ASIAN DEVELOPMENT BANK RRP: CAM 30237

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON A

PROPOSED LOAN

TO THE

KINGDOM OF CAMBODIA

FOR THE

RURAL CREDIT AND SAVINGS PROJECT

March 2000

CURRENCY EQUIVALENTS
(as of 31 January 2000)

Currency Unit	–	Riel (KR)
KR1.00	=	$0.000263
$1.00	=	KR3,800

ABBREVIATIONS

ACLEDA	–	Association of Cambodian Local Economic Development Agencies
ADB	–	Asian Development Bank
AFD	–	French Agency for Development
CCB	–	Cambodia Community Building
COS	–	country operational strategy
CRS	–	Catholic Relief Services
EA	–	executing agency
EIA	–	environmental impact assessment
EMT	–	Ennatien Moulethan Tchonnebat
FIRR	–	financial internal rate of return
GDP	–	gross domestic product
GRET	–	Groupe de Recherche et d’Echanges Technologique
ha	–	hectare
HK	–	Hattha Kaksekar
IEE	–	initial environmental examination
IFC	–	International Finance Corporation
IMF	–	International Monetary Fund
LFI	–	licensed financial institution
MFI	–	microfinance institution
MSD	–	MFI Supervision Division of the National Bank of Cambodia
NBC	–	National Bank of Cambodia
NGO	–	nongovernment organization
OCR	–	ordinary capital resources
PCC	–	project coordination committee
PMU	–	project management unit
RDB	–	Rural Development Bank
SEDP	–	Socio-economic Development Plan of the Government
TA	–	technical assistance
UNDP	–	United Nations Development Programme
UNICEF	–	United Nations Children's Fund
USAID	–	United States Agency for International Development

NOTES

(i) The Government’s fiscal year (FY) ends on 31 December
(ii) In this report, “$” refers to US dollars

CONTENTS

LOAN AND PROJECT SUMMARY

Borrower	Kingdom of Cambodia
Project Description	The Project will support the efforts of nongovernment organizations (NGOs) in delivering reliable and effective rural financial services through a long-term credit line for onlending to agricultural and other income-generating activities of the rural poor. NGOs will be licensed as microfinance institutions under the new regulatory framework of the financial sector, and will provide full financial services in the rural area, including the savings facilities. Under the Project, licensed financial institutions (LFIs) will increase their operational efficiency in financial intermediation by improving their banking skills and financial management, and through increased competition among LFIs and with other financial institutions. A revolving fund will be established in the Rural Development Bank (RDB), a wholesale banking institution, which will channel funds through LFIs to their subborrowers. These funds will be provided for small-scale economic activities in agriculture, agro-processing, trading, livestock, handicrafts, and services by the subborrowers, who are mostly poor people in the rural area.
Classification	Primary: Poverty reduction
Environment Assessment	Category B An Initial Environmental Examination (IEE) was undertaken, and a summary IEE is a core appendix.
Rationale	Cambodia is one of the world's lowest-income countries. About 90 percent of the country's poor people live in the rural areas. The lack of access to reliable financial services is a major constraint to the reduction of rural poverty in Cambodia. No formal financial services exist in the rural areas. Of the country's 24 provinces, 15 have no commercial bank branches. In the provinces where branches exist, they are located only in primary towns. To make up for this deficiency, NGOs have been providing rural households with credit and savings services and have reached about 11 percent of rural households. Most rural households, however, have no access to financial services and rely solely on informal moneylenders and middlemen in agricultural trade, who charge high interest rates, often up to 10 percent per month. Reliance on these moneylenders makes it difficult for the poor to escape from their poverty cycle. Despite the large unmet demand for rural credit, estimated in the range of $50-100 million, the expansion of NGOs' rural credit is being

constrained by the limited sources of financing. Thus, there is a strong need for capital injection and savings mobilization to provide increased access to financial services for the rural poor. The Project supports the operational strategy of the Asian Development Bank (ADB) for steady reduction of poverty in Cambodia, and will contribute to the development of sound regulatory and institutional frameworks, which are essential for sustainable microfinance services in the rural areas.

Objectives and Scope

The primary objective of the Project is to develop effective financial services in the rural areas, which will provide poor households with better access to rural finance. This will be based on a private sector initiative of NGOs that have demonstrated viable systems of credit delivery and achieved substantial outreach. The project scope will include the provision of credit lines to finance income-generating activities of the rural poor, support for rural credit and savings schemes of LFIs, and provision of project management support for the RDB, which will channel funds to LFIs. The Project will cover the operations of LFIs throughout Cambodia, but will be initially implemented mainly in the northwestern, eastern, and southern regions, where the MFIs are currently active.

Cost Estimates

The total cost of the Project is estimated at $26.56 million, including contingencies and taxes. The foreign exchange cost is $13.76 million (52 percent) and the local currency cost is $12.80 million equivalent (48 percent).

Financing Plan

Source	Foreign Exchange	Local Currency	Total Cost	Percent
		($million)		
ADB	13.76	6.24	20.00	75
Government	0.00	2.72	2.72	10
LFIs	0.00	3.84	3.84	15
Total	**13.76**	**12.80**	**26.56**	**100**

Loan Amount and Terms

The equivalent in various currencies of Special Drawing Rights 14,872,000 ($20 million) from ADB's Special Funds Resources, with a maturity of 32 years, including a grace period of 8 years, and an interest charge of 1.0 percent per annum during the grace period and 1.5 percent per annum thereafter to be paid semiannually.

Relending Terms

The Government will provide RDB with lines of credit under a subsidiary loan agreement. It will cover a period of 20 years and include a repayment schedule similar to that between the Government and ADB. The credit lines will be provided to RDB at rates not less than the rate for

ADB's ordinary capital resources, which is currently 6.46 percent per annum, and is considered to reflect a long-term cost of funds.

RDB will onlend funds to LFIs at a rate that covers administrative and financial risk charges appropriate to and calculated for each LFI. The interest spread to be retained by RDB will be initially up to 4 percent per annum. The loan term for LFIs will be for a period of 18 months for the first loan under the Project and may be extended later up to five years, subject to satisfactory performance of LFIs. Interest rates from LFIs to their subborrowers will reflect the prevailing market rates, which will be sufficient to recover LFIs' operating costs to ensure their sustainable activities. These rates are expected to decline rapidly as LFIs improve their operational efficiency and through increased competition among LFIs.

Period of Utilization Until 31 December 2005

Executing Agencies The Rural Development Bank (RDB) and the National Bank of Cambodia (NBC)

Implementation Arrangements RDB will be the Executing Agency (EA) for the credit lines of the Project, assuming overall responsibility for the implementation of microfinance operations, and NBC will be the EA for LFI supervision. RDB will act as a wholesale banking institution to provide funds only to licensed financial institutions including LFIs. ADB funds will pass through the Government to RDB for the credit line and for the expenses relating to project management support for the project management unit (PMU). NBC will assume overall responsibility for the supervision of LFIs through its Microfinance Institution Supervision Division.

Procurement The Project requires the procurement of service vehicles, equipment, and small civil works for RDB. Supply contracts and civil works envisaged under the Project will be limited in size, and will be awarded on the basis of direct purchase or local competitive bidding procedures in accordance with ADB's *Guidelines for Procurement*. RDB should ensure that the goods and services procured are reasonably priced and suitable for the project activities, and that fair canvassing is done in selecting suppliers. With respect to the procurement of goods and services to be made by LFIs and their subborrowers under the Project, normal commercial practices appropriate under the circumstances in the local trade will be applicable.

Consulting Services

A total of 6 person-months of international and 9 person-months of domestic consulting services will be provided under the Project to support the PMU in project implementation. The consultants will be engaged in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for the engagement of domestic consultants.

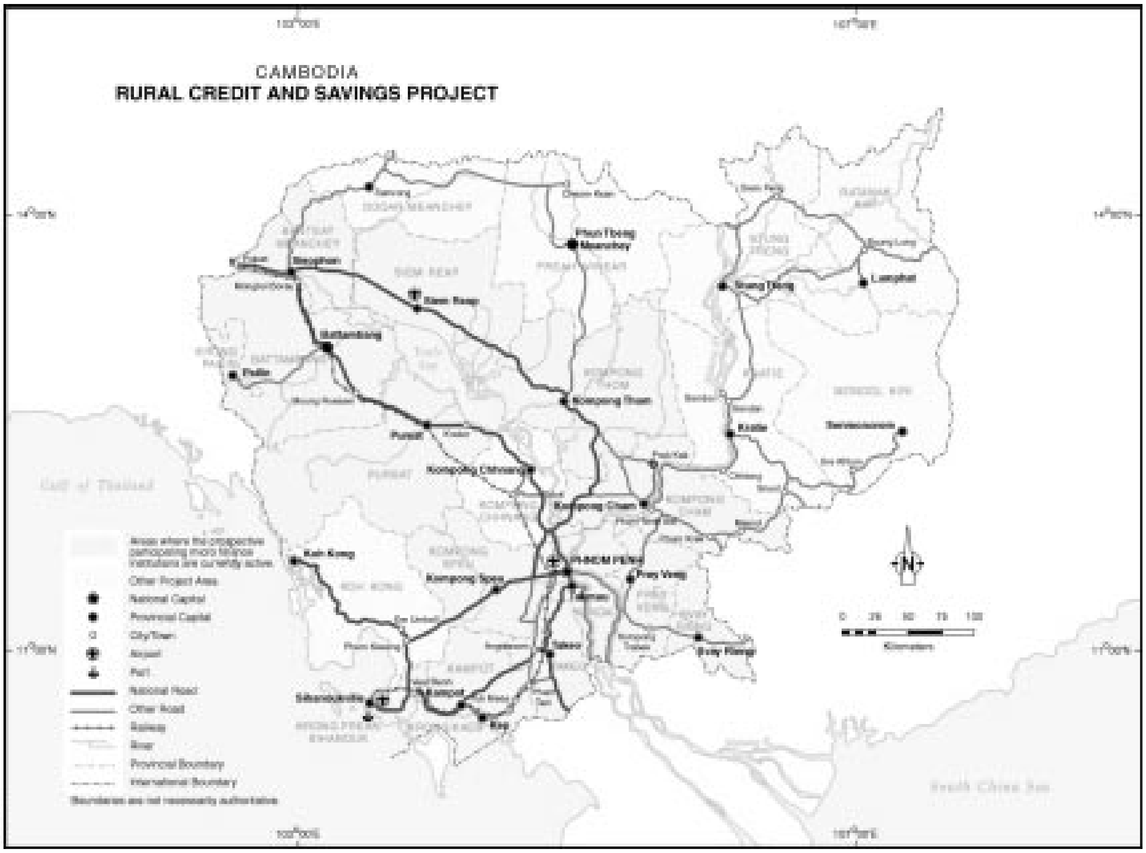
Estimated Project Completion Date

30 June 2005

Project Benefits and Beneficiaries

The Project will contribute substantially to the national goal of poverty reduction through the provision of income-generating activities and sustainable savings facilities for households in the rural areas, where about 90 percent of the poor people live. During the implementation period, the Project is expected to directly benefit about 260,000 rural households. Based on the NGOs' current activities in rural finance, more than 70 percent of these households are expected to be poor households in the rural areas. The subprojects to be financed are viable, with financial internal rates of return in the range of 23-91 percent, and the economic internal rates of return of 13-62 percent. More than 50 percent of the subborrowers are expected to be rural women, who will represent their households and can enhance their households' access to other social services being provided by the prospective LFIs.

The Project will also lay the foundation for the development of the country's formal rural financial system. The system will contribute to the financial deepening through introduction of savings schemes in rural areas, and is expected eventually to integrate with the overall financial sector. The Project will help strengthen LFIs' institutional capabilities for providing sustainable financial services in the rural areas to revitalize rural economy. Throughout the rural development process, the Project will be able to minimize the risk of adverse environmental impact and safeguard and enhance the natural resource base in the country by instilling sound practices for environmental management into LFI activities.


CAMBODIA
RURAL CREDIT AND SAVINGS PROJECT
PHNOM PENH
Battambang
Siem Reap
Kompong Cham
Kompong Thom
Kompong Speu
Kompong Chhnang
Pursat
Prey Veng
Svay Rieng
Kratie
Stung Treng
Kampot
Kep
Takeo
Koh Kong
Sisophon
Pailin
Banlung
Sen Monorom
Phnom Penh
Takhmau
Krong Preah Seihanu
Gulf of Thailand
South China Sea
Kilometers

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on a proposed loan to the Kingdom of Cambodia for the Rural Credit and Savings Project.

II. INTRODUCTION

2. In response to the request of the Government, the Asian Development Bank (ADB) provided technical assistance (TA) to prepare the Rural Credit and Savings Project (the Project) to address the need for effective financial services in the rural area.[1] The TA was implemented from September 1998 to February 1999. A series of participatory workshops were organized under the TA to ensure that key stakeholders, including relevant Government agencies, commercial banks, nongovernment organizations (NGOs), and potential project beneficiaries in the rural areas, were extensively consulted in formulating the Project. ADB fielded a fact-finding mission in March 1999 and an appraisal mission in June 1999[2] to examine the details of the Project. A follow-up consultation mission visited Cambodia in January 2000 to confirm the establishment of the necessary regulatory framework related to the Project. The logical framework for the Project is in Appendix 1.

III. BACKGROUND

A. Sector Description

1. Rural Economy

3. Cambodia's real gross domestic product (GDP) was growing at an average annual rate of 6.7 percent between 1991 and 1996. However, due to the political turmoil in Cambodia and the financial crisis in the region, the real GDP growth declined to 2.6 percent in 1997 and to 1.3 percent in 1998. The main source of the past growth was the industrial sector, which grew at an average rate of 13.8 percent per annum during 1991-1996. By comparison, agricultural growth was rather sluggish at an average rate of 2.7 percent per annum during the same period. This rate of growth was slightly higher than the estimated rate of population growth at about 2.4 percent. As a consequence, the share of agriculture (including livestock, fisheries, and forestry) in the country's GDP declined from 51.8 percent in 1991 to 38.3 percent in 1998. Cambodia is one of the lowest-income countries in the world with its GDP per capita being estimated at $252 at the current exchange rate. In terms of social capacity for human development, Cambodia is now ranked 137th, with its Human Development Index estimated at 0.514.[3]

4. The rural economy is the dominant part of the Cambodian economy with about 85 percent of the population living in rural areas. Poverty incidence is estimated at 36 percent for the whole country and 40 percent for the rural areas based on the reference food bundle,

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[1] TA 2818-CAM: *Rural Credit and Savings Project*, for $600,000, approved on 26 June 1997.

[2] The Mission consisted of M. Otsuka (Sr. Project Economist), H. Pitney (Sr. Counsel), D. Walton (Rural Development Specialist), M. Katagami (Young Professional), D. Lucock, (Rural Credit Specialist – Staff Consultant) and S. Mak (Rural Sociologist – Staff Consultant), and was assisted by the ADB's Cambodia Resident Mission.

[3] United Nations Development Programme (UNDP). 1999. *Human Development Report,* New York.

yielding 2,100 calories per day, and some nonfood allowance.[4] In Cambodia, poverty is concentrated in the rural areas as rural households account for about 90 percent of the poor population in the country. Poverty incidence is particularly high in remote provinces in the northeastern and southeastern regions. Poor households are usually larger in size than the average and are headed by people who are illiterate or have had few years of schooling. Such households are heavily handicapped in terms of (i) ownership of assets, including land, housing and cattle; (ii) access to basic social services such as health, education, and water supply; and (iii) access to financial services.

5. About 20 percent of poor households are headed by women in Cambodia. Households headed by young women with infants are highly vulnerable to poverty and food insecurity due to the lack of access to land, credit, and other agricultural inputs. Commonly cited causes for rural poverty in Cambodia include (i) decades of internal armed conflicts and their consequences, (ii) low agricultural productivity, (iii) high degree of indebtedness, and (iv) inadequate public facilities for social services. Even many of those who are living above the poverty line, live close to it in a near-poverty situation. Due to the importance of rice in people's diet in the country, the availability of rice mainly affects food security and nutrition, and the welfare of the rural population. When there is a bad harvest, rural households need off-farm employment to supplement their income or are forced to borrow money from relatives or informal moneylenders for food. Access to reliable credit and savings facilities are essential to improve the livelihood of poor households in rural Cambodia.

6. Agriculture, which is the primary source of income in rural areas, is generally subsistence-oriented with rice as the dominant crop. Rice is mainly cultivated in areas along the Mekong River and around the Tonle Sap Lake. About 2.1 million hectares (ha) or more than 90 percent of the total cropped area of 2.3 million ha are planted with rice. Other major agricultural crops include maize (44,100 ha), soybeans (30,600 ha), vegetables (29,100 ha), and mung beans (25,600 ha).[5] Rubber and timber have long been the most important export products of Cambodia, but agricultural products are increasingly being traded with neighboring countries. Based on the recent surveys, the average farm size is estimated at 1.10-1.26 ha. However, such national averages mask considerable differences in average farm size between provinces, ranging from 0.55 ha in Kandal Province in the south to 2.10 ha in Mondol Kiri Province in the east. About three-quarters of rural households are also engaged in livestock production.

7. Recent declines in crop yields were mainly caused by irregular weather conditions, particularly rainfall unfavorable for rainfed rice cultivation, and by the shortage of irrigation facilities. Less than 10 percent of the cultivated area in Cambodia is irrigated. The country's annual yield of unhusked rice was estimated at 1.7 tons per ha in 1998. This yield level is considered to be the lowest in the region and has slightly improved from 1.0 ton per ha in 1967. Constraints to the improvement of agricultural productivity include (i) poor conditions of transport infrastructure in rural areas, (ii) inadequate irrigation facilities particularly for rice cultivation, (iii) ineffective agricultural research and extension services, and (iv) lack of reliable and easily accessible financial services. Provision of better access to a package of necessary inputs such as improved seed varieties, fertilizers, and pesticides is also required for increased

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[4] Ministry of Planning, the Royal Government of Cambodia. 1997. *A Poverty Profile of Cambodia*, Phnom Penh. This study was financed by UNDP, the World Bank, and the Swedish International Development Cooperation Agency. A per capita income of about KR1,210 ($0.32) per day is considered to be the poverty line in rural Cambodia.

[5] The Ministry of Agriculture, Forestry and Fisheries, the Royal Government of Cambodia. 1999. *Agricultural Statistics 1998-1999*, Phnom Penh.

agricultural productivity. Nevertheless, there was a slight increase in total rice production, estimated at about 3.50 million tons in 1998 as compared with 3.45 million tons in 1997.

8. Under the Government's liberalization policies and structural reform measures in the past few years, extensive systems for marketing of agricultural inputs and outputs have gradually developed throughout the country. ADB has been supporting the Government in implementing these reform measures under the Agriculture Sector Program,[6] including measures to improve agricultural marketing. There are at least 20 major private fertilizer wholesalers comprising the first tier of the distribution channel. Each wholesaler serves 15–25 retailers in the districts where it operates. Most retailers have a variety of other products to complement their fertilizer business. A similar but a far more complex network has developed for the marketing of agricultural products. There are a wide variety of marketing channels comprising farmers and dealers who have combinations of functions for collecting, milling, storing, retailing, and wholesaling. These input and output trades are efficient as far as physical conditions permit, and the system is flexible, adapting to new opportunities. There is substantial room for the expansion of marketing if adequate credit is available to finance these activities.

2. Rural Financial Services

9. About 40 percent of the country's rural population have no commercial bank branches in their provinces, and, where branches exist, their services are confined to primary towns. Due to remoteness and the high administrative costs involved, commercial banks cannot effectively deliver small-scale financial services, which are required in villages to provide funds for investment in a wide range of economic activities. The demand for these services in rural areas are met by NGOs and individual moneylenders, including relatives, friends, and middlemen in the agricultural trade. Individual moneylenders often charge high interest rates, up to 10 percent per month or equivalent to 120 percent per annum. The lack of reliable financial services is a major constraint to the reduction of rural poverty in Cambodia.

10. Relevant surveys indicate that the credit demand for on-farm and off-farm activities in rural areas is substantial and only partly met, due to the inadequate supply of funds.[7] These surveys were conducted mainly through interviews with farmers, moneylenders, local administration officials, and traders in their areas of operation, and for both group-based and individual business loans. The surveys reported that about 20 percent of the total households in the surveyed areas required group-based business loans and that about 8 percent of the total households need individual loans. Based on the average size of outstanding group-based loans, estimated at about $50 per household, and that for individual loans, at about $300, the total demand for credit in the country is estimated at about $85 million. Other surveys indicated higher figures of $120-130 million. Regarding the supply of rural credit, the socioeconomic survey conducted by the Ministry of Planning indicated that about 30 percent of interviewed households had access to loans from NGOs or individual moneylenders. Assuming that the same proportion of rural households received loans in 1998, about 560,000 households were able to have access to loans. The total amount of agricultural loans provided from these sources was estimated at $8 million while that for off-farm business activities was at $24

[6] Loan 1445-CAM: *Agriculture Sector Program*, for $30 million, approved on 20 June 1996.

[7] Ministry of Planning, the Royal Government of Cambodia. 1998. *Socioeconomic Survey of Cambodia 1997*, Phnom Penh. The surveys undertaken by the Association of Cambodian Local Economic Development Agencies (ACLEDA) in 1998 and Groupe de Recherche et d'Echanges Technologique (GRET) in 1997 were also used for supplementary information.

million. One of the NGOs also estimated that the total supply of rural credit in Cambodia was about $27 million in 1998.

11. Based on these estimates, the total demand for rural credit is likely to be $80-130 million, with the unmet demand of $50-100 million. The medium- to long-term projections for the demand and supply of rural credit will be more complicated because of difficulties involved in estimating the rate of overall economic growth, the need for and the type of investment in rural enterprises, and future business plans of NGOs and commercial banks. However, the demand is likely to grow rapidly in view of the improved political and security situation in the country and the Government's commitment to hasten rural development.

12. The total domestic savings rate in Cambodia was 5 percent of GDP in 1997, which is the lowest in Southeast Asia.[8] The total amount of private savings recently declined due to the political turmoil in 1997 and 1998, and the decline in public confidence in banks. However, the recent ADB study has indicated that there is clearly a strong demand for saving among rural communities if reliable savings facilities are available.[9] The improvement of the overall environment in the financial sector and the expansion of financial services, particularly in the rural area, are essential for savings mobilization in the country. Some NGOs have introduced compulsory savings schemes in conjunction with their credit operations, but are not able to mobilize a substantial amount of savings. Frequently, these savings are considered an additional cost of borrowing due to low interest earnings, which are often lower than the rate of inflation. Some schemes do not have a clear mechanism for the withdrawal of savings and for the ownership of saved funds. There are programs where savings become the property of the community for use in social programs.

13. The current savings schemes of some NGOs accompany their group lending operations and are supported by group borrowers with very small financial transactions. For instance, one NGO introduced a scheme where each borrower was required to deposit KR300 ($0.08) per week so that borrowers could easily practice saving. However, the total amount of savings mobilized in the scheme was so small that the annual cost of administering the scheme was substantially higher than the margin expected from the operation of deposited funds. It is generally accepted among NGOs that, in addition to funds from external funding agencies, domestic resources need to be mobilized through savings schemes to finance the expansion of their credit operations in rural areas. Their savings schemes cannot be confined to their borrowers only. Under the new regulatory framework established in November 1999, NGOs can be converted into licensed financial institutions and can provide both credit and savings services for rural communities. Public confidence in the rural financial services will also be gradually developed. The provision of savings schemes will enable rural households to meet their demand for emergency funds from their savings and to hold liquidity as deposits rather than in the form of non-earning assets such as cash, jewelry, and gold.

3. Financial Sector

14. The banking system in Cambodia was completely destroyed during the Khmer Rouge period. Subsequently, the country had a monobanking system of the National Bank of Cambodia (NBC), operating through its provincial branches. Structural reforms were initiated in 1989 through a Government decree to establish a two-tier banking system by separating the function of commercial banks from NBC, which has been the central bank in Cambodia since

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[8] IN.305-98: *Country Economic Review*, *Cambodia*, 17 December 1998.
[9] TA 2601-CAM: *Rural Credit Review*, for $100,000, approved on 4 July 1996.

then. This decree allowed the formation of private commercial banks as limited liability companies. In 1991, the first private commercial bank was established as a joint venture between NBC and the Siam Commercial Bank of Thailand. Commercial banks operated under the framework of a law on the supervision of financial institutions, which was enacted in August 1992, and a subdecree on supervision of commercial banks approved in November 1992. This legal framework has been replaced by a new, more comprehensive law on banking and financial institutions, which was enacted in November 1999. This new law has introduced more appropriate definitions for banking activities and a refined legal framework for banks. It also allows microfinance institutions (MFIs) to undertake financial operations under the supervision of NBC.

15. At present, 31 commercial banks and 20 provincial branches of NBC are operating. NBC intends to streamline its branches, but the progress has been slow. The total amount of outstanding loans of commercial banks as of the end of December 1999 was estimated at KR751 billion ($198 million). Commercial banks concentrate on credit to trading and services, which comprises 51 percent of their total loan portfolio. Credit for agriculture-related activities accounts for only about 4 percent of total loans outstanding of commercial banks. Since March 1995, banks have been allowed to set their interest rates freely. The Government reconfirmed this policy in conjunction with ADB's Agriculture Sector Program Loan (footnote 6). Interest rates on deposits and lending in local currency are quoted in riel, and the rates on foreign exchange deposits and lending in US dollars. The ranges of annual interest rates on deposits are 4.0–12.0 percent for riel and 3.5–8.5 percent for dollars. For commercial bank credit, the range in interest rates is up to 24.0 percent for 12 months in riel while the range is 16.5–19.0 percent for dollars. Less than 4 percent of the total credit of commercial banks is in local currency.

16. Foreign currencies, mostly the US dollar and to a lesser extent the Thai baht, are commonly used by the public in Cambodia. This was mainly caused by the destruction of the monetary and banking systems during the Khmer Rouge period, and reflects the lack of public confidence in the local currency and the banking system. The use of foreign currencies has somewhat protected Cambodia from the adverse impact of the recent financial crisis in the region. The Government aims at a gradual decrease in the use of the US dollar, only through increased awareness and confidence of the public in the use of the local currency.[10] The progress however is rather slow, and foreign currencies, particularly the US dollar, have a dominant role in the country's economy. The overview of the financial sector is presented in Appendix 2.

4. Operations of Nongovernment Organizations

17. According to a recent report of the Cooperation Committee for Cambodia, which is an association of NGOs in Cambodia, 163 domestic NGOs are registered with the Ministry of Interior and 133 foreign NGOs are registered with various Government agencies. NGOs disburse about $75 million each year for a wide range of their development activities, equivalent to more than 20 percent of the Government's annual budget. The important role of NGOs for the reconstruction and development of the country is increasingly recognized by the public, the Government, and the external funding agencies in Cambodia. Main areas of NGO activities include agriculture and rural development, health, education, water, and sanitation. NGOs are also active in providing assistance to vulnerable groups and in clearing land mines.

[10] The Prime Minister's speech at the NBC's Annual Conference on 24 March 1999.

18. The agenda and the operational strategies of NGOs in Cambodia have changed as the political, social, and economic environment in the country evolved from a planned socialist structure to that of a liberal market system. Most domestic NGOs are small, and often operate in specific geographical areas or sectors in collaboration with international NGOs or external funding agencies. Many domestic NGOs are regarded as adopted, emerging from international NGOs, and receiving support from their parent organizations. But they are increasingly diversifying their operations and becoming less dependent upon a single agency for their operational support. The scope of international NGO operations is more diverse and covers wide geographical areas. The cooperation between the Government and NGOs still consists largely of information exchanges. A mechanism for effective collaboration in development activities is yet to be developed due to the lack of adequate capacity and skills on both sides. However, there is a constructive relationship between the Government and NGOs in development activities based on increasing mutual understanding. NGOs in Cambodia enjoy extensive cooperation with a large number of external funding agencies. Bilateral funding agencies often work directly with NGOs through direct funding to the programs of NGOs or through NGOs' participation in projects financed by such agencies. There are a few sector-based groups of NGOs, for exchanges of information and views, including one for rural credit operations.

19. About 90 NGOs operate rural credit facilities.[11] NGOs have expanded their credit operations to reach about 11 percent of rural households. Most clients of NGOs' credit facilities are poor households in rural areas. These NGOs provide loans to groups, with first-cycle loans to poor people of the same occupation or type of business. Loans are usually provided on a six-month cycle and mostly used for activities related to agriculture and agro-based businesses. Loans for individuals are provided based on the borrowers' performance with their first-cycle loans. The lending rates of NGOs are still high, at flat rates of 3.0–6.0 percent per month or 36.0–72.0 percent annually, reflecting high administrative costs of NGO operations. Smaller credit operating NGOs have compulsory savings requirements where group members control their savings and use these savings for lending among themselves.

20. Major NGOs having credit operations are being monitored by NBC based on the data voluntarily provided by these NGOs with respect to borrowers, loans outstanding, and interest rates. As these schemes of NGOs expand rapidly, a proper system of regulation and supervision urgently needs to be institutionalized to ensure sound financial management and increase public confidence in rural financial services. In this context, NBC introduced in January 2000 a new regulation for licensing and supervising these NGOs as licensed MFIs.[12] The credit and savings operations of NGOs are described in Appendix 3.

B. Government Policies and Plans

21. The Government's medium-term development objectives are set out in its first Socioeconomic Development Plan (SEDP: 1996–2000) with expected public investment programs totaling $2.2 billion. The SEDP is the first medium-term plan in line with the Government's market-oriented policy. The Government considers in the SEDP that poverty reduction is the most important medium- to long-term objective to be focused on the rural areas. The Government's general strategy for poverty reduction in the SEDP aims at addressing aspects of poverty by (i) providing social services in an equitable manner, (ii) ensuring the

[11] In addition, three Government-administered lending programs are financed by the United Nations Children's Fund (UNICEF), the European Union, and the Ministry of Women Affairs.
[12] Circular (*Prakas*) for Licensing of Microfinance Institutions, 11 January 2000.

sustainable pattern of growth and development, and (iii) strengthening domestic self-reliance and reducing dependence on foreign assistance.

22. In line with the SEDP, the Government has formulated a strategic plan for 1997–2001, which describes the sector strategy for agriculture and rural development. Under this strategic plan, the Government aims at (i) improving food security through expanding the production of rice and other food crops, (ii) contributing to economic growth and to increased foreign exchange earnings through agricultural exports, (iii) improving income opportunities for farm households by diversifying crop production, and (iv) adding increased value to crop and livestock production by developing agro-processing industries. One of the strategies to achieve these objectives is to increase the availability of services for loans and savings for farmers and small entrepreneurs through a rural financial system led by the private sector.

23. In December 1998, the Government formulated a rural credit policy and strategy in relation to the Agriculture Sector Program (footnote 6). Its policy statement for rural credit specifically aims to (i) support the expansion of rural credit and savings services by encouraging the entry of MFIs and commercial banks; (ii) strengthen the capacity of NBC to facilitate their supportive roles in promoting rural credit and savings through licensing, regulation, and supervision of MFIs; (iii) make the Rural Development Bank (RDB) a self-sustainable wholesale banking institution with the appointment of banking professionals in its management and board; and (iv) continue to monitor credit activities of NGOs and community-based organizations and encourage their efforts to become licensed MFIs. Subsequently, the Government has prepared a strategy paper for rural credit, which was approved by a meeting of the Council of Ministers on 28 December 1998. The Project has been formulated in line with this policy and strategy of the Government.

24. The Government amended the subdecree and the statute for RDB in November 1999, in line with its policy and strategy for rural finance, and included qualified personnel with adequate banking experience in RDB's senior management. The Government has also taken steps to strengthen NRB's licensing, monitoring, and supervising functions for MFIs.

C. External Assistance to the Sector

25. Since 1992, ADB has provided 12 loans totaling about $374.0 million and 65 TAs totaling about $50.5 million. Three loans since 1995, including a portion of the Special Rehabilitation Assistance Loan,[13] for a total of $65.1 million or about 21 percent of the total committed lending programs, were specifically for agriculture and rural development. Four TAs since 1995 were specifically for credit and savings. ADB is often faced with practical constraints to effective project implementation in Cambodia due to the (i) shortage of skilled people, (ii) lack of Government staff experienced in the preparation and implementation of foreign-aided projects and programs, (iii) inadequate financial resources of the Government, and (iv) lack of understanding of ADB's policies and procedures. These practical issues with ongoing projects are regularly discussed for resolution during project review missions, and at meetings of project managers organized by the ADB's Cambodia Resident Mission. In conjunction with the Project, ADB approved an advisory TA to build institutional capabilities for effective rural financial services.[14] This TA will assist (i) NBC in establishing procedures for licensing and supervising

[13] Loan 1199-CAM: *Special Rehabilitation Assistance Loan*, for $67.7 million, approved on 26 November 1992. A portion of loan proceeds, about $10 million, was allocated for the rehabilitation of irrigation systems and the provision of agricultural inputs.
[14] TA 3270-CAM: *Capacity Building for Rural Financial Services*, for $1.45 million, approved on 7 September 1999.

MFIs and in strengthening its capacity for monitoring and supervision of MFIs; (ii) RDB and MFIs in strengthening their capability in financial management, banking skills, and reporting; and (iii) MFIs in savings promotion and product development. The provision of the TA is based on ADB's recognition that sound institutional development is the key to the establishment of effective and sustainable financial services in the rural areas in Cambodia, and will enhance the Government's policy for rural credit and savings.

26. In the financial sector, ADB provided a TA to enhance professional banking skills through the development of the Center for Banking Studies.[15] This TA aimed at increasing the number of qualified trainers in banking skills and initiating the establishment of a full-fledged and self-sustaining bankers' institute, thereby formulating a firm basis for sustainable development of the financial sector in Cambodia. The World Bank has provided a loan of $18 million to support the development of the Social Fund under the Government's Council of Ministers. The Social Fund has reached 140 districts covering all 24 provinces in the country,[16] and financed more than 1,400 subprojects for water supply, education, health, and village-level infrastructure facilities. These subprojects, with a funding limit of $50,000 for an individual project, are selected based on specific criteria relating to the degree of poverty among the project beneficiaries. The World Bank approved in March 1999 the provision of a follow-up on the Social Fund, in the amount of about $24 million.

27. The United Nations Development Programme (UNDP), in collaboration with the International Finance Corporation (IFC) of the World Bank Group and the United States Agency for International Development (USAID), is supporting an NGO, the Association of Cambodian Local Economic Development Agencies (ACLEDA), to become a formal financial institution and strengthen its capacity to become a financially viable institution to provide rural credit and savings. This assistance to ACLEDA will continue until 2001. ACLEDA plans to become a company with equity participation from IFC and financial corporations in Germany and the Netherlands.

28. The French Agency for Development (AFD) has provided a TA amounting to $4 million through the Government to four NGOs to support their credit operations and assist NBC in formulating regulations and guidelines for sound development of microfinance operations. The TA will continue until 2001. AFD also signed an agreement with the Government in November 1998 for the provision of grant funds of about $1.0 million to finance rubber smallholder development. Of this amount, about $0.8 million will be used for the provision of long-term loans through RDB for rubber plantation by farmers. AFD confirmed that the use of RDB for direct lending to farmers is a temporary measure until a separate fund is established under AFD's project to accommodate this financing facility.

29. The International Fund for Agricultural Development has provided a loan of $8 million for agricultural development in three provinces in northwestern Cambodia. This project will support the agricultural extension services and training, and finance rural credit operations of NGOs in the project area. The total amount of credit is estimated at about $1.4 million provided through NGOs for about 18,000 rural households. The Government will establish a revolving fund at RDB to channel the fund for NGOs. ADB has been conducting dialogue with these donors for closer coordination during the formulation of the proposed Project. Appendix 4 lists the relevant projects and programs of external funding agencies for agriculture and rural development in Cambodia.

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[15] TA 2796-CAM: *Enhancing Banking Skills Project*, for $400,000, approved on 19 May 1997 and completed on 28 February 1999.

[16] These include four municipalities of Phnom Penh, Krong Prean Sihanouk, Krong Kaeb, and Krong Pailin.

D. Lessons Learned

30. In recent years, a number of NGOs have been engaged in rural microfinance programs in Cambodia. These NGOs have demonstrated their capability to provide and expand effective rural financial services if they receive adequate institutional and financial support. Most of these NGOs provide both group lending without collateral to meet the demand for smaller credit and microenterprise loans with collateral requirements. They have achieved substantial outreach within their operational areas. Their average loan recovery rates are generally high, at more than 90 percent. The growth of successful microfinance operations in Cambodia can be attributed to the liberal and market-oriented policy environment that ensured the freedom of market entry and minimal regulatory requirements. The Government is committed to maintaining this policy and encouraging further development of rural microfinance programs.

31. NGOs in Cambodia, which have been successful in rural credit operations, share common characteristics. These are (i) significant outreach within localized areas, (ii) high rates of loan recovery, (iii) an increasingly large loan portfolio that enables overhead costs to be adequately covered, (iv) a high annual rate of growth of the loan portfolio, and (v) a significant transformation toward becoming a domestically managed organization. These successful features have encouraged external funding agencies to increase funds that, in turn, have led to increased efficiency due to a larger scale of activities. On the other hand, the activities of less successful NGOs are often constrained by poorly motivated part-time volunteers, poor management information systems, full or partial reliance on Government assistance, and a de-capitalizing loan portfolio because of poor loan recovery and subsidized interest rates. Any rural credit schemes that provide subsidized loans may bring in distortions in the financial markets and create an unsustainable credit mechanism in Cambodia. It will also undermine the initiatives of NGOs and diminish their outreach in rural areas.

32. Experience in other countries, such as Bangladesh, India, and Philippines, shows that an apex financial institution can provide an effective mechanism with reasonable success to channel funds from the Government and external funding agencies to MFIs for onlending to small-scale borrowers in rural areas. The key factors of such success include the assured autonomy and independence of the apex institution that enabled them to secure its decision making toward self-sustainability and financial viability. Despite the operational objectives for rural development, such institutions need to have freedom in pricing products and choosing their clientele based on the costs and risks of individual transactions. It is also important to have enough MFIs to provide loans to subborrowers and to promote sound competition among such MFIs. The interest rate pricing must be positive in real terms to compensate savers and generate enough profits to realize reasonable returns to the capital and reserve for future investment.

33. Successful rural financial institutions in Asia have strong saving mobilization facilities that sometimes exceed their lending volume. In Cambodia, most cash in circulation is kept outside financial institutions, and there is a strong need for safe and credible saving facilities, particularly in rural areas. Successful savings mobilization requires technical skills to develop saving schemes that correspond well to the needs in the market as well as sound legal and regulatory frameworks that authorize these institutions to take deposits. Sound institutional and regulatory development is essential for the success of sustainable rural financial services. Substantial training programs, technical support, and extension services will initially be required to improve and ensure the long-term sustainability of the MFIs' financial services.

These lessons and experiences have been fully considered in formulating the Project. ADB's TA will provide MFIs with such technical support (para. 25).

34. With respect to implications for poverty reduction, there may be a trade-off between outreach to the poor and financial sustainability of MFIs. Licensed financial institutions, which aim at self-sustainability and are required to meet financial norms, may try to reduce costs by providing larger loans to existing borrowers rather than smaller loans to new borrowers among the rural poor. However, NGOs in Cambodia provide credit to poor people through group lending for their first-cycle borrowing. In this way, successful NGOs are able to expand the number of poor households they serve in the rural area without giving up financial sustainability of their credit operations.

35. The Project will be ADB's first rural finance activity in Cambodia. During the formulation of the Project, lessons learned from ADB's rural finance projects in other countries, including Bangladesh, Indonesia, Nepal, Philippines, and Thailand, have been carefully reviewed and incorporated into the project design. The project performance evaluation reports of these projects indicate that the interest rate must be high enough to ensure the financial viability of lending financial institutions and to guarantee the long-term growth of a sustainable financial system. Subsidized lending at below market interest rates tends to result in the misallocation of scarce resources, encourages misuse of funds, and often reaches the local elite rather than lower-income borrowers. ADB's experience in assisting development finance institutions also suggests that the attainment of managerial autonomy and independence of the financial institutions from governments should be ensured, while simultaneously the internal control and audit functions of the institutions should be strengthened. The greater degree of flexibility in operation and administration helps such an institution to grow into a dynamic and effective financial intermediary.

36. One lesson to be learned from Mongolia, which has also experienced the transition from a monobanking system to a two-tier banking system, is the significance of an overall sector design approach for reforms of financial institutions. The evaluation of ADB's TAs also emphasizes the importance of strengthening the supervisory and regulatory authority at an early stage to maximize the impact of subsequent financial sector reforms and to smoothen the transition process. In this regard, the Project supports the establishment and strengthening of the regulatory and supervisory framework, which is conducive to such a sector design approach. ADB missions were fully involved in the preparation of relevant regulations during the processing of the Project. The Project also envisages the development of a rural financial system through upgrading of NGOs with a view to their eventual interaction with the overall banking sector in the long run.

E. ADB's Sector Strategy

37. In view of the lack of extensive financial services in the rural areas, ADB's rural finance strategy in Cambodia aims at facilitating the expansion of successful experiences of microfinance programs being carried out by NGOs to improve rural livelihoods. There is also a general consensus among major external funding agencies in Cambodia that effective rural financial services can be best established through nurturing the existing activities of NGOs and upgrading them into licensed MFIs. The establishment of a formal rural finance system should be led by the efforts of the private sector, and the state intervention should be mainly confined to the establishment of a sound regulatory and supervisory environment. While a wholesale bank currently channels funds to MFIs in order to support their operations, this should not eliminate the potential for commercial banks to finance MFIs' operations. Rather, the wholesale

banking institution should play a catalytic role and induce other commercial banks to participate in financing MFIs' operations through the demonstration of viability and successful interactions with MFIs.

38. ADB's current country operational strategy (COS) for Cambodia was prepared in November 1995. The major thrusts of the COS include the promotion of economic growth as the principal means for creating employment opportunities and reducing poverty, and the strengthening of capacity for good governance and improved project management through an effective combination of TA and lending modalities. The COS recognizes that agriculture and rural development is the key to sustainable economic growth of Cambodia. In this context, it is essential to achieve the substantial improvement of agricultural productivity through (i) a shift from solely subsistence-oriented farming to the introduction of market-oriented, commercial production; (ii) the promotion of private sector participation in input supply, product processing, and marketing; (iii) improvement in agricultural research and extension services based on a client-oriented strategy; (iv) the provision and proper maintenance of critical infrastructure for rural transport, irrigation, and drainage; and (v) the provision of adequate rural financial services. The ADB's Agriculture Sector Program (footnote 6) has been supporting these aspects in Cambodia.

39. The new COS will be formulated in 2000. Its overall strategic objective will be poverty reduction through economic growth. The new COS will be based on the reassessment of means by which the ADB's operational strategy is to be implemented, taking into account the priorities of the new Government, the present absorptive capacity of the country, and ADB's operational experience in Cambodia. ADB is also formulating a microfinance development strategy to achieve its objective of poverty reduction through effective and consistent support for the expansion of microfinance activities. The Project has been prepared in line with this approach through the expansion of MFIs' outreach to the poor.

40. Major external funding agencies involved in rural credit in Cambodia share the same concern about the financial sustainability of MFIs. Further cooperation with other external funding agencies is vital to maintaining a favorable environment for NGOs to be transformed into licensed MFIs and strengthened. ADB will continue its collaboration with other external funding agencies in relation to the Project.

F. Policy Dialogue

41. ADB's dialogue with the Government, which has evolved since the commencement of ADB-financed TAs and has continued during the preparation of the Project and the implementation of the Agriculture Sector Program (footnote 6), has resulted in the formulation of the Government's new rural credit policy and strategy, which were approved in December 1998. The new policy aims at supporting the expansion of rural credit and the introduction of savings schemes in rural areas by encouraging the licensed microfinance establishments to enter rural finance. Since then, there have been rapid and notable developments in establishing a working relationship among the Government, NBC, and NGOs, which is favorable for the promotion of viable MFIs. The Project has been formulated in line with the new Government policy. The dialogue on the Government's policy of rural finance will continue during project implementation.

42. ADB recognizes the importance of establishing sound legal and institutional frameworks for the sustainable development of rural financial services in the long run. The new law on banking and financial institutions and NBC's regulation for the licensing and supervision

of MFIs provide the basic regulatory framework for rural finance in Cambodia (para. 14). NBC had active consultations with the relevant parties, including NGOs, before finalizing the regulation. ADB missions were fully involved in this process. These undertakings have also been supported by the International Monetary Fund, which is helping the Government strengthen the overall financial sector. NBC will ensure that a set of prudential rules relevant for MFIs will be implemented in accordance with NBC's regulations, for a transparent and enabling operational environment for MFIs.

43. With respect to the institutional set-up relating to the Project, ADB has been engaged in a dialogue with the Government and NBC. RDB's senior management and the board of directors have been changed to introduce adequate knowledge and skills in commercial banking into RDB's management. ADB considers that these changes will form a critical basis for effective project implementation. In addition, strengthening of the institutional capabilities of NBC, RDB, and the prospective MFIs is urgently required for promoting financial services in the rural area. Strengthening of NBC's capability to supervise MFIs will be particularly important after the regulatory framework for the licensing and supervision of MFIs is introduced. ADB is providing an advisory TA to help establish the framework (para. 25).

IV. THE PROPOSED PROJECT

A. Rationale

44. The Project will help fill the need for increased access by Cambodia's rural poor to reliable and effective financial services. About 90 percent of the country's poor live in rural areas, which have no reliable and effective financial services. There are no branches of commercial banks in 15 of Cambodia's 24 provinces. People often need to travel to Phnom Penh for financial transactions. To make up for this deficiency, NGOs have been providing rural households with credit and savings services and have reached about 11 percent of rural households. Most rural households, however, have no access to effective financial services and rely solely on relatives, informal moneylenders, and middlemen in agricultural trade, who charge high interest rates. Poor households in the rural areas are particularly handicapped in this regard. The lack of access to reliable financial services is a major constraint to the reduction of rural poverty in Cambodia. The need to resort to moneylenders also makes it difficult for the poor to escape from the poverty cycle. The Project will build upon the efforts of NGOs to provide rural poor households with increased access to effective financial services.

45. Despite the large unmet demand for rural credit (paras. 9-11), the expansion of NGOs' rural credit is now being constrained by the limited availability of sources of financing. Since nonlicensed financial institutions cannot take in savings from the general public, the deficiency in monetary resources severely constrains the credit operations of NGOs, which need to mobilize savings to finance the expansion of their loan portfolios in rural areas and provide rural households with better and more profitable access to liquidity.

46. The project financial intermediaries will operate close to the communities they serve. A number of better performing NGOs have expressed strong interest in (i) expanding their services to cover both credit and savings services, and (ii) becoming licensed as MFIs. Through an improved regulatory and supervisory environment, and enhanced governance and operational efficiency, these MFIs will be able to attract and service broad-based savings and to increase their borrowings from commercial banks to allow for further expansion.

B. Objectives and Scope

47. The primary objective of the Project is to develop effective financial services in the rural areas, which will provide poor households with better access to rural finance. The Project will support the activities of NGOs that have demonstrated viable systems of credit delivery and achieved substantial outreach. As seen in the pattern of NGOs' lending activities, most subborrowers are from poor households in the rural area. More than 50 percent of the subborrowers are expected to be women representing their households. ADB's operational strategy for rural development emphasizes the need for steady reduction in poverty as a major objective. The Project will help achieve this objective by providing the rural poor with increased access to rural financial services. The Project will support ADB's operational strategy and contribute to the development of sound regulatory and institutional frameworks for the expansion of microfinance services in the rural areas.

48. The Project scope will include (i) microfinance for agricultural and microenterprise subprojects, (ii) operational support for licensed financial institutions (LFIs), including MFIs,[17] and (iii) project management support for RDB. The Project will cover the rural credit and savings operations of the prospective MFIs over the whole country but will initially be implemented mainly in the northwestern, eastern, and southern regions, where the prospective MFIs are currently active.

49. Under the Loan, the Government will provide to RDB lines of credit totaling about $19.0 million equivalent. The credit lines will primarily be financed with proceeds of the ADB loan and used for onlending to agricultural and nonfarm income-generating activities of rural subborrowers and for investment. The loan proceeds will be passed on to RDB under a subsidiary loan agreement between the Government and RDB, which will onlend these funds as a wholesaler to LFIs. These credit lines will be provided both in riels and in US dollars. Based on the interest expressed by MFIs, it is expected that subsidiary loans from the Government to RDB will be equally divided into riel and US dollars. Disbursement of credit funds will take into account the recovery of loans from subborrowers in previous years and LFIs' loan programs as defined in their business plans. The indicative types of major activities to be financed by these lines of credit include agricultural production, retail trading, pig raising, rice milling, silk weaving, brick making, and small-scale irrigation. The average loan size is expected to be about $100. LFIs, including at least five MFIs, will be serving about 260,000 rural households with about two loans per household on average by the end of the project implementation period.

50. LFIs will fund about 15 percent of the total credit for subborrowers out of their own resources and savings they mobilize. RDB will assess savings schemes of LFIs and assist them in improving their services. RDB will only allow LFIs to have access to loan funds under the Project if they are able to implement a sound savings program. Such savings programs will be community based and need not be dependent on or generated from subborrower groups only. Although some NGOs in Cambodia operate compulsory savings schemes among their group members, the experience of most NGOs indicates that the administrative costs for small-volume compulsory savings schemes are too high to be sustainable.

51. A revolving fund for the Project will be established within six months of loan effectiveness, and maintained by RDB to credit funds generated from repayments made by

[17] An NGO will be licensed as a specialized bank engaged in rural finance, which is allowed to have a wider range of financial activities than an MFI.

LFIs. These funds will be used for onlending to LFIs in accordance with the Government's subsidiary loan agreement with RDB. Subborrowers will receive loans as members of groups for their first borrowing. First loans from LFIs to subborrowers under the Project will be about KR200,000 ($53) for terms of up to one year. Subsequent loans will be for larger amounts up to about KR2.0 million ($526) for group borrowers for longer terms as needed. The terms and conditions for loans for individual subborrowers will be determined based on the assessment of individual applications. Based on current patterns, about 80 percent of the lending will be for activities relating to rural livelihoods, including agricultural production, petty trading, pig raising, and small-scale irrigation, with the remainder for food processing and light manufacturing undertakings. The average recovery rate for loans to subborrowers is expected to be more than 90 percent. LFIs will be required to adopt prudent policies for holding a reasonable amount of cash under NBC's regulations and supervision.

52. The credit lines under the Project will also finance LFIs' investment requirements, amounting to about $1.1 million, for the procurement of service vehicles, equipment, and civil works to establish and rehabilitate their branch offices. The equipment to be procured by LFIs will include computers and other office equipment to facilitate the computerization of financial management between their head offices and branches, and safes to hold cash needed to assure depositors of access to their savings. This will strengthen the capability of LFIs in liquidity management and promote the development of their savings schemes based on a broader range of depositors than their group-based borrowers alone. LFIs will be able to develop savings schemes after they are licensed by NBC. The LFIs are required to expand their savings schemes under the Project. Such schemes will initially include facilities for small-scale savings deposits and for deposits to meet medium- and long-term investment needs.

53. The Project will also support RDB for its project implementation through the provision of service vehicles, office equipment, and consulting services. Adequate funds will also be provided to meet incremental operating costs, including expenses for benefit monitoring and evaluation activities of the Project. Such support will be provided for RDB's project management unit (PMU) through the Government's annual budget procedures.

C. Cost Estimates

54. The total cost of the Project is estimated at $26.56 million, including physical and price contingencies, and the interest on the ADB loan during project implementation. Contingencies are provided for the component of project management support only. In view of a large share of imported products to be purchased for retail trading and for agricultural inputs by the subborrowers, the proportion of the direct and indirect foreign exchange costs of the credit line for microcredit is estimated to be about 50 percent of the total amount required for credit funds. The total foreign exchange cost of the Project is estimated at $13.76 million or 52 percent of the total project cost, and the local currency cost at $12.80 million equivalent or 48 percent of the total cost. Project cost estimates are summarized in Table 1, and details are shown in Appendix 5.

Table 1: Summary of Project Costs
($ million)

Component	Foreign Exchange	Local Currency [a]	Total Cost	% of Total Base Costs
A. Base Cost				
1. Microcredit for Subprojects	12.16	12.16	24.32	94
2. Operational Support for LFIs	0.78	0.34	1.12	4
3. Project Management Support	0.25	0.22	0.47	2
Subtotal	**13.19**	**12.72**	**25.91**	**100**
B. Contingencies				
1. Physical	0.10	0.06	0.16	1
2. Price	0.05	0.02	0.07	0
C. Interest Charge	0.42	0.00	0.42	2
Total Cost	**13.76**	**12.80**	**26.56**	**103**
Percent	52	48	100	

[a] Includes taxes and duties of about $0.26 million equivalent.

D. Financing Plan

55. It is proposed that ADB will provide a loan of $20.0 million from the Asian Development Fund. The loan will be from ADB's Special Funds resources with a maturity of 32 years, including a grace period of 8 years, and with an interest charge of 1.0 percent per annum during the grace period and 1.5 percent per annum thereafter. ADB will finance the entire foreign exchange costs of the Project and 49 percent of the local currency costs. This is necessary in view of the Government's fiscal constraints and its difficulties in mobilizing domestic revenue effectively, which averages about 8 percent of GDP. The Borrower will be the Kingdom of Cambodia. The balance of about $6.6 million will be financed by (i) the Government, mainly in the form of equity for RDB and expenditures to support RDB's project management; and (ii) LFIs. There will be little or no cash contributions from subborrowers, who will use their family labor in their subproject activities. The amount of family labor will vary depending upon the type of subprojects to be financed under the Project, which will be determined during project implementation.[18] The financing plan is summarized in Table 2 and details are presented in Appendix 5.

[18] For instance, based on the experience of NGOs' credit operations, the average contribution of family labor in an agricultural subproject, expressed in the market wage rate, is estimated at more than 40 percent of the total cost while that for pig raising at less than 5 percent.

Table 2: Financing Plan
($ million)

Source	Foreign Exchange	Local Currency	Total Cost	Percent
ADB	13.76	6.24	20.00	75
Government[a]	0.00	2.72	2.72	10
LFIs	0.00	3.84	3.84	15
Total	**13.76**	**12.80**	**26.56**	**100**

[a] Includes contributions to the credit lines and project management.

E. Implementation Arrangements

1. Project Organization

56. RDB will be the Executing Agency (EA) for the management of the Project and the microcredit component of the Project, assuming overall responsibility for the implementation of microfinance operations, and NBC will be the EA for LFI supervision. RDB has been designated as the EA for microfinance operations in view of the Government's policy for rural credit and savings, and recent improvements in its managerial capability. RDB established a PMU and appointed a project manager in July 1999. The PMU has five officers, including the project manager, and supporting staff.

57. The Government will also establish a project coordination committee (PCC) with a chairperson at least at the level of undersecretary from the Ministry of Economy and Finance. The PCC will be established as soon as practicable but, in all events, within three months of loan effectiveness. The PCC will meet at least twice yearly and function as a central-level coordination body to support project activities by providing overall policy guidance and directions for project implementation, and by helping to resolve any outstanding issues. Members of the PCC will include representatives of NBC; RDB; the Ministry of Rural Development; the Ministry of Agriculture, Forestry, and Fisheries; and LFIs participating in the Project. The PMU's project manager will act as the PCC's secretary.

58. RDB will act as a wholesale banking institution to provide funds to LFIs. Some financial transactions have taken place between RDB and NGOs since the end of 1998. RDB has provided loans, amounting to a cumulative total of $1.1 million, to NGOs and commercial banks for their microcredit operations. Based on the present performance and their interest in having access to project funds, a number of NGOs have been initially identified as potential LFIs participating in the Project. In the first and second years of the Project, five prospective LFIs are expected to borrow funds from RDB, including ACLEDA, Ennatien Moulethan Tchonnebat, Cambodia Community Building, Hattha Kaksekar, and a group of NGOs assisted by the Catholic Relief Services (an international NGO). These prospective LFIs are domestic NGOs registered with the Ministry of Interior. The Government will provide the proceeds of the ADB loan to RDB for the credit line under a subsidiary loan agreement and for expenses relating to project management support for the PMU through normal budgetary procedures.

59. RDB, as an EA, will comply with the following requirements unless the Government and ADB otherwise agree:

(i) satisfactory completion of an audit and full compliance with recommendations in the audit;

(ii) full compliance with bank regulations and the reporting requirements set by NBC on its financial performance; and

(iii) lending activities only to LFIs.

RDB's performance as the EA will be fully reviewed during a comprehensive midterm review (para. 74).

60. NBC will assume overall responsibility for the supervision of MFIs through its MFI Supervision Division (MSD).[19] A manager will be appointed to head MSD. NBC will act as an EA responsible for MFI supervision under the Project in view of the crucial importance of establishing the right regulatory and supervisory framework for MFIs. NBC's Bank Supervision Department has recently integrated into MSD its Supervision Office of the Decentralized Banking System, which handled projects of the four NGOs financed by the French Agency for Development (AFD). NBC will compile monthly reports on the financial status and microfinance operations of MFIs. NBC's Bank Supervision Department will also be responsible for monitoring and supervising RDB according to NBC's bank regulations. An organization chart for the Project is in Appendix 6.

61. In view of the importance of capacity building for sound institutional development, ADB approved an advisory TA project (para. 25) to strengthen the technical and managerial capabilities of key institutions involved in rural financial services. NBC is an EA for this TA, which will be implemented for three years starting in early 2000.

2. Licensed Financial Institutions

62. The Project will include financial institutions that are able to develop and provide sustainable microfinance services in rural areas. These institutions are mainly NGOs that will be licensed by NBC as financial institutions. They will develop plans that are for the duration of the Project and that set out the locations of service outlets, numbers of potential borrowers, loan volumes, and required financing for each year within the long-term plan. All information will be supported by complete and audited financial statements. RDB will review these plans twice yearly and, in consultation with the concerned institutions, enter into a loan agreement with each institution on a separate and individual basis. LFIs will provide rural credit and savings services on a full cost recovery basis.

63. The criteria for an LFI's participation in the Project and continued eligibility will be as follows:

(i) The LFI must acquire an operating license from NBC, and maintain full compliance with the NBC's relevant regulations, circulars, and reporting requirements. NBC's regulation for licensing MFIs includes, among others,

[19] NBC's Bank Supervision Department was reorganized in January 2000 with the creation of a division for the supervision and licensing of specialized banks and MFIs.

(a) a minimum registered capital of KR250 million ($65,000), (b) a minimum capital adequacy ratio of 20 percent between eligible capital and weighted risks, (c) a minimum liquidity ratio of 100 percent, and (d) loan commitments to an individual subborrower below 10 percent of the net worth of the LFI.

(ii) The LFI must have had at least two years of experience in credit operations, with the average loan recovery rate of more than 90 percent, and adequate staff strength and skills for the appraisal of loan applications from subborrowers.

(iii) The LFI must achieve the savings mobilization targets established by the Project. As a percentage of loan portfolio, these will be 5.0 percent by the end of the third year of participation.

64. To participate in the Project, NGOs will need to become legal entities. Under the current legislation, this is likely to mean that an NGO will become a corporate entity such as a limited liability company. To register as an LFI, a company must (i) issue a prospectus, (ii) identify initial shareholders, (iii) appoint a board of directors and officers, (iv) establish memoranda or articles of association, (v) hold an initial general meeting, and (vi) issue shares. The company may then apply to NBC for a license as a financial institution, following prescribed procedures. NBC’s licensing procedures for an NGO will take at least five months. The prospective LFIs, which are expected to participate in the Project, started preparatory activities in 1998. Participation of an LFI in the Project will be subject to ADB approval.

65. All LFIs will be responsible to RDB for the repayment of funds borrowed from RDB in accordance with appropriate agreements to be entered into with RDB. The agreements will provide that if an LFI fails to comply with the criteria in para. 63 for at least six months, RDB may require the LFI to accelerate its repayment of outstanding loans to RDB. The criteria have been explained to RDB and the prospective LFIs at the workshops organized during project preparation.

3. Relending and Onlending Arrangements

66. The Government will make the proceeds of the ADB loan available to RDB in riel and US dollars for credit lines under a subsidiary loan agreement. The subsidiary loan agreement between the Government and RDB will cover a period of 20 years and include a repayment schedule similar to that between the Government and ADB. The cost of funds to RDB will be at a rate not less than the ADB's ordinary capital resources (OCR) rate, which is currently at 6.46 percent per annum. The OCR rate is considered because (i) RDB is a financial institution and should pay a rate not less than a long-term rate reflected in the OCR rate, (ii) the interest rates quoted in riel do not adequately reflect the long-term cost of funds in view of the current position of riel, and (iii) it will accommodate a fee for the Government to assume any foreign exchange risk.

67. RDB will onlend funds to LFIs at a rate that covers the administrative and financial risk charges appropriate to and calculated for LFIs. The interest spread to be retained by RDB, including these charges, will be initially up to 4 percent per annum. Any change in the spread to be retained by RDB will be subject to approval of the Government and ADB. The loan term will initially be 18 months and may be extended up to five years, including a grace period of up to one year, subject to satisfactory performance of the LFI. RDB will maintain a project revolving fund that fully accommodates and accounts for all project-related disbursements to and principal repayments from LFIs. The revolving fund will be kept as a long-term source of

funds available to LFIs to satisfy their needs for expansion and provide back-up liquidity support.

68. Interest rates on lending by LFIs to their subborrowers will be calculated and determined by each LFI at a rate sufficient to recover all operating expenses including administrative costs, loan losses, and costs of funds. This rate will be affected by the efficiency of the LFI and the average size of loans. Based on the cost of funds from RDB at about 11 percent per annum, the expected administrative costs of 15-30 percent and a loan loss provision of 3-6 percent, the onlending interest rates of loans to subborrowers are expected to be within a common range of 30-40 percent per annum or flat rates of 2.5–3.3 percent per month. These rates are significantly lower than the currently prevailing interest rates charged by moneylenders. The repayment term of loans under the Project is usually 6 months, with a maximum term of 18 months. The maximum size of a loan to a subborrower will be $6,500 equivalent in line with the NBC's regulation for licensing MFIs, although the average loan size under this Project will be $100. The interest rates charged to subborrowers are expected to decline as RDB and LFIs improve their operational efficiency and through increased competition among LFIs. These rates will be regularly reviewed by the Government, ADB, NBC, and RDB. Lending to groups will not have collateral requirements while larger individual loans will require collateral in accordance with the policy of each LFI. These relending and onlending arrangements have been discussed with NBC, RDB, and the prospective LFIs at the workshops organized during project preparation, and have been generally accepted by the concerned parties.

69. Relending from the Government to RDB for the credit line in US dollars will also be covered in the subsidiary loan agreement between the Government and RDB for a period of 20 years. The annual interest rate charged to RDB will be not less than ADB's OCR rate, which is considered to reflect the long-term cost of funds in view of the current financial market in Cambodia. Taking into account the administrative cost and risk factor for lending to LFIs, an appropriate interest spread to be retained by RDB will initially be up to 4 percent per annum. The repayment terms of loans for LFIs will be similar to those for the loans in riel.

4. Participation of Subborrowers

70. Subborrowers will continue to be selected in accordance with the policies and selection criteria of individual LFIs with respect to the subborrowers' business plans, socioeconomic awareness, entrepreneurial capability, and household income. Poorer households are usually given priority in the selection since poverty reduction is the most important agenda item of the prospective LFIs. New subborrowers will be developed by LFIs through group lending for their first-cycle borrowing. NGOs, which are currently operating microfinance schemes in Cambodia, have developed their own credit policies and procedures with technical support from external funding agencies. Some of them have comprehensive credit manuals. Selection procedures usually include individual interviews, group meetings, community meetings, and home visits. Credit officers and agents of these NGOs examine the income and expenditure patterns and business plans of the prospective subborrowers to assess their loan applications. NGOs in Cambodia recognize the importance of proper screening and selection of subborrowers and subprojects. They know that rigorous lending criteria will ensure viable and sustainable financial intermediation, and the development of cost-effective savings schemes. Loan proceeds will be used to finance subprojects for the subborrowers' income-generating activities, which contribute to agriculture and rural development.

5. Project Performance Monitoring

71. RDB will be responsible for monitoring and evaluating project performance. During the preparation of the Project, extensive social surveys were conducted in accordance with ADB's *Guidelines for Incorporation of Social Dimensions in Bank Operations*. This information will provide the benchmark information for the Project. Such information includes the characteristics of the prospective subborrowers, clientele needs and demands, capacity for on-farm and off-farm business activities, roles of men and women, and access to financial services. An appropriate monitoring and evaluation system will be established at the PMU to track the progress of project implementation. With assistance from consultants recruited under the Project, RDB will regularly collect and compile from LFIs information on (i) the number of subborrowers, (ii) the amount of loans to subborrowers outstanding with LFIs, (iii) disbursement and recovery of loans to subborrowers, (iv) savings mobilized, and (v) performance of subprojects financed by loans from LFIs. This information will be used to monitor the progress of project implementation and to determine whether the Project's original purposes are being achieved.

72. In addition to the progress of project implementation, RDB will assess the Project's impact based on data and information received from participating LFIs. Detailed benchmark information on the subborrowers with respect to their income levels, types of jobs, and poverty incidence will be collected and compiled from LFIs. The reporting formats for monitoring performance of the Project will be developed at project inception and in accordance with ADB's recent publication on the project performance management system. Enumerators will be recruited by the PMU as required under the Project.

6. Project Implementation Schedule

73. The Project will be implemented over five years. Project completion is expected in June 2005. Initial activities will include the appointment of the project management staff of the PMU and the MFI supervision staff of MSD; procurement of service vehicles, equipment, and small civil works for PMU and LFIs; staff training; and the establishment of management information systems for PMU, MSD, and LFIs. The project implementation schedule is summarized in Appendix 7.

7. Comprehensive Midterm Review

74. The Government and ADB will jointly carry out a comprehensive review upon the earlier of (i) two years after loan effectiveness, or (ii) an initial amount equivalent to at least $5 million is disbursed. The review will cover all parameters used for assessing project performance and impact, and will critically examine (i) the progress of loan disbursement; (ii) the performance of the EAs; (iii) the participation and performance of LFIs and subborrowers; (iv) adequacy of the project implementation arrangements; (v) the project implementation schedule, and procedures; (vi) the viability of subprojects; and (vii) the project impact. Based on the outcome of the review, ADB will decide on the future course of project activities.

8. Procurement

75. The Project requires the procurement of service vehicles, equipment, and small civil works for RDB. Supply contracts and civil works envisaged under the Project will be limited in size and not more than $100,000. These contracts will be awarded on the basis of direct

purchase or local competitive bidding procedures in accordance with ADB's *Guidelines for Procurement*. RDB should ensure that the goods and services procured are reasonably priced and suitable for project activities, and that fair canvassing is done in selecting suppliers. The procurement for LFIs, including service vehicles, office equipment, and safes to be delivered to their district branches, will be done under loans provided from RDB to LFIs, and will be reasonable and cost effective under the circumstances. Procurement of goods and services by the subborrowers under funds onlent from LFIs under the Project will be done through normal commercial practices appropriate to the local trade, in view of the large number of small procurement items. Fair competition and pricing among suppliers are expected in local markets where subborrowers usually purchase inputs and materials for their subprojects.

9. Consulting Services

76. Consulting services will be provided to support the PMU in project implementation. The consultants will include an individual international consultant in accounting information systems for six person-months, and a domestic consultant in monitoring and evaluation for nine person-months. The consultants will develop an appropriate monitoring and information system in the PMU. The consultants will be engaged in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for the engagement of domestic consultants. The outline terms of reference are included in Appendix 8.

10. Disbursements

77. The Government will establish an imprest fund account immediately after loan effectiveness for the disbursement of loan proceeds for credit and for payments to suppliers and contractors under the Project. The imprest account will be operated in accordance with ADB's *Loan Disbursement Handbook*. Advances to the imprest account will be made based on RDB's projected expenditures. The imprest account will be liquidated and replenished according to ADB's statement of expenditures procedures. The Government contribution for project management support will be provided through its annual budget procedures.

11. Reports, Accounts, and Audit

78. At present, NGOs and commercial banks follow the reporting systems of their major external funding agencies or foreign shareholders. RDB operates a dual accounting system to satisfy the Government as the owner and NBC as the supervisor. There is no universal use or acceptance of a standardized chart of accounts among NGOs or banks. NBC intends to obtain fair and true presentation of financial statements of the financial institutions under its supervision by requiring that auditors of banks (i) are acceptable to NBC, and (ii) conform to the regulations on loan classification and loss provisions.

79. Under these circumstances, NBC faces difficulties in making accurate comparisons on the performance of banks and NGOs due to the differences in reporting and accounting formats and practices. In this regard, NBC plans to develop and require financial institutions to use a standard chart of accounts within a few years. Since LFIs will have relatively simple accounting and management information systems, it is feasible and desirable to introduce and implement a standardized chart of accounts among LFIs. This should be done within three years of project inception in consultation with the Ministry of Economy and Finance, and NBC. Some NGOs have already introduced the generally accepted accounting standards and procedures with the assistance of bilateral funding agencies, and are considering improving their use of these procedures to meet international standards.

80. The PMU will establish and maintain a separate account for expenditures under the Project in accordance with the generally accepted accounting procedures in Cambodia. All financial transactions for the Project will be recorded separately in the project account in a manner that allows identification of expenditures on the project facilities provided under the loan. The project account and the revolving fund account, which will be established to credit repayments from MFIs, should be audited annually by external auditors satisfactory to ADB. Local subsidiaries of internationally reputable accounting firms are available in Cambodia. RDB's financial statements are being audited annually by one of such firms. RDB and NBC, through the PMU and MSD, will submit to ADB certified copies of the audited accounts and financial statements in the English language within nine months after the end of each fiscal year. Audited accounts and financial statements of LFIs participating in the Project will be submitted to ADB upon request.

81. The PMU and MSD will furnish to ADB and the Government quarterly progress reports on project implementation in a form and a level of detail that is satisfactory to ADB before the end of the month following the quarter under review. These reports should include (i) information on the progress of project implementation, (ii) implementation issues encountered and measures adopted for resolution, and (iii) assessment of project goals and purposes achieved. The PMU's quarterly progress reports should also indicate detailed records and quarterly projections on operations and performance of LFIs under the Project. MSD's quarterly progress reports should include information on the overall financial status of LFIs and other matters relating to the financial sector in Cambodia. The PMU and MSD will also prepare and furnish to ADB and the Government project completion reports in accordance with the terms of reference to be agreed between the Government and ADB within three months of the loan closing date or such later date as ADB may agree.

F. The Executing Agencies

1. The Rural Development Bank

82. RDB was created by a Government subdecree in January 1998 with an initial capital of KR10 billion ($2.6 million) provided from Government resources. Its paid-up capital was increased to KR18.9 billion ($5.0 million) in March 2000. RDB was issued a commercial bank license by NBC in June 1998. Under the new law on banking and financial institutions, RDB will be licensed as a specialized bank engaged in rural finance. RDB's statute was revised in November 1999, and includes as its duties (i) provision of financing or refinancing facilities for MFI and commercial banks involved in rural finance, (ii) collaboration with other commercial banks for agriculture and rural development, (iii) negotiation with external funding agencies for adequate resources to support credit operations for agriculture and rural development, and (iv) provision of technical support and training for microfinance institutions.

83. The amended subdecree and statute of RDB accommodate the participation of private commercial banks in the management of RDB in line with the Government policy for rural finance issued in December 1998. RDB's board of directors now includes representatives of the Government, commercial banks, and LFIs. At present, RDB has a total of 25 staff members, including 6 with banking experience. Four officers in RDB's Credit Department are processing and appraising loan applications.

84. Since late 1998, improvements in RDB's management and operations have included (i) the cessation of all retail lending activities; (ii) the amendment of the subdecree and the statute

for RDB being solely engaged in wholesale lending; (iii) the decision to include representatives of private commercial banks and NGOs on its board of directors; and (iv) the recruitment of staff with experience in banking, NGO operations, agriculture, and industry. RDB also has a professional accountant and a lawyer. These improvements in RDB's institutional capability are expected to be enhanced under an ADB-financed TA (para. 25). RDB has also demonstrated a significant degree of autonomy by (i) using a different system for staff salaries from that of civil servants, and (ii) rejecting a request from a Government ministry for a loan to expand its public lending program. This autonomy has been confirmed in the amended subdecree and statute. The financial viability of RDB is essential for its sustainable operations.

85. RDB will borrow funds under the Project based on a subsidiary loan agreement with the Government, and will onlend funds to LFIs at an interest rate that allows for cost recovery relating to credit. The amount of loans to be disbursed to LFIs will be decided by RDB but subject to NBC regulations. The financial risk of onlending to LFIs will be borne by RDB, which will be required to maintain a sound financial structure and performance under the NBC's supervision. RDB is described in detail in Appendix 9.

2. The National Bank of Cambodia

86. In January 1996, NBC became an autonomous central bank with a board of directors responsible for establishing operational policies and issuing decisions, regulations, circulars, and other directives. NBC supervises the banking system and is the banker for the Government. NBC has four organizational areas: (i) the General Cashier, (ii) the General Direction, (iii) the General Secretariat, and (iv) the General Inspection. As of the end of December 1998, NBC's management and staff totaled 1,075 people with 425 in the provincial branches and 87 in the Foreign Trade Bank, which is still managed by NBC.

87. Bank supervision is one of NBC's most important activities. Its Bank Supervision Department was reorganized in December 1999, and now has four divisions, for (i) off-site inspection of commercial banks; (ii) on-site inspection of commercial banks; (iii) administration, regulation, research, and licensing of commercial banks; and (iv) supervision and licensing of specialized banks and MFIs. The Supervision Department has 38 staff including 10 staff who were recently assigned to three sections of the on-site inspection division for commercial banks and received brief training on on-site inspection activities. The six sections of the off-site inspection division supervise commercial banks. Each section comprising three staff each is responsible for five commercial banks. Supervision is done by analyzing the weekly, monthly, quarterly, and annual reports of banks.

88. Until the recent reorganization, the Bank Supervision Department had a separate office, called the Supervision Office for the Decentralized Banking System, which was established by an agreement between AFD and the Government in November 1997. This office, which received financial and technical support from AFD to assist four NGOs, has been integrated into MSD (para. 60). MSD undertakes off-site and on-site inspection of specialized banks and MFIs. At present, NBC monitors the financial activities of major NGOs, which submit quarterly reports on a voluntary basis. Further details on NBC are in Appendix 10.

G. Environmental and Social Measures

1. Environment

89. An initial environmental examination was carried out over a six-week period during November-December 1998. During this period, field visits were undertaken to observe selected microenterprises, and consultations were held with the staff of the prospective LFIs and subborrowers. This examination indicated that adverse environmental impacts from activities financed under the Project will be insignificant or very localized individually. The Project will not have large-scale or intensive adverse environmental impacts unless the subborrowers' activities lead to a substantial increase in (i) the use of toxic pesticides, (ii) the exploitation of forests, (iii) uncontrolled quarrying, or (iv) unmanaged modification of the hydrological regime.

90. To minimize the risks of adverse environmental impacts, the Project will ensure sound environmental management through (i) the provision of environmental training designed for credit officers and managers of LFIs, (ii) the dissemination of information and resources to provide LFIs with access to alternative measures of environmentally sustainable production technologies, and (iii) possible collaboration with the Ministry of Environment in adopting proper procedures for environmental monitoring. These activities will be also used for environmental monitoring during project implementation and in the project completion review. One person in the PMU will be responsible for (i) organizing environmental training programs, (ii) developing a database for natural resource management relating to the Project, (iii) facilitating working relations with LFIs regarding their environment-related activities, and (iv) promoting environmental monitoring programs among LFIs. ADB's TA will assist RDB and LFIs in this regard (para. 25).

91. The capacity for proper environmental management is still limited in Cambodia in terms of both the regulatory framework and skilled personnel. This limited capacity is mostly confined to large-scale industrial enterprises. The institutions relating to microfinance operations are now beginning to acquire knowledge and skills for proper environmental management. Since small-scale enterprises in rural areas may entail threats to environment, there is a strong need for enhancing the capacity of LFIs in sound environmental management. Such needs were fully considered during the preparation of the Project. The initial environmental examination is summarized in Appendix 11.

2. Social Analysis

92. The social assessment was carried out during project preparation to establish an understanding about the intended beneficiaries. The social assessment specifically aimed at identifying the clientele, examining their socioeconomic conditions, analyzing their needs and absorptive capacity in relation to rural financial services, and examining other social concerns. The results of the social assessment were fully taken into account during the formulation of the Project. The field surveys were conducted for three weeks during October 1998 in four representative provinces. The preliminary social assessment results were presented in November 1998 at a workshop for the prospective LFIs. The summary social assessment is presented in Appendix 12.

93. The project clientele will be rural people living outside Phnom Penh, in provincial towns and rural areas. The sample covered under the social assessment had a high incidence of poverty or near-poverty. The sample represents a significant portion of subgroups in the client

group of the Project. The household size in the surveyed area averaged six people, which is slightly higher than the national average of 5.2. Eight percent of the total households surveyed were headed by females, whereas the national average is 25 percent. Ninety one percent of the population is literate to some degree. Illiteracy is higher among poorer households. Female illiteracy (15 percent) is higher than that of males (5 percent). Households value education for their children and they regularly save for school fees, even though this is a major burden on poor households. The cost of health care limits the access of the rural poor to health services. Illnesses and accidents can result in major financial burdens for the poor, forcing the sale of assets such as land and livestock to generate funds.

94. Rural roads are in a generally deteriorated condition due to the lack of regular maintenance. Bicycles and animal-drawn carts remain important modes of transportation for most rural households. Wood, obtained from public forests, is the main source of energy for cooking and other purposes. Scarcity of wood is an increasingly serious problem in the rural area. A regular electricity supply exists only in towns. About 30 percent of the households in the surveyed area rely on storage batteries for basic electricity. Five percent own a generator, which is a highly valued asset in villages. Poor households without electricity rely on kerosene for lighting. Major economic assets include land, buildings, gold, livestock, agricultural equipment, and other items such as motorcycles, generators, and televisions. Such assets often serve as collateral for individual loans. Other socioeconomic indicators, which were collected during the social assessment, also reflect conditions of rural poverty in Cambodia. Access to various social facilities is limited or unavailable for most poor households in the rural areas. The rural households that are expected to participate in the Project are facing these constraints to improved livelihoods.

95. The dominant livelihood is agriculture, predominantly rice farming. Of households surveyed, 57 percent are engaged in rice cultivation. Corn, sweet potatoes, cassava, and other vegetables are grown as market crops, but generally on a small scale. Livestock raising is a significant source of secondary household income. To address the needs of the rural poor, the Project will support the rural finance activities of NGOs whose agenda are consistent with the objective of the Project to reduce rural poverty.

96. It is difficult to form a reliable estimate of the poverty incidence in the surveyed area. However, using a daily income of less than KR1,210 ($0.32) per capita and the ownership of less than 0.5 ha of agricultural land as indicators for rural poverty, about 65 percent of the surveyed households can be classified as poor. Generally, there is a large gap between a small number of better-off people, and people belonging to the poor and the near-poor groups, who constitute the majority of rural population. Some of the better-off people become sources of informal credit for poorer households in the rural area. Poor people are usually engaged in wage labor and other off-farm employment in addition to agriculture as additional sources of income, and need to work hard to avoid a cycle of heavy debt burden.

97. Women in Cambodia have greater equality with men than women in many of ADB's other developing member countries. Women and men have equal status under law, including the right to own land. The legal status and rights of women are protected under the Cambodian constitution. At the household level, women are active and usually equal participants in household management and decision making. Wives usually handle household financial transactions although decisions are jointly made with husbands. Women are full partners in rice cultivation, being engaged in activities such as transplanting seedlings from seedbeds to fields. Both men and women are involved in harvesting, transporting, and threshing. Many other farm activities are shared, such as carrying water and wood, and tending livestock. However, women

are traditionally less empowered than men in companies and government offices in Cambodia. Some social restrictions in terms of transportation and appearance are apparently affecting the mobility of women in the rural area.

98. During the social assessment, nearly all households showed interest in borrowing to support income-generating activities. While the decision to borrow is a shared household decision, women, particularly those who are single and widowed, expressed greater interest in having better access to credit. Such credit will be used to increase agricultural production or expand off-farm income-generating activities. The demand for reliable savings facilities is equally strong among households for better management of household budget and consumption.

V. PROJECT JUSTIFICATION

A. Financial and Economic Analyses

99. Financial and economic analyses were conducted for an indicative sample of subprojects to be financed under the Project. The sample of subprojects used in the analyses includes retail trading, pig raising, rice production, small-scale irrigation, palm sugar production, small-scale rice milling, silk weaving, and brick making. These subprojects have been selected based on discussions with people who received loans from NGOs for income-generating activities, and on the social survey conducted during the project preparation. The results of the analyses are discussed below and presented in detail in Appendix 13. A financial projection for RDB has been prepared separately and included in Appendix 9.

1. Financial Analysis

a. Quantifiable Benefits

100. Quantifiable benefits from the illustrative subprojects have been derived as the values of incremental production less the values of incremental costs. Data and information on these benefits and costs were collected from credit-operating NGOs and their borrowers. In the case of rice production inputs, where many loans have been provided for a wide range of alternative inputs, additional information has been obtained from staff engaged in agricultural extension services. Thus, all the illustrative subprojects are considered to reflect accurate financial projections for subprojects to be financed under the Project. The without-project situation is an assessment of what the subborrowers would be doing if they did not receive a loan. For rice cropping and small-scale irrigation under the without-project situation, it was assumed that less intensive activities would be practiced, while for pig raising it was assumed that fewer animals would be raised. For all other subprojects, it was assumed that subborrowers would be unable to finance their activities without loans and hence would neither incur costs nor receive benefits.

101. All subproject models exclude any allowance for interest on credit to calculate their financial internal rates of return (FIRR). FIRRs have been calculated for individual subprojects with longer term duration. The FIRRs range from 23 percent to 91 percent, and show that the subprojects are financially viable given the current real interest rate of about 20 percent. These subprojects use family labor, thus incurring substantially low labor costs. Even under the financially most conservative scenario for labor based on the market wage rate of about KR4,000 ($1) per day, subprojects will be generally viable except for small-scale rice milling. The results of calculations are shown in Table A13.1 of Appendix 13.

102. Sensitivity analyses were carried out to assess the financial viability of multiyear subprojects under adverse project scenarios relating to an increase in the investment cost and a decrease in the revenue (Appendix 13). Although there are considerable variations among the selected subprojects, their financial viability remains strong under these scenarios. Subprojects of pig raising, small-scale rice milling, and palm sugar production are relatively more sensitive to changes in the investment cost and revenue. The borrowers' responses to the conditions of local markets are usually quick through changes in their types of activities.

103. Based on the business plans of the prospective LFIs, about 260,000 rural households are likely to benefit from the Project. More than 70 percent of these households are expected to be poor households. The project impact on employment will depend on the numbers and types of subprojects to be financed and the incremental labor-days generated. The incremental employment expected from each subproject type is indicated in Table A13.2 of Appendix 13. Assuming that the composition of types of subprojects under the Project will be similar to that of NGOs' current credit operations and that the Project will have average loans outstanding of 70 percent of disbursement from the total amount of loans for subprojects, the Project is expected to generate about 66,000 jobs.

b. Transaction and Administration Costs

104. Transaction costs are not significant as most programs of credit-operating NGOs provide services at the village level, thus minimizing travel costs to their borrowers and reducing their risk of loan default. Where the borrowers have to travel to provincial or district centers to obtain loans, the distance involved is relatively short. Neither compulsory savings nor physical collateral are featured in most of the credit programs. The social assessment conducted for the Project reported that only 5 percent of loans from NGOs are secured against the collateral of a house, land certificate, or gold, while the remaining loans are secured through group guarantee. Experience of NGOs is that collateral is of little direct value since it is difficult to seize in cases of default. Overall transaction costs are minimal and no increase is anticipated under the Project.

105. At present, the credit administration costs of the prospective LFIs, particularly staff expenses, are still high at more than 40 percent of loans outstanding. With the growth in their loan portfolios, these costs are expected to decline to industry standards by the end of the Project. Staff expenses account for about half of administration expenses of these prospective LFIs. LFI administrative expenses are expected to drop substantially during the project period, and this reduction in the administrative expenses will be reflected in the reduction in the interest rate to be charged to subborrowers. By expanding the operations of LFIs, the Project will provide the rural poor with easier access to credit facilities.

c. Impact on Financial Institutions

106. LFIs participating in the Project, including MFIs, will be strengthened by their need to comply with financial structures and performance as stipulated in the regulations to be enforced by NBC. By being required to demonstrate profitability, LFIs will be able to attract a diverse range of funding sources and financing terms from depositors, external funding agencies, commercial lenders, and equity investors. This diversity will strengthen the liability structure of LFIs necessary for their long-term and sustainable expansion of assets and services. In providing savings facilities, LFIs will improve financial intermediation within rural communities and encourage funds to flow toward better yielding investments. The provision of savings facilities will allow many rural households to accumulate and hold liquidity in a safe

and attractive manner. In playing a more significant role within communities, LFIs will become more responsive to the financial needs and opportunities of rural communities.

d. Willingness to Pay

107. Excellent repayment records achieved by NGOs in Cambodia provide strong evidence of borrowers' willingness to pay when services are provided in a timely and efficient manner, and where the ongoing availability of loans is assured. Seven of 10 major NGOs reported average loan recovery rates in 1997 and 1998 in excess of 90 percent. In situations where a follow-on loan cannot be assured, as has been frequently encountered with short-duration project activities, borrowers show some reluctance to repay their loans. The provision of longer term credit lines through RDB is essential to strengthen the activities of LFIs. NGOs also agree that financing vehicles and equipment for their capacity building under the Project on credit rather than as a grant will encourage more rigorous assessments of their own needs.

2. Economic Analysis

108. Economic analyses have been carried out for the same subprojects as those included in the financial analysis. Economic prices for the main traded inputs and outputs (predominantly rice and fertilizer) are based on the latest World Bank commodity price projections, adjusted to constant 1998 values prior to adjusting to farmgate values. Minor traded and nontraded inputs and outputs have been converted to economic values using a standard conversion factor of 0.9 in accordance with the current ADB practice for Cambodia. The economic cost of labor is estimated using a shadow wage rate of 0.75 for employed labor, which is usually unskilled or semiskilled, reflecting the limited alternative opportunities in Cambodia. The shadow wage rate for family labor is 0.95, reflecting the availability of alternative wage labor and greater entrepreneurial skills.

109. The estimated economic rates of return are summarized in Table A13.1 of Appendix 13. The sample subprojects included in the analysis are considered to be economically viable. Micro- and small-scale processing and manufacturing appear to be the most economically viable activities with economic internal rates of return ranging from 13 percent to 62 percent. Sensitivity analyses of the economic internal rates of return were also conducted for changes in the investment costs and revenue of subprojects (Table A13.3 of Appendix 13). The results show that subprojects for pig raising and palm sugar production are more sensitive to the increase in investment costs and the decrease in revenue, and require careful planning for investment. The economic viability of other subprojects remains strong under adverse project scenarios.

110. Subborrowers are expected to benefit directly from subprojects, which will provide them with confidence for further expansion. LFIs will derive substantial benefits by demonstrating sustainable financial services and expanding their clientele. Similarly, the strengthening of RDB's banking skills and financial management, and the supervisory capacity of NBC, will enhance their management of microfinance projects and programs, and support for LFIs.

B. Environment

111. The environmental impact of the Project will be positive. By installing sound practices for environmental management in microfinance activities of the prospective LFIs, the Project will be able to avoid adverse environmental impacts and to safeguard and enhance the natural resource base in the country. RDB staff engaged in credit operations and LFI staff will gain

awareness of environmental concerns in rural areas. They are expected to learn a set of analytical tools for assessing the environmental impact of subprojects. The PMU will have an officer responsible for environmental concerns to ensure that subprojects are adequately monitored. Functional linkages will be developed between environmental and financial institutions. LFIs participating in the Project will gain improved access to the existing Cambodian technical expertise to support sustainable resource management approaches in their activities.

C. Social Dimensions

1. Poverty Reduction

112. In Cambodia, the Government has explicitly committed to the reduction of rural poverty as its most important development objective (para. 21). The Project will greatly contribute to this policy objective by providing small-scale income-generating activities and sustainable savings facilities for rural households, which constitute about 90 percent of the poor population in the country. At present, there are no safe and credible savings facilities to hold liquid assets to meet their emergency or seasonal needs. The financial needs of most rural households are being accommodated by borrowing from individual lenders, who charge high interest rates on funds, often up to 10 percent per month. High costs of funds make it difficult to escape from the poverty cycle. In view of the strong demand for effective rural financial services, NGOs are considering expanding their coverage and transforming into LFIs. The five prospective LFIs (para. 58) that have been initially identified to participate in the Project will be working in at least 15 larger provinces during the project period, which cover 93 percent of the total rural households in the country.

113. As reflected in the social assessment, the prospective beneficiaries have shown a strong demand for borrowing, and, despite the NGOs' expanding coverage, there is a large amount of unmet demand for credit in the rural area. Poor rural households will benefit from the Project through increased availability and reliability of a range of credit and savings services to be provided through LFIs. The availability of these financial services will substantially contribute to the improvement of rural women's livelihoods by providing financial support for their on-farm and off-farm income-generating activities. The Project will build upon the initiatives of NGOs to address social issues among the rural poor in line with the LFIs' respective agenda for poverty reduction. The Project will support the expansion of LFIs' outreach in both credit and savings, and strengthen LFIs' operational sustainability.

2. Community-Based Rural Finance

114. The Project will be implemented based on an approach where financial intermediaries operate close to the communities they serve. This approach will enable these intermediaries to identify specific constraints to the improvement of the communities' rural livelihoods. LFIs are expected to provide rural people with a wide range of services along with rural finance. In addition, their activities and outreach in community development will be expanded in both width and depth by transforming themselves into LFIs, and will contribute to the broadening of the rural economic base. The mobilization of savings within rural communities will expand the local resource base for further investment in economic activities and provide the rural poor with better access to safe and credible savings facilities.

D. Risks

115. The major risk is that RDB will be used for policy or directed lending operations. If used in this way, for example to provide loans directly to some farmers at below-market rates of interest, RDB would not be able to survive as a viable financial institution for many years. As seen in other developing countries, such institutions will then require some form of institutional rehabilitation, which will usually result in failure. This situation would actually be against the Government's policy and strategy for rural credit in Cambodia. Thus, RDB will be required to retain its viability as a wholesale financial institution under the Project. RDB's role as a wholesaler of commercially and externally sourced funds is important so that RDB can attract and fully service open market funding, especially in domestic markets, for agriculture and rural development. The Project has included a specific loan covenant to ensure the wholesaling function of RDB. The subdecree and the statute of RDB clearly indicate this function. RDB is also expected to develop financial linkages with other commercial banks by acting as a catalyst between the overall financial sector in the country and LFIs.

116. ADB also considers that the capabilities of institutions relating to the Project, including RDB, NBC, and LFIs, should be strengthened in collaboration with other external funding agencies in Cambodia. Sound institutional development is essential for the establishment of sustainable financial services in the rural area. In conjunction with the Project, an advisory TA has been provided (para. 25).

VI. ASSURANCES

A. Conditions for Loan Effectiveness

117. The Government has given the following assurances, which have been incorporated in the legal documents:

(i) Prior to loan effectiveness, the subsidiary loan agreement, in form and substance satisfactory to ADB, will be duly executed and delivered on behalf of the Government and RDB, and become fully effective and binding on the parties thereto in accordance with its terms.

(ii) Prior to loan effectiveness, RDB will provide ADB with a satisfactory five-year corporate plan that includes corporate goals, strategies, and an implementation plan, and is supported by its projected financial statements.

(iii) Prior to loan effectiveness, NBC will assign at least five full-time staff for supervision of LFIs.

B. Other Specific Assurances

118. Other specific assurances of the Government required during project implementation are as follows:

(i) Within three months of loan effectiveness, the Government will establish a PCC, which will meet at least twice yearly and function as a central-level coordination body to support project activities by providing overall policy guidance and directions for project implementation, and by helping resolve any outstanding issues.

(ii) RDB will confine its role to being a wholesaler of funds only through LFIs. In this context, the Government and RDB will transfer any loans made to any entities that are not licensed by NBC as financial institutions, from the RDB's accounts to another bank, financial institution, fund, or organization.

(iii) RDB will operate in a self-sustained manner in line with the Government's new rural credit policy, and will, at all times, conform fully to the law on banking and financial institutions and banking regulations with respect to its financial structure and prudential ratios as stipulated by NBC.

(iv) RDB will maintain its policy for the classification of loans and loan write-offs, and procedures for their implementation, in compliance with NBC regulations.

(v) Loan proceeds through the credit line will be held in a revolving fund accessible solely by LFIs.

(vi) RDB will submit to ADB annual financial statements audited by an external auditor satisfactory to ADB, together with the description of specific measures in response to the auditor's opinions.

VII. RECOMMENDATION

119. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve the loan in various currencies equivalent to Special Drawing Rights 14,872,000 to the Kingdom of Cambodia for the Rural Credit and Savings Project, with a term of 32 years, including a grace period of 8 years, and with an interest charge at the rate of 1.0 percent per annum during the grace period and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Project Agreements presented to the Board.

TADAO CHINO
President

31 March 2000

APPENDIXES

SUPPLEMENTARY APPENDIXES

(available on request)

PROJECT LOGICAL FRAMEWORK

Design Summary	Performance Indicators	Monitoring Mechanisms	Assumptions and Risks
Sector/Area Goal			
Provision of increased access to rural financial services for the rural poor	• Provision of rural credit to a substantially increased number of rural households as compared with the estimated level of about 255,200 households as of Dec. 1999 • Savings of at least $4 million mobilized through licensed financial institutions (LFIs) under the Project, including microfinance institutions (MFIs) • Incidence of rural poverty reduced from 40 percent (1999 estimate) • Social and human development index to be increased from 0.514 (1999 estimate)	• Monitoring mechanism of the project management unit at the Rural Development Bank (RDB) and the MFI Supervision Division at the National Bank of Cambodia (NBC) • Progress and impact reports, including monthly reports from participating LFIs to NBC • Asian Development Bank (ADB) review missions • Regular interaction with key stakeholders such as farmers, local administrations, and nongovernment organizations (NGOs)	• Government's continued policy to encourage the development of rural financial services based on the private sector's initiative • Expansion of financial services and outreach in width and depth particularly in remote areas • Effective provision of physical and social infrastructure, and agricultural support services in the rural area • Active participation of rural beneficiaries and NGOs in the development process
Purpose/Objective			
Development of effective financial services in rural areas	• Expanded outreach of LFIs in width and depth with about 260,000 incremental households in the rural areas • Efficient provision of funds by RDB as a wholesale financial institution • Increased financial transactions among RDB and LFIs in rural finance • Environmentally and socially sustainable activities of subborrowers • Higher trust and confidence in MFIs as financial institutions	• Project monitoring mechanism • Progress and impact reports • ADB review missions • Regular interaction with key stakeholders	• Political and social stability for the expansion of rural financial services • Appropriate legal and regulatory framework in place for the development of rural finance • Effective use of rural financial services for productive investment • Provision of rural credit and savings schemes with simple procedures and requirements • Effective supervision and guidance of NBC for RDB and LFIs

Design Summary	Performance Indicators	Monitoring Mechanisms	Assumptions and Risks
Outputs			
1. Microcredit for income-generating activities by subborrowers increased	• Financial viability of subborrowers' activities improved through higher efficiency • Environmental and social awareness substantially improved for subborrowers' activities	• Project monitoring mechanism • Progress and impact reports • ADB review missions • Regular interaction with key stakeholders	• Close interactions between LFIs and subborrowers
2. LFIs' financial operations expanded	• At least five viable LFIs licensed during the project period • Total loans outstanding of major LFIs increased from about $21 million (Dec. 1999 estimate) • Satisfactory operational performance of LFIs in compliance with NBC regulations • Mobilization of LFIs' savings reaching more than 5 percent of their net loans outstanding by the end of the project period • Loan recovery rate of more than 90 percent maintained	• Project monitoring mechanism • Progress and impact reports • ADB review missions. • Regular interaction with key stakeholders	• Successful transformation of NGOs into licensed LFIs • Improvement of governance and operational efficiency of LFIs • Sound competition among LFIs and between LFIs and other providers of rural financial services • Proper selection of beneficiaries and adequate loan appraisal by LFIs
3. RDB developed as an efficient project manager and provider of funds for rural finance	• RDB's net loans outstanding with participating LFIs increased to about $20 million by the end of the project period • RDB's compliance with the NBC's banking regulations and reporting requirements • Efficient operation of a revolving fund established under the Project	• Project monitoring mechanism • Progress and impact reports • ADB review missions • Regular interaction with key stakeholders	• RDB confined to the role of a wholesale bank for rural finance • A satisfactory corporate plan of RDB in place and being implemented
4. Effective system for monitoring and supervision of rural financial services in place	• NBC's regular inspection of RDB and participating LFIs is being effectively carried out each month	• Project monitoring mechanism • Progress and impact reports • ADB review missions • Regular interaction with key stakeholders	• Establishment and strengthening of NBC's implementation procedures for the supervision of participating LFIs • Assignment of an adequate number of qualified staff for LFI supervision

Design Summary	Performance Indicators	Monitoring Mechanisms	Assumptions and Risks
Activities and Inputs			
1. Microcredit for subprojects		• Credit lines for participating LFIs for subprojects and operational support for LFIs	• Adequate and timely provision of counterpart financial and human resources
• Execute the subsidiary loan agreement	• Before loan effectiveness		• Close liaison and cooperation with relevant external funding agencies
• Select LFIs	• Within one month of the first loan application	• Service vehicles and equipment	
• Appraise loan applications	• Within two weeks of loan applications	• Consulting services • Recurrent expenditures	• Close monitoring of implementation progress and project impact
• Monitor loan performance	• Monthly		• Successful mobilization of savings based on increased confidence in rural financial services
2. Operational support for LFIs		**Total Project Cost: $26.56 million**	
• Appraise loan applications.	• Within two weeks of loan applications	• ADB loan ($20.00 million)	• Close linkage between the Project and advisory technical assistance
• Monitor loan performance.	• Monthly	• Government contribution ($2.72 million) • LFI contribution through LFIs' equity, retained earnings and mobilized savings ($3.84 million)	
3. Project Management Support			
• Prepare RDB's corporate plan	• Before loan effectiveness		
• Organize a project coordination committee	• Within three months of loan effectiveness	**ADB TA 3270-CAM: Capacity Building for Rural Financial Services**	
• Procure vehicles and equipment	• Within six months of loan effectiveness		
• Recruit implementation consultants	• Within six months of loan effectiveness	• Consulting services • Equipment • Training programs • Workshops and seminars	
• Establish computerized monitoring and reporting systems	• Within one year of loan effectiveness		
• Report project performance and impact	• Quarterly		
• RDB to provide training to LFIs	• Commencement in the first year		
4. NBC's supervision of LFIs			
• Complete staff assignment for LFI supervision	• Before loan effectiveness		
• Supervise LFIs	• Monthly		

OVERVIEW OF THE FINANCIAL SECTOR

A. The Financial Sector

1. Background

1. Due to the destruction of the banking system during the Khmer Rouge period, the National Bank of Cambodia (NBC) was the only operating bank until July 1989. NBC performed both central and commercial bank functions through its network of 20 provincial branches. By Decree No. 58 dated 26 July 1989, the Government allowed the formation of private commercial banks as limited liability companies. In 1991, the first private commercial bank was established as a joint venture between NBC and the Siam Commercial Bank of Thailand. Subsequently, a law on the supervision of financial institutions was passed by the National Assembly on 27 August 1992, which was followed on 16 November 1992 by a subdecree on the supervision of commercial banks. These laws and regulations formed the legal framework for commercial banks in Cambodia until November 1999 when the new law on banking and financial institutions was enacted.

2. With the privatization of the banking sector and the discontinuance of NBC as a commercial bank, farmers and entrepreneurs with small and medium landholdings and businesses were suddenly deprived of access to financial services. The impact of this sudden disruption in the provision of small-scale finance was partly alleviated by the introduction of nonlicensed credit providers under the credit and savings schemes supported by the United Nations Children's Fund and through credit-delivery nongovernment organizations (NGOs). In most areas outside Phnom Penh, farmers and small-scale businesses still depend for credit on individual moneylenders, including relatives and middlemen in trade.

2. Licensed Commercial Banks

3. As of December 1999, Cambodia had 31 operating licensed banks with total assets of KR2,097 billion ($552 million), an increase of about 21 percent since the end of December 1998. Loans outstanding at these commercial banks amount to KR751 billion ($198 million) or an increase of 14 percent from 1998. Of total commercial lending, more than 90 percent was in foreign currencies mostly in US dollars. Classified by type of business, the largest amount of lending was for wholesale and retail trade (26 percent), followed by services and personal consumption (25 percent), manufacturing (22 percent), import and export (14 percent), and other miscellaneous activities (13 percent). Agriculture-related businesses comprised about KR31 billion ($8 million) or 4 percent of total lending through 12 banks. As of the end of December 1999, deposits held in banks totaled KR1,150 billion ($303 million), of which 93 percent was held in foreign currencies, mainly in US dollars. There has been little change in the proportion of deposits held in foreign currency over the last three years. Demand deposits comprise 37 percent of total deposits.

4. Two banks, the Foreign Trade Bank and the Rural Development Bank (RDB), are Government-owned while other banks are all privately owned. Of these private commercial banks, four are fully owned by domestic interests while the remainder has full or partial foreign ownership. Fully domestically owned banks comprise 34 percent of the total assets of the banking sector and share 19 percent of consolidated profits. Outside Phnom Penh, there are 18 bank branches in nine provinces. Since bank branches are located in towns, only 10 percent of total households in Cambodia and 64 percent of urban households have reasonably good access to formal banking services. In the nine provinces served by bank

branches outside Phnom Penh, there are about 64,000 households per bank branch on average while in Phnom Penh, where there are 36 banks and bank branches, the figure is 4,800 households per bank branch.

5. The banking sector grew marginally in real terms from 1998 to 1999 due to political stability in Cambodia. The average net worth per bank is KR25.0 billion ($6.6 million). Average total assets per bank is KR68.0 billion ($17.9 million). For the year ending 31 December 1999, the 10 largest banks had a return on equity of 4.0 percent and a return on total assets of 1.5 percent. The volume of total deposits increased by 29 percent for the banking sector since the end of December 1998.

3. Nonlicensed Financial Services

a. Nongovernment Organizations

6. As of the end of December 1999, 25 NGOs listed by NBC had total loans outstanding of approximately KR80.3 billion ($21.1 million), see Appendix 3. The total number of borrowers was about 255,200 or 11 percent of total rural households. NGOs currently charge effective interest rates between 36-72 percent, or 3-6 percent flat per month on their lending. Larger NGOs and those making loans to individual borrowers have lower interest rates on their lending. Administrative costs are often more than 40 percent of average loans outstanding with an overall average for the five largest NGOs at 25 percent. This excludes the cost of technical assistance financed by external funding agencies as a grant. Loan recovery rates are 80-100 percent, and the average rate for the five largest NGOs is 96 percent.

b. Project-Supported Services

7. Rural credit provided through the United Nations Children's Fund, the Ministry of Women's Affairs, and the European Union, amount to $1.49 million in loans outstanding and covers 47,470 borrowers. The largest portion is under the program of the European Union, with $1.25 million in loans outstanding to 28,000 borrowers. The initial focus of these programs was the provision of emergency relief, and has now been directed to sustainability and institutional issues.

c. Traders and Individual Moneylenders

8. According to a recent socioeconomic survey in 1996, only 1 percent of the rural households that took loans between 1994 and 1995 received loans from licensed commercial banks. The remaining households received loans from NGOs and informal moneylenders, including traders and relatives. Of these loans from informal sources, 37 percent were used for agricultural production or investment in small-scale businesses. Other loans were used for meeting emergency expenses such as medical expenses for the family. Interest rates on loans from informal sources are high, often up to 10 percent per month. Despite high interest rates, borrowers continue to depend on informal sources for a variety of reasons including ease of access, flexibility in loan repayment terms, personal relationships, and lack of alternatives.

B. Legislation

9. To provide a comprehensive legal framework for the banking sector and to support the development and strengthening of microfinance institutions (MFIs), the Government

introduced a new law on banking and financial institutions (in November 1999) and related regulations. This was followed by a set of regulations appropriate to MFIs. The Government is committed to strengthening NBC's licensing, regulation, and supervision of MFIs. RDB's subdecree was revised in November 1999 to stipulate that it would operate as a wholesale bank to channel funds to licensed financial institutions, which are engaged in rural finance. To facilitate the provision of rural financial services in remote areas, the Government will continue to monitor credit activities of NGOs and community-based organizations, and to encourage their linkage to licensed MFIs or their efforts to become licensed institutions. Commercial interest rates, liberalized by NBC under a subdecree issued on 16 March 1995, will continue to be determined by commercial banks according to each bank's policy and financial performance. This liberalized interest policy will be extended to cover MFIs.

10. Under the new law on banking and financial institutions, financial services of NGOs can be converted into formal financial transactions under NBC's supervision. This will increase public confidence in their financial services and encourage the expansion of their activities. NGOs are also expected to register with whatever Government ministries are relevant to their scope of activities. Domestic NGOs are registered with the Ministry of Interior, and international NGOs are registered with various ministries including the Ministry of Foreign Affairs. Prior to applying for an MFI license, NGOs will need to incorporate as legal entities, mostly as limited liability public companies. Since 1998, NGOs, which are expected to participate in the Project, had started identifying shareholders needed for incorporation as companies. At least five licensed financial institutions will be participating in the Project.

CREDIT AND SAVINGS OPERATIONS OF NGOS

A. Description of Nongovernment Operations

1. The Cooperation Committee for Cambodia reports that 296 nongovernment organizations (NGOs) are registered with the Government, of which 163 are domestic and 133 foreign. In addition, 100 NGOs are not registered with the Government but are operating in Cambodia.[1] About 90 NGOs are engaged in credit operations. At present, the Supervision Department of the National Bank of Cambodia (NBC) monitors financial activities of major credit-operating NGOs. According to NBC's records and individual reports from these NGOs, as of 31 December 1999, 25 major credit-operating NGOs had KR80.3 billion ($21.1 million) in lending to about 255,200 borrowers (Table A3.1) and total savings of KR2.2 billion ($579,000) or about 3 percent of loans outstanding. NBC also monitors the activities of two project-based rural credit schemes of the Government. A review of the nine largest NGOs showed that between 1996 and 1999, total loans outstanding increased from KR18.2 billion ($4.8 million) to KR76.0 billion ($20.0 million) and the number of borrowers from 78,000 to 192,000. Major NGOs in Cambodia confirmed the high levels of unsatisfied demand for credit and feel that they need to expand their activities rapidly at least in the medium term.

2. Savings services remain weak, with few NGOs putting emphasis on the mobilization of public savings. In general, borrower groups and communities are reluctant to manage savings by themselves because of security problems and potential conflicts that may arise in their communities. Access to savings is usually only upon withdrawal from group savings. At present, the new law on banking and financial institutions provides a legal basis for the savings operations of NGOs for (i) the protection of depositors and creditors; (ii) reporting needs of NBC, which is charged with the duty of monitoring macroeconomic aggregates including credit creation and mobilization of savings; and (iii) the question of clear accountability in the event of legal cases. However, NGOs have not launched on full-scale savings schemes.

3. NGO lending is usually carried out through village banks and borrower groups, and to individual borrowers. A common approach involves (i) group formation, (ii) motivation and training, and (iii) formation of a larger village-based association consisting of all groups in the village. Mutual guarantee groups are formed by the villagers themselves with the assistance of an NGO and occasionally with the assistance of a village development committee. There are no intervillage associations for credit operations. In a village, the membership of the association varies from 90 to 200, often involving most households in the village. One household is usually represented by one member, who does not have to be a borrower. A credit committee is also set up with heads of all group leaders, from whose ranks a president and a vice-president are elected. These two people are responsible for major decisions such as the formation of new groups. They are also responsible for collections. Mutual guarantee is now a familiar mechanism to ensure loan repayment. Group members are held jointly responsible for loans. Failure of one person to comply with rules and regulations or to meet financial obligations may result in the exclusion of all members from the association.

4. Group lending is also carried out without the use of a village association, for instance, as in the case of the Association of Cambodian Local Economic Development Agencies (ACLEDA). Group loans from ACLEDA are denominated in riel and are provided through groups of borrowers, predominantly women, being formed with 3-10 members. At the end of December 1999, 94 percent of ACLEDA's active group loan borrowers were women. Prior to receiving loan

[1] A comprehensive list of NGOs in Cambodia is provided in two documents of Cooperation Committee for Cambodia: *Directory of International Humanitarian Assistance in Cambodia*, and *Directory of Cambodian NGOs*.

services, each group receives six hours of training on the use of credit funds. Groups are formed from members within the same community following a briefing from ACLEDA staff. A group leader appointed by group members is responsible for collecting loan repayments weekly or monthly and making these payments to the ACLEDA office. For this service, the group leader receives a commission of 1 percent of repayments.

5. Many NGOs provide for lending to individuals but, except for ACLEDA and Hattha Kaksekar (HK), this is a negligible part of their total loan portfolio. The size of the loan for individuals is usually $300-$2,000, mostly denominated in US dollars.

B. Participating Licensed Financial Institutions

6. Based on the present performance of their credit operations and interest in having access to the project funds as licensed financial institutions (LFIs), five NGOs have been identified for participation in the Project: ACLEDA; Cambodia Community Building (CCB); a group of local NGOs affiliated with the Catholic Relief Services (CRS) International and funded by the United States Agency for International Development (USAID); HK; and Ennatien Moulethan Tchonnebat (EMT). All of these NGOs are expected to become LFIs during the first two years of the Project. The financial performance and projections for these institutions show that their operations will continue to be viable over the project period. The Project will cover the operations of LFIs initially in the northwestern, eastern, and southern regions where major NGOs are currently active (Table A3.2).

7. ACLEDA is expected to obtain a license from NBC in April 2000 and, for this purpose, technical assistance is being provided by a consortium of external funding agencies consisting of the United Nations Development Programme, USAID, and the International Finance Corporation. This assistance covers banking management, banking organization, accounting systems, computer systems review, management information systems, and product development. Through a head office in Phnom Penh, ACLEDA now provides services at 27 branches in 12 provinces. It will open two more branches in Kompong Chhnang and Svay Rieng provinces by 2001. As of 31 December 1999, total loans outstanding were about KR51.8 billion ($13.6 million) to 58,355 borrowers, of which about 17 percent are individual borrowers. Interest rates are 5.0 percent per month for group loans and 4.0 percent per month for individual loans both on a flat basis. Individual loans in US dollars carry lower rates. Average loan disbursement per borrower in 1999 was $1,497 for individual borrowers and $138 for group borrowers. ACLEDA has generated net profits from its financial transactions since 1998. ACLEDA plans to achieve a loan portfolio of at least $43 million during the project period with 118,000 borrowers.

8. EMT, the local counterpart of the French NGO Groupe de Recherche et d'Echanges Technologique (GRET), was formed in 1996 to take over its microfinance operations. At present, GRET is providing EMT with technical support for its rural finance activities. EMT will apply for a license as an MFI following its incorporation (expected in 2000), and will have GRET and at least five other major shareholders. EMT is also being assisted for its transformation to an LFI by the Government of France through a technical assistance project. EMT currently has operations in six provinces through 18 district branches with about 56,600 borrowers, and plans to expand its outreach to 150,000 borrowers by the end of the project period. It expects to be able to expand loans outstanding from around $1.8 million in 1999, with an average loan outstanding per borrower of $32, to $7.6 million in 2005. The interest rate on lending is 4 percent per month on a declining basis. For 1998, EMT made a nominal profit subject to interest charges on subordinate loans received from the Government of France through the Government of Cambodia.

9. The CRS, with USAID funding, carries out a number of functions including (i) direct savings and credit services through two branch offices in two provinces, (ii) a partnership program for strengthening domestic NGOs in credit and savings operations, and (iii) development of NGOs interested in microfinance operations. For these activities, CRS receives substantial support from CRS International and USAID. CRS plans to increase its number of partner NGOs from 7 to 12 by 2005. In forming a licensed MFI, some of these partners could become shareholders in a conglomerate MFI. The total number of CRS borrowers is projected to rise to over 80,000 in 2005 from the current level of about 31,600. In parallel, the average portfolio is expected to increase to about $5.0 million in 2005. There will be a parallel increase in the number of borrowers of partner NGOs, which will form a conglomerate MFI. The average loan outstanding per borrower is $43. The interest rate on a flat basis is 3.0 percent per month for loans in riel. CRS credit operations are expected to remain viable.

10. The main orientation of HK is the provision of rural financial services involving both savings and credit. HK began as a project of Oxfam-Quebec in 1995. HK combines group lending with individual loans. HK's experience with individual loans has been good by concentrating its focus on individual loans ranging from $50 to $500 and averaging $162. HK is also considering an increase in the ceiling of the loan amount to about $1,000. Lending is in US dollars at a flat interest rate of 3.0 percent per month, has about 3,700 borrowers, and expects to have over 8,000 by 2005. The number of savers is expected to grow more rapidly, from around 3,200 to more than 10,000 over the same period. The current loan disbursement is $650,000 per year which is also projected to exceed $2 million by 2005. HK has two provincial branches and one district branch, and expects to have four and six respectively, in 2005. HK has received technical assistance, especially from CARE International, in financial management and management information systems. Training activities have included policy formulation for corporate management, asset and portfolio management, management of cash and information flows, financial reconciliation, and reporting.

11. CCB was created by an international NGO, the World Relief, which has been carrying out microfinance activities in Cambodia with support from USAID since 1992. CCB will take over the financial services of the World Relief, which will continue to provide technical support to CCB. A board of directors was established for CCB, which envisages being transformed into an LFI. However, at the end of 1999, CCB had an internal dispute, which will delay the procedures for becoming a licensed institution. CCB has 13,600 clients with KR3.4 billion ($0.9 million) in loans outstanding and plans to expand its activities with one new branch each year until 2005. The total number of borrowers is projected to rise to over 35,000 by the end of the project period with a loan portfolio of $2.7 million. At present, CCB’s clients are all poor women. The loan size for first time borrowers ranges from $22 to $39. For subsequent borrowers, the maximum loan size is $240 and may rise to about $400 by the end of the project period. Lending in riel is at a flat interest rate of 4.0 percent per month. There is 1.0 percent rebate for prompt repayment. The interest rate on a dollar loan is 2.0 percent per month also on a flat basis. CCB’s savings mobilization is modest; constituting some 25 percent of net loans outstanding, but is projected to rise to 30 percent during the project period.

Table A3.1: 25 Large NGO Credit-Providers
31 December 1999

NGO	Prospective LFI[a]	Loans Outstanding[b] KR m.	%	Borrowers[c] No.	%	Avg.loan out/Borrower KR	$
1 ACLEDA	X	51,790	64.5	58,355	22.9	887,499	234
2 Ennatien Moulethan Tchonnebat	X	6,967	8.7	56,646	22.2	122,992	32
3 Catholic Relief Services	X	5,121	6.4	31,589	12.4	162,113	43
4 Cambodia Community Building[d]	X	3,425	4.3	13,631	5.3	251,265	66
5 Hattha Kaksekar	X	2,299	2.9	3,741	1.5	614,542	162
6 World Vision Int'l Cambodia		2,172	2.7	17,303	6.8	125,527	33
7 Seilaniti		2,155	2.7	11,725	4.6	183,795	48
8 Action Nord Sud		1,154	1.4	7,737	3.0	149,153	39
9 Cambodia Health Committee		885	1.1	3,424	1.3	258,470	68
10 Concern		837	1.0	17,300	6.8	48,382	13
11 Help the Widows		686	0.9	4,117	1.6	166,626	44
12 Community Action for Social Development		489	0.6	11,783	4.6	41,500	11
13 Camfed		395	0.5	1,251	0.5	315,747	83
14 Cambodia Rural Economic Development		332	0.4	3,318	1.3	100,060	26
15 Samarkee		299	0.4	2,135	0.8	140,047	37
16 Cambodia Women's Development Assoc.		233	0.3	1,046	0.4	222,753	59
17 Buddhists for Development		188	0.2	836	0.3	224,880	59
18 Lutheran World Service		169	0.2	2,635	1.0	64,137	17
19 Small Economic Activity Development		120	0.1	1,364	0.5	87,977	23
20 Arunreah		108	0.1	924	0.4	116,883	31
21 Kratie Women's Welfare Association		106	0.1	1,112	0.4	95,324	25
22 Khmer Rural Development Association		95	0.1	932	0.4	101,931	27
23 Social Development in Rural Areas		89	0.1	588	0.2	151,361	40
24 Rural Development Association		89	0.1	773	0.3	115,136	30
25 Samarkithor		80	0.1	897	0.4	89,186	23
Totals		**80,283**	**100**	**255,162**	**100**	**314,635**	**83**
		$21.13	**million**				

ACLEDA=Association of Cambodian Local Economic Development Agencies; LFI=licensed financial institution; NGO=nongovernment organization.

[a] Expressed interest in becoming a licensed financial institution and participating in the Project.

[b] Generally, excludes loan loss provisions.

[c] In some cases the numbers refer to members rather than borrowers.

[d] As of 31 August 1999.

Sources: The National Bank of Cambodia and individual NGOs.

Table A3.2: Provincial Presence of Formal and Semiformal Credit Providers

Province	Population	Population Density (people /km^2)	Total Households No.	Rural Households No.	Major NGOs: ACLEDA	EMT	CRS Partners	CCB	Hattha Kaksekar	Total	Commercial Bank Branches
Banteay Meanchey	577,300	86	111,866	93,489	X		X			2	
Battambang	791,958	68	148,315	122,743	X		X			2	X
Kompong Cham	1,607,913	164	313,019	304,794	X			X	X	3	X
Kompong Chhnang	416,999	76	82,452	74,762	yr 2001					1	
Kompong Speu	598,101	85	115,576	107,999	X	X	X			3	X
Kompong Thom	568,454	41	106,835	94,540	X			X		2	
Kampot	527,904	108	104,920	98,869	X	X				2	
Kandal	1,073,586	301	205,992	195,729	X	X	X	X		4	X
Koh Kong	131,912	12	24,926	19,559							X
Kratie	262,945	24	49,297	34,516							
Mondol Kiri	32,392	2	5,673	4,398							
Phnom Penh	997,986	3,441	173,232	76,248	X			X		2	X
Preah Vihear	119,160	9	21,481	17,351							
Prey Veng	945,129	194	194,019	183,116		X				1	
Pursat	360,291	28	68,206	57,367	X				X	2	
Ratanak Kiri	94,188	9	16,754	13,562							
Siem Reap	695,485	68	127,086	106,106	X			X	X	3	X
Krong P. Sihanouk	155,376	179	28,013	0	X	X				2	X
Stung Treng	80,978	7	14,304	9,873							
Svay Rieng	478,099	161	98,219	94,113	yr 2001		X			2	
Takeo	789,710	222	154,971	147,723	X	X	X			3	
Oddar Meanchey	68,836	11	12,563	8,500							
Krong Keab	28,677	85	5,367	0							
Krong Pailin	22,844	28	4,116	0							X
Totals	**11,426,223**	**64**	**2,187,202**	**1,865,357**	**12**	**6**	**6**	**5**	**3**	**33**	

ACLEDA = Association of Camboidan Local Economic Development Agencies, CCB = Cambodia Community Building, CRS = Catholic Relief Services, EMT = Ennatien Moulethan Tchonnebat, km^2 = square kilometer, NGOs = nongovernmental organizations.

Source: National Institute of Statistics, Ministry of Planning 1998.

EXTERNAL ASSISTANCE TO AGRICULTURE AND RURAL DEVELOPMENT

(1995 - 2000)

		Amount ($ million)		
Funding Source	**Project Title**	**Grant**	**Loan**	**Period**
ADB	Special Rehabilitation Assistance Project (Multisector)	0.0	67.7	1992 - 1997
	Rural Infrastructure Improvement	0.0	25.1	1996 - 2002
	Agriculture Sector Program	0.0	30.0	1996 - 2000
	Rural Credit Review	0.1	0.0	1996 - 1997
	Agricultural Policy Reform Support	1.5	0.0	1996 - 2000
	Stung Chinit Water Resource Development Project	0.8	0.0	1996 - 1999
	Enhancing Banking Skills Project	0.4	0.0	1997 - 1999
	Rural Credit and Savings Project	0.6	0.0	1997 - 1999
	Capacity Building for Rural Financial Services	1.5	0.0	1999 - 2002
Australia	Cambodia-Australia International Rice Research Institute	14.0	0.0	1988 - 2002
	Cambodia-Small Activities Scheme	1.4	0.0	1992 - 1999
	Agricultural Extension	7.3	0.0	1995 - 2000
	CCDP-ADRA Siem Reap Diversified Agriculture	0.5	0.0	1996 - 1999
	Combatting Poverty - Battambang	0.8	0.0	1996 - 1999
	CCDP-IWDA Food for Change Project	0.7	0.0	1996 - 1999
Canada	Canadia Fund for Local Initiatives	0.3	0.0	1996 - 1997
	Cambodia-Canada Development Program (Phase II)	3.7	0.0	1997 - 2002
Denmark	Integrated Agricultural Development Project	0.7	0.0	1995 - 1997
EU	Support Programme for the Agriculture Sector	43.5	0.0	1994 - 1998
FAO	Agriculture Information Center	0.2	0.0	1996 - 1997
	Implementation of Integrated Pest Management in Rice	0.4	0.0	1995 - 1997
	Special Programme on Food Security	0.1	0.0	1997 - 1998
	Food Security for Poverty Alleviation Strategy	0.2	0.0	1997 - 1998
France	Rehabilitation of Rubber Plantations	3.3	0.0	1992 - 1997
	Support for NGOs	1.0	0.0	1992 - 1999
	Integrated Rural Development in Pursat Province	1.6	0.0	1993 - 1997
	Support for Agricultural Policies and Education	2.5	0.0	1994 - 1997
	Silk Product Development in the Siem Reap Area	0.5	0.0	1994 - 1997
	Funds for Rural Credit Schemes (UNICEF)	0.4	0.0	1994 - 1997
	Funds for Rural Credit Schemes (GRET)	0.7	0.0	1994 - 1997
	Restructuring and Privatization Programme in Rubber Plantations	1.7	0.0	1995 - 1997
	Rural Credit Training	1.4	0.0	1995 - 1998
	Support for Village-level credit	0.1	0.0	1996 - 1997
	Support for the Rehabilitation and Development of Polders	4.3	0.0	1996 - 2001
	Financing of Two Projects for Rural Credit	0.6	0.0	1997
	Agriculture Development in Pripheral Area of Siem Reap	2.0	0.0	1997 - 2000
	Support for the Development of Sericulture	2.5	0.0	1997 - 2000
	Rural Credit Programme	4.3	0.0	1998 - 2001
	Rubber Small-holder Development	1.0	0.0	1998 - 2001
	Support to Micro-finance Sector	4.4	0.0	2000 - 2003
Germany	Self-help Funds	2.3	0.0	1995 - 1998
	Tertiary Roads in Kampong Thom and Siem Reap	5.6	0.0	1995 - 1998
	Food Security in Kampot Province	3.8	0.0	1996 - 1997
IFAD	Agricultural Development Support to Seila	8.0	0.0	2000 - 2006
Japan	Joint Cooperation for the Rural Development and Resettlement Project	8.8	0.0	1993 - 1997

	Project Title	Amount ($ million) Grant	Loan	Period
Netherlands	Labour-based Infrastructure Development	6.9	0.0	1992 - 1997
	Small Enterprise and Informal Sector Promotion	1.2	0.0	1992 - 1997
	CARERE Area Development	2.6	0.0	1996 - 1997
Thailand	Community Development Center	1.0	0.0	1996 - 1997
UNDP	Labour-based Infrastructure Development	4.1	0.0	1992 - 1997
	Vocational Training for Employment Generation	5.3	0.0	1992 - 1997
	CARERE Project (Phase II)	17.3	0.0	1992 - 1997
	Rural Credit	0.6	0.0	1994 - 1997
	Food Security for Poverty Alleviation Strategy	0.2	0.0	1997 - 1998
	Natural Resources Based Development for the Tonle Sap Area	1.0	0.0	1996 - 1998
UNICEF	Community Action for Social Development	10.4	0.0	1996 - 2000
WB	Emergency Rehabilitation Credit - Agriculture	0.0	2.5	1994 - 1997
	Social Fund	0.0	18.0	1995 - 1999
	Agriculture Productivity Improvement	0.0	25.2	1997 - 2002
	Second Social Fund	0.0	24.0	1999 - 2002

ADB = Asian Development Bank, EU = European Union, FAO = Food and Agriculture Organization, IFAD = International Fund for Agricultural Development, UNDP = United Nations Development Programme, UNICEF = United Nations Children's Fund, WB = World Bank.
In case of co-financed projects, the lead agency is indicated.
Source: Council for the Development of Cambodia, Royal Government of Cambodia.

DETAILED COST ESTIMATES AND FINANCING PLAN

Table A5.1: Components Project Cost Summary

	(KR Million)			(US$ '000)			% Foreign Exchange	% Total Base Costs
	Local	**Foreign**	**Total**	**Local**	**Foreign**	**Total**		
A. Base Cost								
1. Microcredit for Subprojects	46,741	46,741	93,482	12,159	12,159	24,318	50	94
2. LFI Operational Support	1,286	3,000	4,286	335	780	1,115	70	4
3. Project Management Support	853	973	1,825	222	253	475	53	2
Total Base Costs	48,879	50,714	99,593	12,716	13,193	25,908	51	100
B. Contingencies								
Physical Contingencies	214	397	611	56	103	159	65	1
Price Contingencies	318	544	862	27	47	74	63	0
C. Interest Charge	0	1,620	1,620	0	419	419	100	2
Total Costs	49,411	53,275	102,686	12,798	13,762	26,560	52	103

LFI = licensed financial institution.
Source: Staff estimates.

Table A5.2: Expenditure Accounts by Financiers

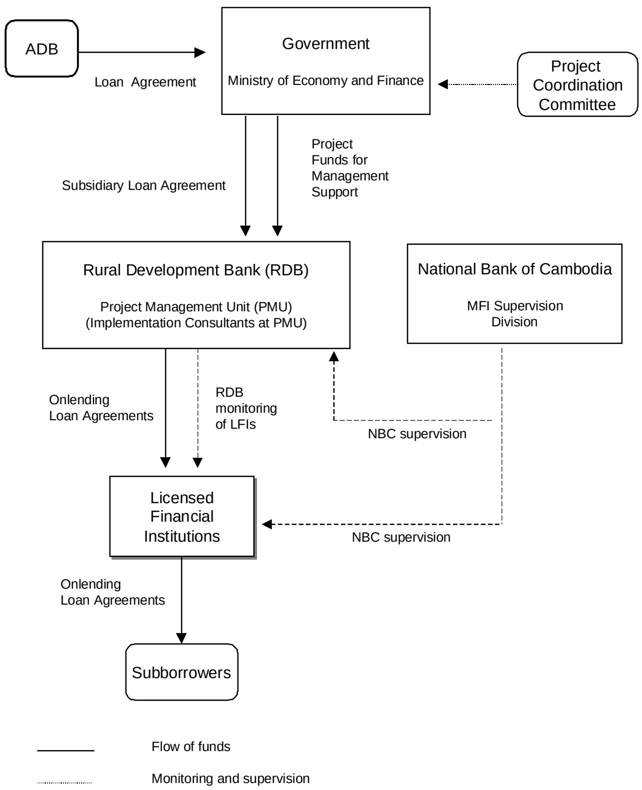
($ '000)

	ADB		The Government		Participating LFIs		Total			Local (Excl. Taxes)	Duties & Taxes
	Amount	FR(%)	Amount	FR(%)	Amount	FR(%)	Amount	PC(%)	For. Exch.		
A. Investment Costs											
1. Credit line	18,239	75	2,432	10	3,648	15	24,319	94	12,159	9,728	2,432
2. Vehicles, Equipment and Civil Works Credit Line	963	75	128	10	193	15	1,284	5	899	257	128
3. Vehicles	43	80	11	20	0	0	54	0	43	5	5
4. Equipment	57	80	14	20	0	0	71	0	57	7	7
5. Consulting Services											
International Consultants	217	100	0	0	0	0	217	1	185	33	0
Domestic Consultants	62	100	0	0	0	0	62	0	0	62	0
Subtotal Consulting Services	279	100	0	0	0	0	279	1	185	94	0
Total Investment Costs	**19,581**	**75**	**2,585**	**10**	**3,840**	**15**	**26,007**	**100**	**13,343**	**10,091**	**2,573**
B. Recurrent Costs											
Total Recurrent Costs	0	0	135	100	0	0	135		0	121	13
Total Disbursement	**19,581**	**75**	**2,720**	**10**	**3,840**	**15**	**26,141**		**13,343**	**10,212**	**2,586**
Interest Charge	419	0	0	0	0	0	419		419	0	0
Total	**20,000**	**75**	**2,720**	**10**	**3,840**	**15**	**26,560**		**13,762**	**10,212**	**2,586**

ADB = Asian Development Bank; LFIs = licensed financial institutions; FR = financing ratios of the financiers; PC = percentage of the total cost.

Source: Staff estimates.

PROJECT ORGANIZATION CHART



ADB = Asian Development Bank;LFI = licensed financial institution; MFI = microfinance institution; NBC = National Bank of Cambodia;PMU = project management unit; RDB = Rural Development Bank.

PROJECT IMPLEMENTATION SCHEDULE

	Year 1				Year 2				Year 3				Year 4				Year 5			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
A. Credit Line for LFIs																				
Execution of the subsidiary loan agreement	■																			
RDB's selection of participating LFIs	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒				
Provision of loans to LFIs		▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒
LFIs' disbursement of subloans		▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒
B. LFI Operational Support																				
RDB's appraisal of loan applications			▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒
Provision of loans to LFIs				▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒
C. Project Management																				
Preparation of RDB's corporate plan	■																			
Procurement of a service vehicle and equipment	■	■	■																	
Recruitment of implementation consultants	■	■	■																	
Establishment of a Project monitoring/reporting system		■	■	■																
Monitoring of Project activities		▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒
Quarterly progress reporting		▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒
Organization of LFI training programs			■		■		■		■		■									
Midterm review										■										
Project completion review																			■	
D. MFI Supervision																				
Staff assignment	■																			
Preparation of staff training programs for MFI supervision		■																		
Staff training under technical assistance			▒	▒	▒	▒	▒	▒												
MFI supervision			▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒
TA 3270-CAM																				
Commencement	■																			
Implementation		▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒	▒							

LFI = licensed financial institution, MFI = microfinance institution, RDB = Rural Development Bank.

■ Project milestones.
▒ Intermittent or ongoing activities.

OUTLINE TERMS OF REFERENCE FOR CONSULTING SERVICES

A. Accounting Information Systems Specialist (International, 6 person-months)

1. The accounting information systems specialist will:

(i) review the present accounting systems used by the Rural Development Bank (RDB) and the participating licensed financial institutions (LFI) and determine their institutional capabilities for providing essential data and information accurately and on a timely basis;

(ii) work with the project management unit (PMU) in the design of reporting formats for financial information and performance monitoring of the project and LFIs' activities, including the establishment of financial indicators for LFIs;

(iii) design and develop an appropriate computerized system for monthly monitoring of project activities, including the establishment of a link with LFIs' financial information systems; and

(iv) prepare practical manuals for RDB and LFI staff and provide training for RDB and LFI staff in the use and management of the accounting information systems.

B. Monitoring and Evaluation (Domestic, 9 person-months)

2. The monitoring and evaluation specialist will:

(i) establish an appropriate system for monitoring and evaluating project activities and impact in accordance with Asian Development Bank guidelines and with the use of selected indicators;

(ii) develop, in collaboration with the management information systems specialist, a progress monitoring system and databases that encompass project activities and provide reliable management information to PMU on a regular basis;

(iii) ensure compatibility between the monitoring and evaluation systems of RDB and the prospective LFIs for their effective linkage; and

(iv) develop manuals and guidelines for RDB and the prospective LFIs on monitoring and evaluating project activities and impact.

THE RURAL DEVELOPMENT BANK

A. Establishment of the Rural Development Bank

1. The Rural Development Bank (RDB) was created by a Government subdecree in January 1998. The main objective of RDB is to promote agricultural and rural development and other economic activities for the improvement of rural livelihoods and facilitate the alleviation of rural poverty. In line with the Government's policy for rural finance,[1] the subdecree and the statute of RDB were modified in November 1999 to promote microfinance operations, to facilitate linkage between RDB and the banking sector, and to enhance its professional focus. RDB has ceased retail lending and is operating solely as a wholesale financial intermediary. In addition to a professional accountant and a lawyer appointed earlier, RDB has employed six staff with banking experience and two staff with nongovernment organization (NGO) experience. Autonomy of management has been gradually demonstrated by its board. The governance of RDB is expected to improve with a new board of directors with seven representatives, having one director each from the Ministry of Economy and Finance, the Council of Ministers, and the Ministry of Rural Development; one representing commercial banks; one representing NGOs or licensed MFIs; the Director General of RDB; and a representative of RDB's employees.

B. Review of RDB's Operations

2. At the beginning, RDB had developed a loan portfolio of $15,340 to 793 farmers in Prey Veng Province. The loans, for terms of five months, were appraised and approved by RDB, and farmers made full repayments. No further lending has been made to these farmers. As of December 1999, RDB had 25 staff, including the director general, the deputy director general, 11 officers, 4 secretaries, and 8 supporting staff. The loan portfolio has reached more than KR3,355 million ($0.9 million) with lending to NGOs and commercial banks. The loans are for terms of 6-12 months, at 12-15 percent per annum in US dollars and 15-20 percent per annum in riel.

3. A comprehensive corporate plan for RDB is required so that RDB's corporate policy will become clear and formalized. Such a plan needs to be prepared before the Asian Development Bank (ADB) loan becomes effective, and should include (i) a specific implementation strategy, (ii) the expected composition of the loan portfolio over the next five years, and (iii) details on the financing of asset growth from a diverse range of debt and equity sources.

C. Participation in the Project

4. RDB will participate in the Project as an Executing Agency to manage the credit line and provide support for the participating licensed financial institutions (LFIs), including microfinance institutions. It will act as a wholesale banking institution drawing down funds received from the Government and onlending these funds to LFIs. RDB will remain viable and maintain an adequate net worth through retained earnings and capital injections. Over the project period, RDB will provide lines of credit for LFIs' operations and for fixed asset purchases of the participating LFIs. RDB is expected to achieve a loan portfolio of about $21 million after loan loss provisions under the Project by 2005, including loans provided prior to inception of the Project. The Project will support the purchase of service vehicles,

[1] The Council of Ministers approved on 28 December 1998 the policy for rural finance in Cambodia.

equipment, and computer software. The onlending interest rate of RDB to LFIs is based on receiving funds from the Government at no less than the rate of ADB's ordinary capital resources in riel and US dollars. To this cost of funds, RDB will add a total interest spread initially up to 4 percent for its administrative expenses and the anticipated LFI institutional risk. The institutional risk of LFIs is critical to loan pricing. In this respect, RDB will liaise closely with NBC in evaluating LFI performance and their compliance with the NBC regulations. It may be feasible to reduce the onlending rate to better-performing LFIs and increase the rate for poorer-performing ones.

5. According to the financial projections for RDB (Table A9), RDB will become profitable during 2000 and will remain profitable in each year of operation, reaching a net profit after tax of $684,835 in 2005. The annual return on equity will reach 9.68 percent by 2005. The interest coverage ratio is maintained at a safe level and, is never below a minimum of 1.70 percent, and the capital adequacy ratio is maintained above 30 percent. Over the project period, the administrative cost of lending steadily declines from 10.9 percent of loans outstanding in 2001 to1.8 percent in 2005.

6. The financial performance and ratios indicate that RDB can be a viable financial institution as a wholesale bank. Particular attention needs to be given to the pricing of loans based on weighted costs of funds and expected loan losses. This will be crucial as RDB is likely to have a range in sources of funds from various external funding agencies, and will face different levels of risk among segments of its loan portfolio. Administrative expenses will also require a regular review to ensure they meet the banking standards. In particular, RDB should not increase its present levels of staffing and administrative expenses until an adequate return on equity is achieved. RDB should aim to achieve a return on equity that is at least 5.0 percent above the rate of inflation. The operational performance of RDB as the Executing Agency needs to be reassessed during a comprehensive midterm review of the Project. Based on the outcome of the review, remedial measures, if necessary, will be taken to improve project implementation.

Table A9: Rural Development Bank Financial Projection: 2000 - 2005
($, as of 31 December)

	2000	2001	2002	2003	2004	2005
A. Lending program						
LFI Credit Line for Onlending	750,000	2,121,000	3,806,400	4,822,200	5,358,000	3,186,000
LFI Credit Line: Civil Works, Vehicles, Equipment	0	380,000	253,500	246,500	117,500	117,500
Other Programs	0	0	0	0	0	0
Total Lending	750,000	2,501,000	4,059,900	5,068,700	5,475,500	3,303,500
B. Income Statements						
Revenues:						
Interest on Lending	102,686	268,386	640,947	1,153,755	1,737,400	2,206,926
Interest on Deposits	269,824	400,383	421,981	470,046	538,343	617,295
Noninterest Income	0	11,201	11,201	11,540	11,880	11,880
Total Revenues	372,510	679,969	1,074,129	1,635,341	2,287,623	2,836,101
Expenses:						
Interest on Commercial Borrowings	0	0	0	0	0	0
Interest on Project Funds	23,400	124,831	329,531	614,344	943,323	1,217,227
Total Cost of Funds	23,400	124,831	329,531	614,344	943,323	1,217,227
Salaries	80,325	90,245	96,562	103,322	110,554	118,293
Staff Training	0	0	4,828	5,166	5,528	5,915
Directors Fees	11,550	11,235	12,021	12,863	13,763	14,727
Office Rental	25,000	25,680	27,478	29,401	31,459	33,661
Communications	9,000	9,630	10,304	11,025	11,797	12,623
Audit Fee	15,000	16,050	17,174	18,376	19,662	21,038
Office Utilities	12,000	12,840	13,739	14,701	15,730	16,831
Software Maintenance	0	6,420	8,014	8,575	9,176	9,818
Office Expenses	9,000	9,630	10,304	11,025	11,797	12,623
Travel	18,000	19,260	20,608	22,051	23,594	25,246
Annual License Fee	2,600	2,782	2,977	3,185	3,408	3,647
Repairs & Maintenance	13,888	14,860	15,900	17,013	18,204	19,478
Sundry	5,891	6,559	7,197	7,701	8,240	8,817
Loan Loss Provision	21,788	71,808	153,006	254,380	363,890	429,960
Depreciation	21,500	23,005	24,615	26,338	28,182	30,155
Total Operating Expenses	268,941	444,835	754,259	1,159,465	1,618,306	1,980,058
Net Operating Profit	103,569	235,134	319,871	475,876	669,317	856,044
Taxes	0	47,027	63,974	95,175	133,863	171,209
Dividends	0	0	0	0	0	0
Net Retained Earnings	103,569	188,107	255,897	380,701	535,453	684,835
C. Balance Sheets						
Assets:	2000	2001	2002	2003	2004	2005
Cash	19,184	65,226	146,441	247,830	357,357	423,445
NBC Reserve Requirements	248,905	248,905	248,905	264,005	264,005	264,005
Bank Deposits	4,354,656	4,542,735	4,834,624	5,610,841	6,352,341	7,365,317
Sundry Debtors	7,450	13,599	21,483	32,707	45,752	56,722
Loans Outstanding	1,089,382	3,590,382	7,650,282	12,718,982	18,194,482	21,497,982
Less Loss Provisions	21,788	93,595	246,601	500,981	864,870	1,294,830
Net Loans Outstanding	1,067,594	3,496,786	7,403,681	12,218,001	17,329,611	20,203,152
Other Assets	5,338	17,484	37,018	61,090	86,648	101,016
Fixed Assets	123,000	131,610	140,823	150,680	161,228	172,514
Total Assets	5,826,127	8,516,345	12,832,974	18,585,155	24,596,942	28,586,170
Liabilities:						
Term Deposits	0	0	0	0	0	0
Sundry Creditors	9,198	10,309	11,141	11,921	12,756	13,648
Commercial Borrowings	0	0	0	0	0	0
Subordinated Borrowings	750,000	3,251,000	7,310,900	12,379,600	17,855,100	21,158,600
Total Liabilities	759,198	3,261,309	7,322,041	12,391,521	17,867,856	21,172,248
Net Worth:						
Paid-up Capital	4,978,100	4,978,100	4,978,100	5,280,100	5,280,100	5,280,100
Retained Earnings	(14,740)	88,829	276,936	532,833	913,534	1,448,987
Current Profit/Loss	103,569	188,107	255,897	380,701	535,453	684,835
Total Net Worth	5,066,929	5,255,036	5,510,933	6,193,634	6,729,087	7,413,922
Total Liabilities and Net Worth	5,826,127	8,516,345	12,832,974	18,585,155	24,596,942	28,586,170
D. Financial Ratios						
Capital Adequacy Ratio		115.38	64.47	45.70	35.70	33.78
Administration Expenses as % loans out		10.88	4.99	2.96	2.11	1.77
Return on Equity		3.64	4.75	6.51	8.29	9.68
Interest Coverage Ratio		2.88	1.97	1.77	1.71	1.70

LFI = licensed financial institution, NBC = National Bank of Cambodia.
Source: Rural Development Bank and TA 2818-CAM: Rural Credit and Savings Project.

THE NATIONAL BANK OF CAMBODIA

A. Overall Organization

1. The National Bank of Cambodia (NBC) is an autonomous central bank as the issuer of the local currency, the banker of the Government, and the supervisor of banks. NBC's board of directors consists of seven members including the governor, the deputy governor, and a staff representative. Members are appointed for four years and are eligible for a further term. The board of directors is responsible for establishing operating policies and issuing decisions, regulations, circulars, and other directives. As of the end of 1998, NBC had a total of 1,075 staff, including 425 staff working in provincial branches and 87 staff in the Foreign Trade Bank. The number of staff in provincial branches is being reduced by either employing them in the head office or by placing them in commercial banks wherever possible.

2. The NBC's balance sheet for 31 December 1998, excluding provincial branches, showed total assets of KR2,077 billion ($547 million), which is an increase by 51 percent as compared with December 1997. Foreign assets, which include foreign exchange, holding bank accounts with foreign banks, the International Monetary Fund (IMF) reserve position, and special drawing rights holdings, comprised 75 percent of its total assets in December 1997 and 81 percent in December 1998. This increase was due to a large increase in foreign accounts with foreign banks. As regards the IMF reserve position, NBC had a liability of KR224.7 billion ($59 million) in 1997 and KR253.8 billion ($67 million) in 1998. The total amount of foreign liabilities was in both years entirely due to the IMF for the General Reserve Account and the enhanced special adjustment facility.

3. NBC had a loan amount outstanding to the Government of KR211 billion ($56 million) in 1997 and KR289 billion ($76 million), an increase by 37 percent, and liabilities, held as a Government deposit, of KR153.5 billion ($40 million) in 1997 and KR106.1 billion ($28 million), a decrease by 31 percent. Since the beginning of 1998, the monetary policy has shifted toward support for the Government's budget deficit since Cambodia was not able to receive any assistance from IMF and was mainly concerned about the resolution of political conflicts. These led to a higher inflation and fast depreciation of the exchange rate. During 1998, although broad money (M2) grew at a rate of 16 percent, currency outside the banking system increased by 43 percent, resulting in soaring inflation.

B. Organization of the Bank Supervision Department

4. Bank supervision is one of the most important activities of NBC. To ensure the well-being of the banking sector, NBC's Supervision Department supervises licensed commercial banks to follow the banking laws and accompanying regulations set by NBC. The department was reorganized in December 1999, and now has four divisions for (i) off-site inspection of commercial banks; (ii) on-site inspection of commercial banks; (iii) administration, regulation, research and licensing of commercial banks; and (iv) supervision and licensing of specialized banks and microfinance institutions (MFIs). The department is headed by a director. Until the recent reorganization, the department had a separate office, called the Supervision Office for Decentralized Banking System, which was established by an agreement between the French Agency for Development and the Ministry of Economy and Finance of the Government in November 1997. This office, which received financial and technical support from French Agency for Development to assist four nongovernment organizations, has been integrated into

the new division for the supervision and licensing of specialized banks and MFIs. At present, NBC monitors the financial activities of major nongovernment organizations, which submit quarterly reports on a voluntary basis.

5. The Supervision Department has 38 staff, including 10 staff recently assigned to the on-site inspection division for commercial banks. These staff members received brief training on on-site inspection activities. There are 18 staff working in six sections of the off-site inspection division for commercial banks. The supervision and licensing division for specialized banks and MFIs will conduct off-site and on-site inspection of these institutions.

C. Supervision of Commercial Banks

6. The six sections of the off-site inspection division supervise 31 operating commercial banks. Each section of three staff is responsible for about five commercial banks. Supervision is done by analyzing weekly, monthly, quarterly, and annual reports of banks. On a 28-day basis, banks are required to provide daily balances of riel and foreign liabilities through their required reserve reports to show compliance with the daily average required balance. The present reserve requirement is fixed at 8 percent of total liabilities. Banks are penalized by 0.1 percent per month of the refinancing rate on the deficit amount if they fail to comply with reserve requirements.

7. Monthly reports required for banks include information on the statements of assets and liabilities, income and expenditures, credit granted by type of business and customer, total deposits classified by type of customer, foreign exchange position, and calculation of net worth. Banks also submit quarterly reports on bad and doubtful debts, capital adequacy ratio, and organization and administration. Annual reports and audited financial statements of banks are also submitted to NBC. Action is taken if banks are found to fail to comply with NBC regulations.

8. There is still substantial room for improving the effectiveness of NBC's bank supervision. Details on the liquidity positions of banks, including their liquid assets and liabilities in the country and abroad, short-term liabilities with local and foreign banks, local and foreign demand deposits, and collateral covering outstanding loans, will be required for more accurate analysis. On-site supervision of commercial banks has been carried out by external auditors at the request of NBC if there are suspicions about bank reports. NBC urgently needs to activate its in-house function for regular on-site supervision for the verification of reports submitted by banks.

D. MFI Supervision under the Project

1. Organization and Staffing

9. Under the new law on banking and financial institutions, MFIs are allowed to carry out financial transactions, including savings mobilization from the public, under NBC's supervision. Supervision of MFIs requires the same approach and strictness as for commercial banks and needs to be under a specialized division for MFI supervision at NBC's Bank Supervision Department. MFIs will need to be licensed by the department prior to being eligible to obtain deposits from the public. MFIs will have to conform to NBC's requirements with respect to their capital adequacy ratios and minimum reserves with NBC, which are different from those for

commercial banks. MFIs will not be allowed to provide payment services through checking accounts or forward dealings in foreign currencies. The assessment of MFIs' financial positions will require a specialized approach in view of their financial structure, performance, experience, and areas of operation. Regular on-site inspection of MFIs, including their branch offices, will be essential for verifying documents NBC receives from MFIs for assessment and reporting.

10. Proper scheduling of on-site inspection should be done annually. About 50 days are required for on-site inspection during the first year and 60 days in the second year, gradually increasing to 90 days by the fifth year. On-site inspection will focus on the quality of the loan portfolio, including loan documentation such as loan agreements and security obtained, and the quality of cash and deposit management.

2. Monitoring and Supervision

11. MFIs may be required to submit monthly reports to NBC on (i) loans outstanding, (ii) savings and deposit balances, (iii) liquidity balances in cash and deposits with NBC and licensed commercial banks, (iv) income and expenses statements, (v) percentage of liquidity reserves in relation to savings and deposits, and (vi) statements of overdue loans classified up to 30 days, from 31-60 days, 61-180 days, and beyond 180 days outstanding. Quarterly reporting may include additional information on (i) management accounts, (ii) the number of borrowers and depositors, (iii) the calculation and evaluation of the net worth, (iv) the statement of investments in fixed assets and in equity participation, and (v) capital adequacy and liquidity ratios as prescribed by NBC. Annual reporting will be accompanied by audited financial statements. The financial statements of MFIs need to be audited by an independent auditor approved by NBC.

12. NBC will process all reports received from licensed MFIs. A diary system will be installed to monitor the timeliness of reports. For each MFI, a card will be prepared to record key details such as the address, contact person, legal form, main shareholders, general manager, and auditor. This card will be filed in a central registry and will be available to authorized persons only. The cash balances and the overall liquidity position of each MFI will be reviewed on a monthly basis. Monthly reports together with financial statements from MFIs should reach the supervision and licensing division not later than 15th of each month following the month under review. Analysis of current assets and liabilities by item, amount, and currency will be required to ensure the maintenance of adequate liquidity. Sudden changes may be a sign of financial deterioration and necessitate NBC's dialogue with the concerned MFI for remedial actions to be taken.

13. Regular meetings need to be organized within NBC's Bank Supervision Department to review the progress of MFI development. Based on the performance and financial positions of MFIs, NBC should flexibly consider amendments of MFI regulations or new regulations if necessary to promote sound development of MFIs.

SUMMARY INITIAL ENVIRONMENTAL EXAMINATION

A. Introduction

1. The initial environmental examination (IEE) of the Project was conducted over a six-week period from November 1998 to December 1998. The IEE covers a range of subprojects that are expected to be financed under the Project, including rice production, small-scale irrigation, pig raising, palm sugar production, rice milling, weaving, brick and tile making, and trading.

B. Description of the Environment

2. The Cambodian landscape features (i) the floodplain of the Mekong River and the associated basin of the Tonle Sap draining to the Mekong delta in the southeast, (ii) the Cardamon and Dangrek mountains to the southwest and northwest, and (iii) the plateau bordering the Lao People's Democratic Republic and Viet Nam in the northeast. A narrow coastal belt lies beyond the Cardamon Mountains. The climate is monsoonal, with the wet season from May to November. Marked variation is present from year to year in the onset, intensity, and duration of the rains. Over 75 percent of the population live in the Mekong Basin and the Tonle Sap Plain, which represent a very large diversity of agro-ecological conditions.

3. Cambodian farms are predominantly subsistence-oriented in rice cultivation. Soils tend to be of low fertility and deficient in nitrogen, phosphorous, and micronutrients. Productivity is maintained in many areas by the deposition of silt by annual floods. Some 80 percent of rice cultivation is rainfed, and resulting in a high variety of rice yields and thus high risks to farming. Only 17 percent of the rice-growing areas are currently under any form of water management, and the use of fertilizers and pest control technology is limited. Opportunities for production increases through the use of these two chemical inputs are significant, and will have environmental implications.

4. The rate of forest coverage in Cambodia is estimated up to 65 percent, including evergreen lowland and mountainous, semi-evergreen, and deciduous communities. The forests provide habitat to a great wealth of animal biodiversity, including wild cats, primates, bears, elephants, pangolins, and about 400 bird species. Rapid and poorly managed commercial logging degrades these forests at an unsustainable rate. Moreover, a large number of rural people depend on materials gathered from common areas for their nutritional well-being. Exploitation of forest species is extensive and often uncontrolled. Deforestation is a major contributor to flood disasters, and possibly also to changes in rainfall patterns.

C. Screening of Potential Environmental Impacts and Mitigation Measures

5. Although environmental impacts of many subprojects in the rural area are expected to be insignificant, the aggregate impacts of all may become apparent, especially when the use of toxic pesticides is increased, the extraction of trees or quarried material is accelerated, and/or the hydrological regime is modified. The examples of possible impacts of subprojects and mitigative measures are discussed in Table A11. Societal means for ensuring a positive balance in such circumstances include (i) appropriate institutional mechanisms for decision making, (ii) effective tools for sound technical analysis, and (iii) transparent and equitable procedures for monitoring and enforcement. An adequate regulatory framework to ensure these is being formulated. The Project provides an

opportunity to contribute to these developments through increased awareness among communities and civil institutions in the rural area.

6. The capacity building for environmental management is necessary for line ministries and local institutions in Cambodia to conduct effective planning and monitoring. Without placing undue burdens on the microfinance institutions (MFIs), the Project will ensure that (i) MFI officers are given at least an initial introduction to the potential environmental impacts of their portfolios, (ii) MFI officers will have access to the technical support programs of the Government and nongovernment organizations for sustainable natural resource management, and (iii) the monitoring activities under the Project will contribute useful information to the country's overall environmental management efforts by properly compiling progress and impact reports.

D. Institutional Requirement and Environmental Monitoring Program

1. Institutional and Legal Framework

7. The Ministry of Environment, which was established in November 1993, has major responsibility for environmental management. Other ministries relevant in the area are the Ministry of Health, the Ministry of Tourism, the Ministry of Public Works and Transport, and the Council for the Development of Cambodia. The Government is making efforts to develop appropriate coordination among these ministries in environmental management, as mandated in the five-year plan.[1] Some collaboration is beginning to emerge, both at the working level among officials and at senior levels among members of the Environmental Steering Committee of the Government. However, it will take some years before an effective system for environmental management becomes operational, given the prevailing institutional and resource constraints. The Project will facilitate the growth of the system through encouraging environmental awareness on the part of MFIs.

8. The law on environmental protection and natural resource management, which specifies the Ministry of Environment's authority, public participation procedures in environmental protection, and penalties for pollution and related offences, was enacted in 1996. Specific details for implementation are left to subordinate regulations such as subdecrees and circulars, which cover environmental impact assessment, water pollution control, solid waste management, protected area management, and control over the use of insecticides. Article 6 of the law requires that environmental impact assessments (EIA) be done for all investment projects that require Government approval, subject to criteria and procedures to be established by a subdecree pursuant to the law. A draft subdecree for the EIA process was prepared with technical support from the Asian Development Bank [2] and United Nations Development Programme.[3]

2. EIA Process

9. Details on how EIA and other requirements are applied for investment projects remain unspecified in Cambodia since the relevant regulations are not in place. An EIA will be required for any project that needs to be approved by a Government institution by a construction permit, operating license, or concession agreement. The Government will determine the level of environmental review required for each project based on each

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[1] Royal Government of Cambodia. 1997. *First Socio-economic Development Plan, 1996-2000*, Phnom Penh.
[2] TA 2723-CAM: *Institutional Strengthening and Expanding Environmental Impact Assessment Capacity*, for $1,000,000, approved on 19 December 1996.
[3] Environmental Technical Advisory Project, United Nations Development Programme.

application for an environmental review. The information required in this application is of the same kind but less comprehensive than that of an IEE, amounting to a brief study. For a proposal judged likely to have little or no environmental impact, the application document will be sufficient for fulfilling requirements under the law. Projects that are considered to have significant environmental impacts will be required to submit their IEE results together with their applications. Some will then be judged to require a full-scale EIA before approval is granted. Most subprojects to be financed under the Project are very small-scale enterprises, and will not require approval from a Government institution for commencement. Even if some subprojects need to be reviewed by the Government, the screening can be done under summary procedures based on the application documents.

3. Environmental Management Process

10. The project management unit will have an officer responsible for environmental concerns under the Project. The officer will commission the work of designing environmental training modules for MFI managers, develop a data base for natural resource management programs, facilitate working relations between the project management unit and MFIs, and organize environmental monitoring activities relating to the Project.

E. Conclusion and Recommendations

11. Cambodia's capacity to manage the environmental impacts of development is beginning to emerge, both in terms of the legal framework for regulation and skilled personnel capable of managing the environmental assessment and monitoring. Appropriate environmental management of larger scale industrial projects will largely occupy this still limited capacity for the next several years. For the majority of the rural population, the development of microenterprises is critical for the reduction of poverty, yet these enterprises could pose a threat to the resource base that people depend on for their food security. By bringing at least a minimum of environmental consideration and technical expertise into the planning process and at the level of investment decision making, the Project will contribute to the promotion of sustainable development paths in the rural area. In addition to the environmental management process to be institutionalized into the project management unit, the adoption of mitigative measures listed in Table A11 is recommended under the Project.

Table A11: Summary of Environmental Impacts of Microenterprises

Subprojects	Anticipated Impacts and Mitigation Measures[a]
1. Rice Production	(++) Increased supply of primary staple food. (--) Increased use of pesticides may adversely affect human health and ecosystem if used improperly. Improper use of chemical fertilizers can pollute various water bodies. Mitigation: Training of farmers on integrated pest management
2. Small-scale Irrigation	(++) Increased rice and vegetable production gives significant marketable surpluses and increased food security. (-) Excessive use of tubewells may deplete subsurface water resources. (-) Standing water can increase parasitic disease risks for rural communities. Mitigation: Systematic hydrological studies and public health training are required.

Subprojects	Anticipated Impacts and Mitigation Measures[a]
3. Pig Raising	(+) Additional cash income for rural households. (-) Poor manure management. (-) Damage to home gardens and small trees. Mitigation: Feeding of pigs in confined areas should be encouraged. Information on benefits and methods of composting manure should be provided to applicants for loans for pig raising.
4. Palm Sugar Production	(+) Additional cash income for rural households. (--) Use of dung as fuelwood substitute reduces soil fertility. Fuel collection task affects family labor budgets, especially women and children. Mitigation: Training on reforestation and community forestry in locations where fuelwood resources are diminishing or already scarce.
5. Rice Milling	(++) Low-cost food available due to economies of scale and increased extraction efficiencies in milling. Additional cash income for rural households. (-) Increased dust for workers in the rice mill and nearby residents. Mitigation: MFIs should provide information on improvements for occupational health and safety conditions relating to increased dust in their areas of operations.
6. Weaving	(+) Additional cash income for rural households. (-) Dyeing operations, if present, may cause local water pollution. Mitigation: Encourage the use of natural and low metal content dyes. Inform weavers of the hazards associated with dyeing operations, and provided with information on safe handling.
7. Brick/Tile Making	(i) **Cement Tiles.** (+) Additional cash income for rural households. Preferred substitute for timber in housing construction. (--) Poor management of sand quarries that are not annually replaced alluvial deposits. (ii) **Fired Clay Brick and Tile** (+) Additional cash income for rural households. Preferred substitute for timber in housing construction. (--) Clay quarrying changes drainage patterns and landscape. (--) Firing of clay bricks requires large fuel supplies, usually wood, risking competition for fuelwood with households and increased deforestation. Mitigation: Encourage revegetation of permanent quarries with appropriate fodder species and through community forestry activities. Encourage recontouring. When MFI loans may have a risk of facilitating deforestation in the area, the local community should develop community forestry programs drawing on expertise available in the Ministry of Environment and the Department of Forestry and Wildlife of the Ministry of Agriculture, Forestry and Fisheries.
8. Trading	(++) Additional cash income for rural households. Livelihood opportunities for disadvantaged households, including those headed by females. (-) Safety risks in handling dangerous goods, such as gasoline and pesticides, and public health risks associated with food preparation and handling. Mitigation: Basic counseling on appropriate handling of materials for sale. Merchants handling dangerous goods should be provided with posters or other information media alerting their customers the relevant risks.

[a] (++) highly positive impacts, (+) minor positive impacts, (--) highly adverse impacts, and (-) minor adverse impacts.

SUMMARY SOCIAL ASSESSMENT

A. Introduction

1. A social assessment was carried out during the preparation of the Project to establish an understanding of the intended beneficiaries. The social assessment specifically aimed at (i) identifying the client group of the Project; (ii) examining the socioeconomic circumstances of the client group, including the poor, the near-poor, the better-off, and women; (iii) analyzing the needs, demands, and absorptive capacity of the clientele identified for rural financial services, including perceptions regarding access to credit and responsibilities involved; and (iv) examining social development concerns relevant to the Project. The field work was carried out for three weeks in October 1998 and November 1998 in four provinces, which were selected from the plain, Tonle Sap Lake, and plateau regions of the country. The four provinces are Kompong Cham, Prey Veng, Banteay Meanchey, and Kompong Speu. Kompong Speu and Prey Veng Provinces are considered to be poorer among the four. The coastal region was not selected since it is characterized differently as a province mainly for tourist enterprises. These four provinces are considered representative of most of Cambodia's rural population. The survey was based on a sample of 348 rural households taken at random from areas where nongovernment organizations (NGOs) are active in credit and savings schemes. Preliminary findings were presented and discussed at a stakeholder workshop involving NGOs on 24 November 1998. The results of the social assessment are summarized in Table A12.

B. Social Assessment

1. Rural Poverty

2. The clientele of the Project will be the people living in provincial areas outside Phnom Penh, including provincial towns. Outside towns, rural people live in agricultural areas and along waterways. The rural population covered under the social assessment was marked by a high incidence of poverty or near-poverty. They represent a significant portion of the subgroups in the client group of the Project. Household sizes in the surveyed area ranged from 2 to 15 persons, with an average of 6, which is higher than the national average of 5.2. The gender ratio in the households was 48 percent male and 52 percent female, roughly reflecting the country's situation. Households surveyed were mainly headed by males with 8 percent of the total households surveyed headed by females, contrasting with a national average of 25 percent. Most households are centered on nuclear families, with few extended families. The dominant ethnicity in the surveyed area is Cambodian (95 percent of the total households surveyed). Cham or Muslim Cambodian is the next largest ethnic group (4 percent). Other ethnic groups include indigenous people, Thai, and Cambodians of Chinese ethnic origin.

3. Households and villages are the main bases for social organization. Temporary groups on the bases of kin, friends, and neighbors often form to deal with circumstances such as labor shortages and emergencies, and for important social events. Political and administrative units at the village level are village development committees, appointed by Government authorities, but comprising community members most often recognized as authority figures. Government hospitals are operated at provincial and district levels. Commune health offices exist at the village level, and private clinics operate. The cost of health care limits the access of the rural poor to health services, and illnesses and accidents can result in major financial burdens, forcing the sale of assets such as land and livestock to generate funds.

4. Ninety-one percent of the population is literate to some degree. Illiteracy is higher among poorer households, and higher among females (15 percent) than males (5 percent). Forty percent of the surveyed respondents reported a primary school education, 28 percent a high school education, and 1 percent a higher level of education. Households value education for their children and save for school fees, though this is a major burden on poor households.

5. Main roads are generally in poor condition. Access rural roads are also poor or more deteriorated. A very limited telephone system exists only in towns. Where an electricity supply exists, radio and television are becoming an increasingly important communication media, being owned by well-off families in the villages. Postal systems are often inadequate. Public bus and motorcycle taxis are the main modes of personal transportation, and trucks for hire are available for transportation of goods. Bicycles and ox- or horse-drawn carts also remain important modes of transportation for most rural households. Wood, obtained from public forests, is the main source of energy for cooking and other purposes. Scarcity of wood is an increasingly serious problem. A regular electricity supply exists only in towns. Some 32 percent of households rely on storage batteries for basic electricity. Five percent own a generator, which is a highly valued asset in villages. Poor households without electricity rely on kerosene as a source of lighting.

6. Major economic assets include land, buildings, gold, livestock, agricultural equipment, and items such as motorcycles, generators, and televisions. Such assets often serve as collateral for individual loans. There are few landless persons in the surveyed area. Fifty one percent of total households had less than 0.5 hectares, which accommodate houses as well as some land for agriculture. Most households own some livestock. Household livestock raising is a significant source of secondary household income. The dominant livelihood is agriculture, predominantly rice farming. Fifty-seven percent of respondents are engaged in rice cultivation. Corn, sweet potatoes, cassava, and other vegetables are grown as market crops, but generally on a small scale. Many households are engaged in a wide range of nonfarming activities. Such activities include a variety of enterprises, trading, provision of services, and labor. Most households have more than one source of income for their subsistence.

7. It is difficult to form a precise estimation of poverty incidence for the surveyed area. A few studies have assessed the poverty situation in Cambodia. United Nations Children's Fund estimates that the poor account for about 85 percent of the population in Cambodia. Another study,[1] reported 40 percent of rural households below the official poverty line of a per capita income of KR1,210 ($0.32) per day. Considering an income of less than KR1,210 per day and the ownership of less than 0.5 ha of agricultural land[2] as indicators for rural poverty, about 65 percent of the surveyed households may be classified as poor households.

8. Poor households in rural Cambodia are heavily handicapped in terms of (i) ownership of assets, (ii) access to basic social services, and (iii) access to financial services. They are characterized by the inability to produce a year-round food supply (six months average of food shortage), small and fragmented landholdings, small or no savings to cover emergency needs such as illness, limited or lack of access to health care, lack of access to minimum sanitary facilities, and the need for borrowing to support and expand income-

[1] *A Poverty Profile of Cambodia – 1997*, the Ministry of Planning, financed by UNDP, the World Bank, and SIDA.
[2] Ownership of 0.5 ha of agricultural land is an informal but accepted indicator of poverty in the rural area.

generating activities. Generally, there is a large gap between a small number of rich people and people belonging to the poor and the near-poor groups, who constitute the majority of rural population. Some of wealthy people become sources of informal credit for poorer households in the rural area. Poor people are usually engaged in wage labor and other off-farm employment in addition to agriculture as additional sources of cash income, and need to work harder to avoid a cycle of heavy debt burden.

2. Role of Women

9. In Cambodia, women have greater social equality with men than is the case on some other Asian countries. Law and practice allow both sons and daughters to inherit property. The legal status and rights of women are protected under the Cambodian constitution. At the household level, women are active and equal participants in household management and decision making, including decisions related to financial issues. Women and men work together in the rural areas, although responsibilities of women include household and family-related work in addition to farm work or other income-generating activities. Some social restrictions affecting the mobility of women in terms of appearance and transportation are apparent in the Cambodian society.

10. Women are full partners in traditional rice agriculture. Women are engaged more in activities such as transplanting seedlings from seedbeds. Both men and women are involved in various degrees in the tasks of harvesting, transporting, and threshing. Many other farm activities are shared, such as carrying water and wood, and tending to livestock. Women tend to be involved in other on-farm or off-farm income-generating activities. Rural women are more active and more skillful in trading and marketing than men, and generally are better managers of household savings and credit. Women most often are the direct borrowers when credit is arranged, whether from an informal lender or a credit operator such as an NGO. However, there is usually a shared decision-making and agreement between a wife and a husband before taking a loan and in enterprise management.

3. Demand for Credit and Savings

11. The social assessment indicated that 34 percent of respondents actually received loans from NGOs, and 66 percent borrowed from individual moneylenders. Credit obtained was mainly for production purposes. For emergency needs, borrowing was mainly from informal sources. Loan size varies, with small loans being mainly for agricultural and livestock purposes, and medium- and large-sized loans for capital to support enterprises or trading activities. Nearly all households showed interest in borrowing to support income-generating activities, and most households identified loan terms and conditions and repayment arrangements as key factors in their decision making for borrowing. About 80 percent of the respondents in social assessment indicated their preference for NGOs as the source of credit funds. While the decision to borrow is a shared household decision, women respondents most often expressed greater interest in borrowing. It is noted that rural households in Cambodia are very cautious in financial transactions. NGOs also adopt prudent practices in their credit schemes by initiating them with a very small amount and increasing the amount, if considered feasible, through a few cycles.

12. With respect to savings, the social assessment results show the general distrust in or lack of access to commercial banks. About 95 percent of the surveyed rural households indicated their preference for saving in the form of cash, gold, or other assets because of the convenience of and trust in such form of traditional savings. Compulsory savings schemes currently practiced by some NGOs are not preferred due to (i) the distance to NGO offices;

(ii) the very small amount of saving, usually equivalent to one quarter of the monthly interest payment for NGO loans; and (iii) unclear systems for withdrawal and ownership of accumulated savings. About one third of the surveyed households indicated that they regularly saved money, another one third saved irregularly, and the remaining households did not have surplus money to save. Rural people usually require savings facilities for emergency purposes, which are commonly met through borrowing from moneylenders. The social assessment clearly showed the strong demand among rural households for reliable savings facilities that are safe, convenient, and attractive.

C. Some Field Observations

13. Interesting cases of microcredit were noted during the preparation of the Project. People interviewed indicated their general satisfaction with the rules and procedures of NGOs' credit operations. People who borrowed from moneylenders were dissatisfied and uniformly stated preference for NGOs. Subsequent to their successful experience in the first borrowing, most beneficiaries request for the second cycle of borrowing funds from NGOs.

14. One example is a poor woman in Takeo Town Market, who was engaged in cloth trading. She received a credit of KR75,000 ($20) from the Association of Cambodian Local Economic Development Agencies (ACLEDA). She regularly buys a small amount of cloth from a wholesaler in Phnom Penh once or twice a month depending upon the level of the previous sales. Generally, the wholesaler allows her to buy on credit, and she repays during her next purchase. Before ACLEDA operated in her area, she made loans from her relatives or moneylenders. The interest charged by moneylenders was KR1,000 per month per KR10,000 ($2.63) borrowed, with repayments daily or weekly. The trader indicated that she would not borrow money from moneylenders in future as some moneylenders gave information about her financial transactions to other people in the village. She prefers the ACLEDA scheme partly because of its businesslike procedures and confidentiality; details of her transactions are shared only with her group members (four other women).

15. The trader was introduced to the ACLEDA scheme during a meeting organized by ACLEDA with local traders in the market. All details were explained to them, and those who were interested to take loans applied for registration, and took a short training program. For small loans, a group of five members is formed, while individual loans require land or house titles as collateral. Her trading budget and business management were assessed by ACLEDA to make sure that she could manage funds properly and make repayments in a timely manner. She also indicated that ACLEDA provided loans to a large number of small local traders in the market.

D. Conclusion

16. The survey and social assessment results indicate a strong demand for reliable credit and savings facilities in the rural area. Although the level of education among rural households is not high, they generally have long experience in financial transactions with individual moneylenders and NGOs, and in savings in the form of cash, both in local and foreign currencies, or various forms of other assets. They are familiar with foreign exchange in US dollars or Thai baht. The lack of access to effective financial services is clearly a major constraint to expansion of small-scale economic activities of the rural poor. The provision of such access to poor households in the rural area under the Project will significantly contribute to poverty reduction.

Table A12: Summary Results of the Initial Social Assessment[a]

Subject	Province				Total Survey
	Banteay Meanchey	Kompong Cham	Kompong Speu	Prey Veng	
Sample size (no.)	101	105	70	72	348
Gender Characteristics					
Male	51	51	44	46	48
Female	49	49	56	54	52
Male-Headed Households	93	92	90	92	92
Female-Headed Households	7	8	10	8	8
Educational Attainment					
Illiterate	12	5	9	10	9
Literate without Schooling	25	20	26	15	22
Primary School	43	44	41	31	40
High School and Above	20	31	24	44	29
Asset Ownership[b]					
Pump	19	16	3	35	18
Tractor	9	3	0	3	4
Electricity Source	56	67	54	65	61
Ox-cart	23	22	40	21	26
Land Holding					
Less than 0.5 ha	30	68	63	42	51
0.5 - 1.0 ha	15	10	24	7	14
Larger than 1.0 ha	55	22	13	51	35
Primary Source of Income					
Farming	72	58	69	56	63
Agriculture-Related Business	0	3	0	5	2
Nonagriculture Business	7	1	6	8	6
Trader/Vendor	11	30	18	19	19
Services	9	6	7	8	8
Laborer	1	2	0	4	2
Preferred Source of Credit					
Self-Help Groups	17	7	15	10	12
Cooperatives	3	6	4	8	6
NGOs	72	85	75	79	78
Government Projects	6	2	3	3	3
Relatives or Moneylenders	2	0	3	0	1

[a] Shares expressed in percentage of the total respondents unless indicated otherwise.

[b] Respondents may have more than one item.

Source: Social assessment conducted under TA 2818-CAM: Rural Credit and Savings Project.

FINANCIAL AND ECONOMIC ANALYSES

1. Financial and economic analyses were carried out for a range of subprojects based on a detailed evaluation of the loan portfolios of major nongovernment organizations (NGOs) in Cambodia. The sample should be considered as indicative as other activities may be financed under the Project. The analyses were undertaken to ensure that subprojects considered most likely to be financed under the Project could generate sufficient income to repay their loans and generate surplus, and that they were in the national interest.

2. An economic analysis of the overall project was not done because the process for a microfinance project precludes accurate identification of all types and numbers of subprojects to be financed or assessment until the Project is being implemented. Nonetheless, the indicative subprojects were assessed to indicate the overall viability of the Project from the national perspective.

A. Financial Analysis

1. Indicative Subprojects

3. Financial internal rates of return (FIRR) were estimated for subprojects with multiyear investments and returns. Some subprojects extend over only two years with the capital investment at the end of one year and the returns in the following year. For agricultural crop subprojects of a one-year duration, in particular rice inputs and trading, FIRRs could not be estimated. Agriculture-related activities include rice inputs for both wet season rice and dry season irrigated rice production, small-scale irrigation, and pig raising. Pond fisheries were not included as the NGOs determined that uncertain production levels and no guarantee of sales make them nonbankable. Palm sugar production, rice milling, silk weaving, and brick making represent manufacturing enterprises. Retail trading, frequently by women to supplement other household incomes, covers a broad range of goods, including cakes, agricultural produce, bicycle parts, soft drinks, clothing, and various consumer goods with daily or weekly turnover cycles and a profit margin for each cycle of 5-15 percent. Based on the current experience of NGOs, such subprojects are expected to account for about 90 percent of loans provided under the Project.

2. Assumptions

4. Prices used were those prevailing during December 1998 to January 1999. Continuity in the current Government policies and general inflation relating to input and output prices are not expected to have a significant impact on relative prices. Physical input and output coefficients are based on data that were collected from households that have already received loans from NGOs and are thus considered to be indicative of the situation in the rural area. Unpaid family labor has been considered to incur no cost for the initial financial analysis, and returns to labor were estimated. Subsequently, the analysis has been repeated with family labor calculated at the prevailing wage rate of about KR4,000 ($1) per day near provincial towns to present the financially most conservative treatment of labor. The expected life of each subproject is based on the social assessment rather than an assessment of what could be achieved so that the analysis will reflect the actual situation more accurately.

3. Financial Rates of Return

5. FIRRs for individual subprojects range from 23 percent for a small-scale rice milling to 91 percent for silk weaving (Table A13.1). The financial net present values for single-year activities, including rice inputs and trading, show positive results. There is clearly a wide range of investment opportunities for individual entrepreneurs, and specific demands for credit will depend largely on the experience and desires of these entrepreneurs. At the lower end of the spectrum are production loans for rice cropping, trading, palm sugar production, and pig raising requiring investments of $300 or less. Such loans are expected to be most common as they support the types of activities with which rural households are most familiar. For small-scale irrigation, silk weaving, rice milling, and brick making, loans of $300 or more will be required. A large number of microenterprises can be undertaken by rural households without significant business experience. Of these activities, silk weaving appears to be the most attractive, providing a good return for households with sufficient labor. All of these activities appear to be financially viable and to have returns in excess of the real interest rates, based on a nominal interest rate of 36 percent per annum and an inflation rate of 13 percent per annum. Nevertheless, returns could be greatly improved with proper attention to technology, minimizing costs, and improved marketing.

6. Based on the subproject budgets, incremental costs, revenue, and employment generation are summarized in Table A13.2. Subprojects for food processing and other light manufacturing undertakings, including palm sugar production, small-scale rice milling, silk weaving, and brick making are expected to increase employment opportunities. Brick making is particularly heavily dependent on nearby unskilled labor. These subprojects are expected to generate an average of about 180 person-days per loan for a year. Medium employment subprojects include pig raising, and trading, which would create about 80-100 person-days per loan. Pig raising and trading are the most common activities among NGO subborrowers. The medium employment subprojects are expected to account for about 60 percent of loans. Subprojects with low employment generation include rice production and small-scale irrigation, which would generate an average of about 20 person-days per loan and are expected to account for about 20 percent of loans. Assuming this composition of types of indicative subprojects, the Project will provide the equivalent of about 66,000 jobs.

B. Economic Analysis

7. Economic analysis was undertaken for the same subprojects as in the financial analysis and for the same time spans. Economic prices for the main traded inputs and outputs (predominantly rice and fertilizer) were based on the latest World Bank commodity price projections and were adjusted to constant 1998 values using the standard index. The average price of rice was estimated based on the existing situation of export to Viet Nam and Thailand during months of surplus and imports from those areas during months of deficit. Fertilizer prices were estimated at import parity reflecting the likely ongoing need for Cambodia to import fertilizer. Border prices were adjusted to farm-gate prices by allowing for the economic values of transport, processing, and marketing. For livestock and manufactured goods, which all tend to be nontraded commodities, the market price was adjusted by a standard conversion factor of 0.9, and the financial prices of all other nontraded inputs were also adjusted by a standard conversion factor of 0.9 in accordance with the procedures used by the Asian Development Bank in recent studies for Cambodia. The economic cost of labor was estimated using an appropriately defined shadow wage rate

for employees and potential beneficiaries in the rural area. Given the wide range of subprojects and the differing capabilities of potential subborrowers, a single shadow wage rate did not appear appropriate. Consequently, two rates (0.95 and 0.75) were used reflecting the differing alternative opportunities for entrepreneurial family labor and general workers, respectively.

8. Economic internal rates of return could not be estimated for the two rice production activities and trading as these represented single-year activities. However, the economic net present values show they are beneficial from the viewpoint of the national interest. The economic internal rates of return of the remaining enterprises also show their economic viability (Table A13.1). Those of small-scale processing and manufacturing range from 24 percent to 62 percent, showing high economic viability.

C. Nonquantifiable Benefits

9. A substantial level of nonquantifiable benefits will accrue from the Project. Appropriate legal and regulatory frameworks will be established for rural finance. Subborrowers will benefit from skill development and environmental awareness activities, which will be beneficial in the long term. Licensed financial institutions (LFI) are expected to improve their management skills, to gain a greater appreciation of environmental issues and how they can be addressed through credit programs, and to achieve financial sustainability. This will enable them to expand their services in a profitable and sustainable manner. Furthermore, they will be able to apply the skills obtained to all of their clients, as well as future clients, many of whom will not be direct beneficiaries of the Project. Similarly, the institutional strengthening of the Rural Development Bank in banking and financial management and the National Bank of Cambodia in the supervision of financial institutions will create bodies able to manage microfinance activities efficiently and in a sustainable manner.

D. Risks and Sensitivity Analysis

10. The main project risks from the subborrowers' perspectives are that individual subprojects will cost more to implement than expected or will produce lower than expected net benefits. Risks of a 10 percent increase in investment costs and a 10 percent decrease in net benefits have been assessed separately for each indicative subproject with multiyear investments and returns. The results show considerable variations between subprojects (Table A13.3). From a financial perspective, pig raising, small-scale rice milling, and palm sugar production are relatively more sensitive to changes in investment costs and net benefits. From an economic perspective, pig raising and palm sugar production are the most sensitive ones. Other enterprises appear sufficiently robust.

11. The major risk for LFIs would be for the Government to limit interest rates on their lending. This would, eventually, result in a decrease in very small loans due to difficulties in cost recovery. The Government has a free interest rate policy, which needs to be retained. Similarly, the Government should not impose high cost barriers to the opening of provincial and district branches. Changes in other financial variables such as loan loss and cost of funds can be accommodated by LFIs through sound management, accurate and prompt financial reporting, and flexibility in their pricing of products.

Table A13.1: Summary Results of Financial and Economic Analyses

Subproject	FIRR (%)	FNPV at 12% (KR thousand)	FIRR (%) with Hired Labor[a]	EIRR (%)	ENPV at 12% (KR thousand)
Fertilizer for Rice (wet season)	0	45	0	0	63
Fertilizer for Rice (dry season, irrigated)	0	105	0	0	145
Small-Scale Irrigation	29	564	13	46	1,163
Pig Raising	54	843	12	13	18
Trading	0	618	0	0	783
Palm Sugar Production	60	607	0	24	128
Small-Scale Rice Milling	23	667	-8	29	1,057
Silk Weaving	91	2,728	32	62	1,468
Brick Making	30	16,235	23	34	18,023

EIRR = economic internal rate of return, ENPV = economic net present value, FIRR = financial internal rate of return, FNPV = financial net present value.
[a] Hired labor assumed at the wage rate of about KR4,000 per day. Palm sugar production has a negative cash flow with hired labor.
Source: Social assessment conducted under TA 2818-CAM: Rural Credit and Savings Project.

Table A13.2: Incremental Financial Costs and Revenues, and Employment

Subproject	Incremental Cost		Incremental Revenue		Incremental Employment (days)
	Initial Investment (KR'000)[a]	Annual Operation (KR'000)	Annual Gross (KR'000)	Annual Net (KR'000)	
Fertilizer for Rice (wet season)	0	15	66	51	10
Fertilizer for Rice (dry season, irrigated)	0	103	220	118	15
Small-Scale Irrigation	820	475	780	305	21
Pig Raising	945	883	2,324	511	99
Trading	223	1,908	2,600	692	80
Palm Sugar Production	416	1,391	1,785	395	150
Small-Scale Rice Milling	2,100	1,066	1,690	624	104
Silk Weaving	735	2,289	3,000	711	96
Brick Making	21,923	50,472	57,960	7,489	360

[a] Including working capital.
Source: Social assessment conducted under TA 2818-CAM: Rural Credit and Savings Project.

Table A13.3: Summary Results of Financial and Economic Analyses

Subproject	FIRR (%)					EIRR (%)				
	Base Case	Incr. in inv. cost by 10%	SI [a]	Decr. in rev. by 10%	SI [a]	Base Case	Incr. in inv. cost by 10%	SI [a]	Decr. in net benef by 10%	SI [a]
Small-Scale Irrigation	29	26	1.035	26	1.035	46	42	0.870	41	1.087
Pig Raising	54	40	2.593	38	2.963	13	3	7.692	2	8.462
Palm Sugar Production	60	49	1.833	48	2.000	24	15	3.750	15	3.750
Small-Scale Rice Milling	23	19	1.739	19	1.739	29	25	1.379	25	1.379
Silk Weaving	91	82	0.989	81	1.099	62	55	1.129	54	1.290
Brick Making	30	27	1.000	26	1.333	34	30	1.177	30	1.177

EIRR = economic internal rate of return, FIRR = financial internal rate of return, SI = sensitivity indicator.
[a] Sensitivity Indicator = percentage change in IRR / percentage change in the variable concerned.
Source: TA 2818-CAM: Rural Credit and Savings Project and staff estimates.