SMALL-MEDIUM ENTERPRISE DEVELOPMENT AND FINANCING ISSUES

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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-үдийн 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.

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

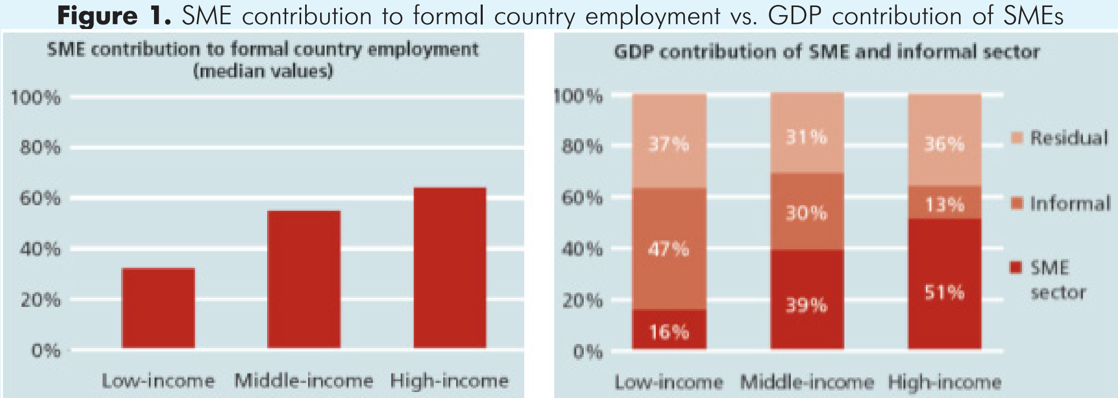
Source: Ayyagari, M., Beck, T., & Demirgьз-Kunt, A (2003) Small and Medium Enterprises across the Globe: A New Database

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 this 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 constitutes 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



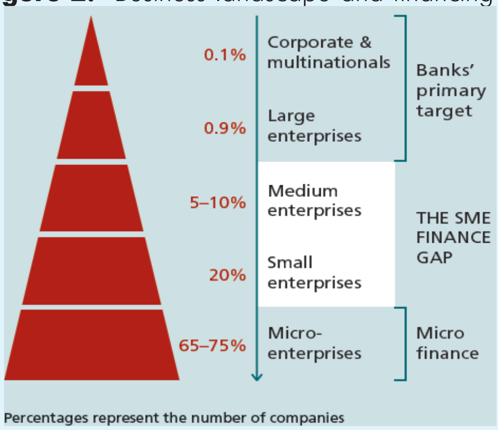
Source: Ayyagari, Beck, and Demirgьз-Kunt (2003), "Residual" includes sources such as large enterprises and public sector

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 needs 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).

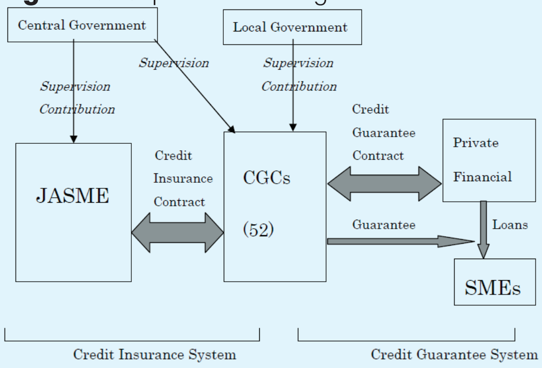
To address SME financing challenges, some countries, in particular developed countries, have developed a number of financial mechanisms, such as a credit guarantee fund (CGF), credit insurance and unified credit information system. Among them, the CGF is widely adopted in many countries.

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.

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.

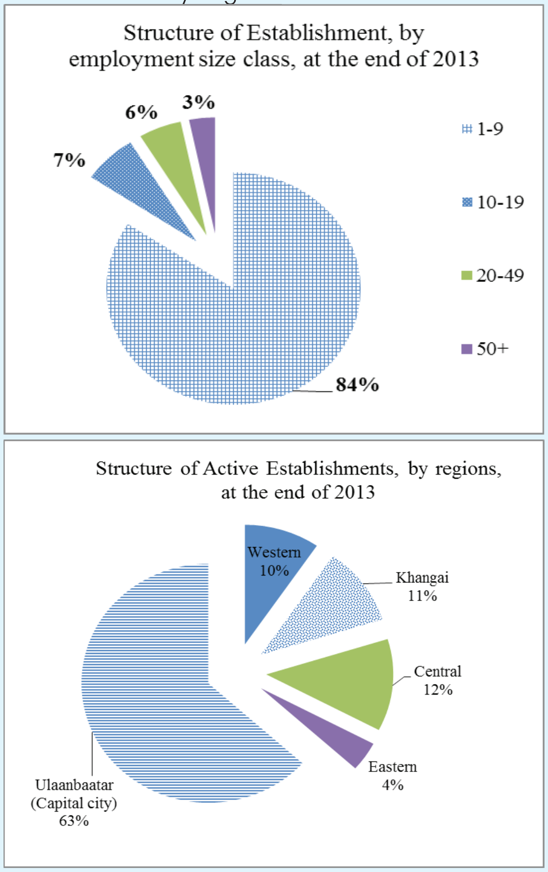
Table 2. SME category

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 (2007)

As of 2013, 99.6 thousand business units are registered, of which 55 thousand business units are active. Between 2008 and 2013, numbers of business establishment increased by 64% within five years period, but economically active businesses only increased by 51% (Table 4). Among all entities, 97% are entities with up to fifty employees (Figure 4). In terms of geographical distribution, the majority (63%) 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 (2013)

In terms of structure of business establishments by economic sectors, there are 21 thousand (38%) business units in wholesale and retail sector, followed by real estate and renting (11.3%). Compared to 2008, entities in social service are slightly decreased by 4.4%, whereas construction sector entities increased by 2.9% in 2013. Among sectors, agriculture and forestry accounts the lowest (4.3% and 5.7%) in both 2008 and 2013.

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

	Sectors	2008				2013			
		Registered	%	Active	%	Registered	%	Active	%
1	Wholesale and retail trade, repair of motor vehicles, household goods	27113	44.8	15031	41.2	43747	43.9	20902	38.1
2	Other community, social and personal services	7408	12.2	4126	11.3	5828	5.9	3769	6.9
3	Real estate, renting and other business activities	4253	7.0	2728	7.5	9908	9.9	6228	11.3
4	Manufacturing	4141	6.8	2243	6.1	8253	8.3	4295	7.8
5	Agriculture, forestry and fishery, hunting	2638	4.4	1584	4.3	5328	5.3	3148	5.7
6	Construction	2638	3.9	1313	3.6	6545	6.6	3560	6.5
7	**Number of the total establishment:**	**60801**	**100**	**36498**	**100**	**99603**	**100**	**54922**	**100**
7.1	Of which (%)				**60.0**				**55.1**

Source: Mongolian National Statistical Year Book (2008-2013), researchers' estimation

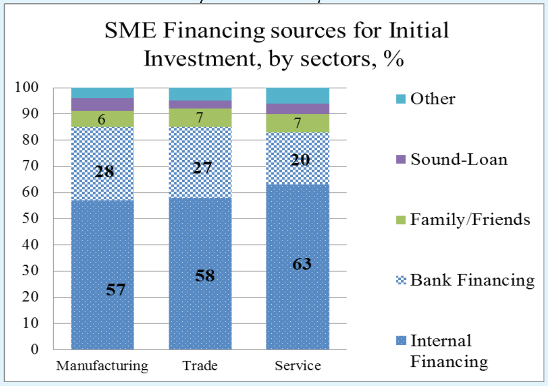
The SMEs together with micro enterprises constitute 97% of total business entities, and they generate 36.3% of sales revenue, and 22.2% of export with over 50% of total employment. Although SMEs contribute a quarter of GDP and half of total employees in Mongolia, they lack favorable financing conditions 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.

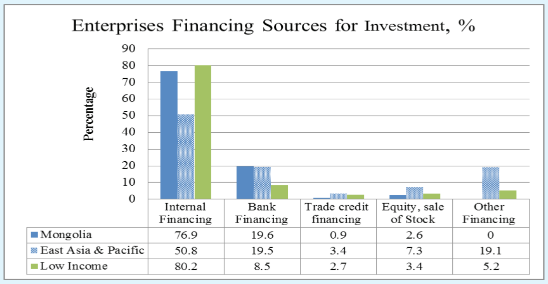
SME financing

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





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 does not exist in Mongolia, whereas these accounts for 19% in East Asia-Pacific region countries and 5% in low income countries (Figure 5). 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.

More than half of total lending (55%) is allocated for the private sector, of which 13.9% are with under one-year maturity up to one year. 32.6% of loans had 1-5 year and 3.9% 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 5), 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 one year maturity and 30-50% of loan outstanding has 1-3 years maturity.

Table 4. Loan outstanding

	2008		2009		2010		2011		2012	
	Amount in	(%)	Amount in	(%)	Amount in	(%)	Amount in	(%)	Amount in	(%)
Loan outstanding to private sector	1,555,982.5	59.0%	1,699,083.2	64.0%	1,854,627.9	57.5%	3,072,444.0	54.9%	3,819,211.7	55.0%
Normal	1,336,125.3	50.7%	1,225,613.3	46.2%	1,472,570.1	45.6%	2,752,844.3	49.2%	3,494,785.6	50.3%
up to 1 year	584,573.7	22.2%	439,816.8	16.6%	414,195.0	12.8%	604,490.6	10.8%	965,401.2	13.9%
1-5 years	703,650.8	26.7%	662,392.4	24.9%	975,254.6	30.2%	1,967,896.5	35.2%	2,259,874.0	32.6%
5 and more than	47,900.7	1.8%	123,404.1	4.6%	83,120.5	2.6%	180,457.3	3.2%	269,510.4	3.9%
Total loan outstanding	2,635,127.8	100%	2,655,000.3	100%	3,228,171.1	100%	5,597,743.6	100%	6,941,135.2	100%

Source: Bank of Mongolia (2012) 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, 80% of loans are issued in Ulaanbaatar, and 16% of loans used for trade sector, 13% in construction, 12% in mining, 12% in manufacture and 3% in agriculture sectors respectively. This minimal 3 percent shows some risks.

Loan disbursement to SME reached 1.2 trillion in 2012, which is 2.4 times increase compared to 2008. This comprises 17.4% of total loans. In 2008-2012 banks disbursed MNT 633.7 billion to 55,474 micro business units, MNT 594.0 billion to 3566 business units. The Bank of Mongolia SME study shows that 70% of total loan were from banks, 11% were concessional loan, 8% from friends, 4% from NBFI and 3% from suppliers. 36% of loan were used for working capital, 19% for extending business, 17% were for equipment, 18% of loan were spent on building extension of premise or buying new building (Bank of Mongolia, 2012).

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, 2012). It shows that bank commercial loan package is enough but other concessional loans are insufficient. The banks cannot accommodate all capital needs of MSME 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.

Non-banking financial institutions (NBFIs) are the second largest SME loan providers after banks. According to statistics, numbers of NBFIs have increased two times within last 5 years and reached 263 NBFIs in 2013 (Table 5).

Table 5. Structure and development of the financial sector

	2008			2009			2010			2011			2012			2013		
	Number	Assets (bln MNT)	Percent of Total Asset	Number	Assets (bln MNT)	Percent of Total Asset	Number	Assets (bln.MNT)	Percent of Total Asset	Number	Assets (bln MNT)	Percent of Total Asset	Number	Assets (bln MNT)	Percent of Total Asset	Number	Assets (bln MNT)	Percent of Total Asset
Commercial Banks:	16	3,527.0	95.7	15	4,215.0	95.5	14	6214	96.3	14	9,223.0	96.4	14	11992.2	96.56	14	20883.7	97.29
Private	16	3,527.0	95.7	14	4,078.0	92.5	13	6034	93.5	13	8,991.0	94.0	13	11103.6	89.40	13	17652.8	82.24
State-Owned	0	-	-	1	137.0	3.1	1	180	2.8	1	232.0	2.4	1	888.6	7.15	1	3230.9	15.05
Non-Banks:	403	159.0	4.3	459	195.0	4.4	465	237	3.7	467	340.0	3.6	472	427.4	3.44	512	581.6	2.71
Insurance compani	16	34.0	0.9	18	41.0	0.9	16	46	0.7	17	77.0	0.8	17	107.6	0.87	17	126.4	0.59
Life	1	1.0	-	1	1.0	0	1	1	0.0	1	3.0	0.0	1	4.7	0.04	1	5.6	0.03
Non-Life	15	33.0	0.9	17	40.0	0.9	15	45	0.7	16	74.0	0.8	16	102.9	0.83	16	120.8	0.56
Saving and Credit Cooperatives	209	32.0	0.9	217	45.0	1	179	49	0.8	162	59.0	0.6	148	67.7	0.55	141	73.8	0.34
NBFIs	132	79.0	2.1	177	97.0	2.2	182	129	2.0	192	189.0	2.0	212	252	2.03	263	381.3	1.78
Securities firms/ broker firms	46	14.0	0.4	47	13.0	0.3	88	14	0.2	88	14.0	0.1	95	0.1	0.00	91	0.1	0.00
Total Financial system	419	3,686.0	100.0	474	4,410.0	100	479	6451	100.0	481	9,563.0	100.0	486	12419.6	100	526	21465.3	100.00

Source: Bank of Mongolia and Financial Regulatory Commision

Although their assets have increased in 4.8 times compared to 2008, the share in total asset of the financial sector is still minimal (1.78%). NBFIs have provided loans from MNT 35 billion to MNT 154 billion, which was 4.4 times increase. Out of their total loan, 70-80% was disbursed to SMEs. The average loan maturity is up to 2 year with average interest rate of 3%.

Besides financial intermediaries, the Government of Mongolia (GOM) is another major investor for SMEs. The GOM has disbursed MNT 60.4 billion for SME development and industrialization, and the GOM disbursed MNT 27.4 billion from the loan revolving fund. In addition, the GOM disbursed MNT 276.5 billion from the government bond. The soum development fund disbursed loans worth MNT 24 billion. In Mongolia, 329 soums depending on population size have received MNT 50-265 million as SMEs support and total MNT 149.2 billion were issued to SMEs. According to Cooperation Agreement with banks another 30% line of credit or MNT 12.2 billion were allocated as SMEs financing. The loan maturity is up to 5 years with 1 year grace period and 7% interest rate.

Recommendations

Supply side

<u>Commercial banks</u>

As banks mostly rely on their deposit and own resources, size of long-term loans are not sufficient to meet growing needs of SMEs. Thus, banks need to find and raise more long-term sources from international financial institutions and international and domestic capital markets.

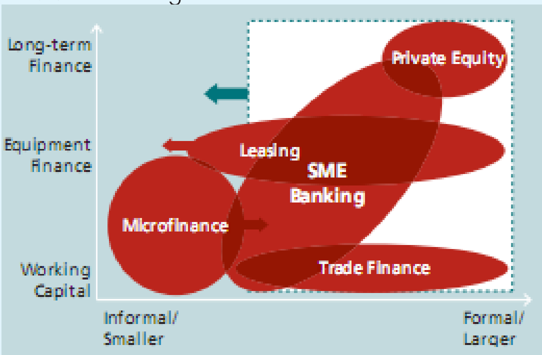
The current collateral-based traditional approach of banks in providing SME loans needs to be shifted towards a project-based financing to promote SME development. However, bank staffs do not have adequate long-term lending knowledge and skills to evaluate efficiency of proposed business projects of SMEs which do not possess immoveable collateral assets they require, but have good proposals with potential growth. Therefore, a special attention should be given to train bank staffs to handle with project financing.

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.

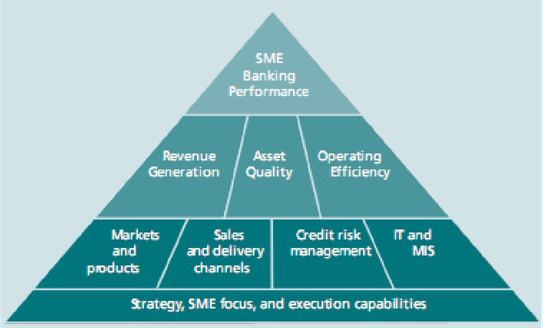
Figure 6. Types of SME financing and coverage of SME banking



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 7. 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[1] in the UK and Japan, can be established to help smaller and growing companies raise the capital that they need for expansion.

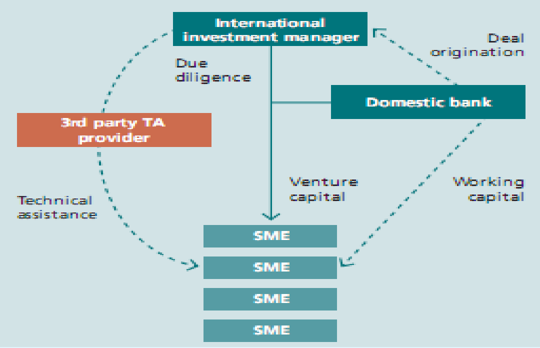
In particular, strategically important, high growth SMEs can raise equity financing from

1 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.

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[2], 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 potential cooperation between these parties.

Figure 8. 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.

Demand side

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.

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

2 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.

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 2009 and 2010, the government allocated MNT 60.4 billion to the SME fund. But, there was no budgetary allocation to the Fund in 2011 and 2012. 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 planned to be implemented between 2011 and 2015.

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.

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 recently passed 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.

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