SMALL-MEDIUM ENTERPRISE DEVELOPMENT AND FINANCING ISSUES

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Хураангуй: Жижиг дунд үйлдвэрлэл (ЖДҮ) нь аливаа улс орны аж ахуйн нэгжүүдийн дийлэнх хувийг бүрдүүлдэг бөгөөд тэдгээрийн эдийн засгийн хөгжил, ажил эрхлэлтэнд оруулдаг хувь нэмэр нь их юм. Ялангуяа, хөгжиж буй улсуудын хувьд ЖДҮ-ийн хөгжлийг дэмжих нь нэн чухал асуудал болохыг 2009 оны дэлхийн санхүүгийн хямралаас хойш олон улсын хөгжлийн байгууллагууд, судалгааны болон санхүүгийн институтууд, засгийн газрууд онцлон тэмдэглэх болсон. Хэдий тийм ч эдгээр улс орны эдийн засгийн чадавхи, санхүүгийн зах зээлийн нөхцөл байдлаас хамаараад ЖДҮ-ийн хөгжлийн тулгамдсан асуудлын нэг болох санхүүжилтийг сайжруулж чадахгүй байна. Монгол улсад ч мөн адил ЖДҮ-үүдийн өсч хөгжих хэрэгцээг хангахуйц урт хугацаатай, харьцангуй бага хүүтэй санхүүжилтийн хэрэгслүүд хангалтгүй байгаа нь энэ чиглэлээр тодорхой судалгаа хийж, илүү цэгцтэй, нэгдмэл бодлого баримтлах, санхүүжилтийн шинэлэг арга хэрэгслийг нэвтрүүлэх шаардлагатай буйг харуулж байна. Уг судалгааны ажил нь ЖДҮ-ийн санхүүжилтийн олон улсын байдлыг судлахын зэрэгцээ Монголын ЖДҮ-ийн санхүүжилтийн асуудлыг эрэлт, нийлүүлэлтийн талаас нь шинжилж, тодорхой санал, зөвлөмжийг дэвшүүлэн тавьсан.

Түлхүүр үгс: ЖДҮ, ЖДҮ-ийн хөгжил, түүний санхүүжилтийн бэрхшээлүүд, шийдвэрлэх арга замууд.

Abstract: Small and medium-sized enterprises /SMEs/ and micro businesses play a crucial role in supporting economic growth, providing jobs for the growing population and reducing poverty around the world as well as in Mongolia (UNDP, 1999; World Bank, 2012) In particular, international development organizations, research institutes and governments have highlighted since the 2009 global financial crisis. However, due to economic capacity and financial market conditions in developing countries, the financing of SME's issue is not improving well. Same as in Mongolia, there are insufficient financing instruments with long term and relatively low interest rates that meet SMEs needs. It is necessary to undertake specific research in this area, to make it more systematic, integrated policy and innovative financing tools. The study examined the international experience of SME finance, while analysed the Mongolian SME financing, its challenges, problems and proposed specific proposals and recommendations.

Key words: SME, SME development, SME financing, financing challenges, overcoming methods.

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International experience of SME development and financing

SME definition varies across countries depending on their development, population size and other factors. Although there is no consensus on the SME definition, the most common classification is based on employee numbers. Normally, registered business entities with less than 250 employees are regarded as SMEs. For more clarification, micro enterprises with less than 10 employees are distinguished from SMEs as they became targets of microfinance institutions for delivering micro lending, saving and insurance services. According to the World Bank definition, micro, small and medium sized enterprises are as follows:

Table 1. World Bank definition of SMEs

Firm size	Employees	Assets	Annual sales
Micro	< 10	< $100,000	< $100,000
Small	< 30	< $3 million	< $3 million
Medium	< 100	< $15 million	< $15 million

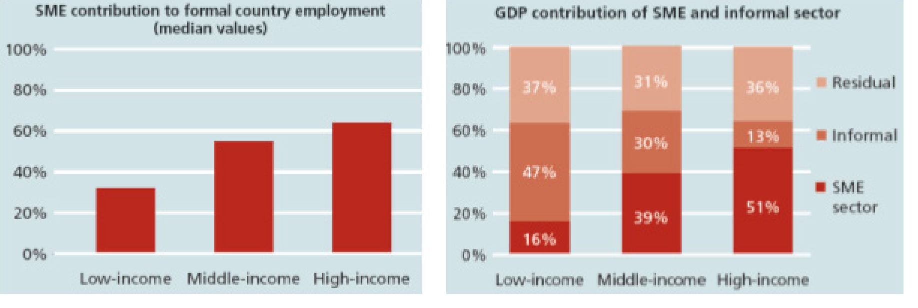
Source: Ayyagari, M., Beck, T., & Demirgьз-Kunt, A (2003) Small and Medium Enterprises across the Globe: A New Database

Based on this definition, almost 95 percent of all entities in the world fall into this category. This percentage is higher in European Union and developing countries as SMEs (including micro enterprises) account for nearly 99 percent of all registered entities (European Central Bank, 2012; IFC, 2009). Although SMEs have been ignored for decades from the mainstream economic policies and development schemes in many countries, their importance in employment and role of stabilization in economies after 1997 and 2008 economic crises has started to be widely acknowledged among academics, multilateral donor organizations and policymakers.

Despite many benefits of SMEs, their contributions to countries simply can be seen from employment SMEs generate and contribution they make to the GDP. Job creation of the SME sector accounts for 30 to 65 percent depending on structure of national economies compositing from formal and informal sectors. In 30 high-income countries of the Organization of Economic Development and Cooperation (OECD), SMEs generates nearly two third of formal employment, whereas the statistics is lower in low-income countries. Due to dominant informal sector in low-income countries, official employment created by SMEs is relatively low averaging about 30 percent. Figure 1 shows SMEs' job creation using the median contribution in sample of low, middle and high-income countries. As informal sector is mostly constitute from micro and small entities and individuals, it is evident that SMEs' contribution to job creation in these countries is significant if we sum up employment in both formal and informal sectors.

In terms of GDP contribution, the SME sector generates almost half of GDP in high-income countries and in some middle-income countries. However, SMEs creates about 20 percent of GDP in low-income countries due to the existence of the informal sector. Figure 1 illustrates that the median contributions of SMEs to GDP are different in low, middle and high-income countries. This figure also shows the reverse correlation of SME and informal sectors' contribution to GDP. Bigger portion of SME contribution to GDP demonstrates the existence of lower level of the informal sectors as in high-income countries a half of GDP is generated by SMEs and only 13 percent is by the informal sector. However, a half of the economy is constituted by the informal sector in low-income countries and less than 20 percent of GDP is created by registered SMEs. Thus, transformation of the informal sector to registered SMEs can significantly contribute to economic development of these countries as they become eligible for bank loans, their employment and outcomes will be recorded in national statistics.

Figure 1. SME contribution to formal country employment vs.
GDP contribution of SMEs



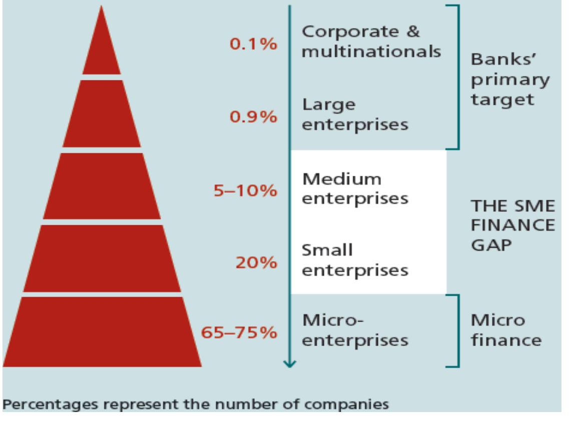
Source: Ayyagari, Beck, and Demirgьз-Kunt (2003), "Residual" includes sources such as large enterprises and public sector

Despite their size and contribution to employment and GDP, development of SMEs in most countries is insufficient. There are a number of factors that limit SME development, namely a lack of long-term financing, inability to access to bank loans due to big portion of informal sector, and poor human and technical capacity. For the purpose of this article, SME financing is discussed in more detail.

Depending on their development stages, SMEs utilize various financing sources. Most SMEs satisfy their primary needs of financing either by their own sources of finance or short-term bank loans. In absence of long-term financing, however, trade credits and short-term loans provided by banks can only meet working capital needs, but not capital investment that they need for their business growth.

Compared with large and micro businesses that have good access to banks, capital markets and microfinance loan providers, SMEs have a lack of access to finance (Ayyagari, et al., 2003). The following figure illustrates a financing gap that SMEs are mostly excluded from the formal banking sector.

Figure 2. Business landscape and financing



Source: IFC (2009) " The SME banking knowledge guide", p.11

SMEs are often too large for microfinance loans and too small and risky for commercial banks and financial institutions (IFC, 2009). Thus, SMEs are often referred as the "missing middle" in financing and this gap started to attract more attention (Angelkort & Stuwe, 2011; Dalberg Global Development Advisors, 2011; European Central Bank, 2012; Hassan, 2012).

There is a gap between demand- and supply-side of SME financing. Main constraints of SME financing from supply-side are tight regulations of central banks discouraging commercial banks to provide appropriate loans for SMEs and encouraging to accept only fixed-assets as collateral for loans; high unit cost of small loans; a lack of long-term funding and underdevelopment of capital market (IFC, 2009; OECD, 2006; Rabbani, 2011). In terms of demand-side problems, there are weak financial reporting systems, poor credit track records, inability to meet bank and capital market requirements, absence of proper business plans for their development, weak capacity building and a lack of understanding of SMEs how to manage their cash flows, financial management and attract long-term resources from money and capital markets (Beck & Demirgьз-Kunt, 2006; European Central Bank, 2012; Kyaw, 2008).

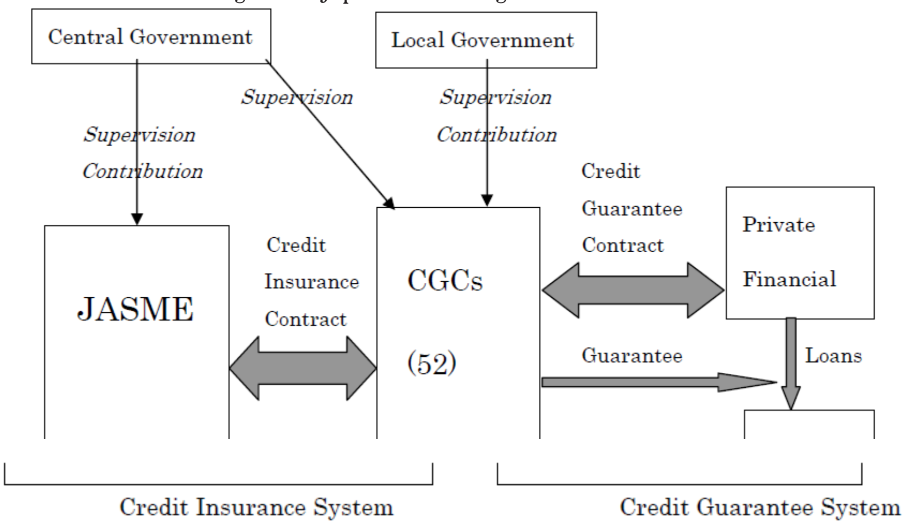
To address SME financing challenges, some countries, in particular developed countries, have developed a number of financial mechanisms, such as a credit guarantee fund (CGF), credit insurance and unified credit information system. Among them, the CGF is widely adopted in many countries.

The U.S. Small Business Administration (SBA) established in 1953 SBA offers a wide range of services: loan guarantee in different programs, micro-loans, advice and training. The German credit guarantee institutions were founded from 1948 to1955. The credit guarantee institutions are banks from the perspective of the Credit Institutions Act. By way of exception, they operate within the legal form of a limited liability company (LLC). The guarantee banks assume guarantees of credits for SMEs. However, they may carryout additional activities to support SMEs. The guarantee banks have a close business relationship with credit institutions. They are multipliers of their (the guarantee banks) promotion activity. As a rule, the bank guarantee may not exceed 80% of the credit to be granted. In East European countries, a number of credit guarantee institutions were developed (e.g., Hungary, Romania, Estonia, and Lithuania) within the last 10 years. Credit Guarantee Schemes in these countries show stronger government participation but includes the private sector too.

In Japan, the credit guarantee system is considered as one of the main pillars of the SME development. The Japanese credit guarantee system (JCGS) was established in 1937. It consists of 52 Credit Guarantee Corporations (CGC), each of which guarantees bank loans made to SMEs. The public status of the LGC in its being backed by the central government was conferred in 1953 by the Credit Guarantee Corporation law. Three parties are involved in credit guarantee transactions in Japan: a small business borrower, a financial institution, and the credit guarantee corporation, which is financially backed by the government.

By 2005, almost half of all SMEs had guaranteed loans. The share of loans that were guaranteed was very large: about 40% of bank loans made to SMEs were covered by the JCGS. The Figure below summarizes Japanese SME financing and credit guarantee schemes.

Figure 3. Japanese credit guarantee schemes



Source: Tsukahara.O (2005) Recent development in SME finance in Japan

In addition, the Japanese CGS is relatively unusual, and perhaps unique, in that its loan guarantees cover 100% of the losses (to banks) engendered by loan defaults. Therefore, banks bear none of the credit risks associated with the guaranteed loans that they extend to SMEs.

Credit guarantees are an important instrument in the development of SMEs and start-ups in the economy. Furthermore, in all cases it needs the activity of the private sector and the support of the government. The Japanese credit guarantee system provides the same guarantee coverage ratio (80%) to all banks for their lending to SMEs regardless of the creditworthiness of the banks. However, the optimal case would be differentiating banks based on their creditworthiness, and those banks that show a healthier status receive a higher guarantee ratio and riskier banks that have accumulated nonperforming loans receive a lower guarantee, so that it is an incentive for them to improve their creditworthiness. Yoshino and Taghizadeh-Hesary (2016b) developed a model for calculating the optimal credit guarantee ratio. They found that the optimal credit guarantee ratio should be applicable to each bank, or to each group of banks, based on their financial soundness. Sound banks should receive a higher guarantee ratio from the government, and less healthy banks should receive a lower guarantee to avoid a moral hazard problem. Moreover, this rate should vary based on economic conditions. Governments should lower the guarantee ratio in good economic conditions where the default risk of SME loans is reduced, and raise it in bad economic conditions to protect SME financing and economic growth. /ADBI Working Paper 768 Yoshino and Taghizadeh-Hesary, p.8/

Some experience of SME banking

In Japan there is a good example of specialized private banks for SME financing, called "Shinkin banks." Shinkin banks are deposit-taking cooperative banks that specialize in financing SMEs within a region. Just like city banks and regional banks, Shinkin banks are protected by deposit insurance and subject to capital adequacy requirements and other banking regulations and supervisions. Unlike city banks or regional banks, however, Shinkin banks provide loans mainly to member SMEs who capitalize the Shinkin banks. They can make loans to nonmember SMEs, but they have to restrict the share of the loans to nonmember SMEs to 20%. On the other hand, they can accept deposits from anyone. Shinkin banks are regional financial institutions in the sense that they can provide loans only to SMEs that operate within the same region as the Shinkin banks. Shinkin banks are generally smaller than city banks and tier-1 and tier-2 regional banks and larger than credit cooperatives (shinyokumiai). Shinkin banks played a significant role in the development of SMEs in different regions and in achieving comprehensive growth throughout Japan (Hosono, Sakai, and Tsuru, 2006). Shinkin banks provide 14.7% of total loans to SMEs, having a total of ₮128 trillion (equivalent to $1,244 billion) in funds (SCB 2015). /ADBI Working Paper 768 Yoshino and Taghizadeh-Hesary, p.9/

Mongolian SME development

Since 1992, Mongolia started its transition to the market economy, and during these three decades the private sector's contribution to the national economy reached 75%. Almost 100 percent of agriculture, wholesale and retail, communication, real estate, construction are run by the private sector. SMEs contribute 25% of GDP and employ half of the workforce in Mongolia. Similar to the world definition, the SME law passed in 2007 defines SMEs based on their employees' number and annual sales revenue.

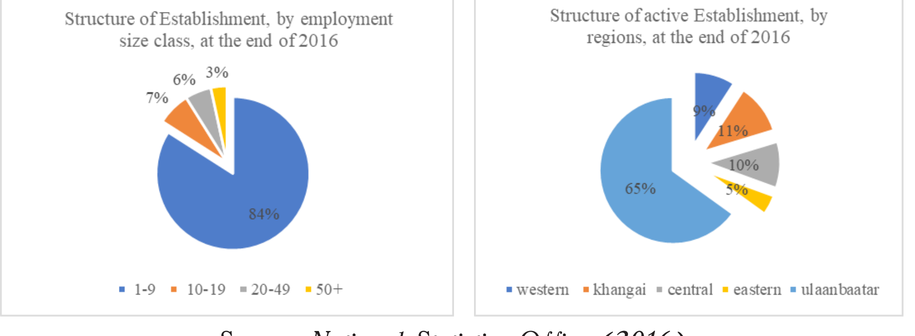
Table 2. SME category

Category	Sector	Number of employees	Sales revenue /billion MNT/
Medium	Production	≤ 199	< 1.5
	Wholesale	≤ 149	< 1.5
	Retail	≤ 199	< 1.5
	Services	≤ 49	< 1.0
Small	Production	≤ 19	< 0.250
	Trade	≤ 9	< 0.250
	Services	≤ 9	< 0.250

Source: SME law Mongolia (2007)

As of 2016, 104.4 thousand business units are registered, of which 46 thousand business units are active. Between 2013 and 2016, numbers of business establishment increased by 8.9% within 3 years of period, but economically active businesses decreased by 16% (Table 4). Among all entities, 84% are entities with up to ten employees (Figure 4). In terms of geographical distribution, the majority (65%) of active business entities are operating in Ulaanbaatar and this indicates that there is a high concentration of business entities in one city alone.

Figure 4. Number of business entities and concentration by regions



Source: National Statistics Office (2016)

In terms of structure of business establishments by economic sectors, there are 21 thousand (41%) business units in wholesale and retail sector, followed by real estate and renting (13%) in 2016. Compared to 2013, Agriculture, forestry and fishery, hunting are decreased by 66.7%, manufacturing sector decreased by 12.5% in 2016.

Table 3. Structure of Establishments, by divisions of economic activities

	Sectors	2013				2016			
		Registered	%	Active	%	Registered	%	Active	%
1	Wholesale and retail trade, repair of motor vehicles, household goods	43,747	44	20,902	38	47,853	46	9,115	41
2	Other community, social and personal services	5,828	6	3,769	7	9,419	9	4,247	9
3	Real estate, renting and other business activities	9,908	10	6,228	11	12,867	12	6,065	13
4	Manufacturing	8,253	8	4,295	8	6,970	7	3,124	7
5	Agriculture, forestry and fishery, hunting	5,328	5	3,148	6	2,580	3	827	2
6	Construction	6,545	7	3,560	7	9,844	10	5,095	11
7	Number of the total establishment:	99,603	100	54,922	100	104,477	100	46,153	100
7.1	Of which (%)				55				44

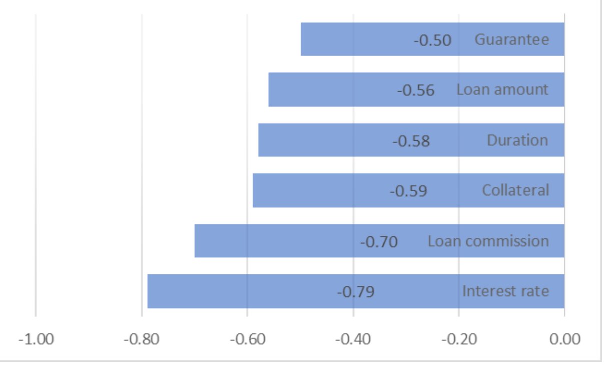
Source: Mongolian National Statistical Year Book (2016), researchers' estimation

The SMEs together with micro enterprises constitute 97% of total business entities, and they generate 36.3% of sales revenue, and 22.2% of export with over 50% of total employment. Although SMEs contribute a quarter of GDP and half of total employees in Mongolia, they lack favorable financing conditions that would enable them to expand operations and contribute to further growth. SME credit is characterized by relatively high interest rates, short loan maturities, relatively small loan sizes, and predominantly immoveable collateral-based lending requirements. On the supply side, banks are constrained by the short maturity structure of deposits and the shortage of other funding sources with longer maturities.

SME financing in Mongolia

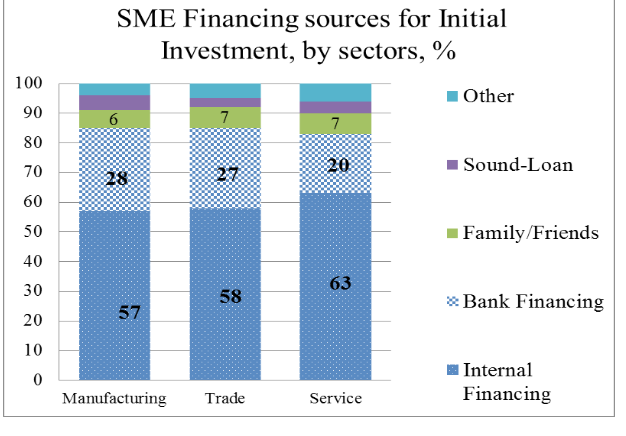
SMEs need finance in every stage of their development from start-up to developing stages, and ultimately, when they go public. By recognizing the role of SMEs in the economy, governments in both developed and developing nations can establish or facilitate different funding programs and institutions to give SMEs easy access to financing in each stage of their development. According to the Bank of Mongolia SME studies, a lack of financing is ranked as the most difficult barrier for the SME development. More than half of SMEs rely on internal financing and about 25% of financial sources comprises from bank loans (Figure 5).

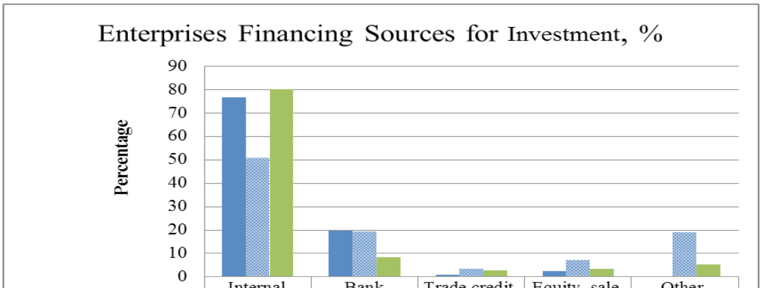
Figure 5. Financial environment
/-2=really bad, -1=bad, 0=affordable, 1=good, 2=really good/



Source. BoM, SME report 2016

Figure 6. SME financing source (by initial investment and by countries)





	Internal Financing	Bank Financing	Trade credit financing	Equity, sale of Stock	Other Financing
Mongolia	76.9	19.6	0.9	2.6	0
East Asia & Pacific	50.8	19.5	3.4	7.3	19.1
Low Income	80.2	8.5	2.7	3.4	5.2

Source: Bank of Mongolia (2011)
Survey on SME Source: World Bank Survey (2010)

With high dependence on internal financing, SMEs are not able to meet their demands to expand their businesses. This situation is similar to low income countries and worse than East Asia-Pacific region countries. The share of bank lending accounts for 19.6% which is same with the average East Asia-Pacific region and higher than low income countries. Both trade credit and equity financing are in near absence in Mongolia. Additionally, other forms of financing did not exist in Mongolia, whereas these accounts for 19% in East Asia-Pacific region countries and 5% in low income countries (Figure 6). This situation suggests that the Mongolian financial sector needs to diversify its financing sources for SMEs by offering innovative financing instruments and by developing the capital market to supply long-term financing.

Bank lending is the key financing source ranked after internal financing of SMEs. Among 13 commercial banks, Khan and XAC banks are the key providers of SME loan as 46 percent of loan portfolio is allocated to the SMEs. Golomt and Capital banks have recently opened their rural branches to target the SME market. Almost half of total lending (53.8%) is allocated for the private sector, of which 7.3% are with under one-year maturity up to one year. 29% of loans had 1-5 year and 4.2% had more than 5-years maturity. Due to short maturity of deposits and a lack of seed fund, the banks have poor abilities to provide long-term loans. Even though loans with 1-5 years maturity comprise the biggest portion (Table 4), the most of them are up to 2-years maturity and designed for working capital financing only. This maturity period is insufficient to meet the SMEs requirements of capital investment. Depending on banks 30-40% of loan outstanding is less than a year maturity and 30-50% of loan outstanding has 1-3 years maturity.

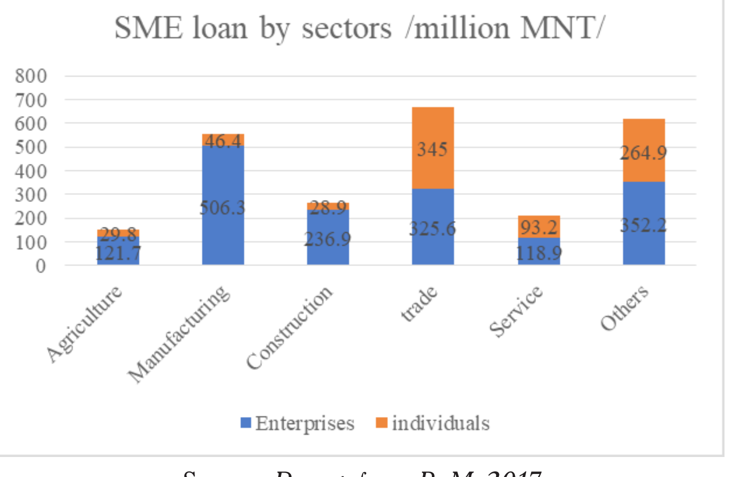
Table 4. Loan outstanding /billion MNT/

	2013		2014		2015		2016	
	Amount in	(%)	Amount in	(%)	Amount in	(%)	Amount in	(%)
Loan outstanding to private sector	5,968,121.0	55.7%	6,618,774.0	53.2%	6,408,347.0	55.1%	6,637,774.0	53.8%
Normal	5,388,818.0	50.3%	5,867,880.0	47.2%	4,967,684.0	42.7%	5,002,094.0	40.5%
up to 1 year	1,362,845.0	12.7%	977,492.0	7.9%	766,777.0	6.6%	906,295.0	7.3%
1-5 years	3,643,335.0	34.0%	4,410,402.0	35.5%	3,644,298.0	31.3%	3,579,127.0	29.0%
5 and more than	382,638.0	3.6%	479,986.0	3.9%	556,610.0	4.8%	516,673.0	4.2%
Total loan outstanding	10,715,632.7	100.0%	12,440,925.9	100.0%	11,633,573.7	100.0%	12,337,508.6	100.0%

Source: Bank of Mongolia (2016) Survey on SME

Banks mostly rely on deposits (constitute 80% of debt, excluding own capital) and most of them have short maturities (more than 50% are on-demand deposits). The financing of long-term loans by the short maturity deposits create gaps and this action is limited according to the basic requirements of the central bank. Therefore, deposits are used to finance short maturity loans only. Due to scarcity of domestic sources and limited availabilities to attract long-term funding at the international market, banks search opportunities from the international financial institutions, donors' capital and lately special projects to be financed by the state budget. Geographically, 76.2% of loans are issued in Ulaanbaatar, and 14.1% of loans used for property sector, 13.8% in trade, 10.2% in manufacturing, 9.3% in construction and 7.6% in mining sectors respectively.

Figure 7. SME loan outstanding by economic sectors 2016 /million MNT/



Source: Report from BoM 2017

Loan disbursement to SME reached 2.5 trillion in 2016. This comprises 18.3% of total loans. The Bank of Mongolia SME study shows that 81% of total loan were from banks, 6% were concessional loan, 4% from friends, 7% from NBFI and 3% from suppliers. 64% of loan were used for working capital, 8.7% for extending business, 11.5% were for equipment, 8.4% of loan were spent on building extension of premise or buying new building (Bank of Mongolia, 2017). The SME study respondents reflected that high interest rate, short maturity, undervalued collateral are the major impediments to SME development. Concessional loans from the government and international institutions are limited and difficult to access (Bank of Mongolia, 2016). It shows that bank commercial loan package is enough but other concessional loans are insufficient. The banks cannot accommodate all capital needs of SME since the banks' capital is not enough and at the same time SME do not have enough collateral, practice poor management and accounting. It is especially true for local small firms.

Besides, the Government of Mongolia (GOM) is another major investor for SMEs. From the following table the GOM has disbursed last 4 years average MNT 50-80 billion for SME development and industrialization. According to policy for the SME develop, SMEDF lent to SME for supporting loan such as duration is up to 5 years, interest rate is 9 percent per year, grace period is 2 years, loan amount is up to 2 billion MNT, lent through by commercial banks.

Table 5. Loan amount issued by SMDF

Year	Liabilities of SMEDF lent by SME
2006	1 billion MNT
2007	1 billion MNT
2008	1 billion MNT
2009	30 billion MNT
2010	30 billion MNT
2011	276 billion MNT
2012	50 billion MNT
2013	60 billion MNT
2014	80 billion MNT
2015	70 billion MNT

Source: Report from BoM SME 2016

Mongolia has established the SME Development Fund (SMEDF) to support financing for SMEs. Its role includes providing long-term concessional loans for

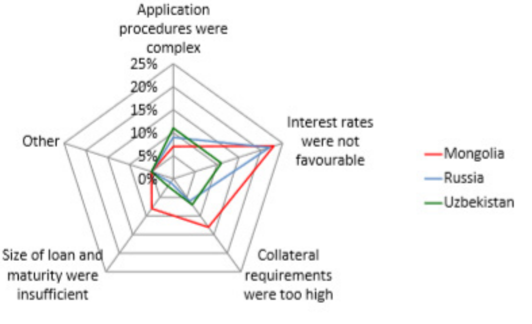
SME operations, helping SMEs to access production equipment through financial leasing, promoting the activities of subsidised SMEs, organising workshops and training, and offering double guarantees for credit. However, following every election the new government changes the status, location and responsibilities of the SMEDF which leads to instability in its function and structure. Prior to 2012 it was an agency within the Ministry of Agriculture and Light Industry, while from 2014 it was a department within the Ministry of Industry. Today it operates from the Ministry of Food, Agriculture and Light Industry.

Objective of Mongolian SME development: Diversify and grow the economy by enhancing SMEs' access to finance

To create a better business environment for SMEs, countries should focus primarily on enhancing access to finance by leveraging the role of the banking system. A system offering better loan conditions and guarantees would help to build trust among the players involved: SMEs, financial institutions, individuals, and public institutions, such as the Mongolian Credit Guarantee Fund and the SME Development Fund. Easier credit would allow SMEs to invest and expand both in internal and external markets, with positive effects on growth and employment.

The latest Business Environment and Enterprise Performance Survey (BEEPS V) found that 56% of Mongolian SMEs do not apply for loans because they are discouraged by the credit conditions (EBRD and World Bank, 2015). SMEs face a wide range of difficulties when accessing finance, including high interest rates (23% of respondents), collateral requirements (13%), size and maturity of loans (8%), and complex application procedures (7%, Figure 8). Moreover, interviews with financial institutions operating in the market show that SMEs' lack of financial knowledge hinders their ability to trust SMEs and extend credit (EBRD and World Bank, 2015).

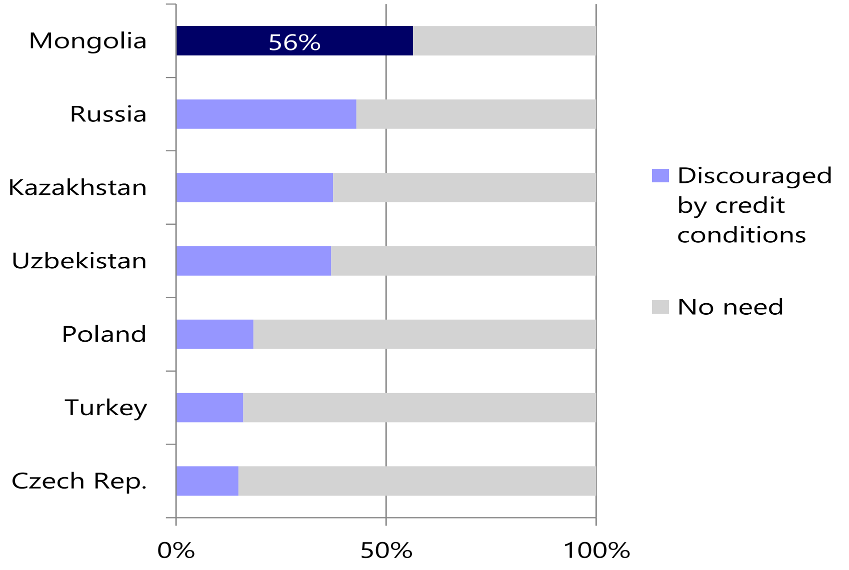
Figure 8. Mongolian SMEs have some major problems in accessing finance



Source: EBRD and World Bank (2015), Business Environment and Enterprise Performance Survey (BEEPS) V Country Profile: Mongolia, http://ebrd-beeps.com/countries/mongolia/

Most SMEs report that the loans on offer from banks and NBFIs do not meet their needs in terms of interest rates and duration. Interest rates are considered too high (average 19.6% in 2016), their maturities are too short (less than a year on average) and while the loans are large enough to provide working capital, they are usually insufficient to finance investment. The BEEPS V survey confirms that the share of SMEs discouraged from seeking loans is the highest in the region (Figure 9).

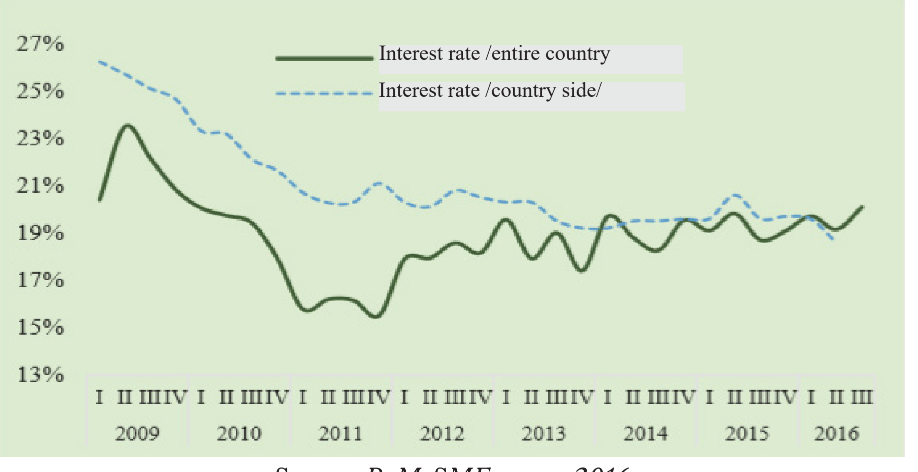
Figure 9. Credit conditions in Mongolia are the most discouraging in the region



Source: EBRD and World Bank (2015), Business Environment and Enterprise Performance Survey (BEEPS) V Country Profile: Mongolia, http://ebrd-beeps.com/countries/mongolia/

Undoubtedly, macroeconomic conditions influence the high rates and the profitability of lenders. With a base rate set by the Bank of Mongolia of 12% (increased again to 15% in August 2016), the interest rate spread for bank loans in Mongolia was 6.6% in 2015. This was in line with that of Russia (6.5%), but below the average for low and middle-income countries (6.9%). Moreover, since the tapering off of quantitative easing by the BoM, banks have been financing themselves with short-term, volatile and costly deposits (close to 12% on average in 2015). Their liquidity management is thus challenging, and explains their limited options for offering SMEs the long-term loans required to invest and expand.

Figure 10. Interest rate percentage /by province/

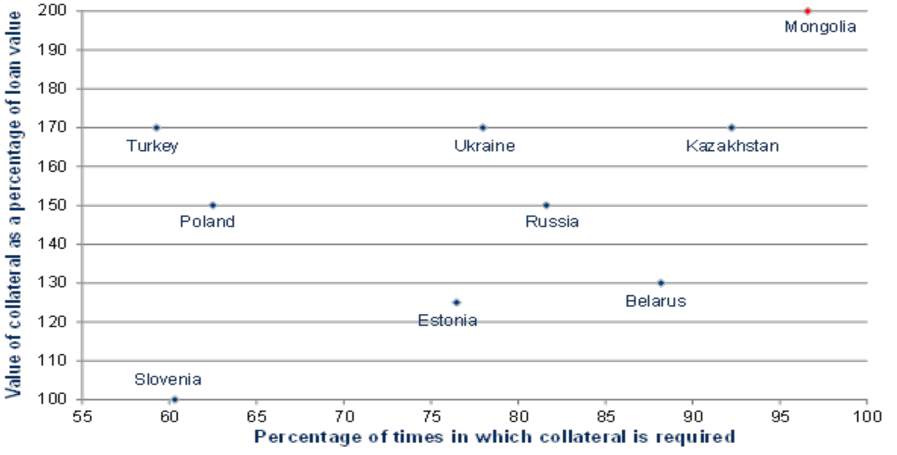


Source: BoM SME report 2016

The lending rate of the banking sector is not significantly decreasing due to macroeconomic current situation, which is most difficult for SMEs in the funding environment. For example, weighted average bank lending rate has increased by 1.4 percentage points compared to the same period of last year, and SME entrepreneurs receive a certain amount of credit and service fees. The weighted average interest rate on local loans is 19.6 percent in 2016. The average loan term for SMEs is 25.4 months or 2 years old, according to the survey participants, which is not so closely related to business activities and is difficult to repay in the short term.

In 99.7% of cases in Mongolia, banks require collateral to guarantee a loan. This is the highest percentage in Central Asia and far higher than the median of OECD countries (where only 40% of SME bank loans require collateral). Furthermore, Mongolia has the highest median collateral value required in the region, at 200% of the value of the loan. In OECD member countries the median value is 148% (OECD, 2016; EBRD and World Bank, 2015) (Figure 11).

Figure 11. Mongolian SMEs face tough collateral requirements



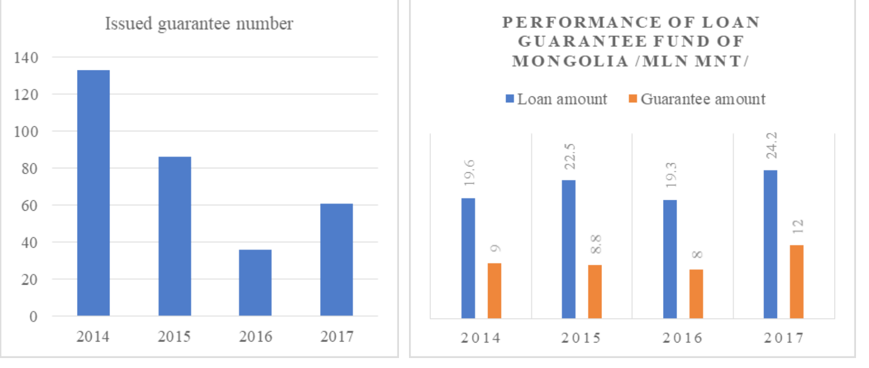
Source: EBRD and World Bank (2015), Business Environment and Enterprise Performance Survey (BEEPS) V Country Profile: Mongolia, http://ebrd-beeps.com/countries/mongolia/

Information asymmetry is the core reason that commercial banks ration credit to SMEs. Credit guarantee schemes (CGSs) can help banks accurately identify lending risk and improve their ability to make appropriate lending decisions (Levitsky, 1997). Public intervention is justified, because weak co-ordination among private sector providers may prevent them entering the market for credit guarantees (de la Torre, Gozzi and Schmukler, 2008). There is some evidence that CGSs are a cheaper way to expand access to finance than direct lending. CGSs are also market friendly, as the lending institution usually has sole responsibility for deciding whether to issue the guarantee (Beck et al., 2008). Moreover, CGSs can be a mechanism for risk transfer and diversification – by covering part of the default risk, the lender's risk is lowered. CGSs are particularly relevant in emerging markets and developing economies as they can encourage banks and NBFIs to get into the SMEs market, thus improving the institutions' lending technologies and risk-management systems (World Bank, 2015c). Provision of credit guarantees is also the most widely used policy instrument in the 34 countries included in the OECD Scoreboard on SME and entrepreneurship finance which reviews policy measures to support SME finance (OECD, 2016).

The Mongolian Credit Guarantee Fund (MCGF) was established in 2013. It is the main institution in charge of providing guarantees to SMEs in Mongolia. From 2013 to 2015 it issued guarantees to the tune of MNT 31.2 billion (USD

16m), unlocking a total of MNT 76.2 billion in loans (ADB, 2015). However, limited resources and unreliable operations have hindered its capacity to support the credit market, and operations have halted since mid-2015 due to the limited guarantee funds available and the decrease in applications sent by banks. Banks have lost confidence since some guarantees were not re-paid by the MCGF; they underlined that no guarantee was paid by the MCGF in 2016.

Figure 12. Annual performance of Mongolian Credit Guarantee fund



Source: Report 2017 of FRC

MCGF representatives also stated that fees amount to 3% of the loan and coverage is up to 60% of the total amount borrowed nearly same as world and OECD average. At 11.8%, defaults appear to be higher than similar schemes in other countries, such as Turkey's Credit Guarantee Fund (around 5%), and Estonia's KredEx (around 2%). This is even more striking given MCGF's high rejection rate for applications (26.3% vs. KredEx's 20%). While the quick screening for MCGF's operation, the risk management tool appeared robust, staff's lack of practice and capacity to use the tool to reduce the rejection and default rate appear to be a substantial problem. The fund's team is currently working on improving internal operations with the support of international organisations.

Commercial banks suggest that there is limited trust in the guarantees offered by the MCGF. There are reported cases of the MCGF refusing to pay out the guarantee and preferring to go through trial instead. Without examining the specifics of these cases, it is apparent that trust in the MCGF can be heavily undermined in such circumstances, reducing the institution's effectiveness in sustaining the credit market. This is also confirmed by the results of the some survey /OECD/ on SMEs, which indicates that bank officers are often not interested in the possibility of a guarantee by the MCGF as a substitute for collateral.

BoM 2017 SME report says that is in the past, borrowers were required to apply for a loan, but 139 SMEs were not covered by the funding due to failure to meet the loan requirements. The reason is 38.8% is insufficient of collateral, 15% does not have permanent income, 7.2% does not have proved document for income, 10% has document conflict, 5% is high business risk, 3.6% has negative records on the credit information bureau. /BoM SME report 2017/

The administrative process to obtain a loan is cumbersome.

Cumbersome procedures were the fourth most important reason given by Mongolian businesses for not applying for a loan 7% of Mongolian businesses declare that they were discouraged from applying for a loan because of the procedures involved (EBRD/WB, 2015). This is similar to Kazakhstan (8%) and Russia (9%), but higher than Poland (4%) and the Czech Republic (2%). SMEs and business associations interviewed and confirmed that SMEs need to submit five different administrative documents, often involving multiple interactions with several public agencies and certification bodies (including the tax administration, local administration, and environment agencies). The complexity of this process stems from insufficient co-ordination among and within government agencies, and with the SMEDF and banks; unnecessary documents being requested; the same documents being asked for several times; the requirement for burdensome and costly notarial seals; limited knowledge by agency staff; and lack of information provided by the administration.

SMEs also face a complex process when applying for a subsidised loan from the SMEDF. The overall process takes between six and nine months according to SMEs, and the uncertainty surrounding the various steps can be discouraging and make their application irrelevant. With very limited support, SMEs must prepare a total of 30 documents for the two institutions (the private bank and SMEDF). Of these, seven are actually administrative documents that the SME must submit to different public agencies. Most official documents are available as online forms, except the social insurance statement which requires additional documents to be presented in person. /OECD survey 2016/

This administrative process is costly for companies in both time and resources. This is particularly acute for SMEs which do not have dedicated staff and time to deal with these procedures. In some cases the complexity of the process discourages SMEs from even attempting to access the financial system.

Understanding of complex financial concepts is limited

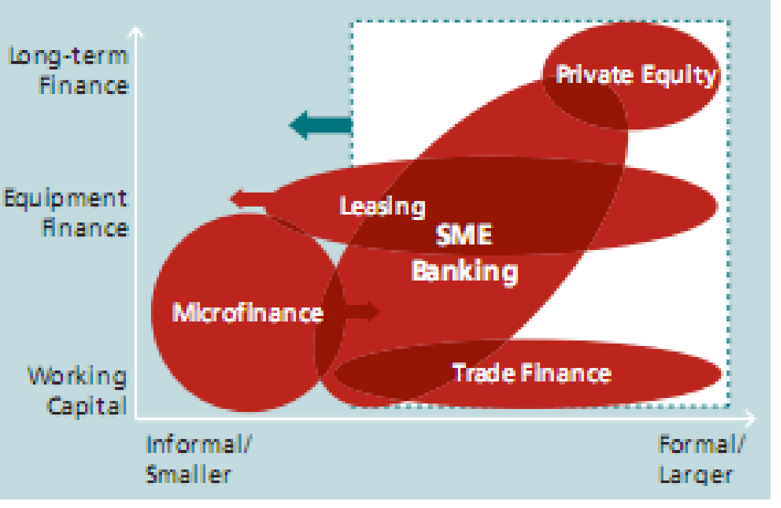
A financial literacy survey carried out by the World Bank in 2012 revealed that Mongolian adults had limited understanding of basic financial concepts, although the vast majority of the population was aware of financial products and had mastered basic arithmetic (World Bank, 2013). For example only 39% understood inflation correctly, in contrast to an average of 44% in the other countries included in the survey and 60% in advanced economies (World Bank, 2013). Another survey found that agricultural SMEs (mostly herders) were less familiar with financial concepts than firms operating in Ulaanbaatar and in regions with mining activities and companies. The Financial Regulatory Committee (FRC), the Bank of Mongolia and the Ministry of Finance have prepared a National Strategy for Financial Literacy that was approved in 2016; however, it does not include provisions explicitly designed for SMEs. In addition, the strategy does not map the various initiatives around the country to expand financial literacy (such as the Banking Academy on the supply side and the National Incubation Centres Association on the demand side). Having an overview of these initiatives would allow them to be leveraged to unlock possible synergies and could avoid overlap (Bank of Mongolia, Financial Regulatory Commission, Ministry of Finance, 2016).

SME banking

Although there are many governments and donor initiatives supporting SMEs, sources are limited and funding allocated through several institutions leads to poor coordination and inefficient use of resources. Drawing from the international experiences of SME banks, to address above challenges we suggest setting up a SME bank, which includes participation of the government, international and domestic financial institutions. One potential source for long-term source of the SME bank in near future can be the sovereign wealth fund generated from mining-induced income.

The SME bank will provide full financial services to SMEs ranging from SME loans, leasing, trade credit and equity finance by closely coordinated with other banks, the Financial Regulation Committee on equity finance and the Credit Guarantee Fund. The Bank also needs to effectively utilize financial infrastructure, such as the payment system, unified credit information system and collateral registries.

Figure 13. Types of SME financing and coverage of SME banking



Source: *IFC (2009) The SME banking knowledge guide*

While there is no single formula for the successful SME bank, there are lessons and good practices that apply to five strategic areas: (1) strategy, SME focus and execution capabilities; (2) market segmentation, products and services; (3) sales culture and delivery channels; (4) credit risk management; and (5) information technology (IT) and management information system (MIS). These are illustrated in the figure below.

Figure 14. Five strategic areas form the foundation for SME banking performance

Source: IFC SME Banking CHECK Diagnostic Toolkit

In order to set up the SME bank, a legislative framework should be developed in consistency with the SME Law, the Credit Guarantee Fund and other related laws and regulations.

Commonly used financing in other countries, such as factoring, leasing, project financing and trade credit can be developed with active engagement of commercial banks, the SME bank and other financial institutions.

Capital market

In terms of capital market development, the entry threshold and requirements need to become SME friendly with close coordination with the Credit Guarantee Fund. Independent credit rating financial institutions should be developed to assess credit rating of SMEs that is necessary for issuing bond and common stocks in the capital market. A separate Stock Exchange board, similar to AIM[3] in the UK and Japan, can be established to help smaller and growing companies raise the capital that they need for expansion.

In particular, strategically important, high growth SMEs can raise equity financing from the capital market through development of venture capitals in Mongolia. The government can engage in venture capital development in two ways: to provide the necessary legal environment for venture capital formation and invest directly in funds. While, the first step is crucial, governments, particularly in developed countries namely Canada, UK and Europe[4], take initiatives that put government cash into venture capital funds alongside private money to make it more attractive for private investors.

One of widely used long-term source for enterprises is a venture capital fund that manages money from investors seeking private equity stakes in businesses with strong growth potential. Benefits of the venture capital are that it not only helps them raising long-term financing from the capital market, but also brings managerial and technical expertise. Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships. Venture capital has not been developed in Mongolia due to the asymmetric information, and uncertain legal and political conditions. Effective engagement of international investment managers, domestic banks, third party technical assistance providers and beneficiaries (in particular SMEs) is the key to success of the venture capital financing. The following figure illustrates

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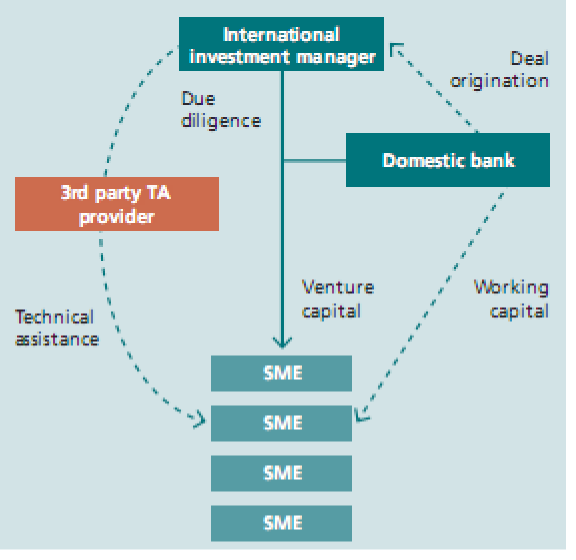
3 The AIM is the London Stock Exchange's international market for smaller growing companies. A wide range of businesses including early stage, venture capital backed as well as more established companies join AIM seeking to growth capital. Similarly, the Tokyo Stock Exchange established Tokyo AIM, Inc. in 2009.

4 The Canadian government invests directly in venture funds. Some other governments have followed that model whilst others achieve the same result via manipulation of the tax code. The Venture Capital Trust and Enterprise Capital Fund schemes in the UK, the French closed-end investment schemes in France, and the European Investment Fund supporting the whole of Europe are other good examples.

potential cooperation between these parties.

Figure 15. Framework of venture capital



Source: IFC (2009) The SME banking knowledge guide

In Mongolia, this framework can work well if necessary legislation, financial infrastructure and capacity building is satisfied with supervision of international benchmark venture capital funds and managers.

Improving legal environment

The government has made special efforts to put in place fundamental laws supporting SME development over the last several years. However, the enforcement of these laws has not been always satisfactory. Clear regulations and implementation mechanisms are either absent or poorly defined. Reviewing key legislation is recommended to address problems related to enforcement of laws.

Tax regime for SMEs needs to be streamlined to lessen the tax burden on SMEs. Although the government has provided a generous tax exemption to SMEs since 2009, there's a need to review certain tax legislations. For instance, the current the VAT threshold (MNT 10 million) needs to be increased. Currently, average sales value of SMEs well exceeds MNT 10 million making SMEs subject to VAT. Under the law, VAT taxpayers are required to report on their VAT return statement on a monthly basis. This adds excessive burden on SMEs especially on those SMEs that lack with qualified personnel.

SME capacity building

It is reported that SMEs lack necessary skills and capacity to prepare business plans with analysis of their markets, financial and technical feasibility and risk assessment. In certain cases, access to necessary information and data hinders the ability of SMEs to develop proper business proposals. Training or assistance to SMEs on financial bookkeeping and maintenance of company records and accounts will also help SMEs to better present themselves to banks as credible borrowers.

Although there are many SME training programs offered by various institutions, the quality, content and practical applicability of training programs is questionable. It is recommended to organize seminars and trainings together with international organizations which have extensive experience in this field, including project financing. The proposed SME bank can also conduct SME training and research.

Creating SME credit rating

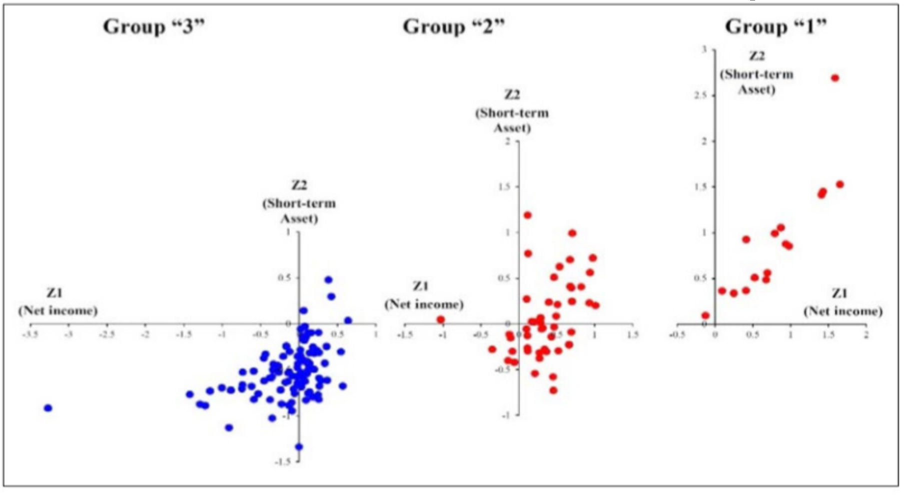
Creating SME credit rating is crusial for SME financing. It will time saving technique for SME. It will be eliminate costly administrative process. The main purpose of developing the CR is to create the infrastructure for improved credit rating of SMEs, which could be the medium-term target for Asian economies in order to remedy the asymmetric information problem of SMEs. /Naoyuki Yoshino and Farhad Taghizadeh-Hesary, 2017 Aug, *p14,15*/

A comprehensive credit rating method developed by Yoshino and Taghizadeh Hesary (2014c) employed statistical analysis techniques on various financial variables of a group of 1363 SME customers of an Iranian bank by utilizing two statistical techniques (principal component analysis and cluster analysis) on various financial ratios of the sample of SMEs.

For SMEs in the financially healthy group, banks can lend them more money by charging low rates of interest with no required collateral, while credit guarantee corporations can charge them lower premiums when guaranteeing the allocated credit. On the other hand, for SMEs in the high-risk group, banks can charge higher rates of interest with greater collateral requirements. If an SME's performance improves and it moves into a lower-risk group, banks can change their interest rates from high to low, accordingly. Similar SME data analysis was done by using NCB data for Thai SMEs (Yoshino et al. 2016). Yoshino et al. (2016) show how a credit rating scheme for SMEs can be developed, when access to other financial and nonfinancial ratios is not possible, by using data on lending by banks to SMEs. They employ statistical techniques on five variables from a sample of Thai SMEs from the NCB database and classify them into subgroups based on their financial health. By employing these techniques in Asian economies, banks could reduce information asymmetry and consequently set interest rates and lending ceilings for

SMEs. This would ease the financing of healthy SMEs and reduce the amount of nonperforming loans to this important sector.

Figure 16. Classification of Small and Medium-Sized Enterprises



SME = small and medium-sized enterprise.
Note: Group 1 = financially healthy SMEs; Group 2 = medium-risk SMEs; Group 3 = financially risky SMEs.
Source: Yoshino and Taghizadeh-Hesary (2014c).

Conclusion

Booming mining development brings both benefits and challenges to the Mongolian economy. Although the country has enjoyed rapid economic growth primarily induced by the mining sector, there is an increasing demand for infrastructure development, economic diversification, especially value-added economic activities in order to prevent so called Dutch disease and sustainable development.

SMEs, accounting for 97 percent of total entities, contribute 25 percent of GDP and employ the half of the workforce in Mongolia. Notwithstanding its contribution to the economy, the SME sector development is still in infancy. There's a tendency of increasing number of SMEs in the manufacturing sector, which indicates shift towards more value-added production. However, SMEs still fall short of human capacity, managerial skills and financial literacy.

While financial intermediation in Mongolia has been growing fast, access to finance remains the main constraint for enterprises, especially for SMEs. They lack favourable financing conditions that would enable them to expand operations and contribute to further growth.

On the supply side, banks, the government and international organizations are key providers of SME loans. SME loans are characterized by relatively high interest rates, short loan maturities, small loan sizes, and predominantly immoveable collateral-based lending requirements. Although banks supply most of SME financing, they do not have sufficient long-term funding to meet the growing needs of SME demand. Banks are constrained by the short maturity structure of deposits, high inflation and deposit rates, and the shortage of other funding sources with longer maturities.

Bank lending is particularly limited in rural areas evidenced by 80 percent of total loan outstanding provided to SMEs in Ulaanbaatar. Bank lending in rural areas is limited due to several reasons, including: (i) the low population density that makes it unprofitable to service isolated areas using traditional banking methods; (ii) the riskiness of agricultural loans; (iii) lack of financial information on micro-firms/herders; and (iv) lack of real estate collateral in rural areas.

Recognizing importance of the SME sector, the government has undertaken a variety of measures to support SMEs. These measures range from (i) reforming existing legal and regulatory framework, (ii) creating institutions providing a financing to SMEs, such as the SME fund and Soum development funds and (iii) supporting through sector specific targeted programs (wool and cashmere sector) financed from the government bond proceeds. However, SME funding of the government is unsustainable as it only relies on budget revenue that is heavily dependent on the world commodity price fluctuation. Between 2013 and 2016, the government allocated MNT 210 billion to the SME fund. In terms of Soum development funds, MNT 24 billion was distributed by soum governing officials, but not through commercial banks. The government is planning to establish a sovereign wealth fund (SWF) generated from future mining income of big mining projects, namely the Oyu Tolgoi copper mining and Tavan Tolgoi coal mining. However, a possibility of sudden collapse of the mineral market puts the SWF at risk as mining revenue is highly volatile and unpredictable. Also, it is uncertain how to effectively manage mining revenue to avoid the Dutch disease. In sum, the government financing mechanism is inefficient and fund resource is unsustainable.

International organizations, such as the World Bank, ADB, GIZ and JICA, have some projects to promote private sector development. Compared with others, the TSL project of JICA is more targeted to SMEs and it had covered more than 400 SMEs since 2007. Phase II of the TSL is ready to be implemented.

Opportunity to raise financing from the capital market and use of financial resources, such as leasing and factoring is practically absent in Mongolia. NBFIs play minimal role in SME financing and still in its early stages of development. A loan amount provided by these institutions is small and has short term maturity and high interest rate.

Mongolia need to develop regular long-term strategy for SME development. These include improving the evidence base; strengthening SME access to bank financing; promoting financial inclusion; improving transparency in SME finance markets; including risk-sharing principles in publicly supported SME finance instruments; and the best way to monitor government programmes.

In particular, in order to improve the ability of SMEs to obtain loans for their working capital and investment projects, it is recommended that the Government of Mongolia design and implement a consistent plan aimed at streamlining the loan offer and making them more affordable. At the same time, the government also has a fundamental role to play in providing entrepreneurs and SMEs with a stronger grounding in financial planning to ensure that loans can be repaid thanks to companies' healthy financial management. Credit conditions and accessibility (especially in rural areas) should be tackled with a comprehensive national strategy that should be included in the next national SME strategy.

On the demand side, SMEs demand for financing is growing constantly. There are many constraints that limit SMEs to obtain financing. SMEs often cannot meet bank lending requirements due to a lack of collateral assets, weak management skills and poor financial reporting.

Unfavourable bank lending terms discourage SMEs to approach banks for financing. Loan size is deemed to be insufficient for SME growth needs, short maturity loans make SMEs to use the funds for working capital financing only rather than long term capital investment. High interest rate leads SMEs to fall into interest rate burden. Current collateral requirements of banks are too rigid as only immovable assets are qualified for collateral. Not many SMEs own immovable assets and if they do, assets are often valued below their real market value.

The presence of institutional and legal obstacles compounds difficulties for SME financing. Currently, a quarter of 30 government special funds are directed towards supporting SME activities. However, operations of these funds are not well coordinated. In addition, government issued bonds to support specific industries. Scattered allocation of funds to support SMEs, weak internal coordination of government programs, a lack professional skills of government officials to manage the funds, select potentially viable projects and monitor results leads to inefficient allocation and use of government funds.

The passage of the SME Law by Parliament in 2007 was a remarkable step towards SME development. For the first time, the Law provided a SME definition and provided a clear framework for government policy and strategies and scope for government of activities in promoting SMEs. Yet, there are significant weaknesses in the legal framework. Definition of SMEs needs to be revised by increasing the sales threshold for SMEs, the definition also needs to be streamlined among financial institutions, as number of banks use own definitions in providing loans to SMEs. Overlapping and conflicting legal provisions serve as impediments to implementation of the SME Law. In terms of SME financing, it is unclear how the SME law interrelates with current the Credit Guarantee Fund Law. Enforcement of laws is weak as regulations and implementation mechanisms are poor.

A reliable legal system and judiciary are necessary for lenders to enforce contracts and foreclose collateral on loans. Inefficient legal processes and court proceedings increase the risk for lenders and make the foreclosure processes time-consuming and expensive. Similarly, inadequate creditor rights can diminish the incentives for borrowers to meet their financial obligations. In turn, these factors translate into a higher cost of financing for borrowers. Bankruptcy procedures are rarely used and the capacity of courts to handle insolvency issues is another bottleneck. The ongoing reform of the insolvency regime should be completed as soon as possible, bringing the law in line with international standards.

Overall some specific recommendations are as follows:

- Develop the conditions for a better and less costly loan offer to SMEs by diversifying the products offered by the SME Development Fund (SMEDF)
- Overcome the collateral issue by improving the Mongolian Credit Guarantee Fund's risk appraisal techniques and building the trust of banks
- Make it easier for SMEs to request loans by streamlining the banks' and SMEDF's administrative processes through a one-stop-shop backed up by support and training, and enhancing the co-operation between the SMEDF and partner banks.
- Increase financial literacy through public-private co-ordination, including activities for SMEs in the National Strategy for Financial Education, and creating tailored tools to meet SME needs.

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