FINANCIAL SECTOR ASSESSMENT PROGRAM
DEVELOPMENT MODULE

MONGOLIA

ACCESS TO FINANCE

TECHNICAL NOTE

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THE WORLD BANK
FINANCIAL AND PRIVATE SECTOR DEVELOPMENT VICE PRESIDENCY
EAST ASIA AND PACIFIC REGIONAL VICE PRESIDENCY

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Glossary

APR	Annual percentage rate
ATM	Automatic teller machine
BOM	Bank of Mongolia (central bank)
CAR	Capital Adequacy Ratio
CGF	Credit Guarantee Fund
CIB	Credit Information Bureau
EAP	East Asia and Pacific region
FRC	Financial Regulatory Commission
FSAP	Financial Sector Assessment Program
GDP	Gross domestic product
GoM	Government of Mongolia
ICT	Information communication technology
IFRS	International Financial Reporting Standards
IPCCN	Interbank Payment Card Centralized Network
IT	Information technology
MDF	Microfinance Development Fund
MNT	Mongolian Tughrik
MOF	Ministry of Finance
MSME	Micro, small and medium enterprise
NBFI	Nonbank financial institution
NPL	Nonperforming loans
NSO	National Statistical Office of Mongolia
POB	Point-of-banking
POS	Point-of-sale
ROSC	Report on Observance of Standards and Codes
SCC	Savings and credit cooperative

EXECUTIVE SUMMARY[1]

Financial intermediation in Mongolia has grown significantly in recent years; credit and deposit penetration are on par with the average in the East Asia and Pacific (EAP) region. Bank credit increased on average by 47 percent in 2006-2008, although banks virtually stopped lending in late 2008 due to the crisis. Credit growth resumed in late 2009 as the economy rebounded strongly, and in 2011 credit grew substantially by more than 70 percent yoy. Deposits have also grown rapidly after the crisis, by an average of 53 percent in 2010 and 2011. At end-2010, credit to the private sector accounted for 49 percent of GDP and deposits for 60 percent of GDP, compared to an average of 52 percent and 63 percent in the EAP region, respectively. Credit by nonbank financial institutions (NBFIs and SCCs) has also increased, although it accounts for a small share (about 3 percent) of total financial sector lending, as NBFIs and SCCs remain small and underdeveloped.

While financial intermediation in Mongolia has been growing fast, access to finance remains a constraint for enterprises, and especially for micro, small, and medium enterprises (MSMEs). The Enterprise Survey shows that access to finance is the most important constraint amongst the top 10 constraints reported by firms. MSMEs contribute 25 percent of GDP and employ half of the workforce in Mongolia. However, they lack favorable financing conditions that would enable them to expand operations and contribute to further growth. MSME credit is characterized by relatively high interest rates, short loan maturities, relatively small loan sizes, and predominantly immoveable collateral-based lending requirements. On the supply side, banks are constrained by the short maturity structure of deposits and the shortage of other funding sources with longer maturities.

Banks are cautious about lending to MSMEs, because many of them are considered un-bankable due to their weak management skills and poor financial reporting. These firms have low levels of technical and managerial skills and low awareness of financial products. They need training on technology improvement, basic management skills, financial reporting, and education on financial products. A more developed credit information system would help improve information about MSME creditworthiness, and it would facilitate the adoption of lending technologies based on credit scoring models.

Bank lending is particularly limited in rural areas. Bank lending in rural areas is limited due to several reasons, including: (i) the low population density that makes it unprofitable to service isolated areas using traditional banking methods; (ii) the riskiness of agricultural loans; (iii) lack of financial information on micro-firms/herders; (iv) lack of real estate collateral in rural areas, etc. The Microfinance Development Fund (MDF) set up under a World Bank project provides wholesale loans to banks and NBFIs for micro-loans on-lent mostly to rural households. However,

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[1] This note was prepared by Bujana Perolli, team member of the Mongolia FSAP Developmental mission that took place in January-February 2012. The note has benefited from comments by Sonja Brajovic-Bratanovic, Colleen Mascenik, Aurora Ferrari, and Mazen Bouri. The FSAP team consisted of Alexander Pankov, Colleen Mascenik, Sau Ngan Wong, Andrey Milyutin, Bujana Perolli, Sonja Brajovic-Bratanovic, and Huixia Chen (all World Bank).

the MDF does not have a legal status outside the World Bank project, although it is financially self-sustaining, and thus a vision is needed on its organizational structure going forward so that it can continue to support rural and microcredit finance. In addition, the World Bank has supported the design, piloting and now the nationwide rollout of livestock insurance, to be available in 2012.

MSMEs obtain financing mostly from bank loans, although NBFIs have a role to play in providing financing especially to microenterprises. NBFIs lend a significant proportion of their portfolio to micro and small enterprises (about 70-80 percent). They provided 6-8 percent of total MSME credit in 2011. However, they have significant funding constraints; they are not allowed to take deposits and are thus dependent on their capital base and borrowings from banks and foreign institutions to fund loans.

Enhancing access to financial services will require strengthening the legal, regulatory and supervisory framework and the financial infrastructure. The main areas of improvement in the legal, regulatory and supervisory framework include: (i) encouraging the entry of foreign banks to bring longer-term funding sources and improve competition; (ii) strengthening the legal framework for leasing and factoring; (iii) improving the regulation and supervision of NBFIs and SCCs and ensuring that it is proportional to the risks posed by them; and (iv) strengthening the institutional, legal, and regulatory framework for consumer protection and financial literacy. More efforts are also needed to improve the financial infrastructure, including: (i) the secured transactions, creditor rights and insolvency regime; (ii) credit reporting system; and (iiii) the infrastructure for electronic payments instruments. In addition, it is important to ensure that there are effective government policies in place to support SME finance.

Given the lack of long-term funding sources in the banking sector, the BOM might consider encouraging foreign bank entry in the market. Encouraging the entry of foreign banks would bring longer-term and sustainable funding sources, more sophisticated credit risk appraisal and management techniques, and more developed financial products.

Leasing and factoring can be important sources of finance for SMEs, especially when there are weaknesses in the financial infrastructure, but they remain largely undeveloped in Mongolia. There is no factoring and very limited leasing in Mongolia. Providing tax incentives in the leasing law would encourage the development of the leasing industry. In addition, ensuring an adequate legal framework for contracts assigning receivables would encourage the development of factoring.

NBFIs and SCCs can also play a role in expanding access to finance, and the regulatory and supervisory framework should encourage the further growth of these sectors. The FRC has limited capacity to regulate and supervise NBFIs and SCCs. A detailed assessment of its functions and responsibilities is needed, as well as an assessment of the regulatory framework for NBFIs in order to ensure that it is conducive to the further growth of the sector. Regulation and supervision should be proportional to the risks posed by various types of NBFIs and SCCs.

Consumer protection and financial literacy are also critical to ensuring confidence in the financial system and increasing financial inclusion. Given the rapid pace of the development of the financial sector in Mongolia, and technological innovations that create new risks for consumers, consumer protection and financial literacy become particularly important. The

institutional framework for financial consumer protection is not clear, and specific consumer protection provisions need to be enacted in laws and regulations.

A modern secured transaction regime would facilitate lending to MSMEs, as they have a wider range of moveable assets and more limited immoveable assets. The registration of pledges on moveable property is not standard practice in Mongolia. A Pledge Law has not yet been approved, and there is no centralized moveable assets registry. The secured transactions framework should be improved by improving the legal framework in the areas of creating, registering, and enforcing a security interest, establishing a central electronic moveable collateral registry, and raising awareness about the importance of an adequate secured transactions regime in improving access to credit.

Effective creditor rights and insolvency regimes are fundamental to sound financial intermediation and stability, but there are significant weaknesses in the legal framework in Mongolia. A reliable legal system and judiciary are necessary for lenders to enforce contracts and foreclose collateral on loans. Inefficient legal processes and court proceedings increase the risk for lenders and make the foreclosure processes time-consuming and expensive. Similarly, inadequate creditor rights can diminish the incentives for borrowers to meet their financial obligations. In turn, these factors translate into market inefficiencies, with less financial intermediation taking place and a higher cost of financing for borrowers. Stronger creditor rights help improve access to finance.[2] In Mongolia, enforcement of court decisions is difficult. There are problems in the Bailiff's office and the auctions process. Informal workouts for viable but distressed enterprises are not encouraged. Bankruptcy procedures are rarely used, and virtually all procedures are liquidations. The treatment of secured creditors is not clear. In addition, the capacity of courts to handle insolvency issues is another bottleneck. The ongoing reform of the insolvency regime should be completed as soon as possible, bringing the law in line with international standards.

The credit information system is nascent. The Bank of Mongolia has been operating a public credit registry since 2000. It has recently broadened its database on credit information and improved data collection and reporting, and it now covers all borrowers. A Credit Information Law was passed at end-2011. A private credit bureau has been established by commercial banks but is not yet operational. Regulations need to be developed that guide the operations of private credit bureaus, including on rights of data subjects, dispute resolution mechanisms, etc.

New technologies, such as mobile banking, provide an opportunity to increase penetration in rural areas, and their further growth should be encouraged. New technologies such as mobile and internet banking are growing fast—especially mobile banking, given the rapid increase in mobile phone users. These technologies provide viable opportunities to overcome penetration problems in rural areas. In recent years, the Bank of Mongolia (BOM) has encouraged the use of new technologies. For example, in 2010 the BOM took an active role in promoting the use of debit and credit cards by establishing a national platform for electronic payment instruments. The BOM plans to broaden the platform to extend the necessary infrastructure for the use of cards in rural

[2] Countries with stronger creditor rights tend to have higher rates of private credit to GDP. See Djankov, McLiesh and Shleifer (2007), Chong, Galindo, and Micco (2004).

areas, and it is also introducing a national chip-based credit card. The further growth of mobile banking should be encouraged with the establishment of a national platform for internet and mobile phone banking services.

The GoM has undertaken a number of initiatives to support SMEs' access to finance, but these efforts can introduce distortions in the market and face sustainability issues. The government's initiatives include providing concessional loans to SMEs through commercial banks and local authorities, and the establishment of a Credit Guarantee Fund (CGF). While subsidized initiatives represent an effort to correct market failures in the provision of finance to SMEs, they introduce distortions in the market and face sustainability issues. Authorities should consider less costly, market-based mechanisms that involve risk-sharing with financial institutions. The CGF has the potential to promote efficient allocation of credit to SMEs, but the scheme needs to follow good principles for partial credit guarantees, including defining target beneficiaries, ensuring partial coverage by the government, narrowly defining the range of products, and establishing a maximum limit. All publicly-funded programs should be carefully designed and evaluated in order to accurately measure their effectiveness.

The aim of this technical note is to assess the level of access to finance in Mongolia, and especially for MSMEs, to identify key obstacles to improving access, and to provide recommendations to overcome these obstacles. The technical note is organized as follows. Section I provides a broad overview of the macroeconomic environment and is followed by Section II on the status of access to finance in Mongolia. Section III discusses products and market segments. Section IV examines the supply of financial services by analyzing the role of key market players. Section V examines the demand for financial services by drawing on enterprise surveys to assess firms' perceptions of their access to finance, and analyzes financing conditions for MSMEs. Section VI examines obstacles in the regulatory, supervisory framework, and financial infrastructure for access to finance. Section VII describes the main government programs related to access to finance. In conclusion, Section VIII provides policy recommendations for overcoming obstacles to enhancing access to finance. Table 1 below presents key findings and policy recommendations.

Table 1. Policy Recommendations

Recommendation	Level of Priority[3]
LEGAL, REGULATORY, AND SUPERVISORY FRAMEWORK FOR FINANCIAL INSTITUTIONS AND INSTRUMENTS	
Competition	
Consider encouraging foreign bank entry in the market to bring longer term funding sources, increase competition, and thus improve borrowers' financing terms.	LT
Leasing and Factoring	
Revise the leasing law and consider preferential tax treatment for leasing transactions. There should be awareness program on the benefits of leasing as a financial instrument.	MT
Review legal framework for contracts assigning receivables with a view to the development of factoring. TA should be provided to SMEs and financial institutions' staff on factoring.	MT

[3] ST, short term, indicates action can be undertaken in 0-6 months. MT, medium term, indicates 6 months-1 year. LT, long term, indicates 1+ years.

Regulatory and Supervisory Framework for NBFIs and SCCs	
Conduct a detailed assessment of the FRC's functions and responsibilities including: (i) realignment of its organization; (ii) assessment of staffing needs; (iii) assessment of training needs; and (iv) improvement of its IT systems, databases, interconnectivity and software tools needed to effectively perform its functions.	ST
Improve the quality of regulation and supervision, and ensure that it is proportional to the risks posed by various types of NBFIs and SCCs.	ST
Undertake an assessment of the regulatory framework for NBFIs to ensure that it is conducive to the further growth of the sector.	MT
Consumer Protection and Financial Literacy	
Clearly define the institutional framework for financial consumer protection in Mongolia.	MT
Improve the legal and regulatory framework for financial consumer protection in order to: (i) protect against unfair or deceptive practices, (ii) improve transparency through disclosure and plain language requirements for products and pricing, in a way that allows consumers to easily compare offers of financial products; and (iii) establish an efficient and fair mechanism for resolving customer complaints and disputes.	MT
FINANCIAL INFRASTRUCTURE	
Secured transactions, creditor rights, and insolvency regime	
Improve the legal and regulatory framework for secured transactions.	MT
Establish a modern moveable collateral registry.	MT
Provide training and awareness-building to stakeholders on compliance with new legal and regulatory framework, and on the use of the registry.	MT
Amend the insolvency legislation to make it consistent with international standards.	ST
Clarify and extend the scope of the insolvency legislation to cover non-corporate SMEs.	ST
Strengthen court capacity to handle commercial matters and consider the creation of commercial courts.	MT
Credit information system	
Issue license and regulations to enable operations of private credit information bureau.	ST
The BOM's supervisory process for the private CIB needs be further developed.	ST
The legal and regulatory framework needs be further developed to protect the rights of data subjects to correct information, and to establish a dispute resolution system.	MT
A training program for clients is needed to improve understanding of credit information sharing.	MT
Electronic payment instruments	
Create a national platform to improve inter-connectivity and service delivery, reduce the cost of maintaining and using mobile banking services, and improve customer security.	MT
GOVERNMENT PROGRAM FOR SMEs	
Develop a medium-term strategy for SME development, including SME finance.	ST
Consider less costly, market-based mechanisms, that may involve risk-sharing with financial institutions, and which promote efficient credit allocation.	ST
Establish a regulatory framework that ensures that the CGF is sound and offers additionality, and that it has adequate institutional capacity.	ST
Provide trainings to SMEs on technology improvement, basic organizational and management skills, financial reporting, and education on financial products via the Banking Association, the business association, or NGOs. Donors can support trainings.	MT

I. MACROECONOMIC ENVIRONMENT

1. **Mongolia's economy has embarked on a very high, long-term growth trajectory**. This is driven primarily by extensive investment in new mining projects, including the largest copper deposit in Asia and the world's largest coking coal deposit, and proximity to Asian markets. Mongolia's real GDP is expected to grow at an average annual rate of 16 percent for the 2011-2013 period and to accelerate further in the following years.

2. **Mongolia's massive economic growth has contributed to a demographic transition in the country.** While the share of rural, primarily nomadic, population remains large at 47 percent, many are seeking new opportunities in the capital, and the population of Ulaanbaatar has more than doubled since 2000. The population is also very young compared to the region and to post-socialist neighbors; about 70 percent of the population is below the age of 35 years.

3. **The growth prospects are overshadowed by the recurrent risk of overheating,** fuelled by an expansionary fiscal policy, volatile global commodity prices, and rising capital inflows. Fiscal spending increased by 50 percent in real terms in 2011, and a 32 percent increase is envisioned for 2012. As a result of structural factors and expansionary policies, consumer price inflation reached 11.1 percent in 2011, and is expected to remain in double digits in the near- to medium-term. Further aggravating the inflation problem, Mongolia's economy is characterized by a high degree of price and exchange rate volatility, related to its dependence on imported fuel and foodstuff, and its commodity-dominated export structure.

4. **Against this backdrop, financial intermediation in Mongolia has grown rapidly since 2007 but remains highly volatile,** mirroring the boom-and-bust nature of the economic cycle. Although the banking sector assets nearly tripled from about US$2.4 billion to about US$7 billion at end-2011, the system went through a severe crisis in 2008-2009. Since late 2009, renewed economic growth and strong capital inflows have resulted in an extended period of accelerated credit growth.

5. **To realize fully its economic potential, Mongolia needs to build a diversified, efficient and stable financial system, capable of intermediating both on a large scale and in specific market segments**. Preserving stability and preventing the build-up of risks in the banking sector through the combination of properly enforced micro- and macro supervision measures is a pre-requisite for sustainable development of the banking sector and access to finance. This is also contingent upon the authorities' ability to maintain a stable macroeconomic environment through a mix of sound and properly coordinated fiscal, monetary and exchange rate policies.

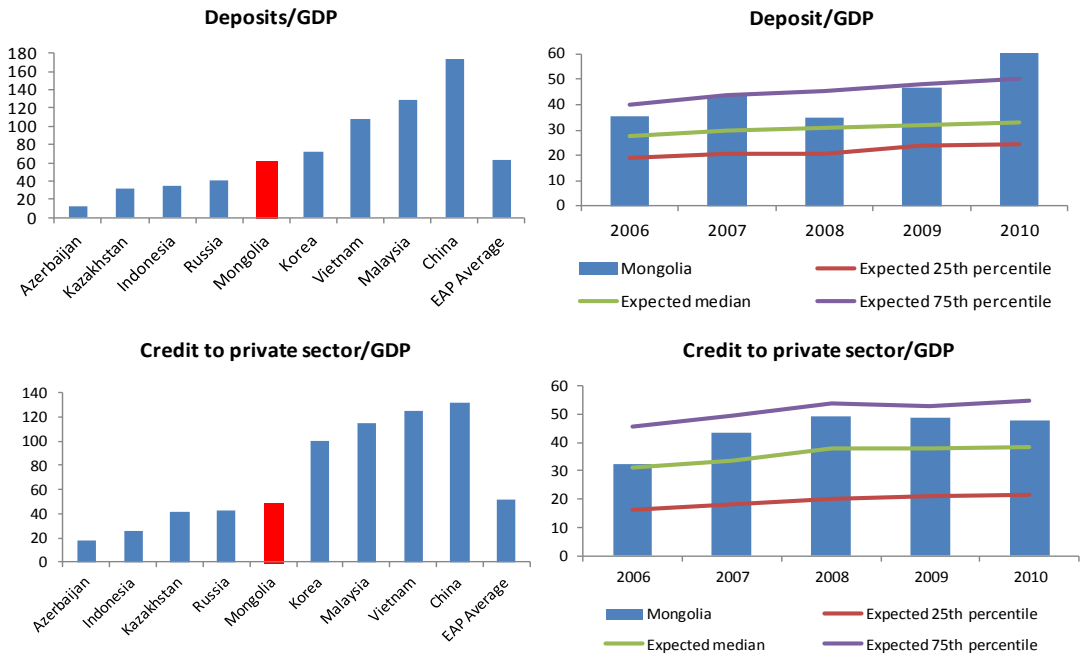
II. STATUS OF ACCESS TO FINANCE

6. **Financial intermediation in Mongolia has grown significantly in recent years.** Bank credit increased on average by 47 percent in 2006-2008, although banks virtually stopped lending in late 2008 due to the crisis. Credit growth resumed in late 2009 as the economy rebounded strongly, and in 2011 credit grew substantially by more than 70 percent yoy. Deposits

have also grown rapidly after the crisis, by 26 percent in 2009, and by an average of 53 percent in 2010 and 2011.

7. **Credit and deposit penetration in Mongolia is close to the average for the East Asia and Pacific (EAP) region.** At end-2010, credit to the private sector accounted for 49 percent of GDP and deposits for 60 percent of GDP, compared to an average of 52 percent and 63 percent in the EAP region, respectively. However, according to the financial indicator tool "Finstats"[4], which controls for countries' structural factors, the ratio of credit to the private sector compared to GDP has been above the expected median since 2006, but below the expected 75th percentile (Figure 5), showing that there is potential for further credit growth. With regard to deposits penetration, the ratio of deposits to GDP was close to the expected 75th percentile in 2009 and surpassed it in 2010 (Figure 1).

Figure 1. Credit and Deposits as Share of GDP and Statistical Benchmark, 2010

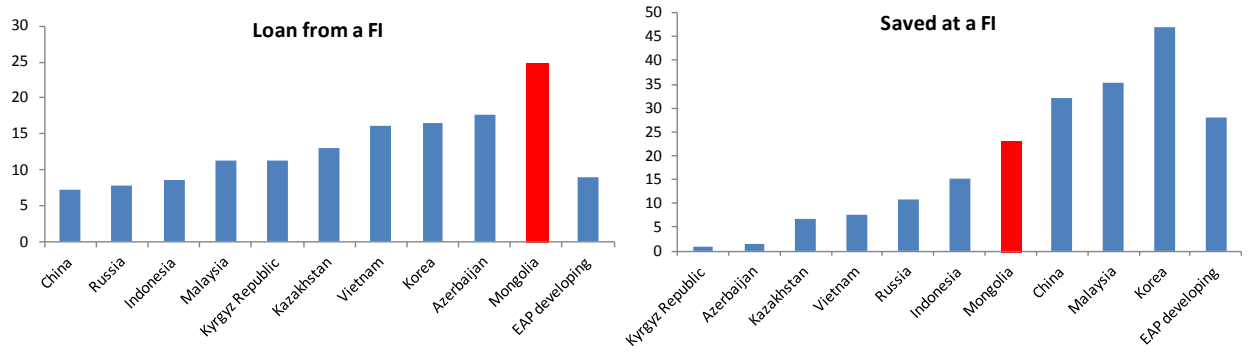


Source: Finstats 2010

8. **Most Mongolians (78 percent) have an account with a formal financial institution (FI), and about a quarter of the population borrows from financial institutions, or has savings in them.** A larger share of the population in Mongolia has a loan from a formal FI, compared to other countries (Figure 2). Half of the population uses their account to receive government payments, a third for business purposes, about 37-40 percent to send or receive remittances, a third to receive wages. In terms of borrowings, 16 percent of the population borrows from family and friends, 5 percent from private lenders, and 4 percent from employers.

[4] Finstats benchmarks Mongolia against other countries by providing the expected median, the expected 25th percentile and the expected 75th percentile, based on the country's structural characteristics, that is, by controlling for economic development, population, demographics, and a few other factors.

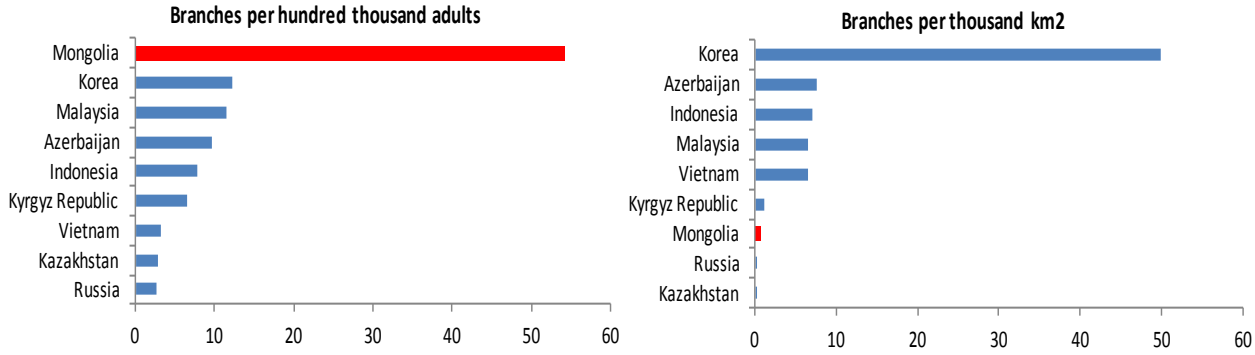
Figure 2. Share of Population with a Loan or Savings at a FI, 2011



Source: Global Findex Database, 2011

9. **Access to financial services in Mongolia is relatively high when measured by the demographic penetration of branches.** Mongolia has one of the highest bank branch penetration rates in the world, with 54 branches per 100,000 adults compared to 12 in Korea, 3 in Vietnam and Russia, and 10 in Azerbaijan. However, due to its large territory, Mongolia's geographical branch penetration is one of the lowest in the world. It has 0.67 branches per thousand km^2 (Figure 3). The low population density makes the provision of traditional banking services outside of the large cities costly. There are about 1,300 bank branches in Mongolia. Khan Bank and Savings Bank have more than 75 percent of all branches in the country and have the most significant presence in rural areas. Most of their branches are located outside Ulaanbaatar.[5]

Figure 3. Branch Penetration

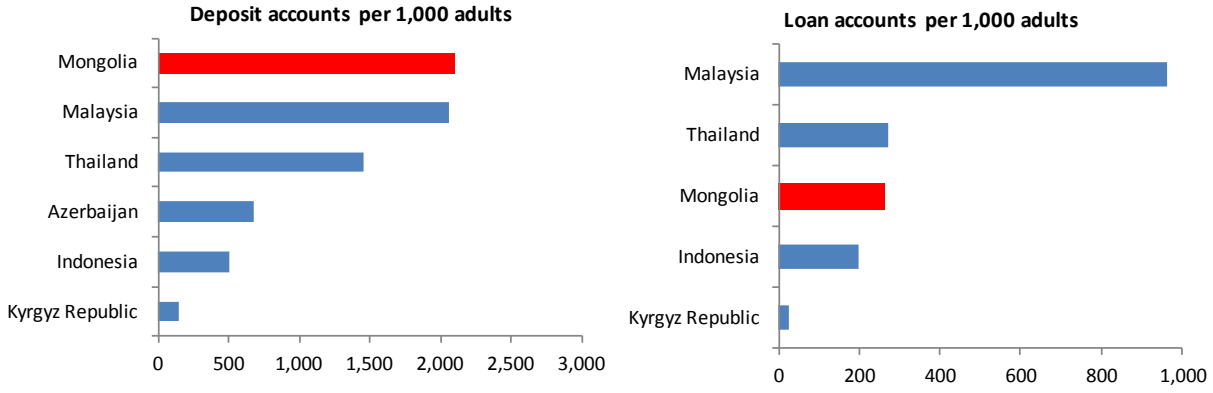


Source: CGAP 2011

10. **Loan and deposit penetration is also high**. There are 260 bank loan accounts per 1,000 adults, compared to 197 in Indonesia, and 27 in Cambodia. There are also more than 2,000 deposit accounts per 1,000 adults, compared to 504 in Indonesia and 678 in Azerbaijan (Figure 4). Deposit penetration is higher than most of its comparator countries.

[5] Khan Bank has 500 branches, out of which 81 are located in Ulaanbaatar, and Savings Bank has 495 branches, 67 of which are located in Ulaanbaatar.

Figure 4. Loan and Deposit Penetration



Source: CGAP Financial Access 2010

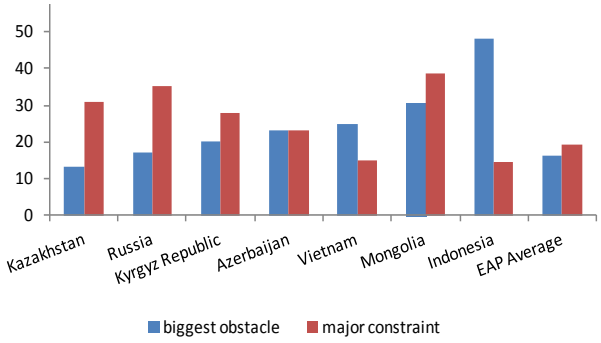
11. **The infrastructure for electronic payments is growing fast, but remains underdeveloped outside Ulaanbaatar.** By mid-2011, the number of card holders reached 2.2 million (over 80 percent of the total population), of which about one quarter are active users. The related infrastructure is mostly in the cities. There are only 410 ATMs in Mongolia—about 15 ATMs per 100,000 adults and 0.2 ATMs per thousand km^2, given that Mongolia has the lowest population density in the world. Only 28 percent of ATMs and 19 percent of Point of Sale (POS) terminals are located outside Ulaanbaatar.[6] About 70 percent of the population in urban areas uses ATMs as the main mode of withdrawals, compared to only 30 percent in rural areas. New technologies such as mobile and internet banking are growing fast, especially mobile banking, given the rapid increase in mobile phone users. These technologies provide viable opportunities to overcome penetration problems in rural areas.

12. **While overall financial intermediation in Mongolia is on par with the average in the EAP region, enterprise surveys and industry players suggest that access to finance remains a constraint for firms, especially for MSMEs.** The World Bank's Enterprise Survey[7] show that access to finance is the most important constraint among the top-10 constraints as reported by firms. More than 30 percent of firms in Mongolia perceive access to finance as the biggest problem to their operations (higher than the average of 17 percent in the EAP region). Access to finance is particularly constrained for MSMEs, which due to their nature are more sensitive to an unstable macroeconomic environment, characterized by high inflation and foreign exchange rate fluctuations. A recent survey by the BOM suggests that SMEs' top constraint for their business operations is the unfavorable macroeconomic and financing environment. In particular, the most constraining factors are: high interest rates, followed by short maturities of loans that are inadequate to meet investment needs, followed by small loan amounts, and predominantly immoveable collateral-based lending requirements.

[6] In addition to POS terminals, there are also Point of Banking (POB) terminals that are often found in rural areas.

[7] http://www.enterprisesurveys.org/

Figure 5. Proportion of Firms that Identify Access to Finance as an Obstacle



Source: Enterprise Survey, 2009

III. PRODUCTS AND MARKET SEGMENTS

13. **The range of financial products and services available in Mongolia is extensive.** Credit products include consumer loans, business loans, overdraft loans, and credit lines. Savings products include checking accounts and savings accounts. Banks also offer debit cards, credit cards, mobile banking, internet banking, electronic transfers, letters of credit, some trade finance, and some financial leasing. The market for savings products is better penetrated than the market for credit products.

A. Credit and Savings Products

14. **Credit products are offered by banks, NBFIs, and SCCs for their members.** For consumers, credit products include savings-backed loans, pension loans, salary loans, car loans, apartment renovation loans, home appliance loans, household loans, overdraft loans, student loans, and mortgage loans. For businesses, credit products include working capital loans, investment loans, equipment and machinery loans, express micro-loans, credit lines, and some trade financing loans. Some banks also offer herder loans, agricultural production loans, import loans (financing the payment of import duty, fees and shipment costs). At end-2011, there were more than 600,000 borrowers.

15. **Microfinance has experienced rapid growth in Mongolia in the last decade.** Since market players do not distinguish between the microfinance and SME market segments, it is difficult to establish total microfinance lending.[8] Banks are the dominant players in microfinance, with Khan Bank and Xac Bank dominating the microlending market. NBFIs also provide microfinance, but they are small and underdeveloped. The majority of microloans are individual collateralized loans with a maturity of 1 year. There is no specific legal and regulatory framework for microfinance, as well as no specific national policy for the development of the microfinance sector.

[8] Xac Bank and a few NBFIs market themselves as specifically microfinance institutions.

16. **A wholesale lending facility, the Microfinance Development Fund (MDF), provides onlending funds for microfinance.** The MDF was established under the Sustainable Livelihood World Bank project to lend to participating financial institutions (PFIs, that include 11 commercial banks and 17 NBFIs) for on-lending mostly to rural households with the aim of expanding and diversifying livelihoods sources and rural incomes. The MDF started its lending in March 2003.[9] As of end-2011, a total of MNT 63 billion (US$45 mln) in loans has been disbursed to over 120,000 sub-borrowers. The maximum amount of the sub-loan is MNT 15 million (US$ 10,000) and the minimum amount is MNT 30,000 ($20). The average sub-loan amount is MNT 1.4 million (US$ 1,000) with a monthly average interest rate of 2 percent. The majority of sub-loans (over 90 percent) are for income-generating activities.[10]

17. **The MDF is financially self-sustaining, however, it does not have a legal status outside the World Bank project.** The future organizational structure of MDF is being discussed, as it is currently only a lending facility created under the World Bank project. The operational expenses of the MDF are covered by the interest income generated from MDF's wholesale loans to PFIs. The MDF is another source of financing to improve rural and microcredit finance, and thus the authorities should agree on a future vision for it, so that it can continue to provide financing to banks and NBFIs to onlend to borrowers.

18. **The market for savings products is well penetrated with about 1.9 million depositors.** Savings products are offered by banks and by SCCs. Savings products include personal or business current accounts, demand deposits, time deposits, certificates of deposits, pension direct deposit, and payroll direct deposits.

B. Leasing and Factoring

19. **Leasing remains underdeveloped in Mongolia, with an estimated leasing penetration rate[11] of about 2-3 percent.** Banks, NBFIs, and SCCs can provide leasing. Leasing is a potentially important source of investment finance for SMEs, because it focuses on the SME's ability to generate cash flows from business operations, rather than on its credit history or availability of collateral. The Leasing Law was adopted in 2006, providing a definition of financial leasing, but the sector has not really taken off. The main obstacles to the development of the leasing industry are as follows: (i) banks do not have long-term funding to finance leasing products; (ii) interest rates are higher than loan rates and thus unaffordable for SMEs; (iii) there is a lack of understanding about leasing as a financial service; and (iv) there are difficulties in establishing connections with suppliers as most goods are imported.

20. **Leasing companies providing financial leasing are not currently regulated and supervised.** Going forward, it would be beneficial to define licensing and regulation of financial

[9] The MDF is administered by the Micro-Finance Development Board (MDB), which consists of representatives of several institutions (including BoM, MOF, FRC, etc.).

[10] In addition to providing loans, the MDF provides training workshops for rural individuals and staff of PFIs to increase their financial literacy.

[11] Penetration rate is measured as annual leasing volume divided by gross fixed capital formation.

leasing in the legal framework, as well as to assign clear responsibility to a regulatory authority for the supervision of the industry.

21. **Factoring is not present in Mongolia, although it is allowed in the legal framework covering banks and NBFIs**. Factoring is an important financial instrument to provide working capital financing for MSMEs, especially in an environment with weak contract enforcement regimes.[12] Factoring provides both credit and a way to manage cash flow for SMEs. Mongolia has an Electronic Signature Law, which is an advantage for the development of factoring.

C. Electronic Payments Instruments

22. **The BOM took an active role in promoting the use of debit and credit cards by establishing a national platform for card processing.** In 2009, the BOM approved the legal framework for a consolidated card clearing and settlement system, including licensing of its participants. In early 2010, the Interbank Payment Card Centralized Network (IPCCN) started operations with the BOM and nine commercial banks as system participants. As of mid-2011, the card service network offers 410 automated teller machines (ATM), 4,956 POS terminals and 2,076 POB terminals that are shared by all participants (Table 2).

23. **The national platform has broadened the range of banking services and facilitated penetration in provinces and rural areas, for both citizens and SMEs.** By mid-2011, there were over 2 million card holders in Mongolia, of which about one quarter are active users (Table 2)[13]. The owners/users in rural areas account for about 25 percent of total users. About 60 percent of the population uses debit cards, higher than in the comparator countries. However, only about 2 percent of the population uses credit cards.

Table 2. Number of Cardholders, Active Users, and Devices, June 2011

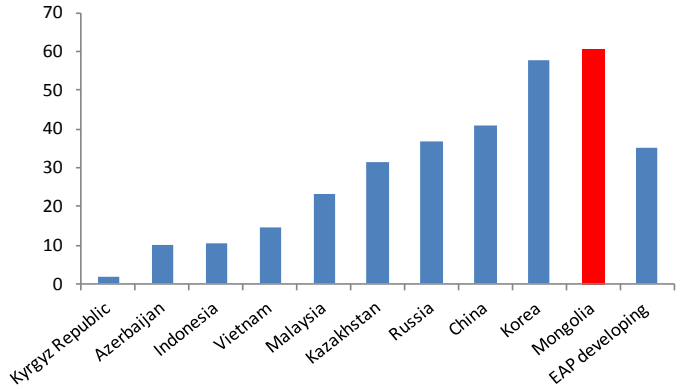
	Number of cardholders	Number of active users	POS terminals	POB terminals	ATMs
Ulaanbaatar	1,622,498	348,931	4,032	813	294
Outside Ulaanbaatar	539,959	89,276	924	1,263	116
Nationwide	2,162,457	474,205	4,956	2,076	410
Outside Ulaanbaatar as % of total	25%	19%	19%	61%	28%

Source: BOM

[12] Factoring is the purchase of a firm's account receivables by a financial institution at a discount that includes interest plus service costs.

[13] As indicated by the BoM, from 2009 to mid-2011 the number of transactions increased by 132% and the transaction amount by 157%. In the first half of 2011, the system registered 20.2 million transactions for the amount of MNT 1.6 trillion.

Figure 6. Share of the Population Using Debit Cards, 2011



Source: Findex

24. **The use of modern technologies has grown fast in recent years, with support of the authorities.** Progress made under the government's e-Mongolia program has provided basic infrastructure for the development of new banking products and delivery channels. As of end-2010, the national fiber optic network reached 21 provincial (aimag) centers and over 160 soums. The ICT authority plans to extend the fiber optic network to over 140 additional soums.

25. **Banks are increasingly using mobile banking as a low-cost delivery channel, particularly in remote and rural areas.** In view of Mongolia's low population density, mobile phone banking is a very promising line of business, as it offers wider access, increased speed, and lower cost. As of end-2011, the number of mobile phone users increased to 2.75 million with a penetration rate of 98 percent.[14] While being used country-wide, mobile banking services target clients living in remote and rural areas. In the past two years, mobile banking has expanded exponentially, with nine banks and a number of NBFIs providing mobile banking services. The largest network, AMAR, is operated by Xac Bank. The NBFI MobiFinance has introduced "mobile money" service, where clients use their mobile phones to create a mobile wallet.[15]

26. **Internet banking is also a new, fast-growing product.** Internet banking service was first introduced by banks in 2002, but the start was rather slow due to complexities and cost of introducing the service. Government initiatives such as the e-Mongolia national program are increasing internet awareness and usage throughout the country. Market penetration is deeper in urban centers, although rural areas are catching up. As of end-2011, the reported number of active internet users was 390,000, of which an estimated 10-15 percent, mostly SMEs, started to use internet banking services. The typical services are payment transactions and account-related inquiries, intra-bank, interbank and international transfers, loan payments, check and print bank statements, exchange rate-related inquiries and transactions, and others.

[14] Clients can make account transfers within their banks (for example, pay for goods and services) using their cell phone; make deposits and withdrawals without going to the bank branch through the authorized agents; and send SMS messages to their bank in order to access their accounts for transactions.

[15] Mobile wallet funds can be accessed using the mobile phone and used to send funds to other mobile phone users within the same system and to purchase goods and services from participating merchants.

IV. Key Market Players and Potential to Expand Access to Finance

A. Overview of the Financial System

27. **The financial sector is dominated by the banking sector, accounting for 96 percent of financial sector assets**. The system comprises 14 local commercial banks, of which 13 are private domestic banks, and one is a state-owned bank.[16] There are no foreign banks currently operating in Mongolia. Banks are supervised by the Bank of Mongolia (BOM). A very small portion of financial sector assets is held by nonbank financial institutions (about 3.5 percent of assets), including 17 insurance companies, 170 savings and credit cooperatives (SCCs), 192 nonbank financial institutions (NBFIs)[17], and 88 securities/brokerage firms (Table 3). These are supervised by the Financial Regulatory Commission (FRC).

Table 3 . Financial System - Market Share (% of Assets), 2011

	Number	Assets (bn MNT)	Percent of Total Assets
Banks	14	9223	96.4%
Private	13	8991	94.0%
State-owned	1	232	2.4%
NBFIs	192	189	2.0%
SCCs	170	59	0.6%
Insurance companies	17	77	0.8%
Securities firms	88	14	0.1%
Total financial system	**481**	**9563**	**100.0%**

Source: BOM and FRC

B. Financial Intermediation by Banks

28. **The banking sector has grown rapidly in recent years from a low base, reaching MNT 9.2 trillion (US$ 7 billion) in assets in 2011.** As a share of GDP, total banking sector assets increased from 66 percent in 2008 to 78 percent in 2011 (Table 4). Bank credit increased on average by 55 percent in 2006 and 2007, although banks stopped lending in late 2008 due to the crisis. Credit growth resumed in 2010 as the economy rebounded, and in 2011 credit grew substantially by more than 70 percent yoy[18].

[16] In addition, the state-owned, non-deposit taking Development Bank was established in 2011, with the mandate to finance large infrastructure projects and participate in implementation of state-supported programs, including social housing.

[17] NBFIs, as defined by the FRC, are microfinance companies; they do not include securities companies, insurance companies, or pension funds.

[18] In an environment of rapid credit growth, in 2011 banks reduced their liquid assets in order to meet the high credit demand. The share of liquid assets to total assets declined from 43 percent in 2010 to 31 percent at end- 2011.

Table 4. Basic Indicators of the Mongolian Banking System
(in percentage, except number of banks)

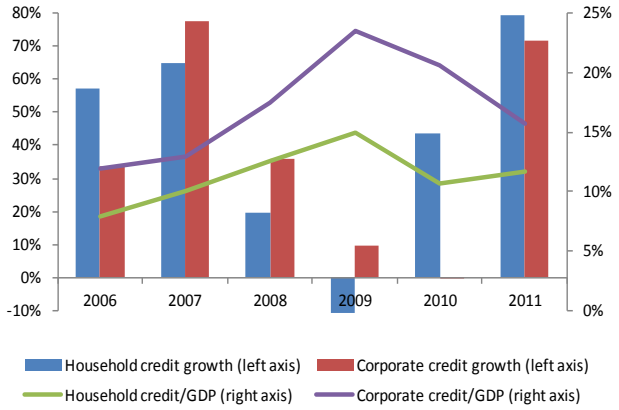
	2006	2007	2008	2009	2010	2011
Number of banks	17	16	16	17	14	14
Assets/GDP	54%	66%	55%	63%	75%	78%
Asset growth yoy	42%	51%	11%	15%	49%	48%
Deposits/GDP	36%	45%	35%	44%	55%	57%
Deposit growth yoy	36%	54%	3%	26%	57%	48%
Household deposits/GDP	17%	19%	22%	20%	21%	24%
Household deposits growth yoy	42%	51%	-10%	36%	45%	43%
Corporate deposits/GDP	4%	4%	6%	6%	6%	13%
Corporate deposits yoy	17%	99%	-2%	42%	156%	23%
Credit/GDP	32%	44%	41%	41%	38%	46%
Credit growth yoy	40%	69%	25%	-1%	15%	75%
Household credit/GDP	8%	10%	13%	15%	11%	12%
Household credit growth yoy	57%	65%	20%	-11%	43%	79%
Corporate credit/GDP	12%	13%	17%	24%	21%	16%
Corporate credit growth yoy	34%	77%	36%	10%	0%	72%

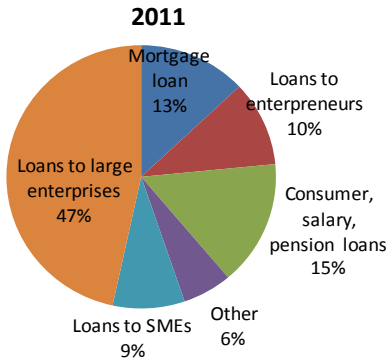
Source: BOM

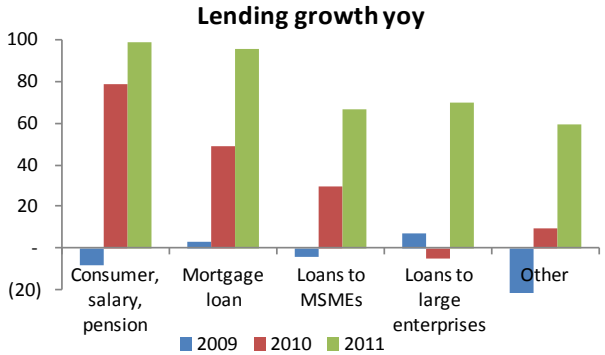
29. **The banking sector is relatively concentrated.** At end-2011, the largest bank, Khan Bank, accounted for 24 percent of total assets. The top three banks (Khan Bank, Golomt Bank, and Trade and Development Bank) accounted for 70 percent of assets, and the top five banks (Khan Bank, Golomt Bank, TDB, Xac Bank, and Savings Bank) accounted for 87 percent of assets. At end-2011, lending represented 58 percent of total bank assets.

30. **Bank lending is growing rapidly to both households and corporates.** About a third of total loans are to households (13 percent are mortgage loans and 15 percent are consumer, pension, and salary loans). Household loans decreased by 3 percent in 2009 as banks stopped lending due to the crisis, but have since grown rapidly with an average growth of 81 percent in 2010 and 2011 yoy, driven by high growth in mortgage loans and salary loans. About a third of total loans are issued in foreign currency. About half of total loans are to large enterprises, 10 percent to entrepreneurs/microfirms and 9 percent to SMEs (Figure 7). Growth in corporate loans declined substantially in 2009 (with a 7 percent growth yoy), followed by a decline of 5 percent in 2010. As with household loans, corporate lending has increased substantially by more than 70 percent yoy in 2011.

Figure 7. Bank Lending to Households and Corporates



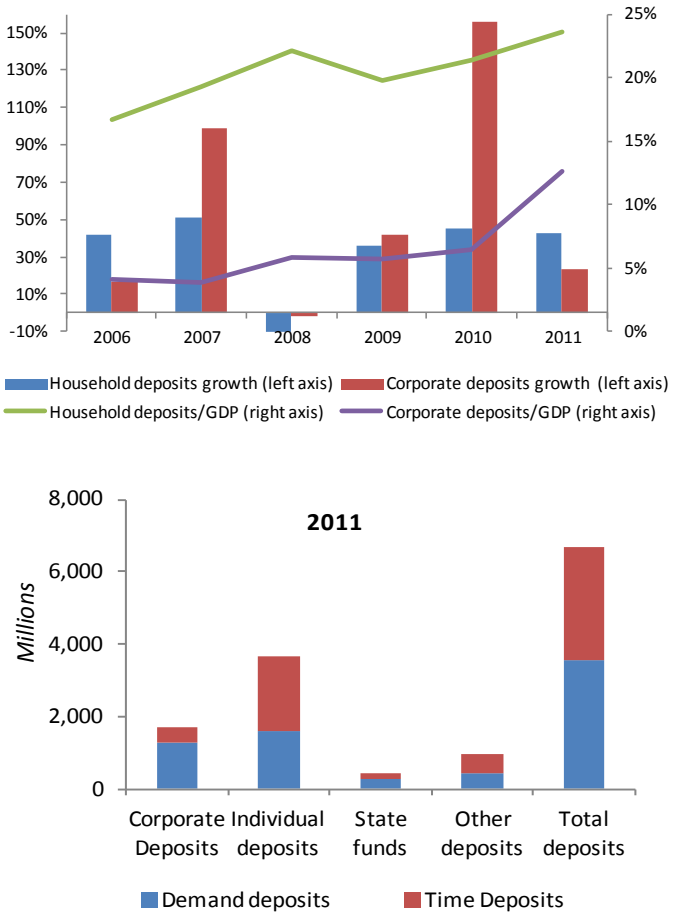




Source: BOM

31. **Deposits have also increased, although not at the pace of credit growth.** Total deposits increased by 45 percent in 2006 and 2007, increased by 3 percent in 2008 due to the crisis, started to recover with a 26 percent growth in 2009, and have since increased significantly with a 53 percent average growth in 2010 and 2011. More than half of total deposits are household deposits, and 25 percent are corporate deposits. Deposit growth has been driven primarily by growth in corporate deposits, that have shown average yoy growth of 56 percent from 2006-2011, compared to a 34 percent growth in household deposits in the same period. In 2011, however, household deposits outpaced corporate deposits (Figure 8). About 53 percent of total deposits are demand deposits, and 43 percent are time deposits. About a third of total deposits are in foreign currency.

Figure 8. Deposit Growth and Structure

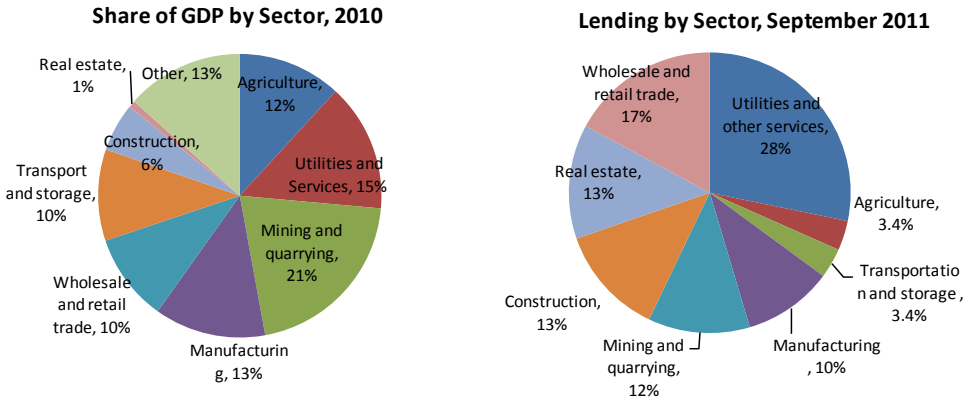


Source: BOM

32. **The bulk of bank lending is concentrated in Ulaanbaatar, and in five sectors of the economy—trade, construction, real estate, mining, and manufacturing—that account for 65 percent of total lending.** At end-September 2011, about 80 percent of bank lending was concentrated in Ulaanbataar. 17 percent of loans were issued to trade (a sector that accounted for 10 percent of GDP in 2010), 13 percent to construction (6 percent of GDP), 13 percent to real estate activities (1 percent of GDP), 12 percent to mining and quarrying (21 percent of GDP), and 10 percent to manufacturing (13 percent of GDP). The agriculture sector, including hunting forestry and fishing, maintained a very low share of credit of about 3 percent, compared to its much larger share of GDP at about 12 percent. This reflects the high risk involved in servicing this sector compared to the other economic sectors that are considered more attractive and less risky to banks.[19]

[19]Agriculture finance is outside the scope of this Technical Note.

Figure 9. Sectoral Contributions to GDP and Lending by Sector of the Economy



Source: National Statistics Office and BOM

C. Financial Intermediation by NBFIs and SCCs

33. **Nonbank financial institutions (NBFIs) and savings and credit cooperatives (SCCs) remain small and underdeveloped.** NBFIs constitute about 2 percent of total financial sector lending, and SCCs constitute less than 1 percent of total financial sector lending. There are 192 NBFIs serving about 137,000 customers nationwide (about a third of which are borrowers). In addition, there are 170 SCCs that serve about 27,000 customers, many low-income and rural households. NBFIs and SCCs are licensed, regulated, and supervised by the FRC. NBFIs can provide a variety of financial services: loans, payment guarantee, currency exchange, remittances, factoring, leasing, short-term investment, trust funds, and electronic payments.[20] SCCs provide mostly savings and loan services to low-income and rural households.

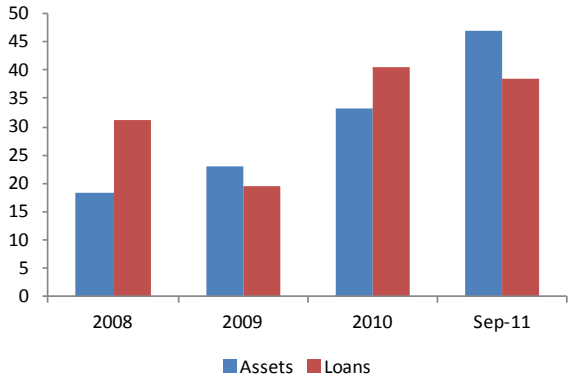
NBFIs

34. **NBFIs' lending has more than tripled from 2007-2011,** from MNT 35 billion to MNT 108 billion (US$26 mln to US$79 mln). Total assets amounted to MNT 189 billion (US$135 mln) at end-September 2011. The 5 largest NBFIs are Credit Mongol, Sar Shine International, New Found, Vision Fund, and Trans Trade, accounting for about a third of total assets (and loans). About half of NBFIs' assets are concentrated in the largest 10 NBFIs as of end-September 2011. NBFIs are predominantly located in Ulaanbaatar and other urban areas (only 23 are in rural areas).[21] About 80 NBFIs are active in lending, and the rest are engaged primarily in currency exchange operations.

[20] About 15 NBFIs take trust services.

[21] The FRC promotes the development of NBFIs in rural areas by requiring half the level of paid-in capital for such institutions operating in rural areas compared to those in urban areas.

Figure 10. NBFIs: Assets and Loan Growth (yoy)

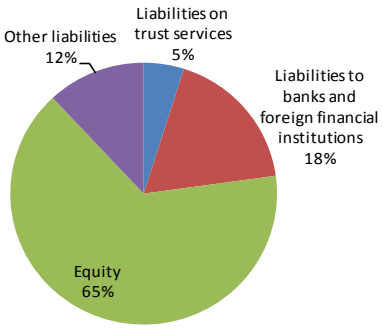


Source: FRC

35. **Most of NBFI lending (70-80 percent) is to microentrepreneurs and small enterprises.** NBFI loans have a maturity of up to 2 years, with average interest rates of 2.9 percent a month (almost double banks' interest rates), and average loan sizes of about MNT 3 mln (US$2,000). Credit Mongol, the largest NBFI with a 30 percent market share, gives loans to SMEs ranging from $10,000 - $300,000, and to microentrepreneurs and consumers from $100 - $10,000, with an average maturity of 13 months, average interest rate of 2.8 percent, and average loan size of MNT 4.8 mln (US$3,400). Industry observers and SME borrowers indicate that they often prefer the quick, efficient loan decision process and lighter informational and collateral requirements for obtaining loans through NBFIs. Nonperforming loans account for about 8 percent of total loans.

36. **NBFIs have significant funding constraints, which limit their future growth.** NBFIs have limited funding sources; they are not allowed to take deposits and are thus mainly dependent on their capital base and borrowings from banks and foreign institutions to fund loans. Equity constitutes 65 percent of total liabilities, borrowings from banks and international institutions 18 percent, and trust services 5 percent.

Figure 11. NBFIs' Funding Structure, September 2011



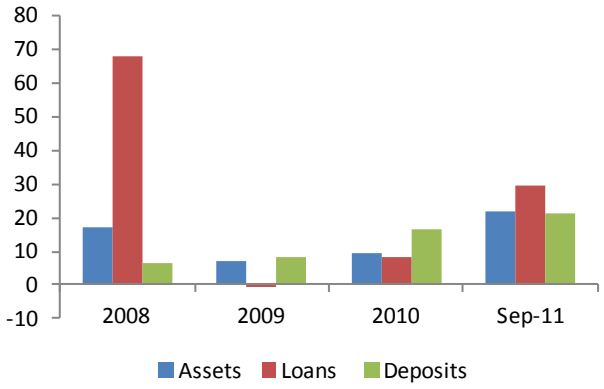
Source: FRC

SCCs

37. **SCCs provide primarily savings and loan services to low-income and rural households.** The sector came under regulation of the FRC in 2006 after an industry crisis and the failure of several SCCs. The FRC introduced licensing requirements and formal regulation that sharply reduced the number of operating SCCs in the market. SCCs may accept deposits and provide loans only to their members.[22] Of the 170 licensed SCCs, almost two-thirds are located outside Ulaanbaatar. Sixty of the SCCs have been established through a franchise, including through start-up loans from Xac Bank, which cover SCC operating expenses in the initial period of operations.

38. **Lending by SCCs has more than doubled from 2007 to 2011.** Total assets of SCCs stood at about MNT 59 billion (US$44 mln) at end-September 2011. Loans have increased from MNT 19 billion (US$14 mln) in 2007 to MNT 45 billion (US$33 mln) in 2011 (Figure 12). The three largest SCCs (Nomin Union, Monkord, and Cidan) account for over 60 percent of total assets. SCCs' funding comes primarily from deposits, as well as own capital and bank loans. NPLs amounted to 9 percent of total loans at end-September 2011.

Figure 12. SCCs: Assets, Loans, Deposit Growth (yoy)



Source: FRC

39. **SCCs attract new customers and grow their portfolios, even as their lending rates of 3 to 3.5 percent per month are triple the rates quoted by banks**. SCCs offer short-term loans, (typically up to 1 year), including loans for small manufacturing, consumption, student tuition, and car purchase. SCCs indicate that borrowers are attracted despite higher borrowing costs for several reasons: speedy lending processes, acceptance of borrowers with no prior credit history, access to very small loans (as small as MNT 100,000-500,000 or US$75-$375, for example), and flexible lending terms, including 1-year extensions of loan repayment for good customers. The average size of loans for one of the biggest SCCs, Monkord, is MNT 6 mln (US$5,000).

[22] Up to 10 percent of their members can be enterprises.

V. MSME FINANCE MARKET

A. Firms' Demand for Financial Services

40. **MSMEs make up 98 percent of all enterprises in Mongolia (three-quarters of which are microenterprises).** The SME Law[23] adopted in 2007 provided for the first time a definition of SMEs.[24] MSMEs contribute 25 percent of GDP[25], 12 percent of all exports, 37 percent of sales, and employ 52 percent of the workforce. About 80 percent are microenterprises. The number of SMEs has grown since 2008 by 24 percent and the number of microenterprises by a modest 8 percent; there were over 14,000 SMEs and about 51,000 microenterprises in Mongolia at end-2011 (Table 5).

Table 5. Contribution of SMEs to Sales, Export, and Employment, 2010

Firms	Companies		Sales		Export		Employment	
	Number	%	Amount in Mln.tog	%	Amount in Mln.$	%	000's people	%
Micro	60,317	82	2,226,400	12	370	13	88	18
Small	5,772	8	876,372	5	22	1	37	8
Medium	6,384	9	3,908,848	20	218	8	126	26
Large	1,349	2	12,277,562	64	2,137	78	231	48
Total	**73,822**	**100**	**19,289,181**	**100**	**2,748**	**100**	**482**	**100**

Source: National Statistics Office

41. **MSMEs constitute almost half of total enterprise output, focused on trade (23 percent), manufacturing (19 percent), or transportation and storage (16 percent).**[26] Nearly 11 percent of MSME sector output is in mining and quarrying, and another 11 percent is in construction. These are also areas where overall output has grown substantially in recent years (Figure 13). About a third of total output is SME output and 16 percent is microenterprise output. MSMEs are concentrated in Ulaanbataar, where about 70 percent of all MSMEs are located.

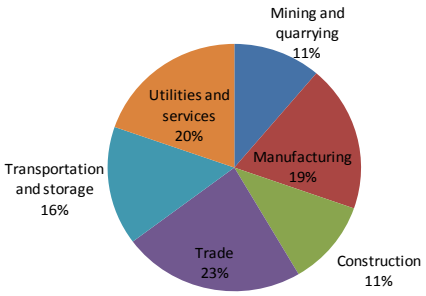
[23] The Law provides for the government to provide financial assistance to SMEs in terms of soft loans, loan guarantees, insurance schemes and preferential tax treatment.

[24] SMEs are defined as any legal entity or natural person which has: (a) for manufacturing industries, equal to/less than 190 employees and annual sales of up to MNT 1.5 billion; (b) for wholesale trade, equal to/less than 149 employees and annual sales of up to MNT 1.5 billion; (c) for retail trade, equal to/less than 199 employees and annual sales of up to MNT 1.5 billion; (d) for services, equal to/less than 49 employees and annual sales of up to MNT 1 billion; (e) for micro businesses, equal to/less than 19 employees and annual sales of up to MNT 250 million. **Note that according to World Bank 2009 Enterprise Survey, more than 90 percent of Mongolian firms are formally registered when they start operations.

[25] SMEs contribute 17 percent of GDP, and microenterprises contribute 8 percent of GDP.

[26] Agriculture constitutes about 12 percent of total output; data for agriculture is not reported by enterprise size.

Figure 13. Share of Sectoral Output in Total MSME Output, 2010



Source: BOM

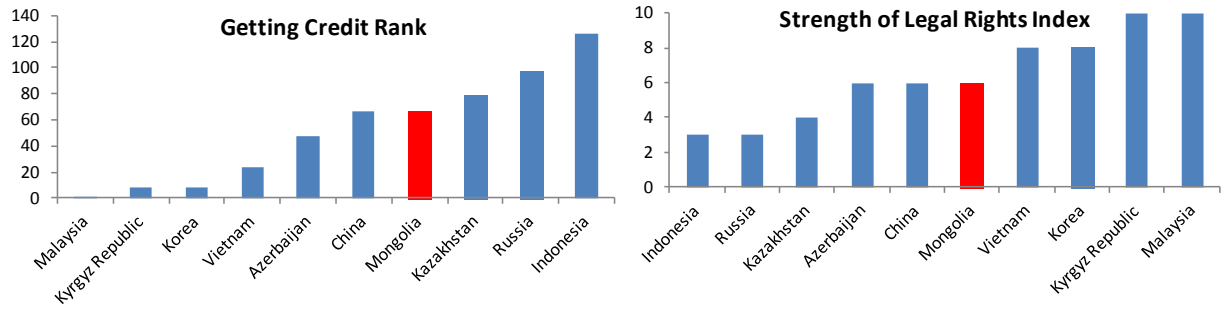
42. **The business environment in Mongolia was ranked 86th by Doing Business 2012, out of 183 economies.** Mongolia ranks high on registering property and protecting investors, but lags behind on other indicators, such as trading across borders (159th), dealing with construction permits (119th), or resolving insolvency (124th). On the Getting Credit indicator[27], Mongolia was ranked 67th, which is up from a rank of 75 in the DB 2011 (Table 6). The Strength of the Legal Rights Index, which measures the level of protection of the rights of borrowers and creditors as measured by laws and regulations, is 6 out of 10 (compared to 3 in Russia, 4 in Kazakhstan, 6 in China, or in Korea). The Credit Information Index is 4 out of 6 and has improved recently, as the threshold on minimum loan size to be included in the public registry database was eliminated. The public credit registry covers more than half of the population.

Table 6. Doing Business Getting Credit Indicator

Getting Credit Indicator	Doing Business 2011	Doing Business 2012	East Asia & Pacific
Rank	75	67	
Strength of Legal Rights Index (0-10)	6	6	7
Depth of Credit Information Index (0-6)	3	4	2
Public Registry Coverage (% of adults)	19.2	51.4	10.3
Private Bureau Coverage (% of adults)	0	0	18.1

[27] The Getting Credit indicator measures the sharing of credit information and the legal rights of borrowers and lenders.

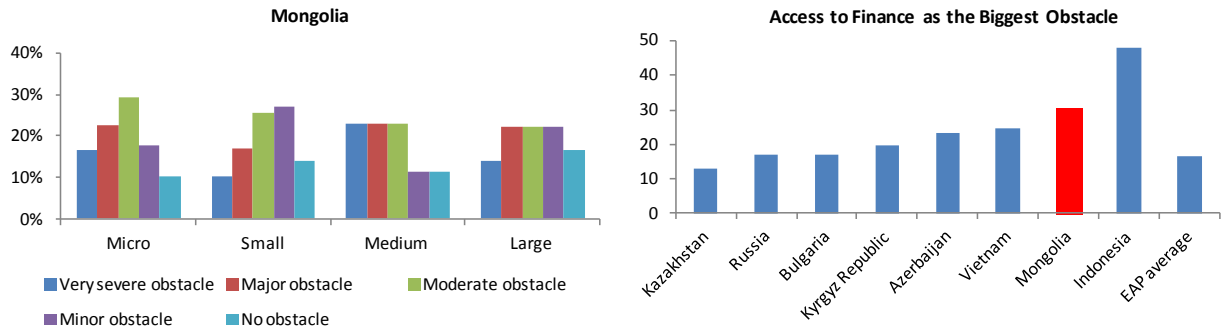
Figure 14. Selected Countries: Doing Business Getting Credit Indicator, 2012



Source: Doing Business 2012

43. **Access to finance is the top constraint amongst the top 10 constraints that firms face.** The World Bank's Enterprise Survey[28] shows that access to finance is the most important constraint amongst the top 10 constraints that firms face, such as electricity, corruption, tax rate, access to land, etc.[29] More than 30 percent of firms in Mongolia perceive access to finance as the biggest problem to their operations, higher than the average of 16 percent in the EAP region, and higher than in other countries, such as in Russia, Vietnam, Azerbaijan, and Kazakhstan. As Figure 15 suggests, MSMEs perceive access to finance as a significant obstacle (very severe, moderate, and major obstacle). In 2009, 68 percent of micro firms, 53 percent of small firms, 69 percent of medium firms, and 58 percent of large firms perceived access to finance as a significant obstacle.

Figure 15. Access to Finance as an Obstacle to Firm Operations



Source: BEEPs, Enterprise Survey

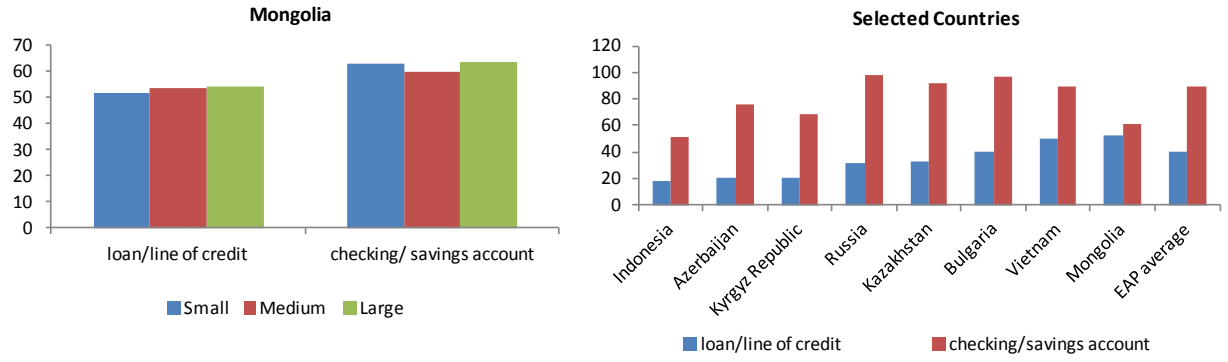
44. **About half of all firms in Mongolia have a loan or line of credit (higher than the average of 45 percent in EAP), and close to 60 percent have a checking or a savings account** (Figure 16). The Enterprise Survey does not show that SMEs have significantly less access to a

[28] http://www.enterprisesurveys.org/

[29] Following access to finance, the top three other obstacles were tax rates (16 percent of firms), inadequately educated workforce (10 percent), and practices of the informal sector (7 percent).

loan/line of credit or a checking/savings account than large enterprises.[30] However, SMEs have less favorable loan term and conditions, a limited range of financial instruments, and almost no equity financing.

Figure 16. Proportion of Firms with Finance Products



Source: Enterprise Survey

45. **A recent MSME survey by the BOM suggests that there are several factors that constrain MSMEs' access to financing.** According to the survey, about half of MSMEs were able to receive loans in 2011, the year of exceptionally high overall credit growth. From the MSMEs that received loans, 70 percent received bank loans, 11 percent had access to concessional loans, 8 percent received loans from friends, 4 percent from NBFIs, and 3 percent from suppliers. The survey also found that about 70 percent of MSMEs need further financing to expand their businesses. According to the survey[31], a large majority of MSMEs see the unfavorable macroeconomic environment with double-digit inflation and foreign exchange fluctuations as a major constraint to their operations and growth. The double-digit inflation increases the cost of funding, and volatility in the tughrik's value creates instability for SMEs, as imports and FX credit become more expensive when the tughrik suddenly depreciates. MSMEs report that the financing terms and conditions are not adequate for their operations, with the most important constraining factors being high interest rates, followed by short maturities of loans that are inadequate to meet investment needs, followed by small loan amounts, and mainly immoveable asset-based collateral requirements.

46. **MSME lending has grown in recent years, however banks confirm that there is a higher demand for credit than they can supply.** At end-2011, 19 percent of total bank lending was to entrepreneurs and SMEs. A World Bank 2008 study found that the share of SME lending in developing countries constitutes 16 percent of total lending, while in developed countries it amounts to 22 percent of total lending.[32] Bank credit to MSMEs has more than doubled from

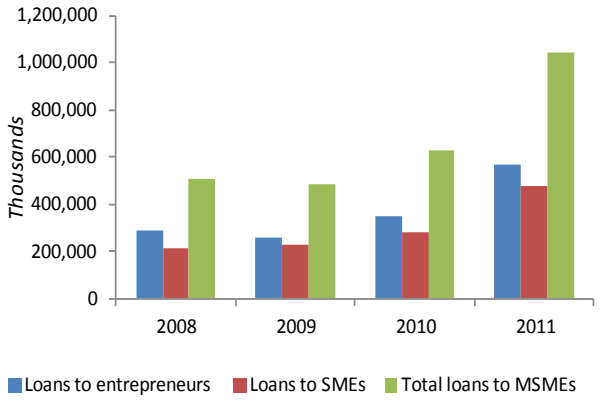
[30] For example, 52 percent of small firms have a loan or line of credit, compared to 54 percent of medium firms, and 55 percent of large firms. In terms of saving products, 63 percent of all firms have a checking or savings account, 63 percent of small firms, 60 percent of medium firms, and 64 percent of large firms.

[31] The survey covered 2200 SMEs, 46% of which were in Ulaanbaatar. 70% of the selected SMEs are micro-firms with 1-9 employees, 25% have 10-49 employees, and 5 percent have more than 50 employees.

[32] Beck, Demirguc-Kunt and Martinez Peria (2008), a survey of 91 large banks in 45 countries. The Financial Access 2010 survey got information from 50 countries on the volume of SME financing, and the statistics look

2008 to 2011, to about MNT 1 trillion (US$735 million) at end-2011 (Figure 17). In 2011, banks issued loans amounting to MNT 569 billion (US$406 mln) to over 53,000 entrepreneurs/microenterprises and about MNT 474 billion (US$339 mln) to 3,300 SMEs.

Figure 17. Mongolia, Bank Loans to MSMEs



Source: BOM

Table 7. Average Share of SME Loans in Total Loans

	Developed Countries		Developing Countries
Source	OECD (2010)[33]	World Bank (2008)[34]	World Bank (2008)
Number of countries	5	7	38
SME Loans/Total Loans	26.8	22.1	16.2

47. **Banks are cautious to lend to MSMEs, because they are considered unbankable due to weak management skills and poor financial reporting.** Most MSMEs do not have the capacity to follow International Financial Reporting Standards (IFRS), and the accounts are not externally audited by reputable auditors. These firms generally have low levels of technical and managerial skills, obsolete technology, and low awareness of financial products. While larger banks have the technical knowledge to analyze corporate clients' financial condition and cash flows, they do not typically do so for MSME clients due to small loan size and lack of reliable financial information.

similar; SME loans account for 19 percent of total lending volume in developed countries, and 15 percent in developing countries.

[33] Canada, France, Korea, Sweden, and the US.

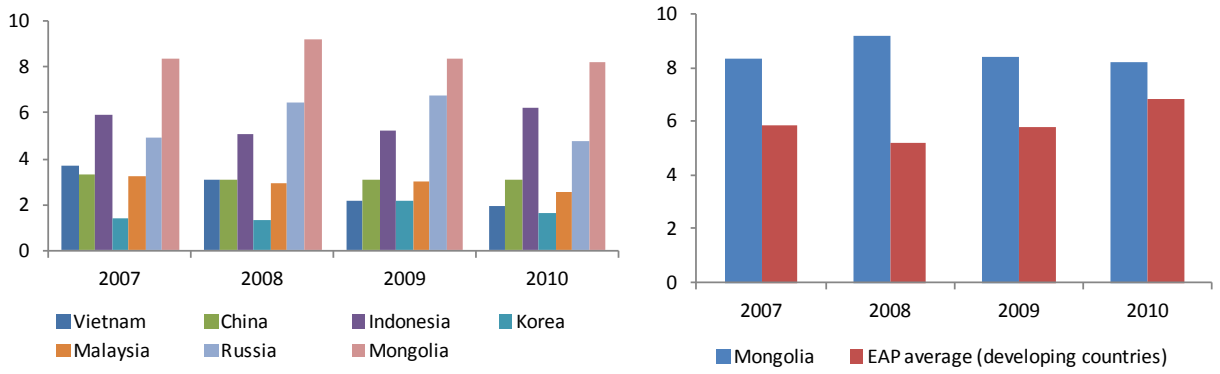
[34] Beck, Demirguc-Kunt, and Martinez Peria (2008).

B. Less Favorable Financing Conditions

48. **MSMEs' access to finance is constrained by less favorable loan terms and conditions.** Banks have significant funding constraints in providing long-term finance to SMEs due to the shortage of longer-term funding sources, resulting in unfavorable loan terms and conditions.[35] The most constraining factors for SME financing in Mongolia are: (i) high interest rates, (ii) short loan maturities, (iii) relatively small loan sizes, and (iv) collateral requirements based primarily on immoveable assets.

49. **Lending rates and spreads in Mongolia are relatively high compared to other countries, and can be higher for MSMEs.** In an environment of high inflation and continuing inflationary pressures, interest rates in Mongolia remain high. At end-April 2012, inflation increased to 17.8 percent from 11.1 percent at end-2011. Lending interest rates also increased. Average nominal lending rates stood at about 15.4 percent (about 18.4 percent for domestic currency loans and 12.4 percent for foreign currency loans) showing an increase compared to the average lending rate of 13.8 percent in 2011, and interest spreads at about 7.1 percent (increasing from 6 percent at end-2011).

Figure 18. Interest Spreads in Mongolia and Other Countries, 2007-2010



Source: World Development Indicators

50. **Loans have short maturities, because banks face chronic constraints in providing longer-term finance due to the short maturity structure of their deposits and the shortage of other funding sources with longer maturities.** Thus, loans are mostly for working capital financing, with maturities of up to 2 years. The largest banks report that maturities for SME loans are mostly between 1-3 years, which is inadequate to meet SMEs' investment needs. Depending on the bank, about 30-50 percent of SME loans have maturities of less than 1 year. In addition, another 30-40 percent have maturities of 1-3 years. Banks rely primarily on deposits, (constituting more than 80 percent of non-equity liabilities), a large percentage of which is with short-term maturities (more than half of deposits are demand deposits). The use of short-term deposits for longer-term loans results in maturity mismatches, which are strictly limited by

[35] Developing the capital market would help financial institutions and businesses alike obtain longer-term funding sources. However, currently the capital market in Mongolia is undeveloped.

prudential regulations. Consequently, banks' deposits are used mostly to finance short-term loans. With limited borrowing options in the local market and little or no access to foreign markets, banks have relied on their own capital, and funding from international financial institutions (IFIs) and bilateral donors and, more recently, on special programs financed from the state budget. Banks report that they can finance loans longer than 3 years only with funding from IFIs, or the government.

51. **Loan sizes for SMEs are relatively small.** For small enterprises, loan sizes range between US$600,000 - US$700,000. For medium firms, loan sizes range between US$700,000 - US$ 2 million. On average, the largest banks report SME loan sizes in the amount of US$ 50,000 - US$200,000. For microloans, the average loan size is between US$1,000 - US$1,500.

52. **Banks rely primarily on collateral-based lending.** Most bank lending is secured by real estate collateral. Banks report that 70-80 percent of loan value is secured by immoveable assets, although for an SME typically the entire loan needs to be secured by immoveable assets. On average, the value of collateral needed for an SME loan is about 190 percent of the loan amount. Although moveable assets (such as accounts receivables, inventory, vehicles, equipment) can in principle be accepted as collateral, banks are reluctant to accept them, because there is no effective registration and enforcement mechanism for security interests over moveable assets.

53. **Larger banks have started to use more sophisticated credit risk appraisal techniques.** Credit appraisal based on credit scoring models is not commonly used yet, as the information about credit history and statistical information necessary for scoring models has not been available until the recent expansion in coverage by the BOM's credit registry. However, larger banks analyze SMEs' cash flows and have started to develop internal credit scoring models.

C. Khan Bank and Xac Bank – Leaders in Micro and SME Finance

54. **Khan Bank and Xac Bank are the primary providers of micro and SME finance in Mongolia.** Khan Bank and Xac Bank account for about 38 percent of total lending to MSMEs.[36] Historically, these two banks have had a substantial engagement in microfinance, but more recently are scaling up and targeting the growing SME market. Both banks have introduced innovations to address the needs of microenterprises and low income households. Taking into account the very low population density in the country, and poor physical infrastructure, their achievements have been impressive and are known in the world as "best practice" examples. The success of these banks lies in responsible corporate governance, usage of ICT and innovative technologies, introducing new products, and building partnerships with the government, international organizations, and others.

55. **Khan Bank (formerly the Agricultural Bank of Mongolia) has become Mongolia's leading bank with the most developed rural branch network in the country.**[37] After being placed under receivership in 2000, Khan Bank was recapitalized and put under a restructuring plan. The government hired Development Alternatives International (DAI) to restore financial

[36] Khan Bank MSME lending accounts for 15 percent of total MSME lending, and Xac Bank's for 23 percent.

[37] Savings Bank also has an extensive branch network, consisting of 495 branches.

soundness to the bank. The bank was privatized in 2003, and DAI retained its management functions. Since the new management was put in place, Khan Bank has become the leading bank with the most extensive branch network (with 500 branches, over 400 of which are in rural areas). The bank offers a large array of financial products. Loan products range from express micro-loans, SME loans, crop and herder loans, pension loans, consumer loans, and larger corporate loans. About 38 percent of its loan portfolio consists of business loans (MSME loans consist of 11 percent of total loans). The average loan size is about US$3,500.

56. **Xac Bank has historically focused on microfinance, but it's shifting its focus to serving SMEs.** Xac Bank was established in 2001 through the merger of then the two largest nonbank financial institutions. Xac Bank contributed to the extensive growth of the microfinance sector in Mongolia, and has become known as an example of a best practice microfinance bank. Xac Bank provides microloans (primarily for micro- and small businesses engaged in trading, production and services), consumption loans, SME loans, mortgage loans, agricultural loans, leasing, and wholesale loans to SCCs to provide them with funding to serve rural areas. Its loan book consists predominantly of SME loans and microfinance loans at about 44 percent of the loan portfolio, about 20 percent mortgages, and about 20 percent consumer loans. The rest includes leasing loans, some rural lending, and loans to SCCs. The average loan size is about US$ 4,000. Although rural clients comprise about half of Xac Bank's clients[38], this represents less than 10 percent of the rural population. Xac Bank is increasingly focusing on SMEs, although it still maintains its commitment to microfinance through its franchise system with SCCs.

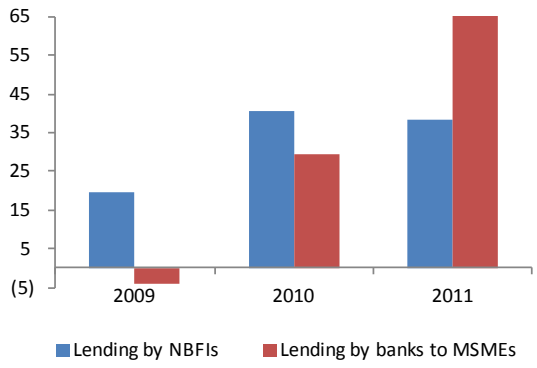
57. **As mentioned above, Xac Bank has developed an interesting approach to reach remote rural areas, the "franchise" service**. Through this innovation the bank provides funding and technical assistance to SCCs to help them become sustainable financial providers in remote rural areas. Using project funds from the Dutch donor agency (FMO), Xac Bank lends concessional rate loans (at around US$200,000 and at maturities of 7-8 years), and sometimes using SCCs' offices as collateral, it provides the initial capital for the establishment of SCCs. Xac Bank organizes local management, assists with the start-up of SCCs, builds their capacity, provides management training and oversight of business plans, basic office equipment, etc. Xac Bank has franchised over 70 SCCs as of 2011. The Xac Bank franchise model is a very useful innovation, which provides greater prospects for SCCs' growth. The initial funding of operating expenses and availability of technical assistance facilitates the start-up and increases the sustainability of the franchised SCCs. At the same time, it provides a learning process for SCC members and creates credit histories, which will facilitate future involvement with the banking sector.

[38] About 58 percent of its clients are women.

D. NBFI Lending to Micro and Small Enterprises

58. **Most SMEs obtain financing from bank loans, although NBFIs have a role to play in expanding access to finance to microenterprises, especially during economic downturns.** NBFIs lend a substantial portion (70-80 percent) of their portfolio to microenterprises. They provided about 6-8 percent of total MSME credit in 2011. Industry players and micro and small borrowers indicate that they often prefer the quick loan decision process and lighter informational and collateral requirements for obtaining loans through NBFIs. As Figure 19 suggests, during the economic downturn of 2009, while banks stopped lending to MSMEs (more than a 4 percent credit decline for MSMEs yoy), NBFIs continued to lend to their clients with a 20 percent credit growth in 2009 yoy.

Figure 19. Lending to MSMEs (yoy)



Source: BOM, FRC

VI. Obstacles in the Regulatory, Supervisory, and Financial Infrastructure for Access to Finance

A. Regulatory and Supervisory Framework for NBFIs and SCCs

59. **NBFIs and SCCs are licensed, regulated, and supervised by the FRC**. Since its establishment in 2006, the FRC's responsibilities have increased both in terms of new functions and in terms of increasing the number of financial intermediaries that are to be supervised. The new responsibilities have been added without a detailed analysis of whether the FRC has the technical capacity and staff to effectively perform the new and increasingly complex assignments.

60. **The legal framework for NBFIs and SCCs has been recently revised.** There is a draft NBFI Law and the SCC Law was adopted in November 2011. The SCC Law includes the following provisions: establishment of an SCC now requires 20 members, rather than 9, not more than 10 percent of members can be legal entities, services may expand beyond savings and loans to include financial leasing, limits on member contributions (no more than 10 percent of total capital of an SCC), specific skill requirements for board members, clarification of the role of audit and loan committees, etc. The law also calls for the establishment of a Stabilization Fund for the SCCs. This fund would provide financial assistance to stabilize SCCs in financial difficulties, and it is to be funded mainly by members.

61. **The current prudential requirements for NBFIs, which are non-deposit taking institutions, cover key risk concerns.** There are a number of prudential requirements for NBFIs capital adequacy, liquidity, concentration risk, exchange rate risk, trust services, fixed assets,

electronic payments and remittances.[39] These include, inter alia: the minimum capital adequacy ratio (CAR) is 20 percent (compared to a 12 percent CAR required for banks), liquid assets should constitute a minimum of 8 percent of total liabilities, loan and guarantees issued to a single borrower and related parties may not exceed 30 percent of capital, loans and guarantees issued to an inside party may not exceed 10 percent of capital and their aggregate sum may not exceed 25 percent of capital, liabilities on trust services shall not exceed 80 percent of capital. NBFIs are subject to the asset classification system and provisioning standards similar to those for banks.

62. **The supervision of NBFIs and SCCs remains relatively weak, as the capacity of the FRC to supervise these institutions is constrained by the limited number of experienced staff.** There are fewer than 20 supervisors responsible for off- and onsite supervision of over 350 NBFIs and SCCs. The off-site monitoring is based on quarterly or monthly data collected from NBFIs and SCCs. The FRC requires detailed financial reporting by NBFIs and SCCs. However, the quality of the off-site analysis does not seem to be adequate to provide a good basis for identifying potential problems and taking prompt corrective actions. For NBFIs, financial reports are mostly in paper form and have to be entered in the system by supervisors, exposing the process to errors. The FRC is just starting to use special software (FINA) for off-site analysis. NBFIs and SCCs are subject to onsite supervision to be conducted once every 2 years. Given the limited number of supervisors for more than 350 NBFIs and SCCs and their lack of experience, the quality of onsite supervision does not seem to be adequate.

B. Consumer Protection and Financial Literacy

63. **Consumer protection and financial literacy are critical to ensuring confidence in the financial system and increasing financial inclusion.** The global financial crisis emphasized the need for adequate consumer protection and financial literacy for the stability of the financial system. Consumer protection ensures that consumers can make informed decisions, are not subject to deceptive practices, have access to redress mechanisms to resolve disputes, and can maintain privacy of their personal information. Financial literacy initiatives give consumers the knowledge to understand the information they receive, and evaluate the risks and rewards of financial products.

64. **Given the rapid pace of the development of the financial sector in Mongolia, and technological innovations that create new risks for consumers, consumer protection and financial literacy initiatives become particularly important.** For example, it appears to be a common practice in Mongolia to quote interest rates on a monthly basis. Financial institutions do not use an annual percentage rate (APR) for quoting the cost of borrowing, and borrowers may not be aware of the actual cost of compounding interest. Financial institutions should be required to clearly state an “effective interest rate” for all loan products, and publish this information on their websites. There are no redress mechanisms for financial consumers. Large banks have set

[39] NBFIs are required to submit reports on a monthly or quarterly basis about: capital adequacy, liquidity, 20 customers with the largest outstanding balance of loans or guarantees, loans issued to insiders, provisions, securities concentration, off-balance sheet obligations, exchange rate risk, trust services payables to share capital, trust services concentration, fixed assets to total assets, and electronic payments and remittances.

up internal complaint mechanisms to address consumer complaints, but there is no independent financial ombudsman scheme.

65. **There is a general Consumer Protection Law in Mongolia, but no specific financial consumer protection law.** There are, however, some provisions with regard to financial consumer protection in the Law on Deposits, Loans, and Banking Transactions and the Banking Law. For example, the Law on Deposits, Loans, and Banking Transactions requires lenders to publicly disclose terms and conditions of loans, and states that the BOM shall determine methods for the calculation of loan interest. In addition, the Banking Law states that banks shall provide customers with true and fair information in accordance with the principles and standards set by the BOM. The Banking Law also requires banks to publish names of shareholders and management, quarterly financial reports, and related party exposures on their websites. The State Monetary Policy Guidelines adopted in 2011 include the objective to "ensure transparent operations, enhance supervision, improve governance, and strengthen financial responsibility of banks." In line with this objective, the BOM and the Banking Association will undertake an examination of banks' lending practices in 2012.

66. **The institutional framework for financial consumer protection is not clear.** There is no consumer protection agency in Mongolia. There is a general Unfair Competition Regulatory Authority with the mandate to enforce competition legislation and promote fair competition in the market. According to the State Monetary Policy Guidelines of 2012, the BOM and the FRC should work on strengthening the transparency and responsibility of banks and other lending institutions. International experience shows that a strong regulatory and institutional framework is needed to regulate and supervise financial market conduct.

C. Secured Transactions, Creditor Rights, and Insolvency Framework

67. **Access to credit in Mongolia is adversely affected by a number of problems in the legal framework**.[40] In particular, there are important issues in the design and functioning of secured transactions, in the enforcement of claims, and in the judicial and administrative institutions supporting the insolvency regime.

Secured Transactions

68. **A modern secured transactions framework allows lenders to conveniently and efficiently use moveable assets as security for lending.** The essential elements of a good secured transactions framework include: (i) a wide scope of moveable assets that can be taken as security; (ii) clear priority rules over competing interests; (iii) a central electronic security interest registration system; and (iv) effective and low-cost enforcement of security interests. Since SMEs usually have a wider range of moveable assets and limited immoveable assets, an effective secured transactions regime would facilitate lending to them. An improved secured transactions framework would also encourage the development of factoring and leasing.

[40] More detailed analysis will be provided in the Insolvency and Creditor Rights ROSC report, currently being finalized by the World Bank.

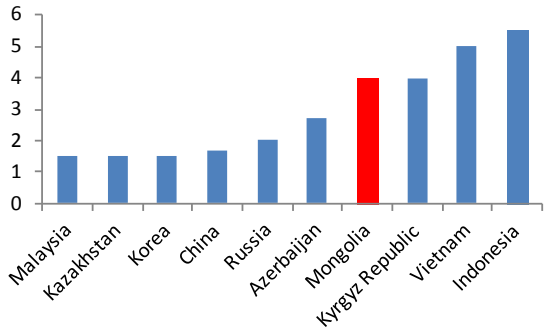
69. **In Mongolia, a Pledge Law has not yet been approved, there is no centralized moveable assets registry, and awareness about the importance of a solid secured transactions regime to promote access to credit is limited.** The State Registry operates as the registry for security interests over immoveable as well as moveable assets. Registration of security over immoveable assets is compulsory, and it seems relatively efficient, although records have not been computerized yet. The registration of pledges over moveable property in Mongolia is optional, and is not standard practice. There are specialized registration entities for vehicles, listed shares, intellectual property and mining licenses; however, there is no single collateral registry.

Enforcement of Creditor Rights and Insolvency Regime

70. **A reliable legal system and judiciary is necessary for lenders to enforce contracts**. Effective frameworks for creditor rights and insolvency systems can foster greater access to credit at more affordable prices. Inefficient legal processes, slow court proceedings, and unpredictable court rulings increase the risk for lenders and make the enforcement process time-consuming and expensive. Similarly, inadequate creditor rights can diminish the incentives for borrowers to meet their financial obligations. In turn, these factors usually translate into market inefficiencies, with less financial intermediation taking place and higher cost of financing for borrowers. The existence of an adequate insolvency framework is an essential element of a creditor rights regime.

71. **Mongolia ranks 124th in the ranking of 183 economies on the ease of resolving insolvency, behind most comparator countries.** Resolving insolvency takes 4 years on average (Figure 20), higher than in many peer countries, and costs 8 percent of the debtor's estate. The average recovery rate is 21 cents on the dollar, compared to more than 40 percent in Kazakhstan or Russia.

Figure 20. Time to resolve insolvency (years)



Source: Doing Business 2012

72. **Enforcement of creditor rights presents important challenges in the Mongolian legal environment.** Enforcement of claims in Mongolia involves a complicated and unpredictable process. Enforcement of court decisions is more difficult than obtaining the judgment itself. Credit institutions try to reach restructuring agreements with debtors and resort to the process as their last option. The enforcement of claims is severely affected by debtors' delaying tactics, notably in connection with valuation and auction processes. There are also significant problems in the operation of the Bailiff's Office. In addition, there are rules for the enforcement of claims over immoveable assets which produce undesirable results. The rules for valuation of immoveable assets and the challenges to valuation complicate the process. Finally, irregularities at auctions have been reported.

73. **The Mongolian legislative framework does not significantly facilitate or encourage enterprise workouts or restructurings.** The law does not possess any mechanisms to encourage lending to or investment in viable distressed enterprises. Nor does it appear to provide favorable tax treatment with respect to losses or write-offs. There are no guidelines for negotiation of restructuring agreements for financial institutions, and the insolvency regime lacks an instrument whereby informal agreements can be easily converted into binding insolvency plans.

74. **The bankruptcy legislation has not provided an adequate response for the problems of business insolvency.** Bankruptcy procedures are hardly ever used, since debtors usually have no incentive to seek bankruptcy protection, and since secured creditors in particular stand to lose significantly from the initiation of the process. Virtually all procedures are liquidations, rather than reorganizations.[41] The Bankruptcy Act (enacted in 1997) suffers from a series of technical deficiencies.[42] The authorities have been working on draft amendments to the Bankruptcy Law.

75. **In particular, the reorganization process has failed in achieving the objective of preserving the value of distressed businesses.** The regulation of reorganization proceedings is deficient and there is virtually no practice of reorganizing distressed but viable enterprises. While there is adequate guidance in the bankruptcy law for the formulation of a reorganization plan, the law suffers from serious deficiencies in other aspects. In particular, the problems in the regulation of executory contracts and the lack of post-petition finance greatly reduce the likelihood of a successful enterprise rescue. A major issue in the reorganization procedure is the approval of the reorganization plan. The criteria for forming classes of creditors do not seem adequate, and the treatment of secured creditors is clearly disadvantageous. In fact, secured creditors can be deprived of their priority status without their consent and without having recourse to fundamental protection mechanisms.

76. **It is also unclear in the legal framework whether non-corporate SMEs are subject to the Bankruptcy Law.** The statement of the purpose of the Law and the definition of debtor do not seem to take into account that natural persons may also undertake business activities, and most of the provisions in the Law assume that the debtor is always a legal person. In an environment with no framework for SME insolvency, SMEs that are viable but have liquidity problems have no possibility of recovery, they cannot seek temporary protection from creditors, cannot be reorganized, cannot be liquidated in an efficient manner, and the owners cannot be discharged from the SME's debt. The absence of a framework for SME insolvency can limit

[41] Most of the bankruptcy cases are 'no-asset' cases, yielding no returns for creditors and not even covering the costs of the procedure.

[42] Some of the most notable shortcomings of the law include: (i) the criteria for the opening of the bankruptcy process are cumbersome and inadequate; (ii) the law does not protect effectively the assets comprising the estate; (iii) the law does not contemplate the continuation of the business in the bankruptcy process, and renders difficult the liquidation of the debtor's business as a going concern; (iv) the treatment of executory contracts is incomplete; (v) avoidance actions do not include all the necessary elements and do not deter debtors from engaging in fraudulent transactions prior to an insolvency process; (vi) secured creditors are negatively affected by the opening of a bankruptcy process, as secured creditors are affected by a stay of creditor actions, without adequate protection; (vii) the process itself is slow and cumbersome, without a correct allocation of administrative responsibilities to the insolvency administrator.

entrepreneurship, entry of SMEs in the market, and the ability of the creditor to be repaid. Legislation on personal/SME insolvency should provide for a clear process by which entrepreneurs can seek to rescue their troubled businesses; a clear method for liquidating the business should the business fail, repaying creditors in a timely manner, and discharging the remaining debts; clear protections for creditors and punishments for fraudulent behavior; and an equilibrium between debtor and creditor protection. Clear protection for creditors will help SMEs to continue accessing credit at favorable rates.

77. **The capacity of courts to effectively handle commercial cases seems to be another major bottleneck.** There is currently no judicial specialization in commercial cases. The high case-load of judges indicates that there is insufficient judicial capacity. The burden appears to be particularly high on the judges who have jurisdiction over the district where the Bailiff's Office is located, the Bailiff being the defendant in the numerous proceedings against the enforcement and valuation process. In addition, there appears to be no current practice of active standard-setting for, or regulation or supervision of, insolvency representatives. The present legal requirements for qualification of insolvency representatives are lax, and do not include the knowledge and skills necessary to deal with bankruptcy cases.

D. Credit Information System

78. **The credit registry at the BOM has broadened its database on credit information and improved data collection and reporting.** The registry currently collects information on 1 million individuals and 10,000 legal entities, which reportedly covers all Mongolian borrowers. The most important developments in the last two years include: (i) credit information is now more comprehensive as it is collected from all banks and from over 30 NBFIs; (ii) the prior limit on the minimum loan amount size of MNT 1 million (US$734) to be reported has been abolished, so credit information is collected on all loans; (iii) credit information is collected and updated automatically at the time of creation or change due to updates in the software system; and (iv) reporting of desired credit information to participating members has been automated. The BOM currently provides an improved credit information service to banks and participating NBFIs, free of charge, and the quality of data is deemed adequate by the market. The BOM registry plans to update its software and broaden the information collected to include state agencies (including the tax authority, the customs authority, and utility companies).

79. **A private credit information bureau (CIB) has been established by commercial banks but is not yet operational.** The private credit bureau is preparing to start operations and is addressing staffing and information technology-related requirements. According to the new Credit Information Law (enacted in December 2011), the private CIB will need to receive an operating license from the BOM. The private CIB will build a credit database with information reported by lending institutions (banks, NBFIs, and SCCs), and state agencies on a contractual basis, and will provide additional services like credit scoring and credit rating. The new law does not oblige lending institutions and state agencies to report to the private CIB, and the information will be included in the database only with borrowers' consent. At the same time, it is now mandatory for all lending institutions and state agencies to report to the BOM credit registry, without borrower consent. According to the new law, the BOM will share information in its public registry with private CIB based on regulations on exchange of information.

E. Electronic Payment Instruments

80. **The BOM plans to broaden the national platform for electronic payment by extending the infrastructure needed for the use of cards in smaller cities and rural areas, and it is introducing a national chip-based credit card.** About 80 percent of the e-payment infrastructure is located in Ulaanbaatar and large cities, as the banks are cost conscious and hesitant to install ATMs or support POS devices in smaller urban and rural areas. The BOM has also taken a lead to introduce a domestic chip-based card, which has broader coverage and is less expensive to use than foreign cards.

81. **The BOM has established a working group of various stakeholders to develop a Mobile Banking Policy and an E-Money Policy**. The main goals of the policies are: to define a development strategy and transaction rules; to achieve interoperability, including IT and system standards and integration into the national payments system; and to create a suitable regulatory and supervisory environment. The draft policies are expected to be approved soon. The BOM will be responsible for regulating and licensing banking services using mobile phones, internet and other mobile devices. The BOM and FRC will regulate e-money.

VII. Government Policies and Programs Related to Access to Finance

82. **Recognizing the importance of SMEs for employment and growth, especially in rural areas, the GoM is undertaking a number of measures to promote SME lending.** The main initiatives include providing concessional loans to SMEs through commercial banks and local authorities, and the establishment of the Credit Guarantee Fund (CGF). Through these initiatives and other policy efforts, the GoM aims to increase the number and productivity of SMEs, improve the sector's competitiveness, and promote business capability within the sector.

83. **The SME Credit Program is currently the largest government initiative, which channels subsidized, longer-term credit through banks to qualifying SMEs pre-screened by provincial councils.** The GoM has allocated from its budget MNT 360 billion (US$264 million) since the program's establishment 3 years ago.[43] The program is administered by the SME Fund[44] that lends to participating banks at 5-year maturities at a below-market rate of 7 percent annually for on-lending to SMEs. Although SME applicants are screened by provincial councils, banks may accept or reject the loan applications, and they must accept the credit risk. However, the reliance of the program on direct interest subsidization, the potential for a non-transparent selection of SMEs by provincial councils, and the distorting impact of limited concessional finance are reasons for concern about the sustainability and effectiveness of this program. Policymakers overseeing the program have indicated that the SME Fund provides for less than 6 percent of the market for SME finance, while accounting for about 3 percent of GDP in 2011.

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[43] SME funding origination from GoM budget included MNT 30 billion in 2009, MNT 30 billion additional funding in 2010, and MNT 300 billion in 2011. The MNT 300 billion funding approved in 2011, was targeted for cashmere producers (MNT100 billion), wool industry (MNT 30 billion), cashmere operators and herders (MNT 20 billion) and SME development in general (MNT 150 billion). In addition, the funding is provided by foreign donors (USD 58 million from Government of Japan to be disbursed over three-year period and USD 10 million by Government of Taiwan).

[44] SME Fund has been established in early 1990s and funded by USAID grant. Until 2006, it was the acting as a project management/implementation unit for a number of donor SME credit projects.

84. **A parallel initiative at the local (or *soum*) level is the Soum Funding Program**, which does not involve financial intermediaries, but simply directs MNT 24 billion (US$18 million) to the 329 village councils, that lend directly to SMEs with operational expenses borne by the government. These councils are not financial institutions, and their governance structures and capacity for credit risk appraisal are unclear.

85. **A Credit Guarantee Fund (CGF) is being established as a public-private partnership in the form of a limited liability credit insurance entity.** In 2010, the government started drafting the Law on Credit Guarantees, which was adopted in February 2012. The CGF was established in January 2011 under a GTZ-supported project as a limited liability company (but not a licensed insurer) with capital of MNT 1.3 billion (US$953,000), with the involvement of seven banks and support from the Chamber of Commerce and the Banking Association. The CGF expects to ramp up operations in 2012, following the enactment of the Law on Credit Guarantees, and to issue guarantees to banks and NBFIs for loans primarily to SME-manufacturers. The CGF currently plans to guarantee loans by banks and NBFIs to SME manufacturers in the amount of up to MNT 100 million (US$73,000) per borrower.

VIII. POLICY RECOMMENDATIONS

86. **Enhancing access to financial services will require improving the legal, regulatory and supervisory framework and the financial infrastructure.** The main areas of improvement in the legal, regulatory and supervisory framework include: (i) encouraging the entry of foreign banks to bring longer-term funding sources and improve competition; (ii) strengthening the legal framework for leasing and factoring; (iii) improving the regulation and supervision of NBFIs and SCCs and ensuring that it is proportional to the risks posed by them; and (iv) strengthening the institutional, legal, and regulatory framework for consumer protection and financial literacy. More efforts are also needed to improve the financial infrastructure, including: (i) the secured transactions, creditor rights and insolvency regime; (ii) credit reporting system; and (iiii) the electronic payments instruments infrastructure. In addition, it is important to ensure that effective government policies are put in place to support SME finance.

A. Legal, Regulatory, and Supervisory Framework

87. **The BOM might consider encouraging foreign bank entry in the market to bring longer-term funding sources and increase competition, which could in turn improve borrowers' financing terms.** Given the lack of long-term funding sources in the banking sector, encouraging the entry of foreign banks would bring longer-term and sustainable funding sources, more sophisticated credit risk appraisal and management techniques, and more developed financial products. Some empirical literature has shown that foreign bank entry can result in increased competition and lower lending rates.[45] Several studies have shown that uncompetitive banking markets are associated with less credit availability and higher price of credit.[46] Foreign

[45] Some studies indicate that competitive pressures caused by foreign entry have led to improvements in banking system efficiency (for example, Barajas, Steiner, and Salazar, 2000; Claessens and Glaessner, 1999; Claessens, Demirgüç-Kunt, and Huizinga, 2001; and Crystal, Dages, and Goldberg, 2001). Studies by Martinez Peria and Mody, 2004; Claeys and Hainz, 2007 have indicated that foreign bank entry can result in lower lending rates.

[46] Carbo- Valverde, Rodriguez-Fernandez, and Udell 2009; Mercieva, Schaeck, Wolfe (2009).

banks may have higher efficiencies when operating in other countries as they have superior managerial skills or best-practice policies, and thus lower costs. Further, foreign banks benefit from better access to international capital markets and funding from their parent companies. This diminishes their cost of funds, which in turn translates into lower lending rates. However, the literature shows that it is not always clear whether foreign banks will increase access to finance for SMEs, as they may favor the best borrowers and lend to larger, more transparent firms. [47] The BOM is advised to consider an adequate legal and regulatory framework that will promote competition by avoiding overly restrictive licensing requirements and allowing foreign banks to enter the market.

Legal Framework for Leasing and Factoring

88. **Leasing and factoring can be important sources of finance for SMEs, especially when there are weaknesses in the financial infrastructure, but they remain largely undeveloped in Mongolia.** Therefore, the authorities are advised to:

- **Provide further incentives to encourage the development of leasing.** For example, accelerated depreciation is not currently allowed in the Leasing Law; instead the straight-line depreciation method is maintained. Accelerated depreciation can be an effective incentive for investment in fixed assets, because it allows an increased portion to be written off against corporate income and thus further reduce the amount of tax payable. There is also a need for an awareness program on the benefits of leasing as a financial instrument, and TA should be provided to SMEs and financial institutions on the potential of this financial product.
- **Consider undertaking an assessment of the legal framework governing contracts between parties and assignment of receivables to ensure that the current framework for the development of factoring is adequate.** There is also a need to provide TA to SMEs to increase their understanding of factoring as a beneficial financial instrument for their working capital finance needs. TA would also be helpful for personnel of commercial banks to understand how factoring works.

Regulatory and Supervisory Framework for NBFIs and SCCs

89. **Given the limited capacity of the FRC to regulate and supervise NBFIs and SCCs as described in Section VI, the FRC is advised to:**

[47] Some studies argue that small and domestic private banks are more likely to finance SMEs, because they are better suited to engage in "relationship lending" (see Berger and others 2001; Mian 2006; Clarke and others, 2006, Gormley 2007b, Sengupta 2007). Also, studies such as Stein (2002), Mian (2006), Canales and Nanda (2008), and Liberti and Mian (2009) have argued that more centralized organizational structures in foreign banks can have a negative impact on lending to less transparent SMEs. However, more recent studies (see Berger and Udell 2006; Berger et al. 2007; and de la Torre et al. 2010) argue that large and foreign banks can be as effective as smaller domestic banks in SME lending through arms-length lending technologies (e.g., asset-based lending, factoring, leasing, fixed-asset lending, credit scoring, etc.) and centralized organizational structures, instead of relationship lending.

- **Undertake a detailed assessment of its functions and responsibilities,** including: (i) realignment of its organization with the broadened and newly-added functions; (ii) assessment of staffing needs; (iii) assessment of training needs and design of training programs in the country and abroad to improve the technical capacity of its staff; and (iv) improvement of its IT systems, databases, interconnectivity and software tools needed to effectively perform its functions.
- **The FRC is also advised to undertake an assessment of the regulatory framework for NBFIs in order to ensure that it is conducive to the further growth of the sector**, since NBFIs are not allowed to take deposits and have significant funding constraints.
- **Improve the quality of regulation and supervision and ensure that it is proportional to the risks posed by various types of NBFIs and SCCs**. Prudential supervision instills financial discipline. However, supervision should be proportional to the risks posed by these institutions. While the quality of supervision for larger NBFIs and SCCs needs improvement, smaller institutions may not need the same level of supervisory effort. In order to allocate its supervisory resources more efficiently, the FRC should consider categorizing NBFIs and SCCs into small, medium, or large, based on asset size, number of members, etc.

Consumer Protection in Financial Services and Financial Literacy

90. **Consumer protection and financial literacy are critical to ensuring confidence in the financial system and increasing financial inclusion**. Given the rapid pace of the development of the financial sector in Mongolia, and technological innovations that create new risks for consumers, consumer protection and financial literacy become particularly important. In order to strengthen the consumer protection and financial literacy framework, efforts are needed to:

- **Clearly define the institutional framework for financial consumer protection.** A strong and specific institutional framework is needed to conduct market conduct regulation and supervision. In some countries, financial supervisors may adopt consumer protection as part of their mandate. In other countries, economy-wide consumer protection agencies may take on financial services, however these agencies need to build the expertise to handle the technical issues related to financial services.
- **Improve the legal and regulatory framework for financial consumer protection in order to:** (i) protect against unfair or deceptive practices, (ii) improve transparency through disclosure and plain language requirements for products and pricing, in a way that allows consumers to easily compare offers of financial products; and (iii) establish an efficient and fair mechanism for resolving customer complaints and disputes.

B. Financial Infrastructure

Secured Transactions, Creditor Rights and Insolvency Regime

91. **The legal framework for secured transactions, creditor rights, and insolvency should provide for affordable, transparent and predictable mechanisms to enforce credit**

claims. Current weaknesses in the secured transactions, creditor rights and insolvency framework affect a number of important areas, from the regime for the creation of security interests over moveable assets, to difficulties in the enforcement of individual claims, to the insolvency regime, that remains largely deficient.

92. **A modern secured transaction regime would facilitate lending to MSMEs, as they have a wider range of moveable assets and more limited immoveable assets**. A collateral regime designed to facilitate increased access to finance for SMEs should include a wide range of allowable moveable assets, the establishment of clear priority schemes for creditors, clarification of the rights of secured creditors, an efficient collateral registry, effective enforcement of collateral in the case of default, and alternative debt resolution mechanisms.

93. **The secured transactions framework in Mongolia should improve through:**

- **Improvements in the legal and regulatory framework.** A law for security interests over moveable assets should be introduced covering the areas of creating a security interest, registering a security interest, priorities, enforcement, and debt resolution, including through insolvency of the debtor and the use of alternative dispute resolution mechanisms.[48] Regulations should also be developed for the more efficient functioning of the collateral registry.
- **Establishment of the moveable collateral registry**. A moveable collateral registry should be established, using an online system of registration for encumbrances over moveable assets, which is easy to access, reliable, and secure. To avoid redundancies and costs, this collateral registry should be linked to other asset-based registries, such as the registry for vehicles, etc.
- **Capacity building**. Training and awareness-building of stakeholders should be provided on compliance with new laws and regulations, and on the use of the new system, including on the use of the registry. Capacity building is important, because if creditors do not know how to evaluate and monitor moveable assets, if debtors are not aware of their obligations to care for the assets, and parties do not know how to use alternative methods of debt resolution to improve recovery, creditors will continue not to take moveable assets as collateral.

94. **Effective creditor rights and insolvency regimes are fundamental to sound financial intermediation and stability.** A reliable legal system and judiciary are necessary for lenders to enforce contracts and foreclose collateral on loans. Inefficient legal processes and court proceedings increase the risk for lenders and make the foreclosure processes time-consuming and expensive. Similarly, inadequate creditor rights can diminish the incentives for borrowers to meet their financial obligations. In turn, these factors translate into market inefficiencies, with

[48] Despite the strength of other parts of a secured transactions framework, if enforcement and debt resolution mechanisms are not efficient and reliable, creditors will face a greater risk of losing their interests upon a debtor's default, and will translate this increased risk into their pricing. It is important for the secured transactions law to maintain a balance between the debtor's rights to due process, and the ability of the creditor to enforce its interest efficiently upon a debtor's default. In addition, the soundness of the overall insolvency system, and the rights of secured creditors in the case of the insolvency of the debtor, should also be evaluated to ensure consistency with the secured transactions law.

less financial intermediation taking place and a higher cost of financing for borrowers. Stronger creditor rights help improve access to finance.[49]

95. **Given significant challenges in the enforcement of creditor rights and weaknesses in the insolvency regime in Mongolia, the following are some recommendations for the authorities' consideration:**

- **Complete reforms for the finalization of the enforcement regime, allowing for ample possibilities of out-of-court enforcement of security interests and a streamlined court enforcement regime.**
- **Amend the legal framework to improve the possibilities of informal restructuring of businesses.** Effective instruments for informal restructuring will be particularly useful in the event of another major economic downturn**.**
- **Complete the ongoing reform of the insolvency regime as soon as possible to bring the law of Mongolia in line with international standards, both for liquidation and reorganization procedures.** The new legislation should aim at a closer integration between the insolvency regime and the commercial and corporate laws. The technical problems of the liquidation and reorganization framework should be addressed by adhering to international standards. The insolvency framework should also allow for an easy and speedy transformation of an informal restructuring agreement into an insolvency plan.
- **Introduce clarity and extend the scope of the bankruptcy regime to non-corporate SMEs.** In specifying that the bankruptcy regime also extends to SMEs, the bankruptcy regime protects the interests of creditors, and can provide SMEs with opportunities to recover their business if viable, or liquidate it and be discharged of debts.
- **Improve judicial capacity to handle insolvency procedures and complex commercial cases, including the potential creation of specialized commercial courts.** The judges need more training in order to be able to deal with complex insolvency questions. In addition, the reinforcement of bankruptcy professionals is an important step towards a more efficient regime for business insolvency.

Credit Information System

96. **The credit information system in Mongolia is nascent**. The efforts of the BOM have helped improve the operations of the public credit registry. The public registry has broadened its database on credit information and improved data collection and reporting, and it now covers all borrowers. A Credit Information Law was passed at end-2011. A private credit bureau has been established by commercial banks but is not yet operational. Therefore, regulations need to be developed that guide the operations of private credit bureaus, including on rights of data subjects, dispute resolution mechanisms, etc. The further development of credit bureau information will

[49] Countries with stronger creditor rights tend to have higher rates of private credit to GDP. See Djankov, McLiesh and Shleifer (2007), Chong, Galindo, and Micco (2004).

also facilitate the adoption of lending technologies based on credit scoring models. More specifically:

- **The BOM is advised to promptly issue implementing regulations prescribed in the Credit Information Law to put in place a balanced framework for the operation of the entire credit information system, including the private credit bureau.** In particular, the regulations should specify: (i) detailed requirements for collecting credit information and using, storing, protecting and transferring it, as well as setting the service fees; (ii) a code of ethics, with principles and responsibilities for internal and external operations of the entity; (iii) rules for refusal, suspension and termination of CIB license; and (iv) the process of reorganization or liquidation. It is essential that the BOM puts in place a reasonable framework for the exchange of information between the BOM registry and the licensed credit bureau. The private CIB is expected to be motivated to meet higher service standards and provide a broader range of credit-related information and services, including information needed for scoring models to facilitate appraisal of credit risk.
- **The BOM's supervisory process for the private CIB needs to be further developed.** It is important to ensure that the supervisory arrangement put in place by the BOM clearly separates the function of the BOM as a provider of credit information through its registry and from its function as a supervisor of private credit information bureaus.
- **The legal and regulatory framework should be further developed to protect the rights of the data subjects to correct information, and it should establish an effective dispute resolution mechanism.** The current Credit Information Law does not put in place a procedure for resolving data inaccuracies and handling complaints.
- **The BOM and/or the Banking Association might consider launching a training program for clients to improve their understanding of credit information sharing, and to increase awareness of the new law and regulations.**

Electronic Payments Instruments

97. **The further growth of mobile banking should be encouraged with the establishment of a national platform for internet and mobile phone banking services.** The BOM has taken an active role to encourage the use of new technologies, such as mobile banking, which provides an opportunity to increase penetration in rural areas. Both mobile and internet banking are growing fast, and mobile banking is growing especially fast, given the rapid increase in mobile phone users. Mobile phone banking is supported by four operators, and banks are effectively limited to contacts with clients served by one operator. The BOM is encouraged to take the lead in establishing a national platform that will introduce better standards and reduced costs, as well as improved customer security. The national platform should also allow entrance of qualified non-bank institutions.

C. Government Programs to Support SMEs

98. **Government support programs for SMEs have recently expanded, but they can introduce distortions in the market and face sustainability issues**. Authorities are advised to consider the following recommendations:

- **Develop a medium-term strategy for SME development, including SME finance.** Given the considerable public expenditure on the promotion of the SME sector, the SME strategy should be a matter of high priority. The SME strategy should make clear the fiscal implications, involve evaluation of the impact and cost effectiveness of prior programs, and promote—rather than replace—innovative market mechanisms for credit risk assessment and credit allocation.
- **Consider less costly, market-based mechanisms, that may involve risk-sharing with financial institutions, and which promote efficient credit allocation.** While subsidized initiatives represent an effort to correct market failures in the provision of finance to SMEs, they potentially introduce major distortions in the market and face sustainability issues. The government needs to measure the SME financing gap and carefully design and evaluate all public programs in order to accurately measure their effectiveness in terms of outreach, additionality, and sustainability.
- **Establish a regulatory framework that ensures that the CGF is sound and offers additionality**, **and that it has adequate institutional capacity.** Important principles need to be defined, including adequate initial capitalization, careful definition of target beneficiaries, narrow definition of the range of products and maximum limit, partial (for example 50 percent) coverage by the government, and strong credit risk management by participating financial institutions. In addition, it is important to ensure that the CGF has adequate institutional capacity, governance, and management to oversee the scheme.
- **Provide training to SMEs on technology improvement, basic organizational and management skills, financial reporting, and financial products via the Banking Association, the business association, or NGOs**. Donor programs could support training for SMEs.