives to support banks and related institutions to do banking business in a safe and efficient manner, through (1) foundations of the financial system especially property rights and contract enforcement / dispute resolution mechanisms, (2) preconditions to effective banking operations and supervision especially a safe and efficient payment system, and (3) effective regulation and supervision of banks and similar institutions such as MFIs, money lenders and money changers to the extent they are conducting banking business.

In most developing economies including throughout Asia, the banking sector plays the most significant role in financial resource allocation and savings in the economy. This is also the case in Cambodia and highlights the key role of the banking sector in Cambodia's economic development. At the same time, MFIs, money lenders and money changers are also active in Cambodia's financial system and play a very important role in financial resource accumulation and allocation. As such, it is important for Cambodia to have a comprehensive system to address the risks of banking activities conducted by various differing types of institution as well as to support the development of the role of these various forms of institution in supporting economic growth and poverty reduction.

In looking at the banking and microfinance sector in Cambodia, a number of key observations emerge. Amongst the banks and the banking system, there is significant

liquidity but limited lending taking place. Beyond the formal banking system, related financial activities and institutions are active both formally and informally. In the formal financial system, MFIs are active lenders but face liquidity constraints. At the same time, estimates suggest that the informal financial sector is perhaps larger than the formal financial sector and active across a variety of banking related forms. In the informal financial sector there are unregistered MFIs, which may or may not view themselves as MFIs, but more often than not as development organizations, money lenders and money changers, as well as various informal financing techniques such as the tontine.

In this context, the key challenges and priorities for supporting the development of banking and microfinance in Cambodia are:

- Identifying and addressing risks.
- Improving financial institution operations and increasing intermediation through human capital development, education and appropriate regulation and supervision.
- Increasing confidence through improving financial institution and supervisory functioning and education.
- Formalizing finance through increasing confidence.
- Linking banking and microfinance through increasing confidence in regulation, supervision and enforcement and developing appropriate financial infrastructure especially a national wholesale payment system, money / inter-bank markets including short term government securities, and improving financial information quality and transparency.
- Treating providers of similar financial services similarly to provide a level playing field and avoid regulatory arbitrage and providing a progressive, developmental system for non-banks conducting banking type activities.

9- Prospects for the Future

Our vision for microfinance is to establish a viable and sustainable private microfinancial market, with the government providing a supportive and appropriate institutional framework to that market. The way forward in the short to medium term towards achieving this vision should be a set of interlocking strategies that require the attention of various stakeholders. In this respect, some of the following issues merit attention for the continuing development of microfinance.

9-1- Increased Access of the Poor to Microfinance

It is particularly interesting to note that, notwithstanding usurious rates, informal lenders are still the main source of finance for rural people. Success in informal lending testifies to the fact that the poor are a good credit risk and are bankable. Therefore, we can conclude that the essential question for rural people is firstly, access to credit and to a lesser extent, the problem of the cost of credit. Expanding the network of microfinance in rural areas is crucial and deserves special attention from both the authorities and the service providers.

The authorities need to establish a favourable regulatory and policy environment for a range of institutions serving the needs of the poor. In Cambodia, this process has to start with the restoration of macroeconomic stability. Effective financial intermediation

requires an efficient market characterized by a stable inflationary environment, a flexible interest rate and exchange rate regime for the case of the highly dollarized Cambodian economy, as well as political and economic stability. In addition, a regulatory framework such as licensing has to be geared toward encouraging the microfinance network. The microfinance operators, on the other hand, have to develop organizational strength and improve the quality of services and outreach of client-friendly services, market penetration, and the promotion of quick and convenient access to credit.

At the same time, we also need to pay attention to reducing the cost of borrowing. At the beginning of rural finance history in Cambodia, interest rates were very high. However, due to an improved regulatory and operational environment coupled with increased involvement from donors in a more efficient way, interest rates were subsequently reduced (but are still considered to be high). Therefore, assistance from bilateral and multilateral agencies continues to be needed for some time more, but it needs to be shaped appropriately in order to promote the self-sustainability of local service providers in the long run.

Moreover, two different issues have arisen between commercial banks and MFIs. Commercial banks have excess liquidities in hand because of limited use of collective funds, whereas MFIs have a lack of resources, especially in Riel for lending. Hence, it is necessary to have a possible mechanism for the commercial banks to lend to MFIs with securities.

9-2- Increased Diversity of Institutions

The institutional frameworks by which financial services are provided to the rural poor need to be diversified in order to accommodate the heterogeneity of the rural people's needs, potential, and business capabilities. We thus aim at encouraging a wide range of microfinance providers with varying degrees of sophistication, targeted clientele, capital base, and geographic coverage. This undertaking requires a better understanding of the market and the exploitation of any collective preference in order to appropriately design an institutional framework, which in turn allows development of appropriate products and satisfies a broad customer base.

9-3- Improved Financial Sustainability of Microfinance Operators

Despite the success reported here, constraints on microfinance remain high, especially with regard to financial resources. Most rural credit operators have utilized external funds such as foreign aid and borrowing. This excessive reliance on external financing in the form of grants or project financing is mainly attributable to a lack of access to savings and deposits and good savings services. A microfinance institution should try to mobilize savings, and the authorities need to be proactive and have the right system in place to protect depositors while allowing licensed MFIs that meet the criteria to collect deposits. This means that sound MFI supervision has to be emphasized in order to maintain the trust and confidence of the people and to assure them that their money is secure and properly managed.

In this respect, it is necessary to highlight the role of public awareness campaigns for the people to understand the benefits of using bank saving services instead of conventional forms of savings such as gold, paddy rice, livestock or the informal Cambodian savings

form called “Tontines”. This is an important issue, given that in Cambodia knowledge about the financial sector is limited. On the other hand, microfinance operators have to acquire professional management skills and the technical capacity to develop savings products that are more flexible and responsive to the needs of the prospective clients. MFIs need to properly manage mobilized savings funds. This line of thinking, if successfully implemented, would provide licensed MFIs the opportunity to better financially intermediate funds, and would provide a more stable domestic resource base to support the growth and sustainability of their lending operations.

9-4- Enhanced Commercial Microfinance

Though financial services to the poor began with NGOs focused on relief and rehabilitation type work, microfinance activities have now steadily and increasingly turned into an important industry in Cambodia. More and more NGOs have acquired licenses and transformed themselves into licensed MFIs. Some have even achieved financial stability and have effective self-regulation mechanisms in place. And experience has shown that effective self-regulation mechanisms associated with a motive of attaining self-sustainability through commercialization of services are compatible.

Regulators see that microfinancial service providers need to develop themselves in order to meet the dynamic, changing operating conditions. They have to consider various elements when moving to commercialization, which include, among others, management information structure, institutional values, operating systems, and professional staff. Bilateral and multilateral agencies can play an active role in promoting the commercialization of microfinance, in particular through equity participation. Just like the advantages of traditional forms of foreign direct investment in the manufacturing or formal banking sector for the host economy, such participation on the part of those agencies in the rural finance institution framework brings both financial benefits and technical expertise to the local service providers.

NBC also promotes participation from private investors involved in microfinance activity. Some of them have been transformed from informal moneylenders into formal microfinance.

9-5- Regulation and Supervision

NBC’s management and supervision of microfinance activities in Cambodia has so far achieved good results which mirror the strengthening of law enforcement and cooperation with the related MFIs. NBC’s approach to rural finance is one of support and flexibility so that supervision will not impose any unnecessary burdens on licensed MFIs. However, capacity building at the NBC in order to acquire adequate expertise and manpower to supervise MFIs remains a challenge. Such a challenge could only be overcome with TA support.

The challenge for the supervisory authority will be to accompany the development of this sector by adapting regulations when needed. So far the regulations have been restrictive for collecting deposits; now, as some MFIs have strengthened their soundness, this regulation could be eased. Collecting more deposits will give more resources to MFIs and will get the rural population used to saving money and to using the banking system. But

these changes would have to be cautiously implemented and only the strongest MFIs could be authorized to collect deposits.

10- Conclusion and Recommendations

So far, microfinance activities have contributed benefits and good experiences for the development of this sector, which is the most important sector in the poverty reduction policy of the government.

The microfinance sector in Cambodia has been internationally recognized and highly rated since it commenced its path towards a sound regulatory, supervisory, and managerial environment.

For borrowers, the main benefit received from microfinance is the upgrading of their living standards because having access to credit services creates a credit culture with the spirit of being responsible for the borrowed money to be repaid on the maturity date including interest. On the other hand, borrowed funds should be utilized for production so that the borrower can have enough income to support his living, meaning that he should not spend borrowing funds on non-business activity.

A good credit culture is observable in the high repayment rate (from 95% to 99%) of the poor who borrowed money from MFIs. The reports also illustrate the capacity of women to pay back loans to be higher than that of men. This suggests that women are better financial managers than men. Borrowing from MFIs is a good resource for the poor because this type of lender charges a lower interest rate than others.

Regulated MFIs have advantages of sound management and compliance with all regulations, which in turn contributes to its operations and builds more confidence in the microfinance system. Adherence to all guidelines and regulations imposed by the NBC will lead MFIs to more effective and sustainable operations.

Even with such satisfactory progress, this remains an initial stage. However, there are outstanding objectives to achieve, such as encouraging MFIs to expand their branches in the remote areas and to mobilize savings.

These achievements cannot be separated from the support of international donors that encourage the micro-finance sector through both technical assistance and funds for sector improvement.

In addition, the government's well-directed policy in the Rectangular Strategy has proven crucial in leading to the successful development of the financial sector, especially in the role of micro-finance for poverty reduction.

The following recommendations for improving microfinance are amongst others:

- strengthening the existing MFIs
- focusing funds on the right target and at the right time
- supporting wholesale credit market
- supporting the establishment of MFI Association
- facilitating the distribution of credit information, and

- encouraging MFIs to use information management system

Samdech Prime Minister Hun Sen in his opening speech during the National Summit on Microfinance in Cambodia on 11 January 2006 has also made the following recommendations for the improvement of microfinance:

- 1- For the NBC: As the supervisory authority, the NBC should continue to perform the present tasks by issuing more prudential regulations for supervision to ensure effective implementation with the protection of the soundness of the MFIs and public confidence. These prudential regulations should be more flexible and not too strict, which would be a big burden on the MFIs, and they shall not be so loose that they result in high risks. In general, these regulations shall follow universally recognized standards so that MFIs can provide their services on a sustainable basis and the benefits of the poor are protected.
- 2- For non-licensed NGOs: Non-licensed NGOs should make efforts to transform themselves into licensed MFIs operating under the law.
- 3- For licensed MFIs: Licensed MFIs should strengthen their management and operations through the creation of new financial products consistent with the demands of the poor and through the opening of more branch networks which can be reached in the rural remote areas of the country so that expanded financial services can be provided to the poor.
- 4- In connection with this, a training program should be considered for poor people to allow them to understand how to use these financial services. Training of basic knowledge provides the poor with the knowledge of how to borrow, how to save and how to use loans, which is beneficial for their living standards and for raising their income so that they can improve their standard of living.
- 5- For the interest rate of micro loans, as I mentioned above, the Royal Government remains committed to the market rate policy, and despite the subsequent decline of interest rate, the parties concerned and the international community providing loans to MFIs shall consider how to further reduce interest rates to help the poor.

The Royal Government will continue to build infrastructure, especially rural roads and irrigation systems, and manage appropriate fiscal and monetary policy to maintain the *riel* and price stability, macroeconomic stability, and improve social security.

All municipal and provincial authorities have to facilitate microfinance operations in their respective jurisdiction to be safe and able to expand their activities throughout the country.



Delegates visiting microfinance clients' products



Fishing activities



Rice planting Activities



Small Business Activities



Jar making Activities



Stone Carving activities



Collection of Agricultural Products



Metal Curving activities