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Improving Access to Finance for SME:
International Good Experiences and Lessons for Mongolia

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Table of Contents

1. Abstract

Importance in the role of SME in the development process continues to be in the forefront of policy debates not only in developing countries but also in developed countries. The advantages claimed for SME are various, including the encouragement of entrepreneurship; the greater likelihood that SME will utilize labor intensive technologies and thus have an immediate impact on employment generation; they can usually be established rapidly and put into operation to produce quick returns; and they may well become a countervailing force against the economic power of larger enterprises. More generally the development of SME is seen as accelerating the achievement of wider socio-economic objectives, including poverty alleviation.

However, the ability of SME to grow depends highly on their potential to invest in restructuring, innovation and qualification. All of these investments need capital and therefore access to finance. Against this background the consistently repeated complaint of SME about their problems regarding access to finance is a highly relevant constraint that endangers the economic growth of the countries.

Mongolia's transition to a market economy and the accompanying reform measures in the financial sector during the past decade have brought about a general policy environment and an overall regulatory framework that encourage formal and informal institutions to provide financial services to different group of individuals, households and organized businesses, including low income segments of the population, micro-enterprises, and small and medium-size businesses in both urban and rural areas.

In spite of the generally fast pace by which access to financial services for SME is being developed, significant segments of the SME sector do not yet benefit from the expansion and deepening of outreach. In attempting to gain access to financial services SME continue to face constraints caused by many common factors.

Thus this research intends to study of regulatory and institutional constraints to the financing of SME in Mongolia, find out best practices from international experiences, and outlines policy recommendations.

2. Literature Review of Access to Finance for SME

2.1 Definition of SME

The term SME covers a wide range of definitions and measures, varying from country to country and between the sources reporting SME statistics. Although there is no universally agreed definition of SME some of the commonly used criteria are the number of employees, value of assets, value of sales and size of capital. Among them the most common definitional basis used is employees because of the comparatively ease of collecting this information, and here again there is variation in defining the upper and lower size limit of an SME. Despite this variance, a large number of sources define an SME to have a cut-off range of 0-250 employees[1].

In the United States and Canada, SME generally include firms with less than 500 employees[2]. The EU defines a medium-sized enterprise as one with 250 employees, a small enterprises as one with less than 50 and a microenterprise as one with a maximum of 10 employees. At the same time, to qualify as an SME in the EU, a firm must have an annual turnover of Euro 40 million or less and/or a balance sheet valuation not exceeding Euro 27 million[3]. In case of Japan SME is defined as a firm with employees of 300 or less and capital size of 300 million yen or less in manufacturing, a firm with employees of 100 or less and capital size of 100 million yen or less in wholesale, and a firm with employees of 50-100 or less and capital size of 50 million yen in retail and service sector. In developing countries, number of employees and size of asset or turnover for SME tend to be much smaller compared with their counterparts in developed countries due to their relative size of business entities and economies. For example, in Mongolia, SME are defined as legally registered business entities with employees of 199 or less and with an annual turnover of 1.5 billion togrog[4](approximately 1.3 million US$ equivalent) or less respectively.

As comparative study purpose, currently the SME Department of the World Bank works with the following definitions: microenterprise up to 10 employees, total assets of up to $10,000 and total annual sales of up to $100,000; small enterprise up to 50 employees, total assets and total sales of up to $3 million; medium enterprise up to 300 employees, total assets and total sales of up to $15 million[5].

2.2 Importance of SME in Socio-Economic Development

SME are considered to have a crucial role in an economy and are a key source of economic growth, dynamism and flexibility and can adapt quickly to changing market demand and supply situations. They are also deemed to generate employment, help diversifying economic activity and make a significant contribution to exports and trade.

In the literature, there are many supporting and also skeptical arguments on the importance of SME for the economic development. Conceptually supporters are mostly based on following three core arguments (World Bank, 2004). First, SME advocates argue that SME enhance competition and entrepreneurship and therefore have external benefits on

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[1] Ayyagari, Meghana, Thorsten Beck, and Asli Demirgüç-Kunt. 2003. “Small and Medium Enterprises across the Globe. A New Database,” Policy Research Working Paper 3127, Washington, D.C.: World Bank.
[2] US Small Business Administration, March, 2008.
[3] EU Commission Recommendation on the definition of SME.
[4] Mongolian currency unit. The exchange rate of 1 US$ against Mongolian togrog is 1,165 by June 2008.
[5] Ayyagari, Meghana, Thorsten Beck, and Asli Demirgüç-Kunt. 2003. “Small and Medium Enterprises across the Globe. A New Database,” Policy Research Working Paper 3127, Washington, D.C.: World Bank.

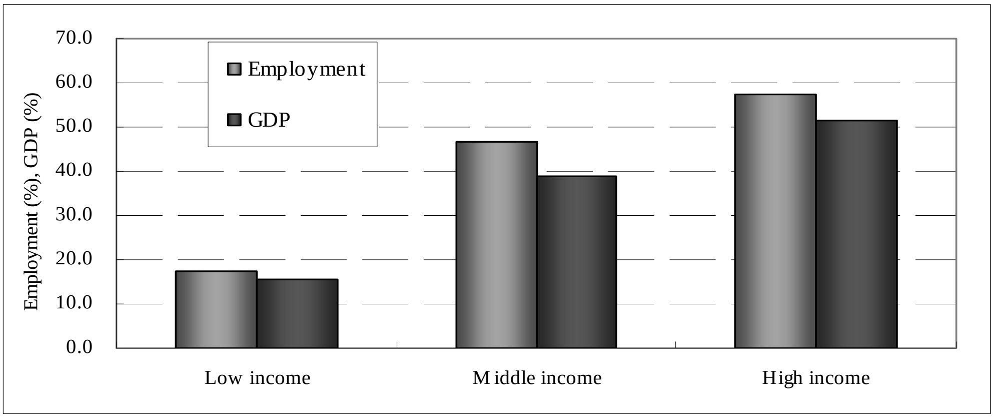
economy-wide efficiency, innovation, and aggregate productivity growth. From this perspective, supporting of SME will help countries to exploit the social benefits from greater competition and entrepreneurship. Second, proponents of SME support frequently claim that SME are generally more productive than large firms but financial market and other institutional failures impede SME development. Thus, pending financial and institutional improvements, broadening access to financial services to SME can boost economic growth and development. Finally, some argue that SME expansion boosts employment more than large firm because SME are more labor intensive. From this perspective, subsidizing SME may represent poverty alleviation tools in developing countries.

While there is significant number of academic literature of pro-SME policy, there are also some skeptical views questioning the efficacy of pro-SME policy. For instances, some authors stress the advantages of large firms and challenge the assumptions underlying the pro-SME view. Specifically, large enterprises may exploit economies of scale and more easily undertake the fixed costs associated with research and development (R&D) with positive productivity effects. Also, some hold that large firms provide more stable and therefore higher quality jobs than small firms with positive implication for poverty alleviation. A second set of skeptical views directly challenges the assumptions underlying pro-SME arguments. In particular, some research finds that SME are neither more labor intensive, nor better at job creation than large firms. A third skeptical view regarding the efficacy of pro-SME policies, which they term the business environment view, doubts the crucial role of SME, but instead stresses the importance of the business environment facing all firms, large and small. From this perspective, low entry and exit barriers, well-defined property rights, effective contract enforcement, and firm access to finance characterize a business environment that is conducive to competition and private commercial transactions. While these factors may encourage SME, the focus of the business environment view is not on SME in isolation, it is on the environment facing all businesses. Thus, consistent with the other skeptical views, the business environment view questions the pro-SME policy prescription of subsidizing SME development.

Even though there are number of pro and opposing arguments of supporting SME in the literature, it is evident that SME play important role in any economy as seen from numerical data. Recent World Bank’s Paper investigates cross-country data of SME’ contribution to GDP and employment[6]. This paper presented comprehensive statistics on the contribution of the SME sector to total employment and GDP across a broad spectrum of countries. At the same time, the paper shows a comparison on how the economic importance of the SME sector varies across countries. A database covers 54 countries in the sample, 13 of which are low income countries, 24 are middle income and 17 are high income countries.

[6] The World Bank. 2003. Policy Research Working Paper 3127.

Figure 1. SME sector's Contribution to Employment and GDP across Countries

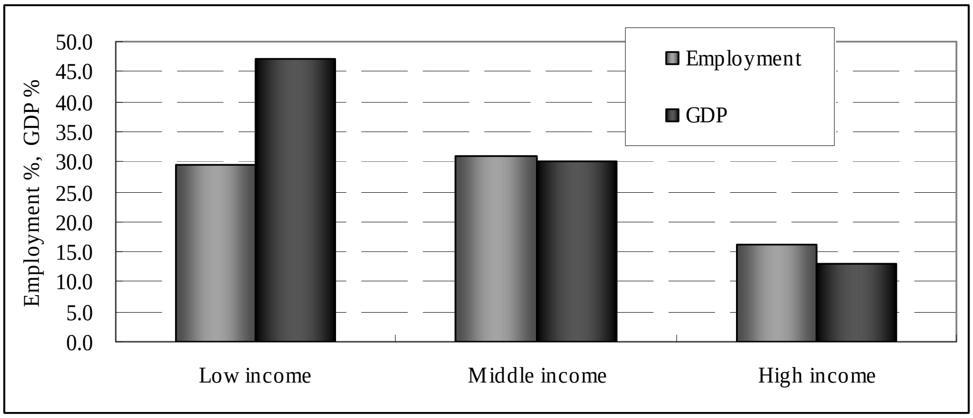


Source: The World Bank, Development Research Group, 2003.

Figure 1 shows the SME sector's contribution to total employment and GDP across different income groups. The graph shows a marked increase in the SME sector's contribution to total employment from the low-income countries (17.6%) to the high income (57.2%). The SME share of GDP follows a similar trend increasing from 15.6% of GDP in the low-income countries to 51.5% in the high-income countries. Therefore, an increase in SME sector's contribution to employment is accompanied by an increase in its share of GDP as well.

As seen Figure 1, one may note that total shares of SME contribution to GDP and employment are comparatively small in developing countries. It does not necessarily mean SME play small role in the developing economies because there are large informal sector in

Figure 2. Informal Sector's Contribution to Employment and GDP



Source: The World Bank, Development Research Group, 2003.

low and middle income countries compared with high income countries (see Figure 2) and possibly sizeable number of potential SME operate in informal economy in this countries.

Figure 1 and Figure 2 show that joint contribution of the informal and SME sector to GDP and employment remains approximately stable across all income groups of countries at around 65-70 percent. As income of the countries increases, there is marked shift from the informal to the SME sector.

2.3 Access to Finance Related General Issues

The access to finance is a subject of significant research interest to academics and an issue of great importance to policy makers for both developed and developing economies for many years. There are a number of factors that have contributed to this. First, there is some empirical evidence that the expansion of access may reduce prevailing poverty in developing countries[7]. Second, the interest in access also comes from the fact that arguments about the channels through which financial development may lead to growth often include access related stories. A third reason is the widespread lack of access to financial services in emerging economies, particularly when compared to the extent of access in developed countries. Fourth, recent Investment Climate Survey conducted by the World Bank shows that one of the major impediment of fostering firms is lack of access to financial services which would expand economic growth and employment generation as well as reducing poverty in many developing countries.

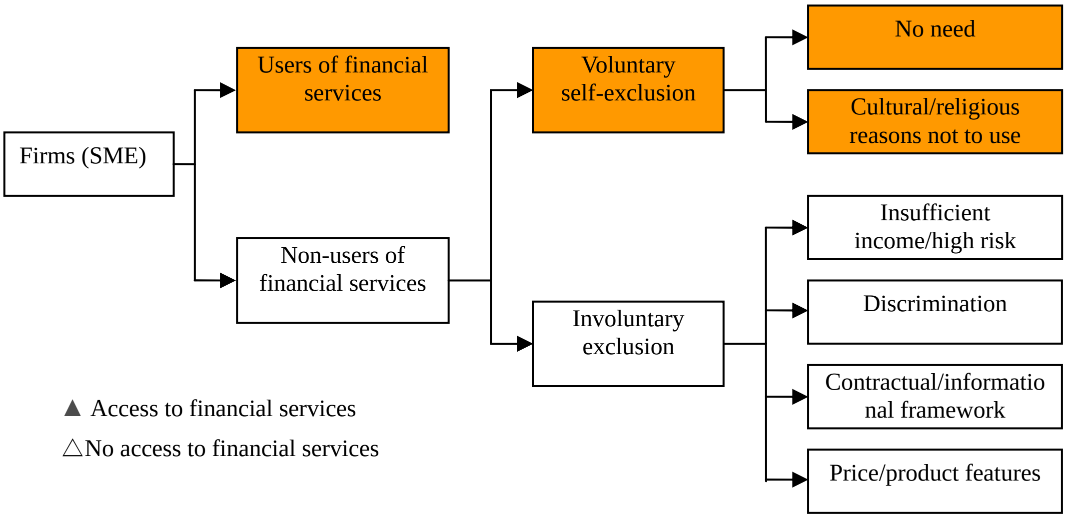
2.3.1 What does access to finance mean?

Generally speaking, financial inclusion, or broad access to financial services, is defined as an absence of price and non-price barriers in the use of financial services[8].
Improving access, then, means improving the degree to which financial services are available to all at a fair price. It is easier to measure the use of financial services since data of use can be observed, but use is not always the same as access. Access essentially refers to the supply of services, whereas use is determined by demand as well as supply.

Figure 3 illustrates the difference between access to and use of financial services. Users of financial services can be distinguished from nonusers, and there are important distinctions among nonusers. On the one hand are those who do not use financial services for cultural or religious reasons or because they do not see any need. These nonusers include enterprises without any promising investment projects. These nonusers have access, but they choose not to use financial services. From a policy maker's viewpoint, nonusers do not really constitute

[7] The IBRD/World Bank. 2008. "Finance for all? Policies and Pitfalls in Expanding Access".
[8] The IBRD/World Bank. 2008. "Finance for all? Policies and Pitfalls in Expanding Access".

Figure 3. Access to finance and use of financial services



Source: The IBRD/World Bank, "Finance for all? Policies and Pitfalls in Expanding Access," 2008.

a problem because their lack of demand drives their nonuse of financial services. On the other hand are the involuntarily excluded who, despite demanding financial services, do not have access to them. There are several different groups among the involuntarily excluded. First, there is a group of firms that are considered "unbankable" by commercial financial institutions and markets because they do not have enough income/collateral or present too high a lending risk. Second, there might be discrimination against certain groups based on social, religious, or ethnic grounds. Third, the contractual and informational framework might prevent financial institutions from reaching out to certain groups of firms because the outreach is too costly to be commercially viable. Finally, the price of financial services may be too high or the product features might not be appropriate for certain firms. While the first group of involuntarily excluded cannot be a target of financial sector policy, the other three groups demand different responses from policy makers.

Theoretically a problem of access to credit for firms exists when a project that would be internally financed if resources were available, does not get external financing. This happens because there is a wedge between the expected internal rate of return of the project and the rate of return that external investors require to finance it. This wedge is mainly introduced by two well-known constraints that hamper the ability to write and enforce financial contracts, namely, *principal-agent problems* and *transaction costs*[9].

[9] Stiglitz, J. E. and A. Weiss, 1981. "Credit Rationing in Markets with Imperfect Information," *American Economic Review*.

Principal-agent problem. The classic principal-agent problems are adverse selection and moral hazard. The adverse selection problem arises because high- risk borrowers (not just those that may be unable to repay their debt, but also those that might be unwilling to do so) are the ones that are more willing to look for external finance. A financer may be willing to provide financing to some projects/debtors by increasing the risk premium charged, but this approach can backfire at some point due to the adverse selection problem. This is because as the risk premium required by lenders rises, so does the riskiness of the pool of interested borrowers. High-risk borrowers are "adversely selected" by higher risk premiums. In effect, the higher the interest rate, the lower its usefulness and reliability for creditors as a device for sorting out the good projects/borrowers from the bad ones. The situation is one where the debtor may know ex-ante whether her project is good or bad, and may have incentives to window-dress the bad ones, but the creditor cannot screen all the projects adequately because she cannot extract or verify all this information. Faced with the risk of adverse selection, lenders will try to use non-price criteria to screen debtors/projects and ration and apportion credit, rather than further increasing the risk premium.

The moral hazard problem, by contrast, concerns the situation after the agent (e.g., the debtor) has received the resources (e.g., the loan) from the principal (e.g., the lender). The problem here is that an agent may have informational advantages and associated incentives to use the resources in ways that are inconsistent with the principal's interests. Acting on such incentives, the agent may divert resources to riskier activities, strip and loot assets, or simply run away with the money, and the creditor may not have an effective way to monitor and prevent such behavior. However, the moral hazard problem can arise even when the agent does not have informational advantages over the principal—i.e., when information is symmetrically shared—if the principal faces high costs of enforcing the contract subscribed with the agent. Faced with the moral hazard risk, a principal (e.g., a financer) would try to find ways to arrange in a line the incentives of the agent with its own. If unable to do so, principals may just not provide funding—i.e., curtail access[10].

Transaction costs problem. Even assuming that there are no principal-agent problems, a problem of access to finance may still exist where the transaction costs involved in the provision of finance exceed the expected risk-adjusted returns. Such a scenario may arise due to the inability of financial intermediaries to reduce costs by capturing economies of scale and scope. The result would affect disproportionately such outsiders as small enterprises, as providing finance to them could be rendered unprofitable by high costs per transaction. Cost barriers could also stem from deficiencies in institutions and market infrastructure that make it expensive to gather information on debtors/projects, value assets appropriately, and monitor and enforce contracts.

[10] De la Torre, Augusto, Juan Carlos Gozzi, and Sergio Schmukler. 2007. "Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand?" Policy Research Working Paper 4326, Washington, D.C. : World Bank.

2.3.3 How to Measure Accessibility to Finance

Before we can improve access, or decide whether and how to do it, we need to measure it. Access is not easy to measure, and empirical evidence linking access to development outcomes has been quite scarce due to lack of data. Financial depth (total loan outstanding/GDP), more generally, can be seen as an approximate indicator with direct and indirect effects on financing firms. Greater depth is likely to be associated with greater access for firms.

Beck, Demirgüç-Kunt, and Martinez Peria (2007) presented, first time, indicators of banking sector penetration across 99 countries, based on a survey of bank regulatory authorities. They put together the following indicators of banking sector outreach:

(1) Geographic branch penetration: number of bank branches per 1,000 km^2

(2) Demographic branch penetration: number of bank branches per 100,000 people

(3) Geographic ATM penetration: number of bank ATMs per 1,000 km^2

(4) Demographic ATM penetration: number of bank ATMs per 100,000 people

(5) Loan accounts per capita: number of loans per 1,000 people

(6) Loan-income ratio: average size of loans to GDP per capita

(7) Deposit accounts per capita: number of deposits per 1,000 people

(8) Deposit-income ratio: average size of deposits to GDP per capita

Indicators (1) through (4) measure the outreach of the financial sector in terms of access to banks' physical outlets while indicators (5) through (8) measure the use of banking services. Although those indicators can not be precise measurement of access to finance, those can be good proxy indicators of measuring accessibility of financial services.

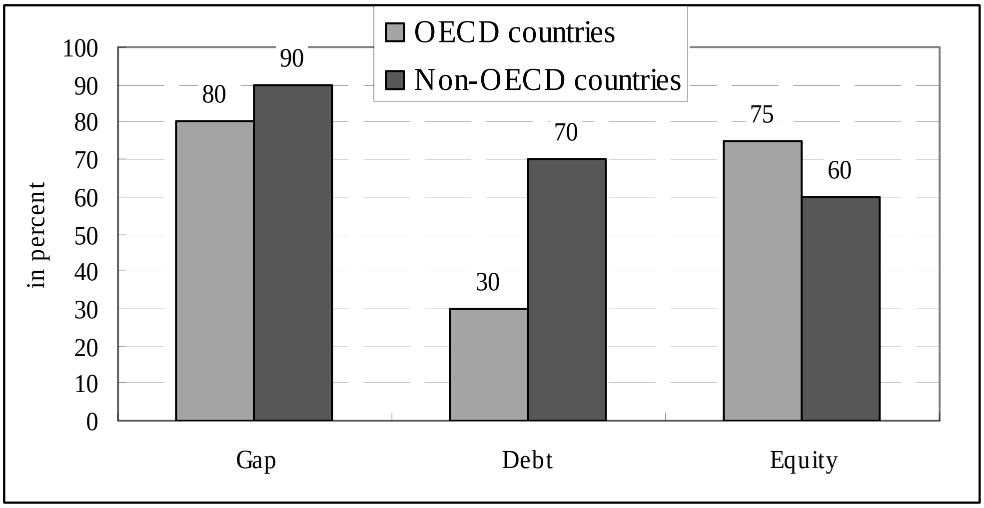
2.4 SME's Constraints to Access to Finance

The studies and empirical evidences on finance consistently address that inadequacies in access to finance are key obstacles to SME growth. Beck, Demirguc-Kunt, and Maksimovic (2004, 2006, 2007), and others show that SME find accessing financing more difficult than larger firms.

Other example shows in the OECD survey. The OECD developed a questionnaire on SME access to finance (debt and equity finance) in December 2004 (see Figure 4).

Although 20 OECD countries and 12 non-OECD countries were covered in this survey, the results of survey provide some support for the analysis and the conclusions that there is significant problem of access to finance elsewhere and more serious in developing countries. As mentioned above, theoretical argument on lack of access to finance in general is that suppliers of finance may choose (due to problems of dealing with uncertainties such as agency and principal problem, asymmetric information, adverse credit selection, and institutional problems) to offer higher interest rate and credit rationing that would leave

Figure 4. Financing Gap to SME



Source: OECD, The SME Financing Gap: Theory and Evidence, 2006.

significant numbers of potential borrowers without access to credit. The argument was not specifically aimed at SME, but the specific characteristics of SME are such that these problems are more severe to SME than larger firms.

Malhotra, Chen and others[11] demonstrate that SMEs are usually more credit constrained than other segments of the economy because of the following reasons: (i) financial sector policy distortions; (ii) lack of know-how on the part of banks; (iii) information asymmetries, for example, lack of audited financial statements; and (iv) high risks inherent in lending to SMEs. Detailed discussions on each of these reasons are as follow.

(i) Financial Sector Policy Distortions

Firms' ability to access finance is directly related to the presence of well-functioning financial markets that connect firms to lenders and investors willing to fund their ventures. In their efforts to respond to market failures, governments have often intervened heavily in financial markets in the following ways, with overall poor results.

Interest Rate Ceilings. Government-mandated, below-market interest rates caps usually cause more problems than they solve and discourage banks from lending to higher-risk borrowers such as SME.

State-Owned Enterprises. In many countries, large state-owned enterprises and

[11] Malhotra, Mohini, Yanni Chen, Alberto Criscuolo, Qimiao Fan, Iva Ilieva Hamel, and Yevgeniya Savchenko. 2006. "Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises," Washington, D.C. : World Bank.

government infrastructure projects enjoy preferential access to bank credit, crowding out non-state enterprises, especially SME.

Public Sector Borrowing. Public sector borrowing likewise crowds out credit from financial institutions to the private sector: investing in government securities is a safer bet than investing in unknown SMEs.

Legal and Regulatory Frameworks. Although various promising forms of financing such as leasing, factoring, and venture capital have been introduced in most financial markets, the lack of supportive legislation, regulations, and tax treatment has often restrained their growth.

Weak Judicial and Legal Frameworks and Lack of Property Rights. Governments can increase financial institutions' willingness to provide finance to SME by ensuring that both lenders and borrowers have clearly defined property rights. Stronger creditor rights-stemming, for example, from laws guaranteeing secured creditors' priority in the case of default-allow lenders to reduce the risk of future losses. Securing borrowers' property rights to assets they can pledge as collateral can help borrowers both in accessing finance and in obtaining cheaper and longer-term loans. However, having legal provisions that ensure debtors' and creditors' rights are not sufficient. Their effectiveness depends on strong enforcement of the law. The lack of an effective legal system to enforce laws impedes the development of a deeper credit market.

Some laws exclude movable assets, such as machinery, vehicles, and livestock. As movable assets often account for a greater share of the assets of smaller firms than of larger ones, the impact on access to credit is relatively negative for SME. Laws and registries permitting the collateral of movable assets can offer greater benefits to small firms. Title to land and real estate is often crucial for providing access to finance for business development. The lack of enforceable property rights limits the ability of physical assets to generate capital. If property cannot be bought and sold with the confidence that the authorities will uphold the transaction, financial institutions will be reluctant to take on the risk of lending against physical collateral. Poorly defined property rights not only reduce firms' ability to access finance, but also lead to the overall failure of markets to generate dynamic growth.

(ii) Lack of Suppliers' Know-How

Small Loan Size Relative to Transaction Costs. SME typically require relatively small loans compared with large firms. The transaction costs associated with processing and administering loans are, however, fixed, and banks often find that processing small SME loans is inefficient. They lack the techniques, such as credit scoring, to increase volume and lower costs.

Difficulty in Adopting New Lending Technologies. Experience from the microfinance industry shows that one way to successfully bridge the gap between the demand for and supply of credit is through innovative lending methodologies. Such methodologies include the following: (a) undertaking loan analysis that focuses on prospective clients' ability to pay (cash flow), with less emphasis on collateral; (b) giving loan officers incentives for maintaining high-quality portfolios; (c) introducing appropriate decision-making and control mechanisms supported by management information systems and information technology to help manage and administer the loan portfolio; and (d) providing larger loan amounts and longer terms for well-performing borrowers.

(iii) Information Asymmetries

The main information asymmetries that constrain SME access to finance are as follows:

High Cost of Obtaining Credit Information on SME. For markets to allocate resources efficiently, all market participants must have the same relevant information. This is seldom the case, however, in developing countries, and the resulting market failures can create biases against small firms. Under these circumstances, for banks to obtain information on the creditworthiness of potential SME clients is difficult or costly. If, as a result, lenders perceive the risks of lending to SME to be greater than they actually are, they will charge higher interest rates or refrain from lending to them altogether. If lenders do charge high interest rates, this increases the risk they are exposed to by discouraging low-risk, low-return borrowers from seeking loans, ultimately discouraging lenders from lending to SME altogether. At the same time, higher interest rates are associated with mainly high-risk projects, a circumstance referred to as adverse selection.

Inconsistent SME Financial Statements and Audits. As SME are often not required to adopt international accounting standards when preparing their financial statements, large discrepancies arise in the ways firms report their financial positions. For example, many firms in developing countries may have two or three sets of books for different audiences. Auditing such statements can be labor- and time-intensive, which raises the cost of loan processing for SME. In addition, even audited financial statements can be unreliable.

Lack of Access to Third Party Information by Providers in the Marketplace. Lenders' lack of knowledge of their clients and of information on clients' credit profiles and histories reinforce their perception of the high risk involved in lending to SME. One way to overcome the high cost to lenders of directly screening and monitoring clients is through the establishment and use of credit bureaus as third party information providers.

(iv) High Risks of SME Operations

SME operations are subject to two major risks.

Vulnerability and Turnover. SME are riskier borrowers than large firms. This is because SME are more vulnerable to market changes and often have inadequate management capabilities because of their smaller size. Lack of demand and shortages of working capital were the two most frequently mentioned underlying causes of these business failures. SME activities are extreme volatile with a large number of them starting up while many others are closing down.

Management Weaknesses. Despite evidence that lack of access to finance constrains many SME, actual effective (or bankable) demand may itself be constrained by weaknesses in firm management and the dossiers their management can present when applying for credit. Programs to increase financing for SME often begin with training and business development services to strengthen firms' management and productivity. However, sole proprietorships, such as many SME, have few incentives to obtain external audits of their financial statements to improve management and productivity, and such audits are also expensive relative to the size of loans that SME may be seeking. Thus banks often complain that loan applications from SME do not meet their standards.

In addition to above mentioned constraints of SME, many literatures reveal other characteristic that SME in developing or emerging countries are more disadvantaged in obtaining external finance than SME in developed countries. Developing countries are more likely to have macroeconomic imbalances that lead to excess demand for available domestic savings as well as institutional weakness that encourage large number of individuals to engage in low productivity informal activity. Furthermore, financial systems in developing countries are often characterized by less deregulation, openness and reform of ownership, governance and supervision. There are persuasive reasons to believe that when the institutional and financial framework in developing countries is weak, the SME will be adversely affected to a much large degree than large firms.

Finally, capital markets do not compensate for deficiencies in the banking sector as they do not have a comparative advantage to deal with opaque and small firms. In effect, capital market financing rests on comparatively high accounting and disclosure requirements which, by definition, opaque SME lack. Thus capital markets are typically not a source of direct funding for SME, given that these firms are unable to issue debt or equity in amounts sufficiently large to attract investors (who prefer liquid issues and are not willing to take too large a share of a single asset) and amortize issuance-related transaction costs (including compliance with complex legal, regulatory, accounting, and disclosure requirements). These factors normally render unfeasible the direct access to capital market financing for SME.

2.5 International Good Experiences for Improving Access to Finance for SME

This section focuses on how financial institutions and governments have resolved of or worked on the problems faced by SME in accessing to finance. Broadly international experiences could be divided into two levels: firm (financial intermediaries) and government.

2.5.1 Role of Financial Intermediaries

In the process of globalization, openness and financial liberalization, financial institutions are now facing steep competition in supplying financial services. Driven by competition pressures, private commercial banks are increasingly moving toward reaching to niche markets and small businesses, and poorer clients in many developed and developing countries.

As reviewing international practices, it can be noted that good suppliers of financial services or lenders commonly try to find possible solutions for problems of access to finance SME addressing three basic questions:

(a) How to lower or share the risk for the banks with the small business loan applications?

(b) How to reduce the cost of the application and processing for small loans?

(c) How to improve the quality of the information on enterprises to the level required by the banks in the loan application process without putting a too heavy administrative burden on the small businesses that cannot afford a well staffed administrative structure?

Recent World Bank research paper[12] concluded that all kinds of private commercial banks now view SME as a strategic sector and are expanding or planning to expand their operations aggressively in this segment. As a consequence, the market for SME is becoming increasingly competitive, although far from saturated and this is not happening in most developing countries. But it will be important lessons for banks in developing countries. According to the paper, banks are now developing new business models, technologies, and risk management systems to serve volatile SME sector. Lending is only a fraction of what banks offer to SME, as banks try to serve SME in a holistic way through a wide range of products and services, with fee-based products rising in importance. Large banks and foreign universal banks are leading the process, capitalizing on their ability to exploit economies of scale and scope. They can lend on a large scale and provide a wide range of complementary products and services that are attractive to SME. They can sort out well-functioning and promising SME via their corporate clients with which SME maintain supply and outsourcing relations. Once they establish a client relationship with SME, large banks can use their well-established retail and consumer units to more easily extend services to individuals (workers, owners, and their families) linked to those SME. Multi-service large banks can also manage risk better by diversifying it more, having more data, and using more sophisticated risk management tools. International banks, moreover, can learn relatively fast from their successful experiences in SME banking elsewhere in the world.

Many of these changes in the relation between banks and SME in more advanced countries are connected to technological advances that allow banks to offer products and

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[12] De la Torre, Augusto, Juan Carlos Gozzi, and Sergio Schmukler. 2007. "Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand?" Policy Research Working Paper 4326, Washington, D.C.: World Bank.

services at a scale and cost that they were not able to do before.

Technology promises to reduce costs and improve transparency in delivering financial services, both of which can translate into increased access for large numbers of SME clients. Streamlined and automated processes allow financial institutions to extend services to harder-to-reach and more costly clientele by replacing people and branches. At the same time, reducing the “hassle factor” makes banking relationships attractive for more customers. Finally, technology undergirds the information and reporting systems that are essential for efficient financial service delivery. Despite the appeal of advanced delivery technologies, relatively few financial institutions have successfully deployed them to reach SME clients.

Several challenges remain, including the high cost and limited availability of existing technological solutions, consumer acceptance of technology, the lack of basic communications infrastructure in some countries, and inadequate government policies.

The following are brief definitions of technologies commonly used in successive case of expanding access to financial services[13].

Information Systems. Custom-built or commercially available software that allows financial institutions to track transactions and create reliable financial reports. Getting this right is a critical building block for all other technology applications.

Connectivity. Network connections (for example, dial-up, broadband, or satellite) that link staff and branches for real-time information exchange, transaction processing, and distance learning.

Personal Digital Assistants (PDAs). Small handheld computers that help field staff more efficiently collect data, manage SME client records, and process loans.

Credit Scoring. Automating or enhancing the loan approval process by computerized analysis of client characteristics and behavior to predict willingness and ability to repay.

Automatic Teller Machines (ATMs). Machines that dispense cash or provide a wider range of services to cardholders. ATMs are relatively expensive to own and operate. Most require network connectivity and reliable power.

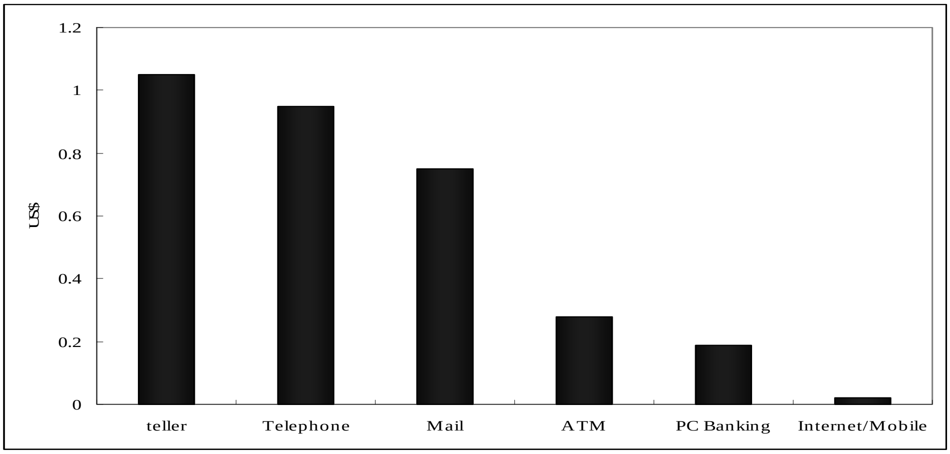
Internet Banking. The ability to conduct banking transactions from any location, such as Internet kiosks. This service is probably more relevant for urban area clients.

Mobile Phones. Millions of people in both urban and remote areas now have access to cell phones, and increasingly use text messaging. This technology offers an opportunity to operate virtual bank accounts with minimal infrastructure.

Financial institutions can employ some combination of these technologies to reach clients directly, or in partnership with others. The large volumes of transactions required to ensure a return on technology investments (especially ATMs) drive financial institutions to leverage each other’s networks. Also, by working with agents like local merchants and smaller banks, financial institutions can reach small businesses or more remote rural clients

[13] Cracknell, Electronic Banking for the Poor: Panacea, Potential and Pitfalls; Using Electronic Payments to Build Inclusive Financial Systems; and the CGAP IT Innovations Series.

Figure 4. Illustrative Costs per Distribution Channel



Source: Brigit Helms, Access for All: Building Inclusive Financial Sector, CGAP, 2006.

without building expensive branch networks. Perhaps the most important contribution of technology is lower operating costs. For instance, a recent study demonstrates that a typical ATM transaction costs nearly five times less than a teller transaction (see Figure 4).

These costs are based on data from the United States, and the actual costs would vary tremendously depending on the country context, the costs of labor relative to imported hardware and software, and other circumstances.

A number of banks around the globe have also learned the lending and pricing strategies that allow them to compensate for the high transaction costs of making many small loans and have adopted risk management techniques commensurate with the higher risk profiles of their SME clients. In terms of lending, credit scoring technique allows banks to reduce the costs and time of making loans, process a larger volume of small loans more efficiently, and be better able to monitor the risk of the portfolio.

Another way in which technology has helped banks sell services to SME is through online banking. Firms can now use banks' websites to, for example, process payments, input accounting and administrative data, monitor receivables, manage their liquidity, make investments, make international money transfers, buy insurance products, and more generally hedge risk.

In developing countries, many of the innovations were originated in serving clients at the lower end of the private sector spectrum using microfinance technologies. These innovations consisted of providing small, uncollateralized working capital loans; promising access to larger amounts for longer terms based on repayment performance; and permitting small savings accounts that were safe, convenient, and flexible in terms of withdrawal. The key characteristic cutting across developing country commercial banks applying microfinance principles to SME finance is that they have focused on relationship-intensive banking rather than more traditional transactions banking. The relationship-lending model is based on qualitative information with an emphasis on the character and reliability of micro business or SME owners gathered from informal sources such as suppliers and community leaders. Banco do Noreste in Brazil contracted its loan officers through employment agencies on a temporary basis for the micro-finance business in order to keep fixed costs low while it experimented with a new product line. In Armenia, the first stage of credit screening was devolved to village associations[14].

When assessing an SME owner's character, informal references need to be taken in the community from customers, respected persons or other reference points such as faith-based organizations. Incentive structures hold loan officers accountable for their institution's relationship with a client throughout the life of the loan, including analysis, disbursement, monitoring, and repayment. Loan officers are paid performance-based salaries, with their compensation being a function of productivity and portfolio quality.

2.5.2 Role of Government and Public Sector Policies

Given the major potential benefits of access-enhancing financial development, a relevant question, especially in countries with underdeveloped financial systems, is whether government intervention to foster financial development and broaden access is necessary and, if so, what form should this intervention take.

Standard arguments for government intervention in the financial sector stress that financial markets are different from other markets because they rely heavily on information and produce externalities that cannot be easily internalized by market participants. When information is asymmetric between lenders and borrowers and is costly to obtain, or when the social benefit of a project is higher than the private benefit, the market may fail to provide adequate financing. Financial markets rely heavily on the production and processing of information, which is fundamentally a public-good, in the sense that it is non-rival in consumption (the consumption of the good by one individual does not detract from that of another individual) and non-excludable (it is very costly to exclude anyone from enjoying the good)[15].

While most economists would agree that some type of government intervention to foster financial development is warranted, there is less consensus regarding the specific nature of this intervention. Answers to this question tend to be polarized in two highly contrasting but well-established views: the *interventionist* and the *laissez-faire (free-market)* views. The *interventionist* view argues that an active public sector involvement in

[14] Malhotra, Mohini, Yanni Chen, Alberto Criscuolo, Qimiao Fan, Iva Ilieva Hamel, and Yevgeniya Savchenko. 2006. "Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises," Washington, D.C. : World Bank.

[15] Stiglitz, Joseph. E. 2000. *Economics of the Public Sector.*

mobilizing and allocating financial resources, including government ownership of banks, is needed to broaden access to credit, as private markets fail to expand access. In contrast, the *laissez-faire* view contends that governments can do more harm than good by intervening directly in the financial system and argues that government efforts should instead focus on improving the enabling environment, which will help to reduce agency problems and transaction costs and mitigate problems of access.

A third view is also emerging in the middle ground, favoring direct government interventions in non-traditional ways. This third view is in a sense closer to the laissez-faire view, to the extent that it recognizes a limited role for the government in financial markets and acknowledges that institutional efficiency is the economy's first best, but, as it will be explained below, it does not exclude the possibility that in the short run, while institutions are taking time to build and consolidate, some government actions undertaken in collaboration with market participants may be warranted. This is the view of *pro-market activism*[16].

Most literatures emphasize that the government's best role in improving access to finance is to offer a policy environment that allows competitive and diverse financial service providers to flourish.

Theoretical and empirical research has confirmed that macroeconomic instability is an important obstacle to effective contracting[17]. Fiscal imbalances in particular generate high and variable inflation, often making the future value of money so uncertain (and difficult to hedge) for both suppliers and demanders that long-term financial contracts simply do not exist. Households will not give up control over their savings for longer time-periods in unstable macroeconomic environments, and financial institutions will not commit beyond short-term contracts given funding uncertainties. Unsustainable macroeconomic and fiscal policies have often been the prelude to financial instability and crises. The fear of macroeconomic and financial instability also inhibits financial innovation that can promote access. In addition, the scale of borrowing by free-spending governments tends to crowd out other borrowers, perhaps especially SME.

Government role in ensuring competition is an essential part of broadening access as competition encourages incumbent institutions to seek out profitable ways of providing services to previously excluded SME sector and increase the speed of new, access-improving technologies are adopted.

International experiences suggest broadly three complementary roles that governments can address some of the constraints and facilitate the broadening the access to finance for SME: (i) improve or build sound legal and judiciary infrastructure, (ii) Build effective

[16] De la Torre, Augusto, Juan Carlos Gozzi, and Sergio Schmukler. 2007. "Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand?" Policy Research Working Paper 4326, Washington, D.C.: World Bank.
[17] The IBRD/World Bank. 2008. "Finance for all? Policies and Pitfalls in Expanding Access."

information infrastructure, (iii) Make some rational direct intervention. A review of each of three complementary roles is addressed as follow.

(i) Improving Sound Regal and Judiciary Infrastructure

Legislation that defines the right and responsibilities of companies, financial entities, and other financial market participants, avoiding uncertainty or ambiguity in contracts, is a valuable of the financial infrastructure provided by government.

When banks consider a lending decision, the clarity, consistency, cost, and convenience of collecting loans all affect the price and availability of financing. The laws and procedures governing bankruptcies, the securing of collateral, the accuracy and availability of property right and registries, and the relative sanctity of property rights are all critical.

Some precautions are needed for institutions specializing in serving SME, particularly if they provide unsecured lending, namely:

- ✓ Limiting unsecured lending to some percentage (often 100 percent) of a bank's equity base makes it impossible for the financial institution to leverage its equity with deposits or borrowed money.
- ✓ Regulations requiring 100 percent loan loss provisioning for all unsecured loans at the time they are made makes lending to microenterprises and small enterprises virtually impossible.
- ✓ Standardized reporting requirements on banks' financial positions are too onerous and expensive to comply with for portfolios consisting of many small transactions

The rapidly evolving technologies based on the Internet (e-finance) and cell phones (mobile phone or m-finance) can be powerful engines of access. But a lack of legal clarity may impede the adaptation of these technologies. Government needs to keep legislation up to date not only to ensure contracting parties that what they intend will be unambiguously enforceable but also to prevent legislation from blocking new innovations. Even though most of the technical problems seem to have been readily soluble, and despite the huge potential market m-finance has been slow to take off. A major early success experiences was in the Philippines, where two companies signed up a total of 4 million customers. South Africa was also an early adopter of m-finance, and it has been followed in Africa by the Democratic Republic of Congo, Kenya, and Zambia, illustrating the potential for this technology (with its low marginal costs) to overcome the problem of high unit costs that shut out low-income customers in countries with relatively weak infrastructures[18].

While indispensable for long-term sustainable broadening and deepening of financial systems, broad institution building is a long-term process. The government can achieve additional impact in the short to medium term by taking action specifically directed at facilitating financial market activity that helps access. Beyond the overall legal structure and

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[18] The IBRD/World Bank. 2008. "Finance for all? Policies and Pitfalls in Expanding Access".

its protections, an important practical question is the extent to which contract enforcement in finance needs to be supplemented by specific laws restricting and clarifying, and thereby offering more reliable protection to, certain types of financial contracts or financial business more generally.

Therefore, the trend worldwide has been to expand greatly the degree to which the law is tightly defined by statute rather than relying on judicial precedent in areas such as accountancy, banking, securities markets, unit trusts, leasing, payments, and so on. Indeed, the experience of developing countries has been that many financial contracts simply do not happen without the presence of an adequate explicit law to clarify that the contract will have the protection of the courts. These measures include putting in place the legislation, taxation, and other rules needed for specific financing tools and institutions such as leasing, factoring, equity or venture capital, asset-backed securitization and credit guarantee scheme that are particularly suited to SME. Some of good experiences these specific financing tools will be discussed later separately.

(ii) Build Effective Information Infrastructure

The availability of information about payment performance through credit bureaus has been empirically shown to increase the availability of credit for SME. Surveys show that the time needed to process loans, the costs of making loans, and the extent of defaults are all higher without credit bureaus.

Credit information registries support well-functioning and modern financial systems and are critical elements of the institutional framework (Miller, 2003). They provide rapid access to standardized information on potential borrowers. There are two main types of credit bureaus: public and private. Public credit bureaus usually only cover supervised institutions, require mandatory reporting of credit exposures, and typically have a high cut-off minimum loan amount. Private bureaus take five possible forms: private firms with bank ownership, private firms without bank ownership, bank associations, chambers of commerce, and commercial and credit insurance firms.

Policy Issues Concerning Credit Bureaus. Despite little controversy about the importance of credit information sharing and its role in remedying credit constraints, the development of credit bureaus is not without debate. Policy conditions, including the legal and regulatory frameworks, can greatly affect whether credit reporting develops in a country, how it develops, and whether credit reports are useful for predicting risk (Miller, 2003). Critical policy issues that governments ought to consider in developing credit registries include the following:

- ***Enabling legal and regulatory framework.*** Such a framework is necessary to encourage information sharing among lenders and facilitate the flow of credit information. This often requires reviewing bank secrecy laws, permitting and providing incentives for the sharing of both positive and negative information, and eliminating restrictions on access to public records. Bank secrecy laws in many developing countries effectively prohibit or limit the operation of private credit bureaus (World Bank, 2004).

- ***Balance between protecting privacy and consumers' rights and the need for information sharing.*** Consumer protection concerns include issues such as fairness in the treatment of borrowers and lenders, accuracy in credit information, types of information collected, and non-invasion of privacy. Credit bureaus must follow reasonable procedures to ensure that the information they obtain is accurate, relevant, and unbiased. In addition, laws and regulations should provide sufficient protection to consumers by ensuring that data are not misused, creating a balance between privacy protection and effective information sharing, allowing borrowers to access their own credit reports, and prescribing clear procedures for borrowers to challenge and correct incorrect information.
- ***Balance between reasonable penalties for noncompliance and overly restrictive regulations***. An adequate legal and regulatory framework ensures the health and robustness of credit bureaus, however, legislation must be carefully crafted so that it is not overly restrictive, unnecessarily severe in relation to penalties or sanctions, or too complicated and so that procedures for information collection and exchange are not too extensive and expensive. The impact of overly restrictive rules can be severe. In Thailand, two credit bureaus that had operated for several years shut down when a new law was passed in 2003 that imposed large fines and criminal liabilities on participating financial institutions for minor violations in sharing information. The two bureaus did not reopen until five months later, when clarifying regulations were issued (World Bank, 2004).
- ***Public versus private credit bureaus.*** Public and private credit bureaus are not considered substitutes, but rather complements to each other. Governments in many countries have been prompted to establish public credit bureaus, typically through the central bank or the banking supervisor, to overcome the limitations of private bureaus or legal and regulatory restrictions on information sharing in the private sector (Miller, 2003). In some poor countries and those with highly concentrated lending markets, there may not be sufficient interest in the private sector to set up credit bureaus. Under such circumstances, the establishment of a public registry may offer the advantage of rapid setup, and direct enforcement by bank supervisors can counter lenders' unwillingness to comply.

Establishing public credit bureaus should not stifle private information sharing. As the credit market matures, or as private initiatives materialize, public credit bureaus can be restructured to complement the private initiatives by focusing on overall supervision and sharing data with the private registries. Public credit bureaus in Argentina, the Dominican Republic, and Peru share data with private bureaus. An example of more extensive private-public partnership is Sri Lanka's credit bureau, set up in 1990, with 51 percent of the capital held by the central bank and the rest shared among commercial financial institutions. The government's share declines as more institutions join the bureau (World Bank, 2004).

In the Czech Republic, Guatemala, India, and Mexico, private bureaus are being formed in joint ventures with foreign firms, which provide TA and expertise (World Bank, 2004). Countries need to ensure that legal obstacles do not stand in the way of such foreign investment.

Strong accounting standards and credible accounting firms are necessary for SME to have informative financial statements. Reducing SME' opacity by means of simplified, standardized charts of accounts would pave the way for additional forms of transactional lending technologies that depend on hard information, such as lending based on financial statements. At the same time, complementary support to SME to improve their financial accounting systems and obtain audits, for instance, through matching grants, is likely to result in more credible SME applications for financing.

(iii) Some Rational Direct Intervention

International experiences suggest that government intervention in improving access to finance for SME should consider of program's sustainability, time limits, governance, and transparency—and even in terms of their objectives, as they seek to complement and promote private financial intermediation, rather than replace it. Here main policy lessons from these interventions are discussed.

Public Provision of Market Infrastructure. A traditional argument for government intervention in the banking sector is that private banks may not find it profitable to open branches in rural and isolated areas, and thus government intervention is necessary to provide financial services to customers of those areas. This led to the creation of public banks to serve rural areas and in many cases also resulted in the establishment of regulations requiring banks to open branches in certain regions. In India, for instance, the government imposed the so-called 1:4 license rule in 1977. This rule stated that banks could open one branch in an already banked location only if they opened four in unbanked locations. However result was mixed.

The right to provide banking services through the post office was granted to Banco Bradesco, the largest private bank in Brazil, through a public bidding process. The use of correspondents significantly reduces the cost of servicing remote locations. According to Kumar and others (2006), initial investments for a correspondent outpost in Brazil can be as low as 0.5 percent of those for a traditional bank branch, and operating costs are negligible if existing employees and communication networks are used. This has resulted in a significant geographic expansion in access to financial services. While in 2001, 29 percent of the municipalities in Brazil had no bank services (branches or bank service outposts), by 2004 all municipalities had access to these services, with 31 percent of them being served exclusively by bank correspondents.

Another example of a government intervention designed to help reduce the costs of providing financial services in unbanked areas for private financial intermediaries is the Mexican development bank BANSEFI (Banco de Ahorro Nacional Servicios Financieros, *National Savings and Financial Services Bank*). BANSEFI has the mandate of spearheading the development of semi-formal and informal financial institutions (called *popular savings and credit institutions*), including a variety of credit unions, savings and credit associations, cooperatives, and NGOs that serve regions where the presence of commercial banks is minimal or non-existent[19].

Credit Guarantee Systems. Credit guarantee systems are mechanisms in which a third party, the guarantor, pledges to guarantee loans to a particular group of borrowers. Credit guarantee systems reduce the lender's expected credit losses even if the probability of default remains unchanged acting as a form of insurance against default. Public credit guarantee systems are widespread. According to a survey conducted by Graham Bannock and Partners, there were at least 85 countries with some type of government credit guarantee program. The largest and more established guarantee schemes are mostly in developed countries, including Canada, Japan, the U.S., and several European countries.

The general experience with credit guarantee systems, especially in developing countries, has been with poor to mixed results. Most systems have depleted their reserves due to high credit losses and bad investment decisions and in many cases they have been designed to channel funds to certain sectors without due regard to loss rates. There is significant debate in the literature regarding the role fulfilled by credit guarantees and the need for this type of government intervention. The most frequent cited justification for credit guarantee schemes is as a substitute for collateral where the collateral market operates imperfectly due to cumbersome and costly repossession processes, political difficulties in the realization of assets pledged by certain sectors, or uncertainty about the value of collateral, which lead to excessive collateral requirements. However, one could reasonably argue that imperfections in the legal system should be addressed through improvements in collateral laws and enforcement mechanisms, rather than through direct government intervention. Nevertheless, both strategies are not necessarily exclusive, at least in the short-term (Graham Bannock and Partners, 1997), and therefore collateral guarantee systems could help to reduce problems of access to finance while institutional reform is taking time to mature. An alternative argument contends that credit guarantee systems work as subsidies to cover the costs of learning how to provide loans to a new group of borrowers by financial intermediaries. Critics of public credit guarantee systems argue that these schemes cannot decrease asymmetric information problems in credit markets, and are even likely to increase them. Public guarantee systems may increase moral hazard for both borrowers and lenders: borrowers that know that their loans are guaranteed by the government may not feel

[19] See Coutinho (2006), and Taber (2005) for more detailed descriptions of BANSEFI's operations.

obligated to repay them and lenders may have fewer incentives for screening and monitoring borrowers, as guarantees cover their credit losses. An open question therefore is whether credit guarantee systems can be designed in a market-friendly way, minimizing their unintended consequences while at the same time promoting private financial market activity.

FOGAPE (Fondo de Garantia para Pequeños Empresarios), a state fund designed to provide partial credit guarantees to loans issued by commercial banks to small firms in Chile, has been considered a success story in terms of fostering market activity while minimizing the problems that have characterized previous guarantee schemes (Benavente, Galetovic, and Sanhueza, 2006, and Bennett, Billington, and Doran, 2005).

FOGAPE was created in 1980 but remained relatively inactive until 1999, when the Chilean government decided to reformulate the program. The fund is administered by Banco Estado, a public commercial bank, which charges a fee for its services. FOGAPE functions as a classical guarantee fund, sharing the risk of default on eligible loans and charging a guarantee premium. The commercial relationship is between FOGAPE and the banks. Banks select those loans that the wish guaranteed and FOGAPE only checks whether they meet eligibility criteria. According to Benavente, Galetovic, and Sanhueza (2006), several features of FOGAPE’s operations have been key in reducing moral hazard problems. First, commercial banks share part of the risk of default, as guarantees only cover between 70 and 80 percent of credit losses. Second, and more important, to allocate the available guarantees Banco Estado conducts auctions four to six times per year among participating banks. Each bank has to submit a bid indicating the amount of guarantee it wants to receive and the maximum coverage rate as a percentage of lending. The bids are selected by the lowest coverage required until the total amount auctioned has been assigned; therefore the biding process determines how the risks are shared among FOGAPE and financial intermediaries. Banks with high default rates on previously guaranteed loans can be permanently or temporarily excluded from participating in the bidding process. This helps to reduce moral hazard, as banks that reduce screening and monitoring today lose profitable opportunities in the future. Also, the use of a bidding process increases competition among financial institutions. The risk share taken by commercial banks has increased from 21 percent in 2001 to 29 percent in 2003 (Bennett, Billington, and Doran, 2005). Third, the amount of FOGAPE guarantees each bank can obtain is limited: no bank can be awarded more than two thirds of the total rights auctioned. This also helps to reduce moral hazard, as the amount that can be gained by reducing screening and monitoring today is reduced.

Following the bidding process, banks have three months to grant the corresponding loans. FOGAPE used to charge a fixed commission of one percent of the credit guaranteed, but since June 2004 has increased it to a range between one and two percent, depending on the claims performance of each bank. Default rates on loans guaranteed by FOGAPE have been relatively low, standing at 1.05 percent in the second semester of 2005, suggesting that the provision of its guarantees has not resulted in lower screening and monitoring by banks.

FOGAPE is designed to be a sustainable fund, in the sense that fees and other income, such as returns on investment, should cover all administrative costs and claims.

In general, international experiences suggest three main recommendations to design CGS. First is the question of whether the guarantee scheme should carry out its own credit appraisal of each final borrower who is being guaranteed. Some of the best-regarded schemes do not conduct such retail assessments but instead rely on an assessment of the intermediary whose portfolio of loans is being guaranteed. Second is the rate of guarantee, that is, the proportion of the total loan that is guaranteed (along with related aspects, such as whether the losses are shared proportionately between lender and guarantor, or if the guarantor covers the first or last portions). Many practitioners argue that the lender should retain a significant part of the risk (at least 20 percent and preferably 30–40 percent, according to Levitzky, 1997 and Green, 2003), so that there will be an incentive to conduct credit appraisal. In practice, most schemes offer slightly higher rates of guarantee, 70 to 80 percent being about the norm and up to 85 percent in the case of the U.S. Small Business Administration and 100 percent in some other cases (for example, Japan). Guarantee rates significantly under 50 percent fail to attract lenders. Scaling guarantee rates according to the claims experience from each lender can improve lender incentives without the adverse distributional impact that would result from requiring final borrower guarantees. Third is the nature of the lending criteria, such as the categories of eligible borrowers and the terms of the lending. Some schemes have relatively broad eligibility rules (for example, a ceiling on borrower size as measured by turnover, and a ceiling on the guarantee fund's overall exposure to the borrower). The more complex the criteria, the more likely opaque political interference with the granting of guarantees were appear to be in international experiences. At the same time, a broad set of criteria leaves the door open to deadweight in the allocation of subsidy to borrowers that have no need of it. Restrictions on the lending terms, such as interest ceilings, seek to limit the degree to which the lenders in an uncompetitive market capture rent from the scheme, but if these restrictions are set at unrealistic levels, they can open the door to corrupt side-payments. In practice the trend has been to move toward less complicated eligibility criteria over time.

Transaction Cost Subsidies. To address high transaction costs of lending per unit problem for SME, in Mexico, the development agency FIRA has introduced a program called SIEBAN (Sistema de Estímulos a la Banca) to provide subsidies to cover the administrative and screening costs of serving small borrowers[20]. This subsidy covers low-income rural producers that access credit from commercial banks, credit unions, or financial firms for the first time. The subsidy is a fixed amount that varies with the size of the loan, representing a maximum of 16.7 percent of the amount borrowed in the case of

[20] Malhotra, Mohini, Yanni Chen, Alberto Criscuolo, Qimiao Fan, Iva Ilieva Hamel, and Yevgeniya Savchenko. 2006. "Expanding Access to Finance: Good Practices and Policies for Micro, Small, and Medium Enterprises," Washington, D.C. : World Bank.

smaller loans, consistent with the idea of covering costs that tend to be relatively fixed.

SIEBAN subsidies are portable by borrower (i.e., they can be used to obtain credit from different financial institutions), fostering competition. Financial institutions are required to provide borrower information to the credit bureau in order to help them establish credit histories. The subsidy decreases over time and has duration of three years. The temporary nature of the subsidy is based on the fact that once borrowers have been able to establish credit history, screening costs for financial institutions should be significantly lower, eliminating the need for subsidization.

The provision of a subsidy like SIEBAN could be justified on the basis of one of the arguments mentioned above for the creation of public credit guarantee systems, that is, subsidizing the costs for financial institutions of learning how to provide loans to a new group, in this case low-income rural borrowers. However, SIEBAN has several design features that address the limitations of credit guarantees in achieving this objective. First, as Vogel and Adams (1997) point out, there is no evidence of public guarantee programs that have been able to eliminate guarantees after a certain period. In contrast, SIEBAN is designed to be temporary: after three years borrowers no longer receive any subsidy. Second, SIEBAN does not generate moral hazard. As discussed above, credit guarantee systems reduce incentives for financial institutions to screen and monitor borrowers, as the guarantee covers part of their credit losses. In the case of SIEBAN, there is no risk shifting to the public sector. Financial intermediaries only receive a (relatively small) fixed initial subsidy and have incentives to adequately assess borrowers' credit quality, since they face all the costs in case of default. Another important feature of SIEBAN is that it requires financial intermediaries to register borrowers in the credit bureau, consistent with the idea of reducing the information asymmetries that typically characterize small borrowers. An open question, however, is how effective SIEBAN has actually been in improving access to credit and whether small borrowers continue to receive credit once the subsidy ends.

Public Direct Lending. The general experience with the provision of credit by public banks has been negative, resulting in high subsidies, recurring fiscal drains, and retarding, rather than fostering, financial market development. Major incentive and governance problems in the operation of public banks have tended to surface, leading to poor loan origination and even poorer loan collection, wasteful administrative expenditures, overstaffing, plain corruption, and political manipulation of lending. An open question is whether there is any role for the provision of public credit in fostering financial development and if this type of intervention can be designed in a way that ensures that at least no harm is done.

The microfinance lending operation implemented by Banco Estado, a public commercial bank from Chile, has also been considered a successful experience of provision of credit by a public financial institution (Benavente, 2006). Banco Estado decided to start lending to micro entrepreneurs in 1996 in order to foster the development of the Chilean microfinance market. At the time, no commercial bank was participating in this market and Banco Estado wanted to generate a demonstration effect.

As discussed above, financial innovation in many cases can be hampered by the fact that once a new lending technology is introduced and proves to be successful, others can easily adopt it. Therefore, there is little incentive for lenders to invest in new credit technologies. In this situation, there might be a role for the government to subsidize innovation. A key factor for the success of Banco Estado's microfinance program has been the implementation of a new organizational structure tailored to meet the needs of micro entrepreneurs. Banco Estado also established new incentive systems for employees. An important change in this respect has been the increase in the fixed portion of the remuneration of account executives, in order to reduce incentives to focus solely on loan disbursement. Banco Estado's microfinance operations are managed by a separate business unit with its own profit and loss statement. The program was designed to be self-sustainable, without providing any subsidies. In fact, this program achieved break-even by the third year of operations and has remained profitable since then. Banco Estado's microfinance program seems to have been successful in terms of fostering innovation, as three commercial banks have now entered the microfinance market. The program has also had a positive impact on the micro entrepreneurs that have access its funds, helping their firms to expand, increasing formality, and improving business practices (Benavente, 2006).

2.5.3 Some Specific Financing Technologies Relevant to SME Finance

Factoring. In many countries, small businesses find it difficult to finance their production cycle, since they lack access to bank credit and most buyers usually take between 30 and 90 days to pay. After delivery, sellers issue an invoice, recorded as an account receivable by the seller and an account payable by the buyer. Factoring is a type of financing in which firms sell their accounts receivable at a discount (equal to interest plus service fees) to a financial firm (called the factor) and receive immediate cash. Factoring is an asset sale, not a loan. There is no debt repayment and no additional liabilities on the supplier's balance sheet. An alternative to ordinary factoring is reverse factoring. In this case, the factor only purchases accounts receivable issued by certain buyers. Reverse factoring reduces information problems, as the factor only needs to assess the credit worthiness of a specific group of large firms. A significant advantage of factoring, especially in developing countries, is that it does not require good collateral laws, just the legal ability to sell, or assign, accounts receivables.

In Mexico, there have been innovative ways of trade finance using reverse factoring. The program developed by NAFIN, a government development bank, allows many small suppliers to use their receivables from large credit-worthy buyers, including foreign MNCs, to receive working capital financing, effectively transferring their creditworthiness to allow small firms to access more and cheaper financing. What makes NAFIN special is that it operates an internet-based platform, providing on-line services, reducing costs, increasing transparency and improving security. In the short-run, there is a subsidization of overhead costs, but by lowering costs for SME working capital, it expects to generate more business and become sustainable (see Klapper, 2006).

Leasing. Leasing is a medium-term financial instrument aimed at covering the investment needs of companies for machinery, equipment, vehicles, and real estate. Leasing institutions (lessors) purchase the equipment, usually as selected by the lessee, and provide the use of equipment to the lessee for a set period. For the duration of the lease, the lessee makes periodic payments to the lessor, with an underlying interest cost. At the end of the lease period, the equipment can be transferred to the ownership of the lessee (typically in financial leasing), returned to the lessor (typically in operational leasing), discarded, or sold to a third party (depending on the characteristics of the contract and the underlying asset).

The benefits of leasing for SMEs are manifold. First, leasing is a tailored instrument to finance investments without making a large initial cash outlay, enabling companies to match expected income and expenditure flows. Accordingly, leasing can increase the productive capacity of the company without affecting significantly its liquidity or leverage levels. Second, leasing contracts can benefit from favorable tax treatment, enabling companies to deduct the leasing monthly expenses from the companies' taxable income. Third, the cost of lease finance is competitive with traditional credit because of the increased security held by lessors.

For financial intermediaries, leasing can be a good instrument to provide financing while assuming lower risks. First, while the risk of default of clients is commensurate to that in bank loans, the loss in case of default can be significantly lower. The repossession and liquidation of the underlying asset is much more rapid, because the ownership of the asset is maintained by the leasing company. Second, the leasing company has reasonable certainty about the value of the asset in a secondary market (in case of repossession) and can price leasing contracts accordingly. Third, leasing by independent operators is subject to lower regulatory oversight than bank loans, hence they face lower regulatory costs and can have leaner processes for credit approval. But, as in the case of factoring, independent leasing companies have a higher cost of funding than banks since they must tap securities markets or borrow from banks.

Until now, leasing has been only a small source of financing in many developing countries. There are several reasons for the leasing industry's limited development in developing countries. First, in the absence of specialized leasing laws, judges tend to misunderstand the leasing product, slowing down the recovery of leased assets after default, even though banking laws usually clarify that leasing is distinct from rental and should be governed by the civil code. Second, high informality in the corporate sector can render companies insensitive to the fiscal advantages of (operational) leasing. Third, the registry system for assets needs to be improved and enlarged, allowing for a broader variety of assets to be eligible—and for registration to be reliable, efficient, and cost effective. Finally, the high cost of funding is sometimes presented as an obstacle, since leasing tends to be provided by specialized companies that can fund themselves only on the capital markets or through bank credit lines—that is, they are at a disadvantage against commercial banks' cheap funding for collateralized credits.

A full-fledged leasing law is required to address the various obstacles in developing countries. First, this law should make it easier to recover the leased asset in case of lessee default, allowing for extrajudicial processing. Second, the law should clarify the priority of the lessor in case of corporate restructuring or liquidation of the lessee. Third, the law should provide clear accounting and taxation rules, preferably in line with international accounting standards.

Other important regulatory and institutional requirements include an efficient and reliable registry system to establish clearly the property right on assets, a wide definition of assets that can be leased and the possibility of transferring ownership of leasing future flows in securitizations.

Securitization or Structured Finance. Securitization has become a popular source of financing and risk transfer for many financial institutions and corporations in most developed countries and also in some developing countries that capital market has developed at moderate level.

Securitization is the mechanism by which individually illiquid financial assets such as loans are converted into tradable capital market instruments. More specifically, selected receivables (assets) of the originator are packaged together in an underlying pool and sold by the originator to a Special Purpose Vehicle (SPV). The SPV refinances the pool by issuing debt instruments (Asset Backed Securities or ABS) on the capital markets.

Among benefits of securitization, ABS transactions help issuers to get funding, transfer risk and extend maturity of financing. These benefits can be achieved under two main structures; a cash structure where the primary benefit for the originator is to get funding and a synthetic structure with no funding elements allowing a pure risk transfer through credit protection contracts. An ABS structure allocates collections from an underlying collateral of receivables (asset claims) to the securities in the form of so called tranches. This allocation of collections also extends (inversely) to the distribution of losses among the different tranches in accordance with the priority of payment of the SPV. Individual security mechanisms such as liquidity or credit support offer protection against bad debt loss. External rating is a key to the structuring of transactions in order to allow investors to assess risks of portfolios and structures.

Public sectors bodies have implemented proposals geared at maximizing the impact, efficiency and catalytic effect of public sector intervention in SME securitization. The principal advantage in SME securitization being developed further is without doubt that it can help support greater lending volumes to SME. Securitization helps to ease the capital and funding constraints of their primary lenders. Thus, banks and other financial institutions will potentially have enhanced capital and funding resources by using SME securitization techniques that attract new investors with previously limited exposure to SME risks and transfer risks from banks to broader risk taking population.

In the last few years, SME loan portfolios were securitized in a number of European countries and USA. Supports as deal facilitators by a number of public sector bodies (e.g. EIF, KfW and the Spanish FTPYME program) have in this context helped to develop the market[21].

Public sectors could play an active role in supporting SME securitization. From a policy standpoint, it will be especially important to accelerate the building of a broader basis for the securitization such as "easier to securitize" SME loans. A mature securitization market is a precondition for the extension of the range of enterprises which are suitable for securitization – i.e. smaller firms and SME with non-investment grade ratings. The benefit of more mature and specialized markets can nowadays be observed in those countries in which SME securitization has already gained a certain momentum and where more sophisticated transactions take place. Looking at the role of public sector support in more detail, the following starting points can be identified to overcome the current difficulties accompanying SME securitization:

- Due to its complex nature, securitization generates transaction costs. Especially for smaller banks, costs of securitization can be prohibitively high. Public sector support via the standard platforms can reduce these costs considerably: Standardization and repeated transactions allow service providers like rating agencies, legal advisors and investment banks to work more efficiently as they become familiar with the details of the platform. Public platforms can thus exploit economies of scale, and securitization can become economically more attractive to a wider range of potential market participants. The cost saving argument is of special importance for originators who conduct their first transaction and for originators with smaller portfolios.

  When standardized platforms require a high level of quality, with respect to reporting standards, this sends a positive signal to investors and contributes to liquidity. Successful examples in this context are KfW´s PROMISE platform and the Spanish FTPYME-Program, which both contributed decisively to the securitization of SME loans.
- A further starting point for public support is to act as risk takers. Precisely, public entities invest in subordinated tranches. This support is particularly necessary in transactions which are difficult to securitize, e.g. transactions with new asset classes and/ or portfolios with low granularity. Public investment enhances the attractiveness of

[21] Euro Debt Market Association. 2006. *Supporting SME Financing Using Securitization Techniques*.

the whole transaction, as investors feel more comfortable with participation of key investors. The public support thus contributes as a catalyst to the creation of a liquid secondary market. Furthermore, public investment yields high leverage, as the volume of the transaction is large compared to the money invested by the public risk taker.

In overall, the rising support of the literature documents that securitization is an effective means to promote access to finance for SME.

3. Issues of Access to Finance for SME in Mongolia

3.1. Country in Brief

Mongolia is a large landlocked country with a land area of some 1.5 million sq km with a relatively small population of 2.6 million. Consequently it has the distinction of being the least densely populated country in the world, with 1.7 persons per sq km, compared to 137 and 8.5 for two neighboring China and Russia, respectively. Climatic conditions are severe with mean average temperatures ranging from -40ºC to +40ºC during the summer season.

Mongolia has a rich endowment of natural, social, and cultural resources, with a high and growing urbanization and concentration rate. Mongolia benefits in particular from world class mineral reserves, a living nomadic culture, and a large territory with intact examples of Eurasia's forest, steppe, and Gobi desert ecosystems, and associated species that are rare or endangered in the rest of the world. The share of its total population living in its capital city is one of the highest in the world, while the population density in the rest of the country is one of the lowest in the world. Mongolia has several comparative advantages in terms of the country’s endowments, namely a well educated population as reflected in a 98 percent literacy rate, a strong sense of cohesion and well developed social capital due to an almost absence of ethno-linguistic variation, a vibrant political democracy and wealth of largely untapped mineral deposits. Mongolia’s mineral resources are largely unexplored and unexploited. About 80 types of minerals were discovered in Mongolia, of which the most valuable are coal, copper, fluorspar, gold, iron, lead, molybdenum, silver, tungsten, uranium, and zinc.

Although Mongolia has a low per-capita income (US$1,494 by the end of 2007) and a weak, narrowly based economic structure, its per-capita income has been surging in recent years that stems from the combination of fast economic growth in conjunction with higher commodity prices and a low population growth rate.

Mongolia enjoys a relatively high degree of political and social stability even after peaceful transition from one-party centralized political system to multi-party democratic system. Its rapid transformation into a working democracy is founded on a well-educated, homogenous population with broad consensus on reform and market-led policies. As such, electoral uncertainties and changes in government have neither undermined policy resolve regarding structural reform nor resulted in abrupt policy change.

Unusually for a low income economy, Mongolia demonstrates a high degree of openness, where the absence of restrictions on current or capital accounts transactions supplementary to a liberal domestic economy. Since the transition to a market economy began in the early 1990s, privatization reduced the state's role in the economy to where private sector contributes around 80% of GDP by 2007, while state sector role made up from electricity, railway, air transportation companies and giant Erdenet copper mining company.

Now Mongolia is facing some important challenges in the way toward its rapid development. Mongolia’s heavy dependence on the exports of a few key commodities-gold, copper, cashmere-has been making the economy particularly vulnerable to fluctuations in commodity prices and natural disasters. The country needs to diversify its economy in order to reduce its dependence on mining and agricultural sector activities. Mongolia also has to overcome formidable challenges in managing its costs of long distance and geographical isolation from the international market, delivering domestic services equitably and cost effectively, and generating growth that is broadly shared regionally and across income groups. There are growing tendency of widening income gap between rich and poor, and urban and rural population. The country is also facing some sort of political populism which can lead to risk hindering current high economic growth, associated with red-tape and corruption that has been emerging during last decade.

3.2 Current Economic Situation

3.2.1 Economic Growth

Mongolia has managed the transition from a planned economy to a market economy quite well relative to most other countries in similar circumstances. In a space of 17 years it has made much progress in undertaking fundamental economic reforms centered on price liberalization, privatization and the establishment of market institutions. These efforts are reflected in the growth performance of the Mongolian economy over the period and the accompanying structural changes in the economy[22].

At present Mongolia is in the midst of good economic times, although external economic factors remain uncertain. The associated gains in economic well-being have occurred while at the same time Mongolia has, by and large, protected the high levels of human development that are a legacy of its socialist period.

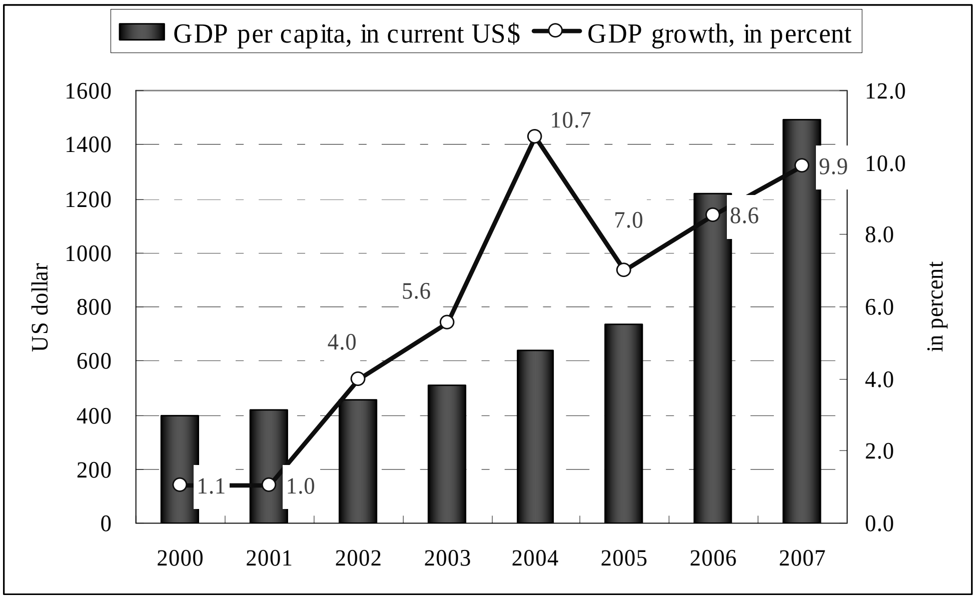
Following a sharp decline in output during the early transition period (1990-1993), the economy returned to a positive growth rate in 1994, and grew by 3.9% annually from 1994 to 1999. The relatively quick economic recovery reflected favorable international copper and

[22] World Bank. 2007. “Mongolia Country Economic Memorandum.”

cashmere prices and the efficiency gains from market-oriented reforms. Demonstrating the country's vulnerability to exogenous shocks, the annual gross domestic product (GDP) growth rate dropped to 1% in 2001 as international copper prices fell and consecutive harsh winters and an outbreak of foot and mouth disease led to sharp decline in agricultural output. Boosted by strong growth in agriculture and mining—which jointly account for 30% of GDP at that time—the annual growth rate climbed from 1.0% in 2001 to 10.6% in 2004. In recent years, Mongolia has achieved high economic growth. Average economic growth in last 5 years was 8.3 percent, which is far above from world average economic growth.

Real GDP growth rate was 9.9 percent in 2007 (Figure 6). Economic growth has been primarily driven by agriculture (which contributed 3.4 percentage points to economic growth), and services (which contributed 4.3 percentage points). In the agriculture sector, the December 2007 annual livestock census reported an increase of 15 percent of livestock from 34.8 to 40.3 million livestock. While most of the foreign direct investment (FDI) coming into Mongolia continues to go to mining, its value-added only grew by only 1.7 percent this year (mainly came from coal extraction). The services sector continues to show a strong growth, driven in particular by transports and trade (2.1 and 1.3 points of economic growth respectively).

Figure 6. Mongolia's GDP Growth and Per Capita GDP



Source: National Statistical Office, Monthly Bulletin December 2007.

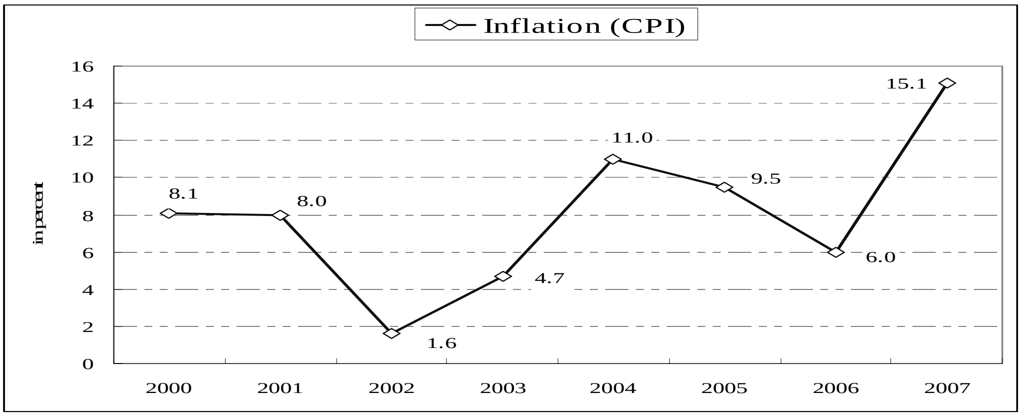
Over the near term, Mongolia should continue to experience solid growth based on sustained high mineral prices and the related services and industry. Mining-related profits, a resurgent banking system as well as significant public sector wage and benefits rises will underpin domestic demand, in particular a construction boom. After 9.9% GDP growth in 2007, 2008 is projected to be similarly strong-likely at 10%. Over the period 2009-2010, continued bright prospects in the mining sector, with lower tax rates and wage increases boosting demand, growth will remain robust at about 9%, even though the election cycle and associated policy delay affecting the mining sector will pare back FDI and slow growth somewhat.

Medium-term economic growth prospects (in next 5-10 years) will be greatly enhanced by an expected rise in output volumes in the extractive sector, as more projects come on stream. Chief among these are two pre-operation stage deposits: Oyu Tolgoi, which could become one of the world's largest copper and gold project when fully developed, and Tavan Tolgoi, with estimated reserves of 6.8 billion tons of high quality coal. These projects are approximately three or more years away from production. Some estimates show that Mongolian economy could grow by 20 percent annually or even more rapidly once these two giant projects are in operation.

3.2.2 Price and Exchange Rates

Inflation, as measured by the end-of-period consumer price index (CPI) averaged 8.0 percent durind 2000-2007. The moderate inflation in the 2000s' is in sharp contrast with 1990s. In early 1990s, Mongolia recorded triple digit inflation in 1993-1994 and an average inflation rate of nearly 20 percent during 1995-2000. Inflation has picked up to reach 15.1 percent in 2007, the highest level in the decade (Figure 7) and it was mostly driven by food

Figure 7. Inflation Rate in Mongolia



Source: National Statistical Office of Mongolia, 2008.

items, exacerbated by the sharp rise in oil prices (Mongolia is almost 100% dependent on oil imports) and rising inflation in the main trading partners such as China and Russia.

Typically, inflation is highly seasonal in Mongolia. Food prices tend to go up starting in April and go down again from August. In 2007, however, such a seasonal pattern was not observed and the increase in prices of consumption goods (including food) has continued into September and following months in 2007. Since then, however, meat prices have started to decline somewhat. This marked increase in inflation is also due to rapid monetary growth, public sector wage increases and increases in the price of some main imports. In 2007, money supply (M2) increased by 56.3% and currency issued in circulation by 48.5%. Total loans outstanding increased by 68.1% of which loans to private sector increased by 83.3%. Some monetization of the economy is still at work. Compared with other similar developing countries, the level of monetization in Mongolia is still low (M2/GDP is 53% by the end of 2007). The accelerating inflation prompted the Central Bank to raise policy rates, but more tightening will likely be needed to bring inflation back into the target range. The central bank has repeatedly been frustrated in its attempts to use interest rates to manage banking activity, where in the face of consecutive rate rises, banks have continued to lower rates due to intense competition.

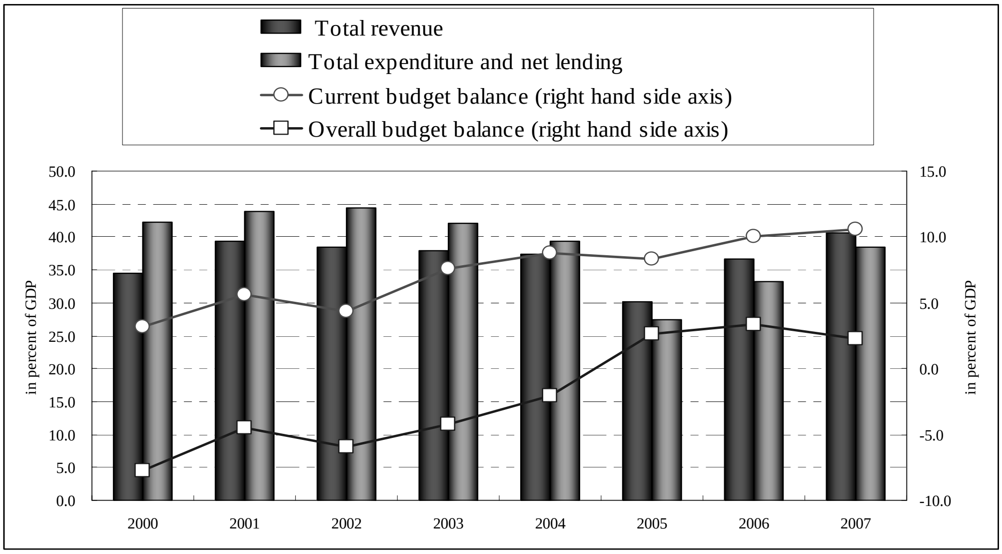
Mongolia has been pursuing a managed floating exchange rate regime in last 15 years. National currency togrog's exchange rate has been stable in recent years. At end of 2007, the nominal exchange rate of togrog against the US dollar was stable at 1,170.0. It has only a 0.4% depreciation of the currency compared to a year ago. This has led the IMF to re-classify Mongolia's exchange rate arrangement to a conventional peg, which acknowledges the de facto peg of the Mongolian togrog within margins of ±1 percent or less vis-à-vis the US dollar. In 2007 togrog exchange rates against euro, yuan, and yen (key trading currencies) have depreciated moderately in 11.8, 7.4, and 5.3 percents respectively.

3.2.3 Government Budget

Mongolia's public finances are heavily dependent on revenues from the non-oil mineral sector. Overall, revenues from copper, cold and coal mining made up almost 20 percent of total budget revenues in 2007. The combination of a growing economy and relatively stable macroeconomic conditions has led to an improving budget picture with respect to fiscal sustainability. This is reflected in the trends of all relevant indicators (Figure 8).

The government's fiscal balance recorded a surplus again in 2007, for the third consecutive year. Preliminary outturns suggest a 2.2 percent fiscal surplus in 2007, with revenues reaching 40.6 percent of GDP and expenditures 39.4 percent of GDP. Reasons for this surplus are (i) higher than expected revenues in particular coming from the windfall and value-added tax; (ii) under-spent expenditures and in particular capital expenditures.

Figure 8. Government Budget Indicators



Source: Compiled from NSO Bulletin December 2007, and Ministry of Finance of Mongolia.

Tax revenue performance has remained strong across all taxes. Cumulatively, total government revenues (including grants) have over-performed against the budget 2007 projections (by 9 percent). The key reasons for this strong revenue performance were: (i) higher than anticipated commodity prices; (ii) robust economic growth rate; and (iii) improved revenue administration.

On the expenditure side, wages and salaries were significantly increased in 2007, and average salaries reached US$300 for civil servants. The execution rate for capital expenditures was much lower than budgeted. This was mainly due to absorptive capacity constraints at line ministries to execute their respective capital budgets.

Fiscal policy in recent years was significantly expansionary, and so is the planned 2008 fiscal stance. The fiscal stance as assessed from the 2008 budget is expansionary, albeit ensuring that overall budget deficit remains contained at 2.5 percent of GDP. The expansion in expenditures is driven by increased revenue collection, rather than resorting to deficit financing.

Mongolia's public external debt as a percentage of GDP has decreased significantly over the last seven years, from 76 percent in 2000 to an estimated 37.5 percent in 2007. The NPV debt to GDP ratio is now below the 40 percent debt sustainability threshold that is applied to countries, at equivalent levels of policy performance. Mongolia's external debt ratios would decline substantially over the long term. However, some analysis suggests that the debt situation could become unsustainable if there were severe negative terms of trade shocks.

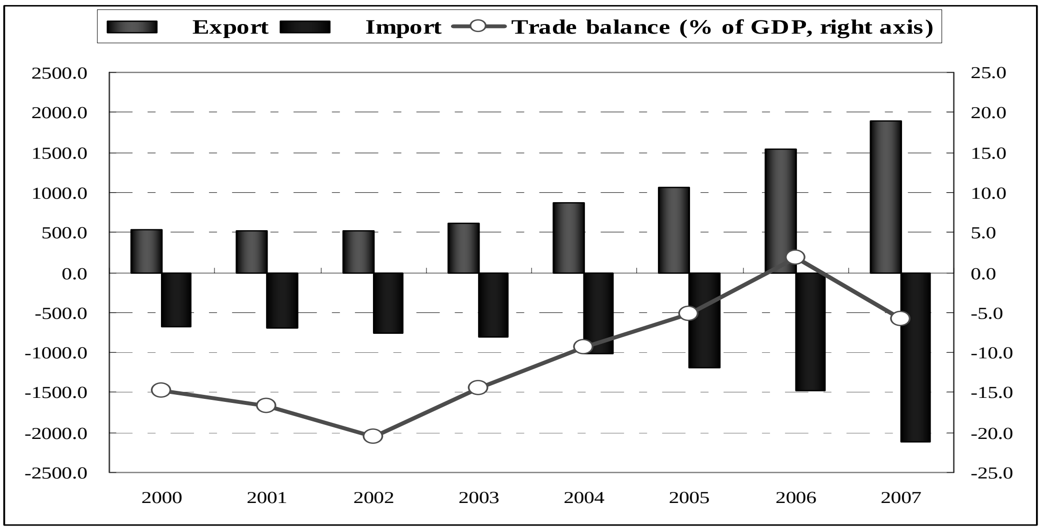
3.2.4 External Trade

Mongolia embraced an open trading system early on in its transition to a market-based economy. Import tariffs were removed in 1997. Due to the resulting revenue loss, estimated at the time to be equivalent to 2.5 percent of GDP these were re-imposed almost immediately thereafter, but at very low uniform rates (5%). Mongolia joined the World Trade Organization (WTO) in 1997, the first transition economy outside Europe to do so. Consequently, trade has expanded rapidly as reflected in the trade to GDP ratio which increased from 15 percent in 1990 to 102.6 percent at the end of 2007. This openness indicator, (Exports+Imports)/GDP, exceeded 100 percent over the whole period since 2000, indicating the importance of international trade to the Mongolian economy.

Mongolian imports consistently exceeded exports by approximately 165 million US$ on average over the entire period 2000-05. However, exports have turned to exceed imports by 57 million US$ in 2006. In 2007, again Mongolia has a trade deficit of 228 million US$.

Mongolia remains an undiversified exporter, dependent on mineral commodities for some 77 percent of its export earnings in 2007-copper (43 percent), gold (12.4 percent), zinc (9.3) and coal (6.2 percent). These developments point up Mongolia's vulnerability as a relatively undiversified economy. Production problems, price or policy induced shocks could easily send export earnings into a distress, destabilize the balance of payments and lead to a broader economic crisis. Newly emerging export commodities which may hold some promise for the future include crude oil and uranium.

Figure 9. Mongolia’s Foreign Trade Indicators



Source: National Statistical Office 2008, Monthly Bulletin December 2007.

Import demand has been strong, outstripping export growth over most of the post 1990 and early 2000 period. This is a reflection of growing domestic incomes, the relatively open trade regime and Mongolia's import needs which cover a diverse range of goods.

Over the course of time the pattern of major trading partners has shifted significantly for Mongolia. During the 1990 China and Russia were the two largest export destinations accounting for some 46 percent of total exports and each having nearly equal shares. Since 2000, China has emerged as the dominant export destination with 74.4 percent of total exports going to it, while Russia has seen its share slip to 3 percent in 2007. The picture with respect to imports has been relatively static across the two time periods with the major sources of imports remaining unchanged. Notable trends here are the significant increase in imports from China and nearly offsetting declines in imports from Russia and Japan. Import and export shares of the seven largest trading partners have not changed much between the 1990s and the present time.

3.3 Financial Sector Development

The financial sector comprises the banking sector, and the Non-bank financial sector, which includes Non-bank financial institutions (NBFIs), savings and credit cooperatives (SCCs), securities market intermediaries, and insurance companies. The banking sector has grown rapidly since 2000. Even though the NBF sector has grown in recent years, it is significantly smaller than the banking sector, and does not yet play a meaningful role in financial intermediation.

Table.1 Financial Intermediaries in Mongolia

	2000			2007		
	Number	Assets billion togrog	Assets million US$	Number	Assets billion togrog	Assets million US$
Banks	12	214.9	195.9	16	2858.3	2443.0
Private	6	53.7	49.0	16	2858.3	2443.0
State-owned/state participated	6	161.2	146.9			
Nonbank financial sector	160			363	135.3	115.6
Insurance companies	21			15	28.4	24.3
SCCs*	90	1.0	0.9	181	35	29.9
Financial Companies (NBFIs)	7	2.9	2.6	131	66.4	56.8
Securities and Brokerage firms	42	2.5	2.3	36	5.5	4.7
Total assets of financial system					2993.6	2558.6

*Note: * Number of registered SCCs by Financial Regulatory Committee (FRC) since 2006.*
Source: Author compiled from the Bank of Mongolia, FRC, Mongolian Stock Exchange, and Ministry of Finance of Mongolia.

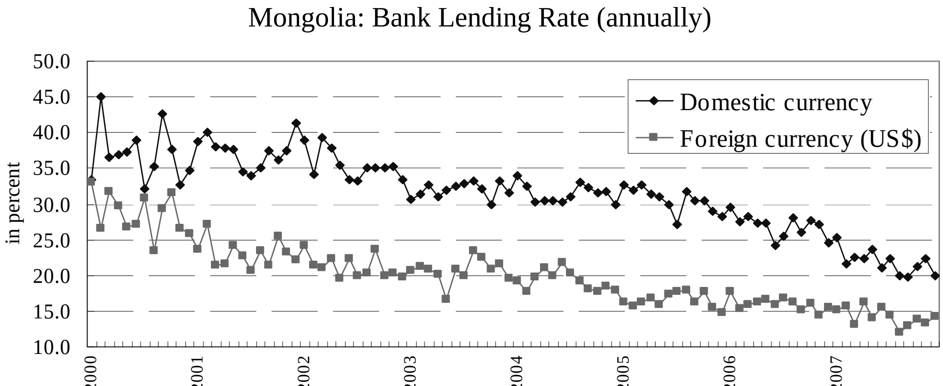
Commercial banks remain the dominant institutions, with 95.5 percent of financial system assets by 2007 (Table 1). Total assets of the banking system grew from 21.1 percent of GDP in 2000 to about 62.7 percent of GDP in 2007, or by 13.3 times. Deposits continue to be the main source of funding for most commercial banks

3.3.1 Banking Sector

Mongolia moved from a Soviet-style mono-banking system to a two-tiered banking system in 1991. However, numerous nonperforming loans (NPLs) were inherited from the mono-banking system. Continued directed lending to poorly performing enterprises further damaged the solvency and stability of the banking system. In 1996, four of the five largest banks could not meet the liquidity ratio of 20% set by the Bank of Mongolia (BOM). Two major banks were closed in 1996 and their assets were transferred to the newly established Reconstruction Bank. Reconstruction Bank and another major bank were closed down in 1999, while another major bank (Agriculture Bank) was placed under receivership and subsequently rehabilitated. Some small banks were also liquidated during the late 1990s. Over the past decade, banking laws and regulations have been strengthened; the Government’s involvement in bank operations has been substantially reduced; and a well-functioning interbank market has been introduced. As a result, public confidence in the banking sector has been strengthened and the sector has grown rapidly over the past few years.

With total assets of 2.9 trillion togrog or 62.7% of GDP, the banking system dominates the financial sector. All 16 commercial banks are privately-owned. The banking sector is highly concentrated, with the four largest banks accounting for 61% of total banking assets, and 69% of deposits. Most bank deposits and loans are short-term, with maturities of less than 1 year.

Figure 10. Bank Lending Rate in Mongolia



Source: Bank of Mongolia, 2008.

While interest rates are trending down, they remain high. The deposit and lending rates of banks were about 6-19.3% and 19.9% by the end of 2007. High interest spreads are symptomatic of high credit risk, high operating costs of banks, strong demand for bank loans because of a lack of other funding sources, and lack of effective competition among banks.

The ratio of total capital to assets of the banking sector has remained almost same as it was 13.9% in 2000 and 13.2% in 2007, and the entire banking sector has been profitable for the past 8 years (2000–2007). The Non-performing loans ratio declined from 54% in 1999 to 8% in 2001 and then stayed at 5–11% until 2007. The loan loss reserves are provisioned in line with the BOM guidelines, and stand at a high level. While the rapid increase in bank loans since 2001 to until recently raised concerns, credit expansion slowed down in April 2007.

3.3.2 Non-Bank Financial Institutions

The term of Non-Bank Financial Institution (NBFI) refers to a licensee under the Law on Nonbank Financial Activities (2002). The activities covered under this law include lending, factoring, issuing guarantees, issuing payment instruments, electronic payments and remittance services, foreign exchange services, trust services, investment in short-term financial instruments, and advisory services. Each NBFI is licensed for one or more activities, but there is no overall license to be an NBFI. NBFIs are not allowed to take deposits. While most of the smaller NBFIs are financed by equity, some large ones have significant loan financing and accrued interests.

The number, loans, and total assets of NBFIs have grown rapidly since 2000, when Mongol Credit was established as the first licensed NBFI. Of the 131 NBFIs in 2007, 14 of them were fully foreign-owned companies. Most NBFIs provide small consumer loans, or short-term loans to small- and medium-sized enterprises (SMEs), and a handful are engaged in other activities such as foreign exchange trading. NBFIs are incorporated as limited liability companies, and are typically owned by an individual, a family, or a small group of related individuals. With total assets of 66.4 billion togrog, NBFIs as a group account for about 1.5% of total financial sector assets.

3.3.3 Savings and Credit Cooperatives

Saving and Credit Cooperatives (SCCs) have been emerged under the Law on Cooperatives to provide saving and lending services to members since 1997. The SCCs sector grew rapidly, without the clear formal regulatory and supervisory framework that would ensure financial discipline and protect member savings. Prior to the creation of the FRC in early 2006, SCCs were not under the supervision of a government entity and were governed by the law on cooperatives which does not adequately distinguish between the financial intermediation role of SCCs and those cooperatives which offer non-financial services to their member base. A consequence was the failure of 32 SCCs accounting for more than half the assets of the sector in 2006. The reputation of the SCCs sector has suffered as a result and it has yet to recover. In the absence of appropriate legislation for SCCs and in light of a large number of member complaints, in 2006 FRC issued a temporary regulation on licensing SCCs' activities. Out of 955 counted SCCs in 2006, over 350 applied for a license and 181 to date have been licensed. The registered SCCs' total assets reached to 35.0 billion togrog, about only 1.2% of total financial sector assets in 2007.

3.3.4 Security Market and Security Intermediaries

Mongolian Stock Exchange (MSE) was established in 1991, in order to implement privatization of state-owned enterprises in early phase of transition. Passing the Securities and Exchange Law in 1994 and Corporate Law in 1995 resulted in establishment of secondary market at the MSE. The number of listed companies has declined from 458 in 1996 to 384 in 2007 because many listed companies were transformed into limited liability companies, while the number of newly listed companies is very small.

Last two years, trading in the stock market has activated largely due to rapid economic growth and high growth potentials in forthcoming years. As result all stock market indicators surged in 2006 and 2007 (Table 2).

Stock market capitalization has risen dramatically last two years and it was 716.3 billion togrog (15.7% of GDP) at the end of 2007. Although the trading value at the MSE has been declined from 1999 to 2004 due to a large part of corporate shares have been traded outside MSE and concentrated in small number of shareholders, however it has been soaring ever since 2005 reaching to 62.1 billion togrog at the of 2007. Sharp increase of share prices and increased new shares to the market due to elevated economic activities in Mongolia both contributed to hasty growth of market capitalization in 2007. Recently private companies and financial institutions are more willing to use MSE to raise new equity capital.

Total trade value of bonds in 2007 was 40.4 billion, of which 98.0% were government bonds and only 2.0% corporate bonds. Nearly all the government and corporate bonds are bought by banks and held to maturity, and there is virtually no secondary market trading. As a result of rapid decline in trading activity and the increase in minimum capital requirement (from 10 million togrog to 50 million togrog in January 2003), the number of licensed securities broker/dealer companies declined from 42 in 2000 to 25 in 2004. Again there were growing tendency for number of securities companies since 2005 and there were 36 brokers, dealers, underwriting consulting companies by the end of 2007. Among them, there are two 100% foreign-owned, 5 partly foreign-invested companies. Currently 8 companies out of 36 have permitted to engage in underwriting services and 2 companies have special permission to provide investment consulting services. Although there were 17 investment funds in 2000,

Table 2. Mongolian Stock Market Indicators

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Listed companies	418	410	400	403	402	395	392	387	384
Market capitalization									
in million togrog	4,428.0	40,482.8	41,283.3	35,847.6	49,513.4	29,832.1	55,701.0	131,179.1	716,272.3
in million US$	4.1	36.9	37.5	31.9	42.4	24.7	45.6	112.6	612.2
in percent of GDP	0.5	4.0	3.7	2.9	3.4	1.6	2.0	3.5	15.7
Trading value									
in million togrog	3,274.2	2,973.3	1,723.3	1,373.0	895.9	645.0	2,547.3	12,604.3	62,126.8
in million US$	3.1	2.7	1.6	1.2	0.8	0.5	2.1	10.8	53.1
in percent of GDP	0.4	0.3	0.2	0.1	0.1	0.0	0.1	0.3	1.4
Trading volume, in million togrog	21.4	35.4	15.9	9.8	8.1	9.1	25.9	74.5	116.3
Daily average									
value (in million togrog)	13.0	11.7	6.8	5.4	3.6	2.6	10.1	49.8	245.6
volume (in thousands)	85.1	138.9	62.3	38.6	32.3	35.6	102.6	294.6	458.9
Bond trading value (in million togrog)									
Government		11,132.1	30,750.2	41,690.7	21,722.5	12,463.8	6,767.7	4,461.5	39,599.3
Corporate			1,204.3	2,958.0	2,988.3	2,776.5	2,663.7	960.9	850.7
Top-20 index:									
High	274.2	506.3	963.0	1,450.4	1,045.5	910.7	1,053.0	2,030.8	13,676.9
Low	192.1	260.4	479.8	803.7	541.8	477.6	502.2	988.0	2,031.9
Average	230.3	359.3	650.8	1,120.6	740.7	667.4	796.9	1,291.9	6,699.9
Close	255.7	469.9	814.0	933.9	895.9	585.7	1,019.2	2,030.8	10,618.8
Number of transaction (in thousands)	60.8	29.8	14.7	14.7	13.5	13.0	9.1	11.6	28.9
No. of accounts at CD* (in thousands)	270.2	277.2	273.3	277.3	281.2	287.8	292.7	309.1	74.9
Member brok.and deal. companies	41	42	42	34	26	25	24	25	30
Member investment funds	16	17	16	2					
Exhange rate Togrog/US$	1,072.0	1,097.0	1,102.0	1,125.0	1,168.0	1,209.0	1,221.0	1,165.0	1,170.0
Inflation rate	10.0	8.1	8.0	1.6	4.7	11.0	9.5	6.0	15.1
GDP in billion togrog	925.3	1,018.9	1,115.6	1,240.8	1,461.2	1,910.9	2,779.6	3,715.0	4,557.5

Source: Compiled from Mongolian Stock Exchange Factbook, 2007.

all of the licenses have been withdrawn or revoked and there are currently no licensed investment funds.

Table 3. SME Classification in Mongolia

Category	Sector	Number of employees	Annual revenue in togrog
Small	Trade/services	≥9	≥250 million
	Manufacturing/processing	≥19	≥250 million
Medium	Services	≥49	≥1.0 billion
	Wholesale trade	≥149	≥1.5 billion
	Retail trade	≥199	≥1.5 billion
	Manufacturing/processing	≥199	≥1.5 billion

Source: SME Law of Mongolia, 2007.
*Note: *Mongolian currency unit.*

3.4 Characteristics of Mongolian SME Sector

Definition of SME. Until 2007, there was not any official definition of SME in Mongolia. Thus it was difficult to design and propose any SME development programs and measures. The SME Law of 2007 defines SME, first time in Mongolia, as an entity or an individual who has satisfied the below mentioned requirements and registered in accordance with this law.

The SME Law provides for the first time a clear definition of SME which should help to improve the consistency and effectiveness of government support programs. The purpose of SME Law is to set up basic guidelines and policies of the government for SME development and define scope and general measure promoting SME by the government in line with ensuring national economic development. SME can be in a form of company, cooperative and partnership.

General Characteristics of Mongolian SME. Unlike many other countries, which experienced a natural birth of new, small firms, the SME sector in Mongolia emerged as a result of the privatization and breakup of large state-owned enterprises, as well as through a large number of new, generally very small firms that came as a consequence of the market liberalization process in the past 17 years. The restructuring and downsizing of large firms, the privatization of public utilities and other large companies, the outsourcing of many support services, and the vertical fragmentation of production are all forces that promoted the creation and expansion of SME. According to the National Statistical Office of Mongolia there are over 32,000 active businesses by the end of 2007, of which 80.1% are very small or micro enterprises with less than 10 employees, 8.8% enterprises with 10 to 19 employees, 9.8% enterprises with 20 to 49 employees. In terms of number of business entities, SME accounts almost 99% of total entities in Mongolia by the end of 2007. Larger entities are concentrated in urban areas such as Ulaanbaatar, Darkhan and Erdenet, while smaller businesses spread with little signs of geographic clustering or concentration, except Ulaanbaatar[23].

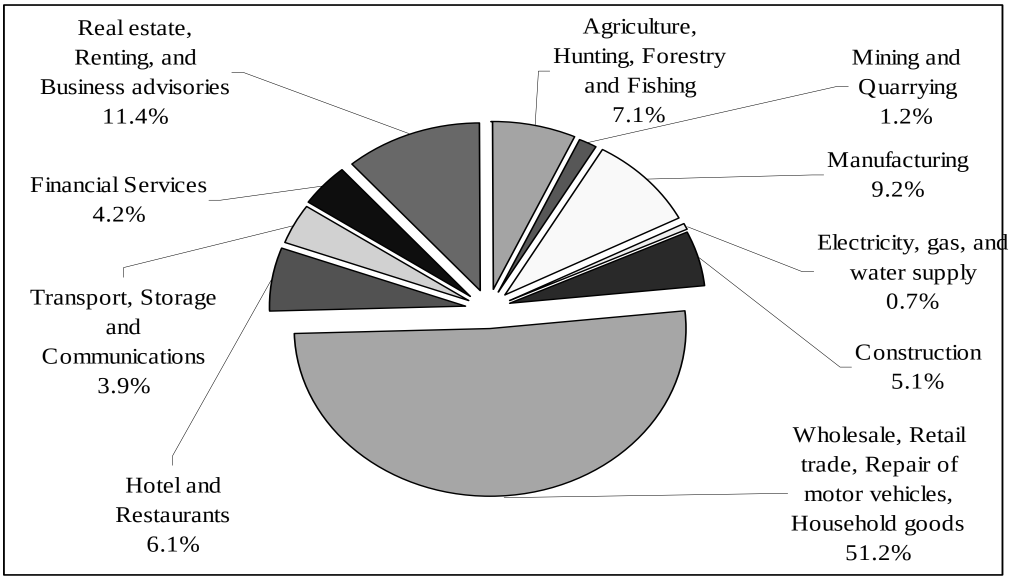
According to the data from NSO, over half (51.2 %) of total number of SME engage in wholesale, retail, and household goods sector.

SME sector in Mongolia employ over 300 thousand people which is around 30% of total employees and are accountable for approximately 40% of the GDP, contributing mere 1.8 percent to the state budget in taxes.

For broad based growth in Mongolia, development of a strong SME sector is critical, especially given the need for diversification and development of new products and services in the future. However, until recently, the special needs of SME seem to have been ignored in the development debate in Mongolia

The new SME law provides for direct interventions, such as provision of funds at below market rates to SME. However, international experience suggests that this measure can often lead to weaker financial discipline by SME and further distorted credit risk assessments of these SME's by their creditors, who in turn, expect the Government to bail them out in case these loans become non-performing. Thus, the Government should develop programs that use market mechanisms to support SME development since these have a much higher rate of success (as witnessed in other countries).

Figure 11. Sectoral Distribution of SME in Mongolia



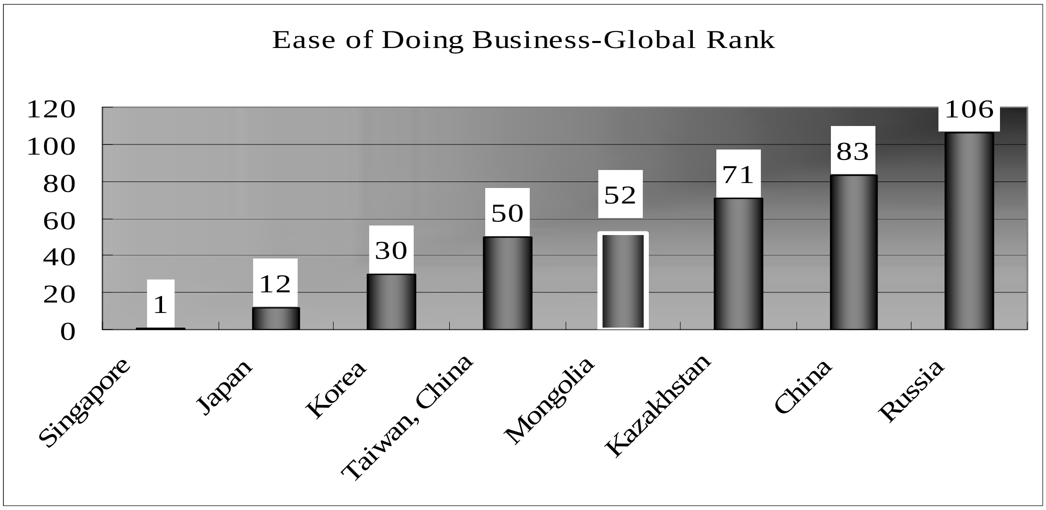
Source: National Statistical Office of Mongolia, by the end of 2008.

[23] 58.3% of total number of SME operates in Ulaanbaatar.

3.5 Business Enabling Environment for SME

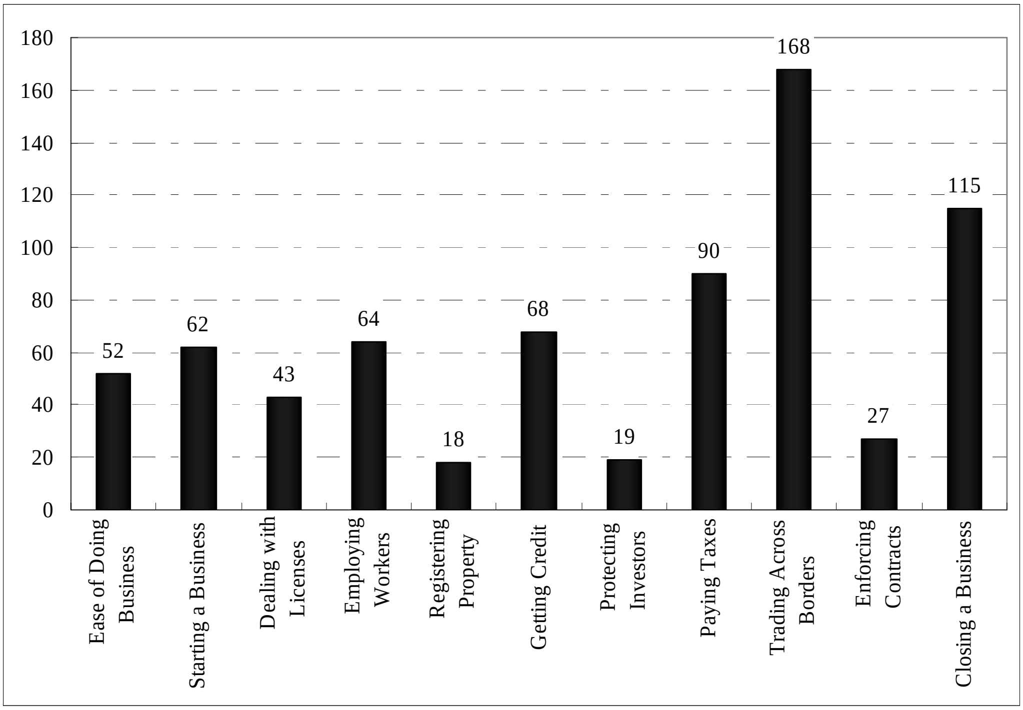
A favorable enabling environment for SME sector refers to the economic, physical, legal and institutional framework within which SME sector operates. A positive environment can be defined as the existence of a competitive internal market with access to financial services and supported by healthy and educated human resources. In addition to this market needs to be connected to an increasingly global economy by an efficient and viable infrastructure and guided by a well-defined legal and regulatory framework. But the establishment of an environment conducive to supporting SME is not in itself enough to ensure SME sector growth, for the SMEs themselves must be competitive and profitable. In other words, SME itself should overcome internal constraints such as weak management skills and outdated technology that prevent SME from taking advantage of good enabling environment too. Generally speaking, Mongolia's business environment compares well to other comparators such as neighboring and/or mineral rich low-income countries (see Figure 12, Table 4). According to the World Bank *Doing Business 2008 Report*, Mongolia is ranked 52 out of 178 economies in terms of ease of doing business (see Figure 12, 13).

Figure 12. Global Rank of Ease of Doing Business



Source: The World Bank, Doing Business 2008 Report.

Figure 13. Selected Parameters of the Business Environment



Source: Doing Business Data, World Bank, 2008.

Physical Infrastructure. It is well known that Mongolia faces a unique set of physical characteristics - a landlocked country, relatively isolated by two large neighbors, challenges of large internal distances, a widely dispersed population, and a very cold climate. The share of its total population living in its capital city is one of the highest in the world, while the population density in the rest of the country is one of the lowest in the world. Ulaanbaatar represents a growing critical viable market. However, the high cost water provision, transport, heating, and communication costs give Mongolian firms a disadvantage compared to their peers in other countries. For example, Mongolia's rail transport unit costs are relative much higher than select comparator countries in Central Asia even though the nearest port is much closer than for the other land locked comparator countries (see Table 4).

Since Mongolia's export volume on the railroad is about 10 percent of the volume for goods being imported by rail, the fee for an empty container that returns to the border adds to the transport cost, especially for Mongolian exporters that significantly rely on imported intermediate inputs. Access to foreign markets is especially important to Mongolian firms as the country is land-locked and the domestic market is tiny due to low population density and low per capita income.

Table 4: Mongolia's Rail Transport Unit Costs Are High Relative to Comparator Countries in Central Asia

	Kazakhstan	Uzbekistan	Tajikistan	Kyrgyz Rep.	Mongolia	
	Almaty	Tashkent	Dushanbe	Bishkek	Ulaanbaatar	
	Trade	Trade	Trade	Trade	Exports	Imports
Distance to nearest port* (km)	3,380	2,720	2,040	3,100	1,700	1,700
Cost ($/TEU[24]/km)	0.37	0.35	0.59	0.34	0.61	0.87

Source: World Bank.
*Note: * Karachi for Kazakhstan, Uzbekistan, Tajikistan, Kyrgyz Republic; Tianjin for Mongolia.*

Human Resources. On the other hand, Mongolian firms benefit from a educated population (Table 5), demonstrated entrepreneurship in terms of new products being exported each year (but not able to sustain them), and a location that is adjacent to two of the world's largest and rapidly growing economies.

Mongolia's educated population and its large concentration in Ulaanbaatar offer ample opportunities for SME development

Mongolia's education indicators compare well to other mineral rich low-income countries (Table 5, 6).

Table 5. Selected Educational Indicators, Mongolia and Some Comparators, 2005

	GNI per capita	Population			Literacy Rate/a	Land Area
	(US$)	in million.	growth rate %	% in largest city	(%)	(million km^2)
Azerbaijan	1,240	8.4	1.0	43.7	98.8	0.1
Cambodia	380	14.1	2.0	..	73.6	0.2
Ghana	450	22.1	2.0	19.2	57.9	0.2
Kazakhstan	2,930	15.1	0.9	13.0	99.5	2.7
Kyrgyz Republic	440	5.2	1.2	47.6	98.7	0.2
Mongolia	690	2.6	1.6	37.6	97.8	1.6
Uruguay	4,360	3.5	0.7	42.0	96.5	0.2
Uzbekistan	510	26.6	1.5	22.3	98.7	0.4
Vietnam	620	83.0	1.0	22.7	90.3	0.3
Memo:						
East Asia and Pacific	1,627	1,885.3	0.8	7.4	90.7	15.9
Low Income	580	2,353.0	1.8	17.1	61.5	28.2

Source: World Development Indicators Database.

[24] TEU-Twenty-foot Equivalent Unit.

Table 6. Selected Schooling Indicators, Mongolia and Some Comparators, 2005

	Secondary school enrollment rates (gross) (%)	Tertiary school enrollment rates (gross) (%)
Mongolia	89.5	38.9
Cambodia	29.4	2.9
Vietnam	73.5	10.2
Azerbaijan	83.1	14.8
Kazakhstan	98.1	48.0
Kyrgyz republic	88.0	39.7
Uzbekistan	94.6	15.3
Ghana	41.8	3.1
Uruguay	108.0	39.3
East Asia & Pacific	70.9	19.4
Low income	45.1	9.1
Low & middle income	61.4	18.6
Middle income	75.3	26.5
High income	99.5	68.8

Source: World Bank.

However, skilled managers, engineering, technicians, finance professionals, and technologists are in short supply in Mongolia. Although private involvement in the tertiary education sector has led to a large increase in the number of graduates, many have no practical skills. Foreign investors in the garment industry cite a lack of work ethic among workers, which leads to low productivity. In an employer survey carried out in 2001, 48% of company respondents said that high school graduates lacked interest in business, and 24% said that graduates of higher education had poor levels of technical knowledge. Inadequate human resources are therefore a significant constraint to private sector development.

Legal and Regulatory Framework. A difficult structural problem in legal and regulatory framework in Mongolia is that the judiciary has been trained according to the Civil Law code of much of continental Europe and Russia, while laws introduced in the last decade have adopted the Common Law approach of the United Kingdom and the United States. The former approach (in very simplified terms) prohibits actions unless the law specifically permits them, while the latter relies more on broad principles of fairness and precedent and gives the judges greater discretion to make rulings grounded in these concepts. This conflict between approaches in Mongolia has the potential to create uncertainty as to legal outcomes. Laws and regulations have yet to set out clearly the procedures, requirements and remedies for the protection of private property rights (including the rights of a lender over collateral received) and the enforcement of commercial contracts, including settlement finality in financial markets.

To enable private-property owners to uphold their rights against third-party claims and to dispose of or pledge such rights in whatever way they choose, an effective legal framework and dispute resolution system is needed. In Mongolia, private-property rights are protected under the Mongolia Civil Code (amended in 2002) and a number of specific laws, which generally have been harmonized or are in the process of being harmonized with the Civil Code. However there is still lack of clearly defined specific laws of regulating specific financial instruments such as factoring, credit guarantee system, and a structured financing.

3.6 Access to Finance for Mongolian SME

In general, access to financial services in Mongolia appears to be low when measured by composite indicator and the bank branch network in rural areas is limited, however it is high when measured by the demographic bank branch penetration. Most of Mongolian banks, in particular Has and Khan, provide services in microfinance and SME finance. Three banks (Khan, Mongol Post and Has) also operate in the rural areas including the rural town centers. Mongolia is ranked at 105th out of 157 countries with 25 percent of total adult population has access to finance as indicated in the Composite measure of access to financial services. Mongolia’s demographic branch penetration is high and according to a study, it ranks 16th out of a total of 97 countries[25]. However, due to its low population density its geographical branch penetration is one of the lowest in the world.

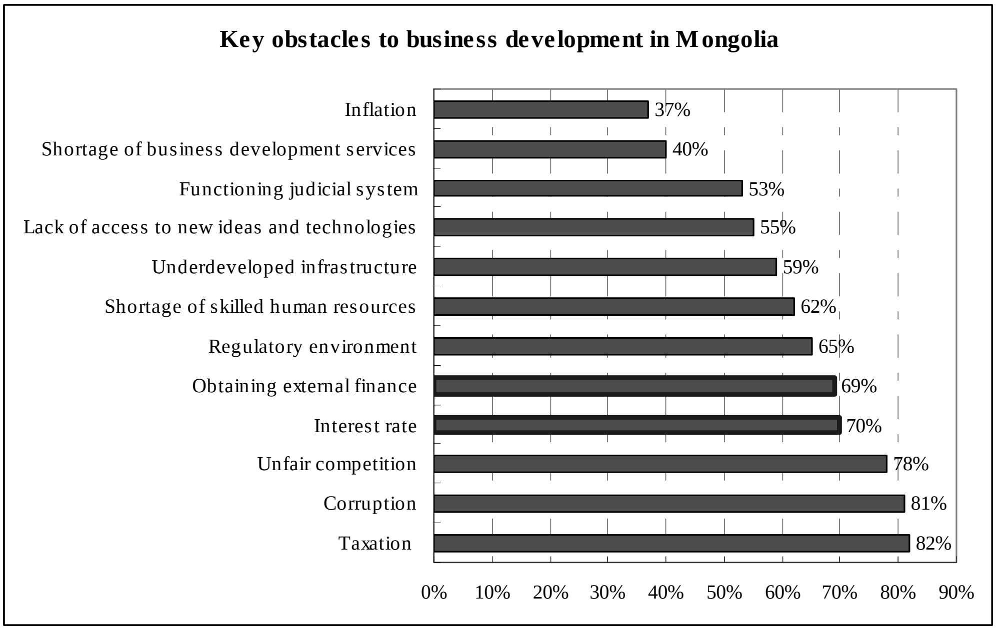
Like many other countries, access to finance for SME remains a major impediment. According to “*A Survey of the Business Enabling Environment*”, done by Enterprise Restructuring Project[26], June 2004, problem obtaining external finance is one of the most troublesome issues for firms (see Figure14).

Most registered business entities in Mongolia fall in the SME category per the definitions provided in the new SME Law. However, compared to larger companies, SME often find it difficult to finance their capital investment and daily operational needs. The main impediments for SME include relatively high lending rates, limited access to long-term loans, high collateral requirements, and weak capacity for market research and business planning (see Figure 15).

[25] Beck, T., Demirguc-Kunt, A., and Martinez Peria, M.S. 2005. “Reaching Out: Access to and Use of Banking Services across Countries.”

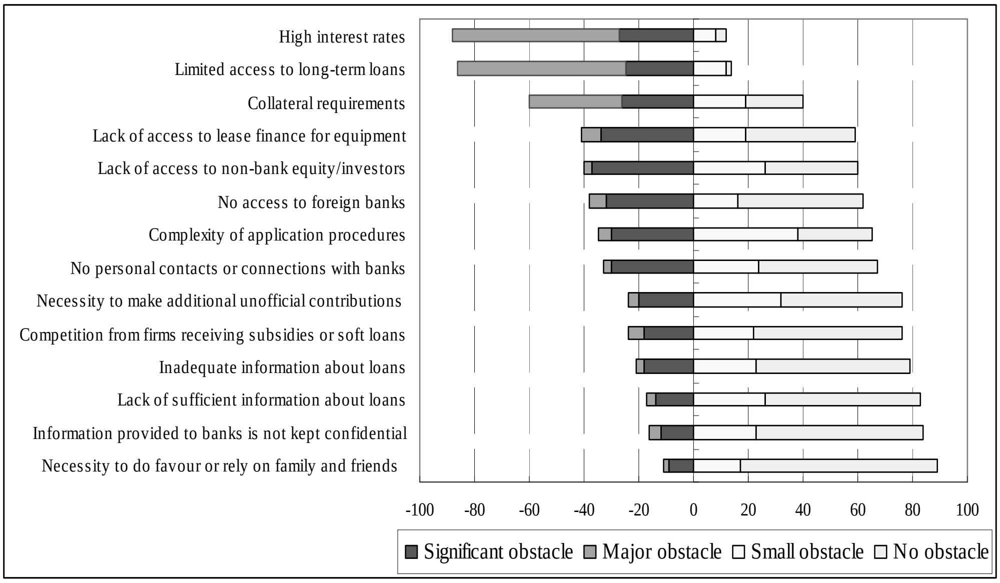
[26] The Project was implemented by German Development Cooperation (GTZ) and the Survey presented views of 100 small businesses on the obstacles that they face in doing business.

Figure 14. Key Obstacles to Doing Business in Mongolia



Source: Enterprise Restructuring Project, "Mongolia: A Survey of the Business Enabling Environment," June 2004.

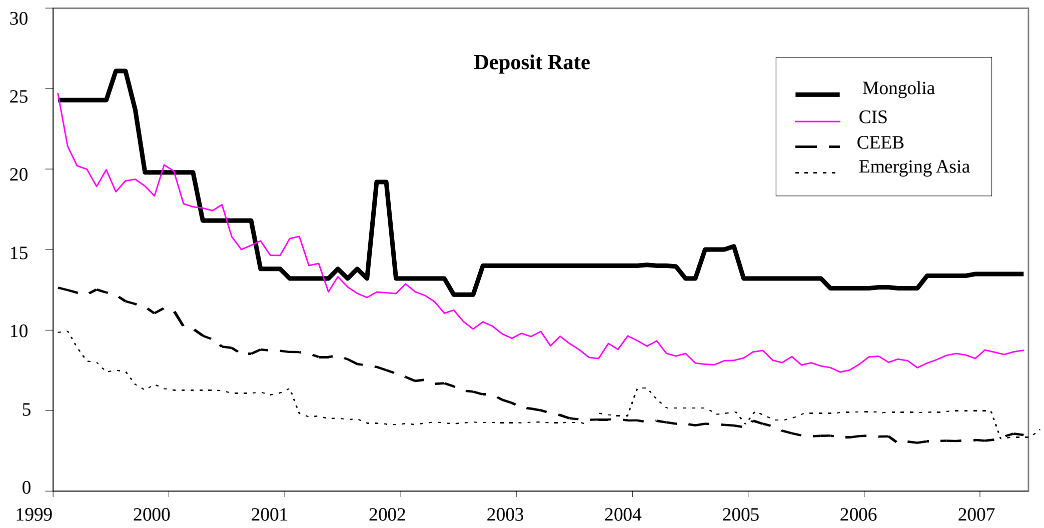
Figure 15. Financial Issues as Obstacles to Business Development



Source: Enterprise Restructuring Project, "Mongolia: A Survey of the Business Enabling Environment," June 2004.

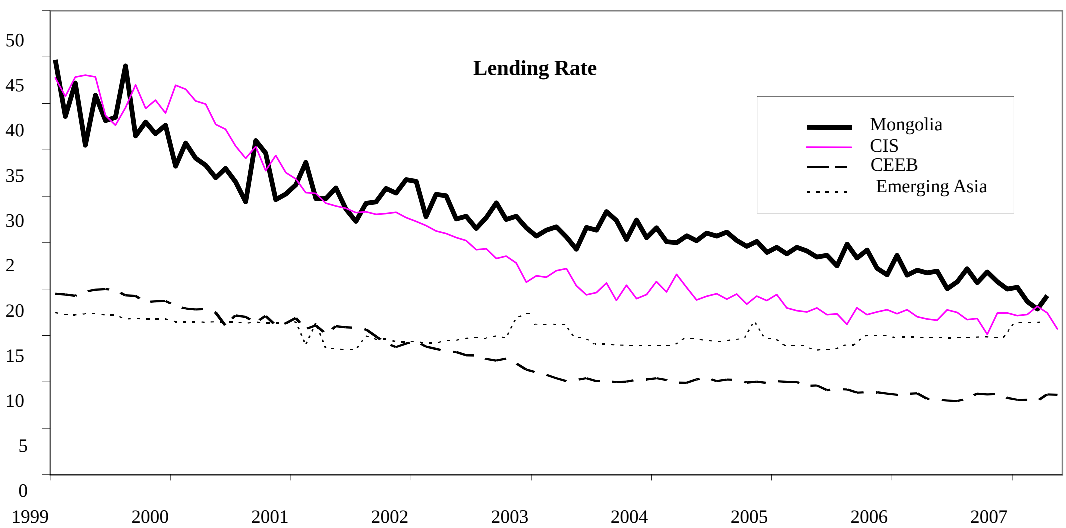
As seen above survey result, high interest rates in Mongolia are major financing obstacle to business in Mongolia, even though they have come down substantially since the late 1990s (Figure 16, 17).

Figure 16. Average Nominal Deposit Rates in Mongolia and Comparator Countries



Source: IMF, International Financial Statistics, Bank of Mongolia, 2007.

Figure 17. Average Nominal Lending Rates in Mongolia and Comparator Countries



Source: IMF, International Financial Statistics, Bank of Mongolia.

Despite high profitability of the largest Mongolian banks, there seems to be a reasonable degree of competition in the banking sector. Interest rates and the spread between deposit and lending rates have been declining in recent years. While spreads have been converging to levels comparable to a range of peer countries, deposit rates in Mongolia are still relatively high due to intensive competition among financial institutions in Mongolia (Figure 16).

In spite of ample liquidity in the banking system, banks-motivated, by the desire to expand their market shares-remain aggressive in attracting depositors by offering high deposit rates, and compressing their interest margins. Such competition has exerted an upward pressure on bank deposit rates, and in turn, commercial bank lending rates (Figure 17).

The analysis suggests that it is not low domestic saving, but poor financial intermediation that has been primarily responsible for the high cost of capital in Mongolia.

The spreads between deposit and lending rates are also high compared to other countries. This is largely due to the difficulty banks have in assessing credit risk. In addition, the profitability of bank's non-lending assets remains low since their operating costs and required reserve ratio are high by international standards. The difficulty in assessing credit risk derives from a number of sources. The most important constraints are being poor corporate governance, and the lack of transparency in business operations, which makes it difficult for potential lenders to assess borrowers' creditworthiness. The weakness of the bankruptcy and debt recovery framework in Mongolia has translated itself to increased risks and costs of banking business. Data shows that bankruptcy claimants recover only 17 percent of total claims from insolvent firms in Mongolia, on average, compared to 24 percent for East Asia as a group, and 73.8 percent for OECD countries[27]. In response, banks in Mongolia have been forced to rely entirely on collateralized lending and need to change high risk premiums on their loans to SME. Cheap financing is only made available to a very few prime customers-typically big companies. For instance, whereas large firms can obtain financing for as little as 9.6 percent per year, the annual nominal cost of micro finance can be as high as 72 percent on short term loans to individuals or small firms

Competition in the banking system is generally adequate, the view of the Unfair Trade Commission (UTC) is that there are no clear signs of collusive behavior among banks and the mobility of depositors is currently sufficiently high.[28] That said, a recent evaluation study by the UTC noted that individual banks may be benefiting from preferential access to government business; only a few banks maintain government deposits and only two banks are authorized to manage social protection funds. Some banks are also apparently using their dominant position in different rural areas to charge relatively high fees to their customers.

[27] World Bank, Investment Climate Survey 2006.

[28] Established in January 2005, the Unfair Trade Commission is in charge of measuring the competition in all economic sectors, including banking, with an objective of ensuring efficient provision of goods and services.

While loans in rural areas would be expected to involve higher administration and overhead costs, due to the smaller average size of loan, a review of average intermediation spreads for the large banks supports the view that interest margins in the rural areas are higher than those in the cities. Thus there may be scope to foster more competition in the banking sector.

Many banks have started to target SME borrowers but a large portion of their programs appear to rely on donor funding. Recognizing the distinct access to the financial needs of SME, several banks have started to develop strategies to cater to this market. The larger banks, which traditionally have focused on large corporate clients, have begun to downscale to target SME while the banks predominantly focusing on microfinance are scaling up. It will take time for these banks to accumulate knowledge of SME customers and develop appropriate financial products. In the longer run, banks will need to diversify their funding sources for SME banking to ensure that there is not a perennial reliance on donor programs.

One of the actions spelled out in the SME Law is the transformation of the SME Development Fund (originally established by two donor programs under the Ministry of Industry and Trade) into a permanent apex institution which would provide funding at below market rate to the financial institutions for loans to SME at an agreed rate. International experience has shown that government programs that use market mechanisms to support SME development have a much higher rate of success. Direct interventions, such as provision of funds at below market rates to SME, can often lead to weaker financial discipline by SME and distorted credit risk assessment of these SME's by their creditors.

4. Concluding Remarks and Suggested Recommendations

SME are considered to have a crucial role in an economy and are a key source of economic growth, dynamism and flexibility and can adapt quickly to changing market demand and supply situations. They are also deemed to generate employment, help diversifying economic activity and make a significant contribution to exports and trade.

Role of competent SME sector to the development process is also highly relevant to small developing countries like Mongolia considering its small domestic market, weak and narrow based economy against volatile global environment.

However, inadequacies in access to finance are one of the key obstacles to SME growth, not only in developing countries including Mongolia but also in developed countries too.

International experiences demonstrate that SME are usually more credit constrained than other segments of the economy because of financial sector policy distortions, lack of know-how extending access to finance on the part of banks, information asymmetries, and high risks inherent in lending to SME.

In addition to above mentioned constraints of lack of access to finance to SME, many literatures reveal one characteristic that SME in developing or emerging countries are more disadvantaged in obtaining external finance than SME in developed countries. Developing countries are more likely to have macroeconomic imbalances that lead to excess demand for available domestic savings as well as institutional weakness that encourage large number of individuals to engage in low productivity informal activity. Furthermore, financial systems in developing countries are often characterized by less deregulation, openness and reform of ownership, governance and supervision. There are persuasive reasons to believe that when the institutional and financial framework in developing countries is weak, the SME will be adversely affected to a much large degree than large firms.

Also capital markets do not compensate for deficiencies in the banking sector as they do not have a comparative advantage to deal with opaque and small firms. In effect, capital market financing rests on comparatively high accounting and disclosure requirements which, by definition, opaque SME lack. Thus capital markets are typically not a source of direct funding for SME. All above mentioned problems are a current case in Mongolian SME sector.

Therefore government action is necessary to correct market failures, and to assist potential start-ups and disadvantaged groups in society.

Thus there is clear scope for positive government action in the areas of macroeconomic stability and general institution building that supports greater financial access for SME. Policies not specifically addressed to financial sector needs but designed to improve the general business environment (communication, transportation, and energy infrastructure) in which financial institutions operate, as well as the general security situation, are also of evident importance.

International experiences encourage that governments should provide public goods that level the playing field for financial institutions to innovate financial services for improving access to finance in all segments of the market.

These public goods entail a sound financial sector legal and policy framework, investing in building sound institutions, and investing in a supportive information infrastructure, such as effective credit bureaus and solid accounting standards.

International experience has also shown that government programs that use market mechanisms to support SME financing have a much higher rate of success. Direct interventions, such as provision of funds at below market rates to SME, can often lead to weaker financial discipline by SME and distorted credit risk assessment of these SME by their creditors.

All these are mostly related to well-developed institutions. While it is indispensable that creating long-term sustainable and improved accessibility of finance for SME is necessary, broad institution building is a long-term process.

Therefore the government can achieve additional impact in the short to medium term by taking action specifically directed at facilitating financial market activity that helps improving access to finance.

As reviewing good practices that were experienced in many countries in the past, following recommendations are suggested to Mongolia for improving access to finance for Mongolian SME sector, apart from general macroeconomic stability.

First, the government should provide specific laws restricting and clarifying, and therefore offering certain type of financial contracts or financial business, including factoring, venture capital, structured finance, credit guarantee system, and credit information bureau etc., which are an absent or have ambiguities in respective legislations in Mongolia. The international trend has been to expand greatly the degree which the law is tightly defined by statute rather than judicial precedent.

Second, there is a need to improve financial information infrastructure in Mongolia. Better coordination between the existing Credit Information Bureau and the industry's plans for a new bureau will be important to ensure development of an information system which can effectively serve supervisory and SME needs. The government should consider undertaking a few urgent measures to better respond to the current need of the industry, improve information reliability and enhance the central bank's capacity to monitor the rapid credit expansion, including improvement of information timeliness, data quality, coverage, and improve system interoperability. The linkage with other government databases can significantly improve data adequacy of the public credit registration system. However, as the credit information system has been locally developed, there may be an interoperability problem requiring ongoing modifications, with associated costs and opportunity losses. A more standard and compatible system upgrade could be considered.

Third, the government should urgently expedite the process of providing laws and regulations on e-banking or mobile-banking services regarding authenticity and finality of e-transactions, verification of e-signatures, customer privacy protection, banking information confidentiality, and so on. Banks are offering new products and services through e-banking and bank cards to shorten loan application processes, ease bank account enquiries and facilitate payments of consumer goods and utility bills. The increased use of technologies by banks is taking place without sufficient laws and regulations

Fourth, the government and donor programs to improve access to financial services for SME in rural areas need to be designed to ensure that these services are sustainable on market principles after the completion of the programs.

Fifth, the government should urgently consider establishing Credit Guarantee System. The following criteria for evaluating CGS can serve as best-practice benchmarks for designing CGS: (1) Risk sharing among the CGS, borrowers, and banks. CGSs should obtain whatever collateral is available from borrowers and should pursue loan recovery vigorously, even after the guarantee has been paid out. The lender should assume at least 30 to 40 percent of the risk, and never less than 20 percent. (2) Sustainability is important. CGS should be designed so that fees and other income, such as the return on investments, cover all administrative costs and claims. (3) Minimum 5 percent default rate is the point at which action may be considered to remedy the situation as best practices were shown.

Sixth, transaction cost subsidies should be well designed in terms of eligibility criteria, transaction cost assessment, and receivers (banks or borrowers). It should not be based on ad hoc decision as currently experiencing.

Seventh, the government has to pay attention on efficiency and effectiveness of any direct intervention, using following criteria: (1) clarity and logic coherence of the objectives of intervention, (2) governance structures that inhibit subversion of these objectives, (3) control over agency costs, especially credit risk related to adverse selection and moral hazard, and (4) adequate technical and administrative arrangements.

Finally, the government should pay attention on improving financial literacy of entrepreneurs and individuals. The capacity of individuals and entrepreneurs to take advantage of available financial services (and to avoid risks) depends to some degree on adequate financial education.

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Summary of the Research Paper

Importance in the role of SME in the development process continues to be in the forefront of policy debates not only in developing countries but also in developed countries. The advantages claimed for SME are various, including the encouragement of entrepreneurship; the greater likelihood that SME will utilize labor intensive technologies and thus have an immediate impact on employment generation; they can usually be established rapidly and put into operation to produce quick returns; and they may well become a countervailing force against the economic power of larger enterprises. More generally the development of SME is seen as accelerating the achievement of wider economic and socio-economic objectives, including poverty alleviation. However, the ability of SME to grow depends highly on their potential to invest in restructuring, innovation and qualification. All of these investments need capital and therefore access to finance.

A theoretical argument on lack of access to finance in general is that suppliers of finance may choose (due to problems of dealing with uncertainties such as agency and principal problem, asymmetric information, adverse credit selection, and institutional problems) to offer higher interest rate and credit rationing that would leave significant numbers of potential borrowers without access to credit. The argument is not specifically aimed at SME, but the specific characteristics of SME are such that these problems are more severe to SME than larger firms. A literature demonstrates that SME are usually more credit constrained than other segments of the economy because of the following reasons: (i) financial sector policy distortions; (ii) lack of know-how on the part of banks; (iii) information asymmetries, for example, lack of audited financial statements; and (iv) high risks inherent in lending to SME.

In addition to above mentioned constraints of lack of access to finance to SME, many literatures also reveal that SME in developing or emerging countries are more disadvantaged in obtaining external finance than SME in developed countries. Developing countries are more likely to have macroeconomic imbalances that lead to excess demand for available domestic savings as well as institutional weakness that encourage large number of individuals to engage in low productivity informal activity. Also financial systems in developing countries are often characterized by less deregulation, openness and reform of ownership, governance and supervision. Further, capital markets do not compensate for deficiencies in the banking sector as they do not have a comparative advantage to deal with opaque and small firms. In effect, capital market financing rests on comparatively high accounting and disclosure requirements which, by definition, opaque SME lack. Thus capital markets are typically not a source of direct funding for SME, given that these firms are unable to issue debt or equity in amounts sufficiently large to attract investors (who prefer liquid issues and are not willing to take too large a share of a single asset) and amortize issuance-related transaction costs (including compliance with complex legal, regulatory, accounting, and disclosure requirements). These factors normally render unfeasible the direct access to capital market financing for SME.

Against this background the consistently repeated complaint of SME about their problems regarding access to finance is a highly relevant constraint that endangers the economic growth of the countries.

Mongolia's transition to a market economy and the accompanying reform measures in the financial sector during the past decade have brought about a general policy environment and an overall regulatory framework that encourage formal and informal institutions to provide financial services to different strata of individuals, households and organized businesses, including low income segments of the population, micro-enterprises, and small and medium-size businesses in both urban and rural areas.

In spite of the generally fast pace by which access to financial services for SME is being developed, significant segments of the SME sector do not yet benefit from the expansion and deepening of outreach. In attempting to gain access to financial services SME continue to face constraints caused by many common factors.

The main impediments for SME include relatively high lending rates, limited access to long-term loans, high collateral requirements, and weak capacity for market research and business planning

Therefore government action is necessary to correct market failures, and to assist potential start-ups and disadvantaged groups in society. There is clear scope for positive government action in the areas of macroeconomic stability and general institution building that supports greater financial access for SME. Policies not specifically addressed to financial sector needs but designed to improve the general business environment (communication, transportation, and energy infrastructure) in which financial institutions operate, as well as the general security situation, are also of evident importance.

International experiences encourage that governments should provide public goods that level the playing field for financial institutions to innovate financial services for improving access to finance in all segments of the market. These public goods entail a sound financial sector legal and policy framework, investing in building sound institutions, and investing in a supportive information infrastructure, such as effective credit bureaus and solid accounting standards.

While it is indispensable that creating long-term sustainable and improved accessibility of finance for SME is necessary, broad institution building is a long-term process. Therefore the government can achieve additional impact in the short to medium term by taking action specifically directed at facilitating financial market activity that helps improving access to finance.

As reviewing good practices that were experienced in many countries in the past, following recommendations are suggested to Mongolia for improving access to finance for

Mongolian SME sector, apart from general macroeconomic stability.

First, the government should provide specific laws restricting and clarifying, and therefore offering certain type of financial contracts or financial business, including factoring, venture capital, structured finance, credit guarantee system, and credit information bureau etc., which are an absent or have ambiguities in respective legislations in Mongolia. The international trend has been to expand greatly the degree which the law is tightly defined by statute rather than judicial precedent. Second, there is a need to improve financial information infrastructure in Mongolia. Better coordination between the existing Credit Information Bureau and the industry's plans for a new bureau will be important to ensure development of an information system which can effectively serve supervisory and SME needs. Third, the government should urgently expedite the process of providing laws and regulations on e-banking or mobile-banking services regarding authenticity and finality of e-transactions, verification of e-signatures, customer privacy protection, banking information confidentiality, and so on. Fourth, the government and donor programs to improve access to financial services for SME in rural areas need to be designed to ensure that these services are sustainable on market principles after the completion of the programs. Fifth, the government should urgently consider establishing Credit Guarantee System. Sixth, transaction cost subsidies should be well designed in terms of eligibility criteria, transaction cost assessment, and receivers (banks or borrowers). It should not be based on ad hoc decision as currently experiencing. Seventh, the government has to pay attention on efficiency and effectiveness of any direct intervention, using following criteria: (1) clarity and logic coherence of the objectives of intervention, (2) governance structures that inhibit subversion of these objectives, (3) control over agency costs, especially credit risk related to adverse selection and moral hazard, and (4) adequate technical and administrative arrangements. Finally, the government should pay attention on improving financial literacy of entrepreneurs and individuals. The capacity of individuals and entrepreneurs to take advantage of available financial services (and to avoid risks) depends to some degree on adequate financial education.