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

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Literature review

Definition of SME

- The term SME covers a wide range of definitions and measures, varying from country to country and between the sources reporting SME statistics.
- No universally agreed definition of SME.
- Some of the commonly used criteria are the number of employees, value of assets, value of sales and size of capital.
- The most common definitional basis used is employees because of the comparatively ease of collecting this information, and here again there is variation in defining the upper and lower size limit of an SME.
- Despite this variance, a large number of sources define an SME to have a cut-off range of 0-250 employees. (Meghana Ayyagari, Thorsten Beck and Asli Demirgüç-Kunt, "Small and Medium Enterprises across the Globe: A New Database", August 2003)

Definition of SME

- In the United States and Canada, SME generally include firms with less than 500 employees.
- The EU defines a medium-sized enterprise as one with 250 employees, a small enterprises as one with less than 50 and a microenterprise as one with a maximum of 10 employees. At the same time, to qualify as an SME in the EU, a firm must have an annual turnover of Euro 40 million or less and/or a balance sheet valuation not exceeding Euro 27 million.
- In case of Japan SME is defined as a firm with employees of 300 or less and capital size of 300 million yen or less in manufacturing, a firm with employees of 100 or less and capital size of 100 million yen or less in wholesale, and a firm with employees of 50-100 or less and capital size of 50 million yen in retail and service sector.
- In developing countries, number of employees and size of asset or turnover for SME tend to be smaller compared with its counterparts in developed countries. For example, in Mongolia, SME are defined as legally registered business entities with employees of 199 or less and with an annual turnover of up to 1.5 billion togrog (approximately 1.3 million US$ equivalent) or less respectively.
- As comparative study purpose, currently the SME Department of the World Bank works with the following definitions: microenterprise up to 10 employees, total assets of up to $10,000 and total annual sales of up to $100,000; small enterprise up to 50 employees, total assets and total sales of up to $3 million; medium enterprise up to 300 employees, total assets and total sales of up to $15 million

Importance of SME in Socio-Economic Development

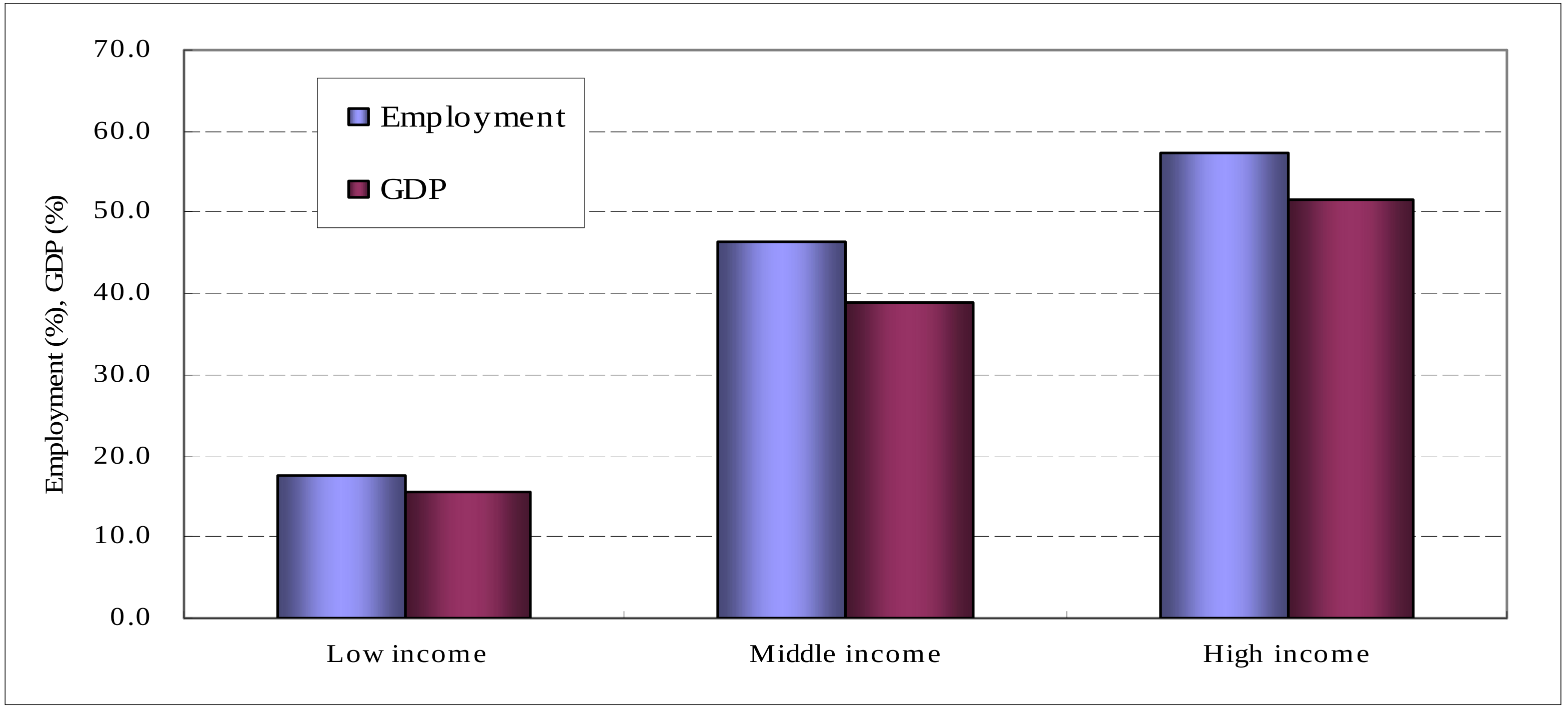
- In the literature, there are many supporting and also skeptical arguments on the importance of SME for the economic development.
- Conceptually supporters are mostly based on following three core arguments:
  1. SME enhance competition and entrepreneurship and therefore have external benefits on economy-wide efficiency, innovation, and aggregate productivity growth. From this perspective, supporting of SME will help countries to exploit the social benefits from greater competition and entrepreneurship.
  2. SME are generally more productive than large firms but financial market and other institutional failures impede SME development. Thus, pending financial and institutional improvements, broadening access to financial services to SME can boost economic growth and development.
  3. SME expansion boosts employment more than large firm growth because SME are more labor intensive. From this perspective, subsidizing SME may represent poverty alleviation too in developing countries

Importance of SME in Socio-Economic Development

- There are also some skeptical views questioning the efficacy of pro-SME policy.
  1. Some authors stress the advantages of large firms and challenge the assumptions underlying the pro-SME view. Specifically, large enterprises may exploit economies of scale and more easily undertake the fixed costs associated with research and development (R&D) with positive productivity effects. Also, some hold that large firms provide more stable and therefore higher quality jobs than small firms with positive implication for poverty alleviation.
  2. A second set of skeptical views directly challenges the assumptions underlying pro-SME arguments. In particular, some research finds that SME are neither more labor intensive, nor better at job creation than large firms.
  3. A third skeptical view, which they term the business environment view, doubts the crucial role of SME, but instead stresses the importance of the business environment facing all firms, large and small. From this perspective, low entry and exit barriers, well-defined property rights, effective contract enforcement, and firm access to finance characterize a business environment that is conducive to competition and private commercial transactions. The focus of the business environment view is not on SME in isolation; it is on the environment facing all businesses. Thus they question the pro-SME policy prescription of subsidizing SME development.
- Even though there are number of pro and opposing arguments of supporting SME in the literature, it is evident that SME play important role in any economy as seen from numerical data.

Importance of SME in Socio-Economic Development

SME sector's Contribution to Employment and GDP across countries

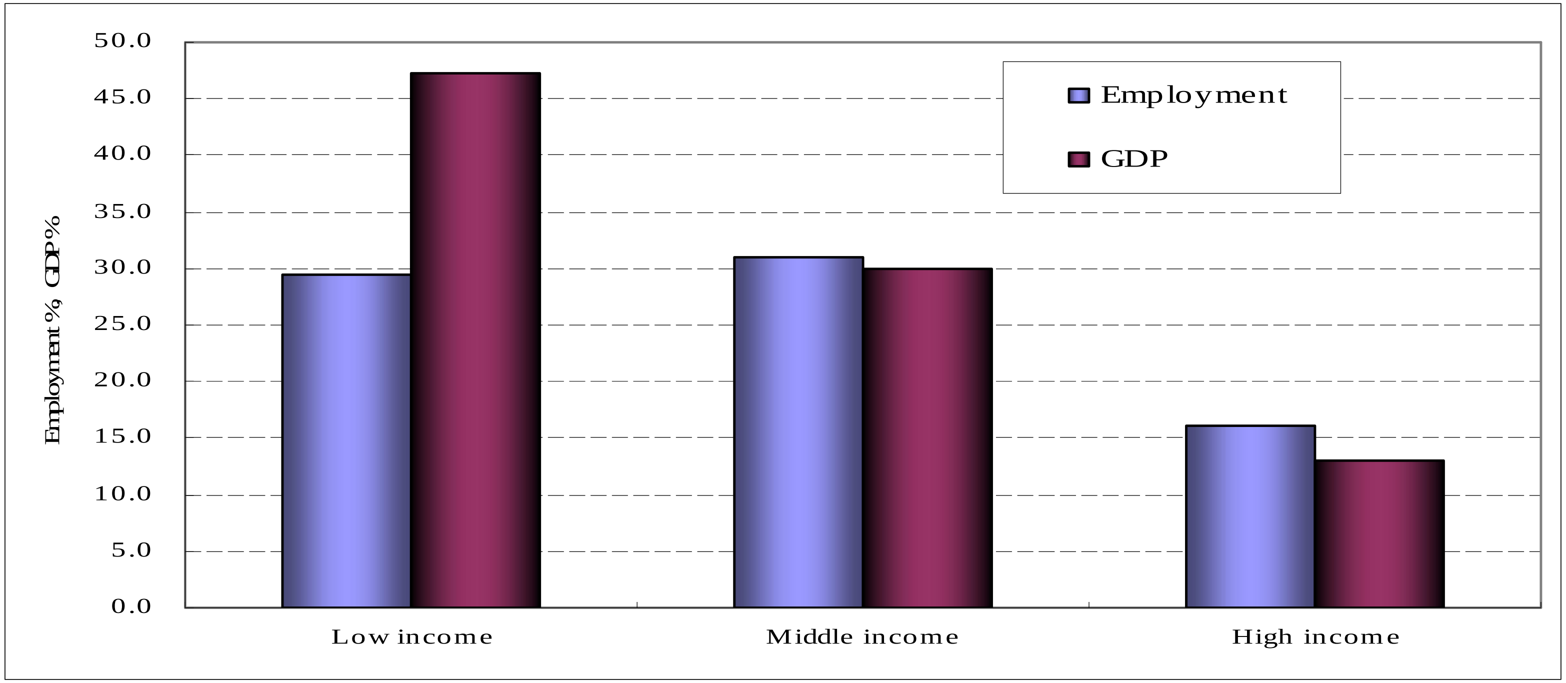


Source: The World Bank, Policy Research Working Paper, 2003

A database covers 54 countries in the sample, 13 of which are low income countries, 24 are middle income and 17 are high income countries.

Importance of SME in Socio-Economic Development

Informal Sector's Contribution to Employment and GDP across countries



Source: The World Bank, Policy Research Working Paper, 2003

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

General Issues of Access to Finance

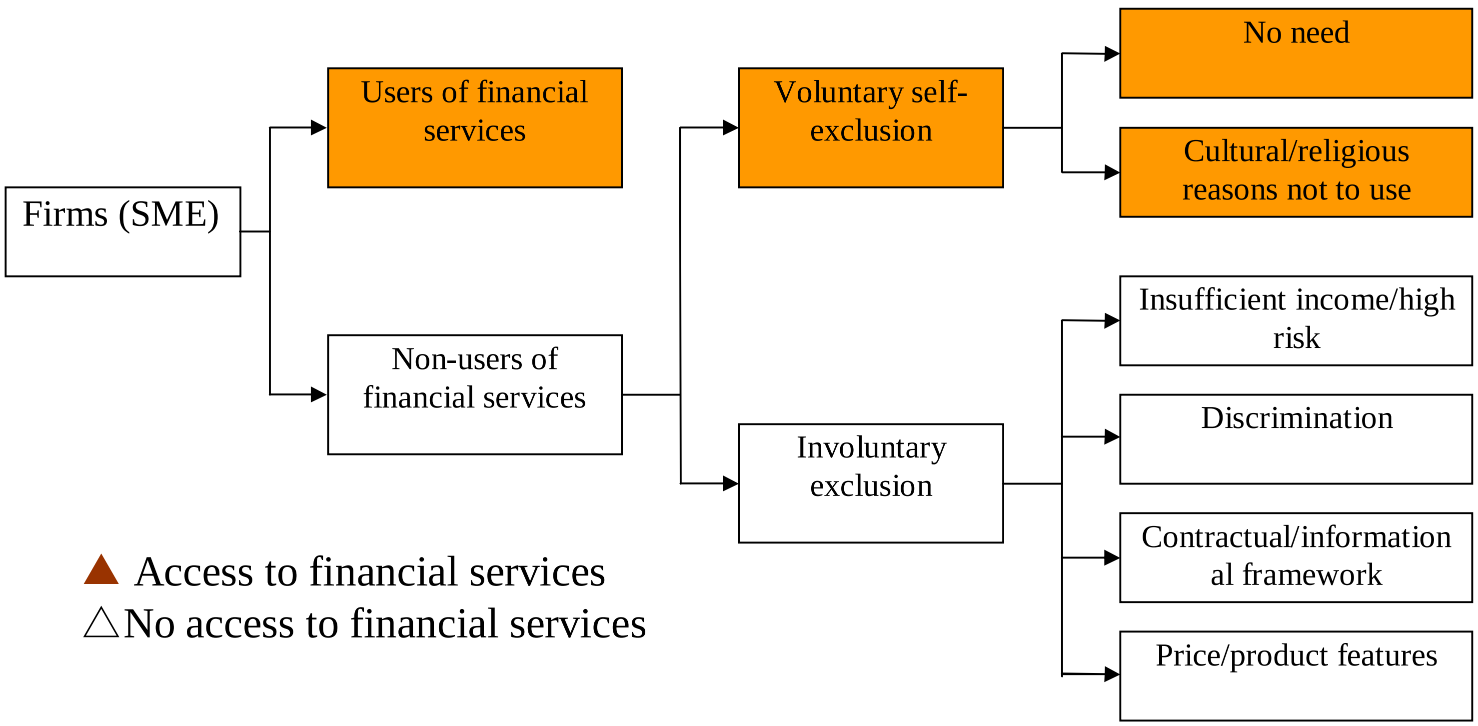
- The access to finance is a subject of significant research interest to academics and an issue of great importance to policy makers for both developed and developing economies for many years. There are a number of factors that have contributed to this.
  - First, there is some empirical evidence, albeit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

What does access to finance mean?

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

What does access to finance mean?

Access to finance and use of financial services



What does access to finance mean?

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

(Stiglitz, J. E. and A. Weiss, 1981. Credit Rationing in Markets with Imperfect Information, *American Economic Review*).

What does access to finance mean?

Principal-agent problem.

- The classic principal-agent problems are adverse selection and moral hazard.
  - The adverse selection problem arises because high- risk borrowers are the ones that are more willing to look for external finance. A financer may be willing to provide financing to some projects/debtors by increasing the risk premium charged, but this approach can backfire at some point due to the adverse selection problem. Faced with the risk of adverse selection, lenders will try to use non-price criteria to screen debtors/projects and ration credit, rather than further increasing the risk premium.
  - The moral hazard problem, by contrast, concerns the situation after the agent (e.g., the debtor) has received the resources (e.g., the loan) from the principal (e.g., the lender). The problem here is that an agent may have informational advantages and associated incentives to use the resources in ways that are inconsistent with the principal's interests. Acting on such incentives, the agent may divert resources to riskier activities or simply run away with the money, and the creditor may not have an effective way to monitor and prevent such behavior. Faced with the moral hazard risk, a principal (e.g., a financer) would try to find ways to arrange in line with the incentives of the agent. If unable to do so, principals may just not provide funding—i.e., curtail access.

What does access to finance mean?

Transaction costs problem.

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

How to measure accessibility to finance

- Before we can improve access, or decide whether and how to do it, we need to measure it.
- It is difficult to define and measure because access has many dimensions.
- Financial depth (total loan outstanding/GDP), more generally, can be broad indicator with direct and indirect effects on small firms. Greater depth is likely to be associated with greater access for firms, which will make them better able to take advantage of investment opportunities.
- Beck, Demirgüç-Kunt, and Martinez Peria (2007) presented, first time, indicators of banking sector penetration across 99 countries, based on a survey of bank regulatory authorities.

How to measure accessibility to finance

They put together the following indicators of banking sector outreach:

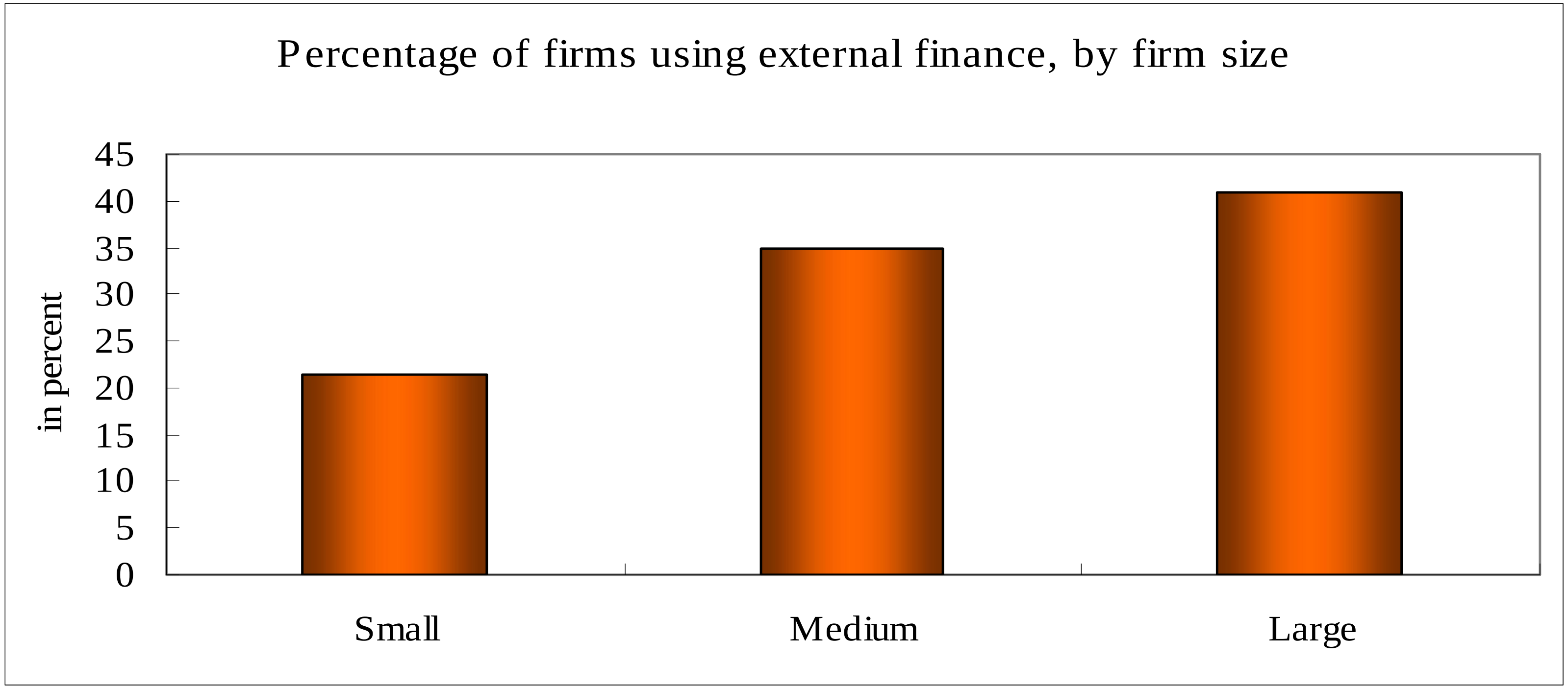
① Geographic branch penetration: number of bank branches per 1,000 km2
② Demographic branch penetration: number of bank branches per 100,000 people
③ Geographic ATM penetration: number of bank ATMs per 1,000 km2
④ Demographic ATM penetration: number of bank ATMs per 100,000 people
⑤ Loan accounts per capita: number of loans per 1,000 people
⑥ Loan-income ratio: average size of loans to GDP per capita
⑦ Deposit accounts per capita: number of deposits per 1,000 people
⑧ Deposit-income ratio: average size of deposits to GDP per capita

- Indicators (1) through (4) measure the outreach of the financial sector in terms of access to banks’ physical outlets.

Implications of Access to Finance for SME

- The theoretical studies and empirical evidences on finance consistently address that inadequacies in access to finance are key obstacles to firm growth.
- Schiffer and Weder (2001), Beck, Demirguc-Kunt, and Maksimovic (2002, 2004, 2006, 2008), and others claimed in their empirical studies that SME find accessing financing more difficult than larger firms.
- In general, small firms report financing constraints to be among the most important business constraints they face (the WBES and ICS)
- The OECD also presented data on SME access to finance (debt and equity finance) in December 2004

Implications of Access to Finance for SME

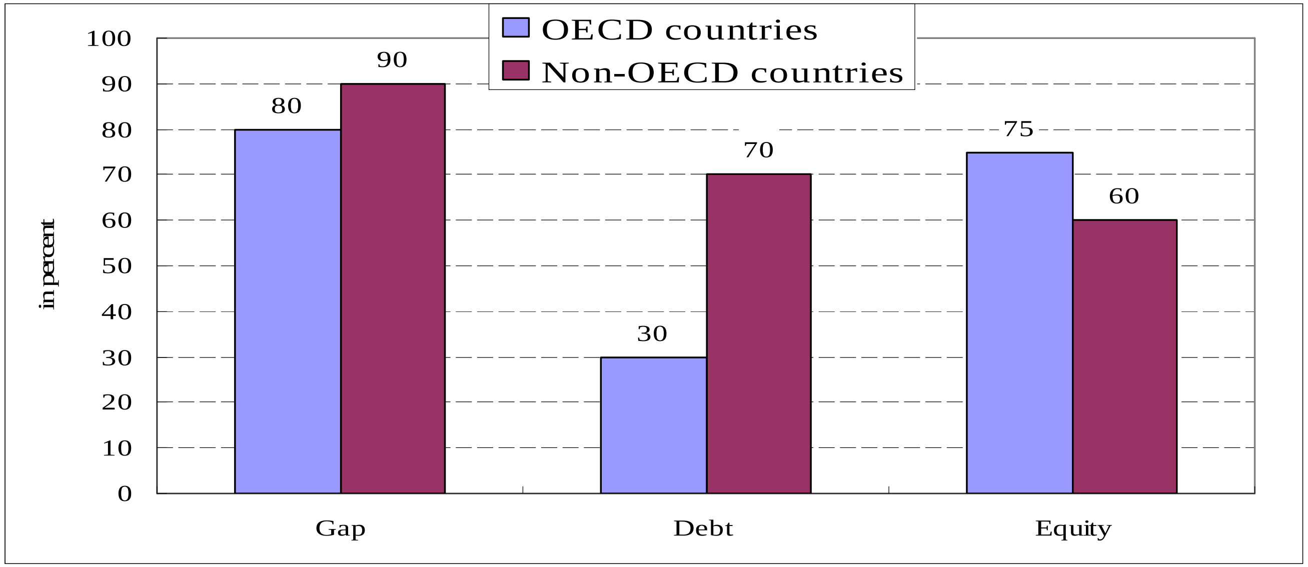


Source: Investment Climate Survey

- World Bank's Investment Climate Survey shows that more than 40 percent of large firms, but just over 20 percent of small firms, use external finance for new investment

Implications of Access to Finance for SME

Financing Gap to SME



Source: OECD, 2004

■ Although 20 OECD countries and 12 non-OECD countries were covered in this survey, the results of survey provide some support for the analysis and the conclusions that there is significant problem of access to finance elsewhere and more serious in developing countries

Implications of Access to Finance for SME

- Literatures demonstrate that SMEs are usually more credit constrained than other segments of the economy because of the following reasons:
  I. Financial sector policy distortions
     - *Interest rate ceiling*
     - *State-Owned Enterprises*
     - *Public sector borrowing*
     - *Inefficient Directed Public Sector Credit and Guarantees*
     - *Weak Judicial and Legal Frameworks and Lack of Property Rights*

  II. Lack of know-how on the part of banks
     - *Small loan size relative to transaction cost*
     - *Difficulty to adapting new lending technologies*

Implications of Access to Finance for SME

III. Information asymmetries, for example, lack of audited financial statements
   - *High cost obtaining credit information on SME*
   - *Inconsistent Financial Statements and Audits*

IV. High risks inherent in lending to SME
   - *Vulnerability and turnover*
   - *Management weakness*

- Finally, capital markets do not compensate for deficiencies in the banking sector as they do not have a comparative advantage to deal with small firm
  - Capital market financing rests on comparatively high accounting and disclosure requirements which, by definition, opaque SME lack
  - Thus capital markets are typically not a source of direct funding for SME, given that these firms are unable to issue debt or equity in amounts sufficiently large to attract investors

Role of Government in Improving Access to Credit

- Standard arguments for government intervention in the financial sector stress that financial markets are different from other markets because they rely heavily on information and produce externalities that cannot be easily internalized by market participants.
- When information is asymmetric between lenders and borrowers and is costly to obtain, or when the social benefit of a project is higher than the private benefit, the market may fail to provide adequate financing.
- While most economists would agree that some type of government intervention to foster financial development is warranted, there is less consensus regarding the specific nature of this intervention.
- Answers to this question tend to be polarized in two highly contrasting but well-established views: the *interventionist* and the *laissez-faire (free-market)* views.

Role of Government in Improving Access to Credit

- The *interventionist* view argues that an active public sector involvement in mobilizing and allocating financial resources, including government ownership of banks, is needed to broaden access to credit, as private markets fail to expand access.
- In contrast, the *laissez-faire* view contends that governments can do more harm than good by intervening directly in the financial system and argues that government efforts should instead focus on improving the enabling environment, which will help to reduce agency problems and transaction costs and mitigate problems of access.
- A third view is emerging in the middle ground, favoring direct government interventions in non-traditional ways. This third view is in a sense closer to the laissez-faire view, to the extent that it recognizes a limited role for the government in financial markets and acknowledges that institutional efficiency is the economy's first best, but it does not exclude the possibility that in the short run, while institutions are taking time to build and consolidate, some government actions undertaken in collaboration with market participants may be warranted. This is the view of *pro-market activism*.

International Good Practices for Expanding Access to Finance for SME

At Micro Level

- As reviewing international practices, it can be noted that good suppliers of financial services or lenders commonly try to find possible solutions for problems of access to finance SME addressing three basic questions:
  - How to lower or share the risk for the banks with the small business loan applications?
  - How to reduce the cost of the application and processing for small loans?
  - How to improve the quality of the information on enterprises to the level required by the banks in the loan application process without putting a too heavy administrative burden on the small businesses that cannot afford a well staffed administrative structure?

International Good Practices for Expanding Access to Finance for SME

At Micro Level

- Banks are now developing new business models, technologies, and risk management systems to serve volatile SME sector. Lending is only a fraction of what banks offer to SME, as banks try to serve SME in a holistic way through a wide range of products and services, with fee-based products rising in importance.
- Foreign banks entry and banking sector consolidation is important. Large banks can sort out well-functioning and promising SME via their corporate clients with which SME maintain supply and outsourcing relations.
- Adaptation of technology promises to reduce costs and improve transparency in delivering financial services

International Good Practices for Expanding Access to Finance for SME

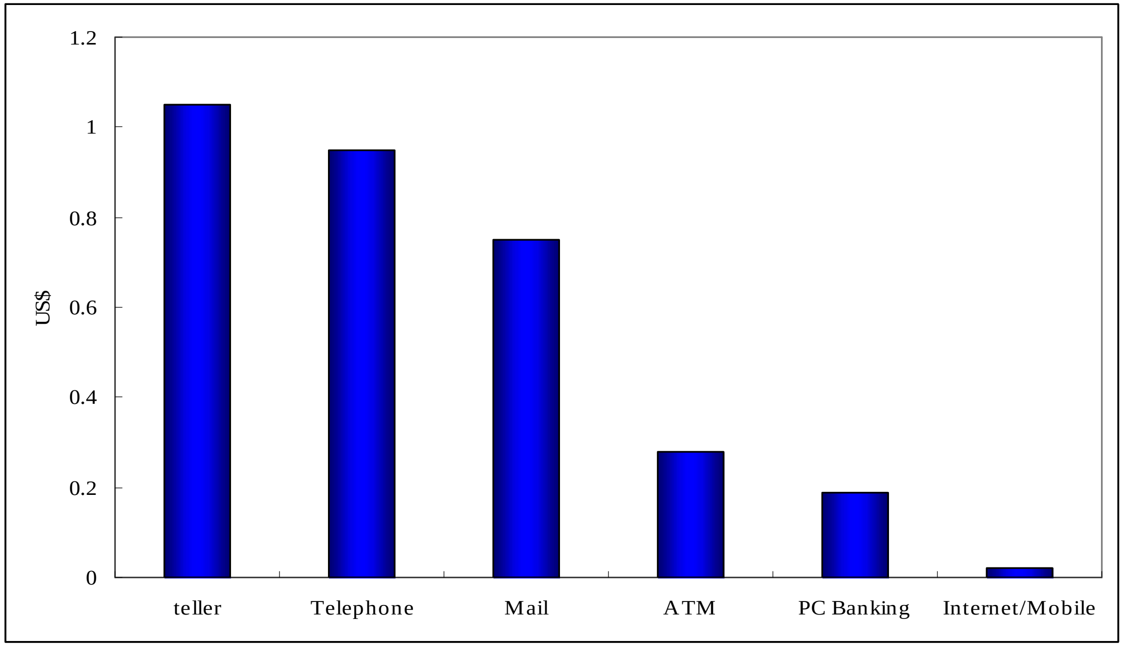
At Micro Level

- The following are brief definitions of technologies commonly used in successive case of expanding access to financial services in microfinance[1] that is highly relevant to SME sector too:
  - **Information Systems:** Custom-built or commercially available software that allows financial institutions to track transactions and create reliable financial reports. Getting this right is a critical building block for all other technology applications.
  - **Connectivity:** Network connections (for example, dial-up, broadband, or satellite) that link staff and branches for real-time information exchange, transaction processing, and distance learning.
  - **Personal Digital Assistants (PDAs):** Small handheld computers that help field staff more efficiently collect data, manage SME client records, and process loans.
  - **Credit Scoring:** Automating or enhancing the loan approval process by computerized analysis of client characteristics and behavior to predict willingness and ability to repay.
  - **Automatic Teller Machines (ATMs):** Machines that dispense cash or provide a wider range of services to cardholders. ATMs are relatively expensive to own and operate. Most require network connectivity and reliable power.
  - **Internet Banking:** The ability to conduct banking transactions from any location, such as Internet kiosks. This service is probably more relevant for urban area clients.
  - **Mobile Phones:** Millions of people in both urban and remote areas now have access to cell phones, and increasingly use text messaging. This technology offers an opportunity to operate virtual bank accounts with minimal infrastructure

International Good Practices for Expanding Access to Finance for SME

At Micro Level

Illustrative Costs per Distribution Channel



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

Perhaps the most important contribution of technology is lower operating costs. For instance, a recent study demonstrates that a typical ATM transaction costs nearly five times less than a teller transaction

International Good Practices for Expanding Access to Finance for SME

At Micro level

- Use of Microfinance technology
- Establishing private credit guarantee and credit information system by banking associations
- Business advisory services (market surveys, production process, human resources organization etc.)

International Good Practices for Expanding Access to Finance for SME

At Macro Level-Role of Public Policy

- Empirical research has confirmed that macroeconomic instability is an important obstacle to effective contracting.
  - International experiences suggest broadly three complementary roles that governments can address some of the constraints and facilitate the broadening the access to finance for SME:
  - Improve or build sound legal and judiciary infrastructure
  - Build effective information infrastructure
  - Make some rational direct intervention

International Good Practices for Expanding Access to Finance for SME

At Macro Level-Role of Public Policy

- Legislation that defines the right and responsibilities of companies, financial entities, and other financial market participants, avoiding uncertainty or ambiguity in contracts, is a valuable of the financial infrastructure provided by government.
- Some precautions are needed for institutions specializing in serving SME, particularly if they provide unsecured lending, namely:
  - Limiting unsecured lending to some percentage (often 100 percent) of a bank’s equity base makes it impossible for the financial institution to leverage its equity with deposits or borrowed money.
  - Regulations requiring 100 percent loan loss provisioning for all unsecured loans at the time they are made makes lending to microenterprises and small enterprises virtually impossible.
  - Standardized reporting requirements on banks’ financial positions are too onerous and expensive to comply with for portfolios consisting of many small transactions
- Have Supportive Regulations Regarding SME Banking, Leasing, Factoring, Equity and Credit Guarantee Scheme

International Good Practices for Expanding Access to Finance for SME

At Macro Level-Role of Public Policy

- Strong accounting standards and credible accounting firms are necessary for SMEs to have informative financial statements.
- Reducing SMEs' opacity by means of simplified, standardized charts of accounts would pave the way for additional forms of transactional lending technologies that depend on hard information, such as lending based on financial statements.
- At the same time, complementary support to SMEs to improve their financial accounting systems and obtain audits, for instance, through matching grants, is likely to result in more credible SME applications for financing.
- ***Invest in and Promote Credit Bureaus and Registries***
- ***Invest in Technology***
  - One way to support technological efficiency is through such industry-level technology initiatives as building the capacity of information technology firms. This, in turn, can provide quality information technology services to financial institutions and/or programs that teach consumers how to use automatic teller machines, debit cards, and credit cards.

International Good Practices for Expanding Access to Finance for SME

At Macro Level-Role of Public Policy

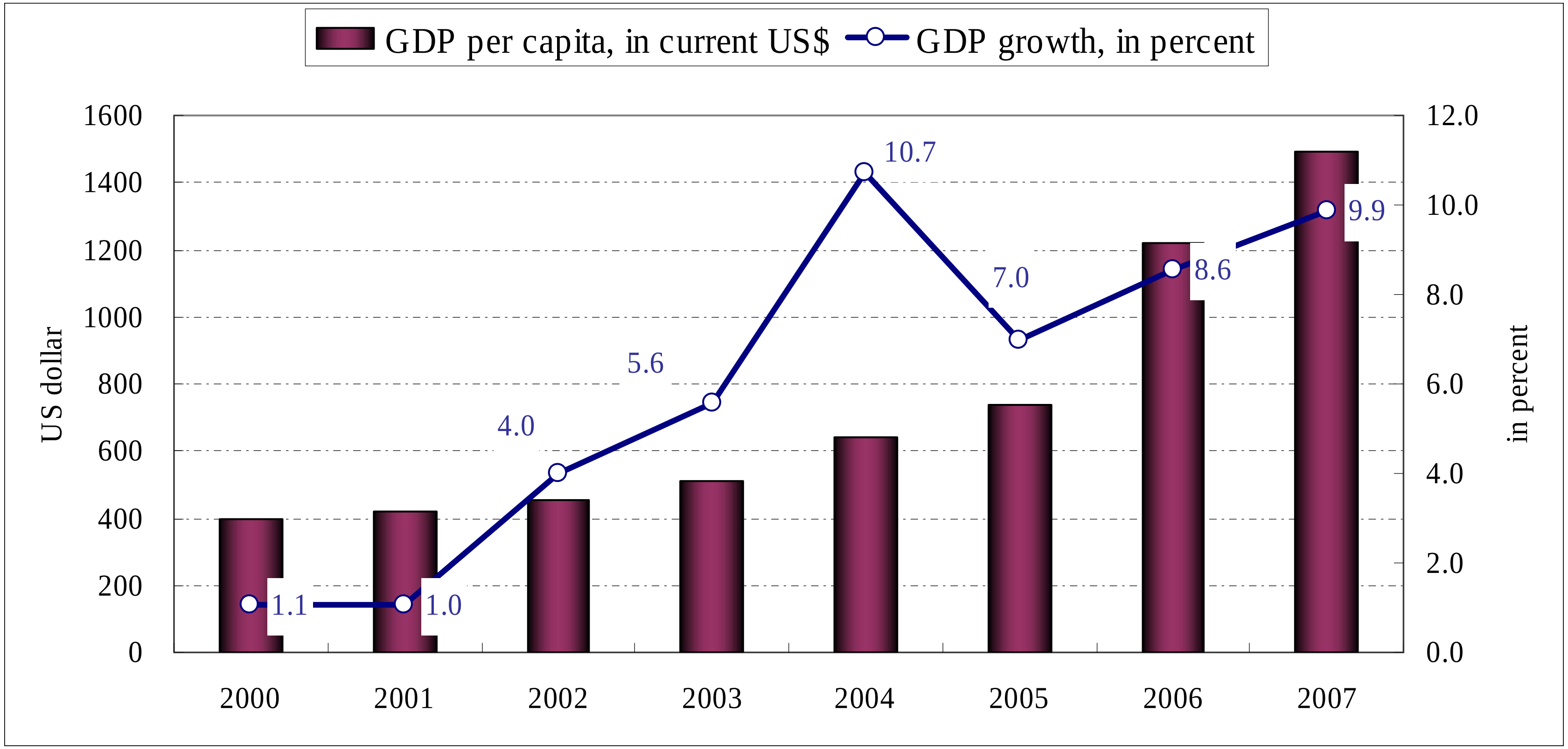
- The rapidly evolving technologies based on the Internet (e-finance) and cell phones (mobile phones, or m-finance) can be powerful engines of access.
- But a lack of legal clarity may impede the adaptation of these technologies. Government needs to keep legislation up to date not only to ensure contracting parties that what they intend will be unambiguously enforceable but also to prevent legislation from blocking new innovations
- Reviewing bank secrecy laws, which have effectively prevented the establishment of private credit bureaus in almost every country of the former Soviet Union; provide incentives for sharing both positive and negative information; and eliminate restrictions on access to public records.
- Thus the legal framework must balance the need for information sharing and the protection of privacy and of consumers’ rights. Also important is the creation of public versus private credit bureaus.

Case study of Mongolia

Socio-Economic Development of Mongolia

- Mongolia is a landlocked country located between the Russian Federation and the PRC.
- Mongolia is a unique country with distinctiveness of a vast land with sparse population, abundant natural resources. All these peculiar factors influence the economy in many ways.
- It is also a country that has been taking social and economic transformation from soviet-style socialist system toward market-oriented democratic system since 1990s
- Small-open, developing country
- Population – 2.6 million
- Land -1567.0 thousands sq.km.
- Size of economy – 3903.7 US$ millions (by 2007)
- GDP per capita – 1494 US$ (by 2007)

Socio-Economic Development of Mongolia



Socio-Economic Development of Mongolia

Financial Sector Intermediaries

	2000			2007		
	Number	Assets billion togrog	share to total assets	Number	Assets billion togrog	share to total assets
Banks	12	214.9	92.9	16	2858.3	95.5
Private	6	53.7	23.2	16	2858.3	95.5
Domestic	6	53.7	23.2	16	2858.3	95.5
Foreign						
State-owned/state participated	6	161.2	69.7			
Nonbank financial sector	151	16.4	7.1	363	135.3	4.5
Insurance companies	12	10	4.3	15	28.4	0.9
Life						
Non-life	12	10	4.3	15	28.4	0.9
Pension funds						
SCCs	90	1.0	0.4	181	35	1.2
Financial Companies (NBFIs)	7	2.9	1.3	131	66.4	2.2
Securities and Brokerage firms	42	2.5	1.1	36	5.5	0.2
Total assets of financial system		231.3			2993.6	

SME Sector in Mongolia

- The SME Law of 2007 provides for the first time a clear definition of SME and prescribes a number of government funded programs (including subsidized credit) to address the above-mentioned main impediments.
- SME in Mongolia are fell into one of the following categories:

Category	Sector	Number of employees	Annual revenue in togrog
Small	All sector	≥19	≥250 million
Medium	Service	≥49	≥1.0 billion
	Wholesale	≥149	≥1.5 billion
	Retail	≥199	≥1.5 billion
	Manufacturing/processing	≥199	≥1.5 billion

SME Sector in Mongolia

- According to the statistics there are over 32105 active businesses, of which 80.0% are enterprises with less than 10 employees, 8.8% enterprises with 10 to 19 employees, 7.3% enterprises with 20 to 49 employees and 3.8% enterprises with over 50 employees by the end of 2007.
- SMEs in Mongolia employ over 1/3 of total employees and are accountable for approximately 60% of the GDP, contributing mere 1.8 percent to the state budget in taxes.
- The sector distribution pattern is stable with sight fluctuations, identifying most SMEs in trade (41%), service (28%) and manufacturing (26%)

SME Sector in Mongolia

There are a number of common problems or challenges faced by SMEs in Mongolia. These problems are as follows:

- Lack of credit/finance/capital - the cost of capital is often high, and in times of economic uncertainty, lenders tend to be very risk averse.
- Lack of credit collateral and credit guarentees.
- Access to technology - the digital divide is a significant problem. Improving access to technological networks of international standard is also very expensive.
- Training/human resource development - this covers both on-the-job training and the broader education system.

SME Sector in Mongolia

- Funding for research and development - SMEs lack assistance both for developing new ideas and turning these ideas into commercial products.
- Weaknesses in transportation and infrastructure - this can affect access to markets and business revenue as inreasing costs(telecommunications, ports, airports, road networks).
- Limited information on possible markets and clients - most SME owner/operators have little experience in exporting into foreign markets.
- SMEs are often the most vulnerable in times of economic recession. Lack of insurance and subsequent business failures can often make the economic situation worse.

Problems and Challenges in Access to Finance for SME

- General access to finance issues.
  - Access to financial services in Mongolia appears to be high when measured by the demographic bank branch penetration; however, the branch network in rural areas is limited.
  - Most of Mongolian banks, in particular Has and Khan, provide services in microfinance and SME finance. Three banks (Khan, Mongol Post and Has) also operate in the rural areas including the rural town centers.
  - Mongolia’s demographic branch penetration is high and according to a study, it ranks 16th out of a total of 97 countries. However, due to its low population density its geographical branch penetration is one of the lowest in the world.

Problems and Challenges in Access to Finance for SME

- The development of SME ranks high on the government's social and economic development agenda, but access to finance remains a major impediment.
  - Most registered business entities in Mongolia fall in the SME category per the definitions provided in the new SME Law.
  - However, compared to larger companies, SME often find it difficult to finance their capital investment and daily operational needs.
  - The main impediments for SME include relatively high lending rates, limited market information, and weak capacity for market research and business planning.

Problems and Challenges in Access to Finance for SME

- Many banks have started to target SME borrowers but a large portion of their programs appear to rely on donor funding.
  - Recognizing the distinct access to the financial needs of SME, several banks have started to develop strategies to cater to this market. The larger banks, which traditionally have focused on large corporate clients, have begun to downscale to target SME while the banks predominantly focusing on microfinance are scaling up.
  - It will take time for these banks to accumulate knowledge of SME customers and develop appropriate financial products.
  - In the longer run, banks will need to diversify their funding sources for SME banking to ensure that there is not a perennial reliance on donor programs.
  - The SME Law, passed in July 2007 provides clear eligibility criteria for the participation of SME in government programs. One of the actions spelled out in the Law is the transformation of the SME Development Fund (originally established by two donor programs under the Ministry of Industry and Trade) into a permanent apex institution which would provide funding at below market rate to the financial institutions for loans to SME at an agreed rate.

Problems and Challenges in Access to Finance for SME

- The legal environment for the development of financial leasing has been improved, but the remaining loopholes need to be addressed.
  - The leasing law adopted in June 2006 spells out the definition of financial leasing, as compared to renting, property leasing and other types of leasing contracts.
  - The amendments to the tax laws in 2006 bring the tax treatments for financial leasing closer to international practices.
  - While the leasing law and the amendments to the tax laws are considered by international experts as a reasonably good framework, even some of the larger companies and banks that provide leasing-like products do not seem to be aware of the specific provisions of these laws.
  - There is a clear need for a public awareness program on the laws on financial leasing. The remaining legal/regulatory loopholes that need urgent attention relate to depreciation methodology of leased equipment and the regulation of financial leasing activities.

Problems and Challenges in Access to Finance for SME

- Financial institutions are looking to technological innovations to reach out to new customers and maintain market shares, but the legal and regulatory environment needs significant strengthening to support these innovations.
  - Banks are offering new products and services through e-banking and bank cards to shorten loan application processes, ease bank account enquiries and facilitate payments of consumer goods and utility bills.
  - The increased use of technologies by banks is taking place without sufficient laws and regulations regarding authenticity and finality of e-transactions, verification of e-signatures, customer privacy protection, banking information confidentiality, and so on.

Problems and Challenges in Access to Finance for SME

- The Credit Information Bureau (CIB) of the BOM, a public credit registrar established in 2000, has served as a useful tool for banks and some large NBFIs to check a borrower's credit record and status when reviewing credit applications.
  - All banks to submit information on loans above one million togrog, related collateral and the borrowers, on a regular basis. NBFIs can also participate in the credit information system on a mutual agreement basis.
  - The CIB was recently linked up with two government information systems on company registration and customs, and talks are underway to hook up the system with the databases of the Administration of State Registry of Titles and the stock exchange.
  - The CIB has shown signs of stress in recent years due to design weaknesses, software limitations and capacity constraints. The system collects limited information which is reported in a single report format.
  - Capacity constraints hamper the CIB's ability to update information quickly and maintain good data quality.
  - There are also complaints about lack of connection outside Ulaanbaatar city, and limited data on rural credit. Although by design the CIB should collect both the positive and negative credit information and sort them out by economic sector and region, so far these data are either not collected or not available

Problems and Challenges in Access to Finance for SME

- The Accounting Law of Mongolia requires accounts to be prepared to International Accounting Standards, however, implementation appears to be weak.
- There appears to be significant variability in standards and quality between the significant number of accountants and audit firms in Mongolia.
  - The accountants' local professional body, the Mongolian Institute of Certified Public Accountants lists 1610 accountants in 2006 (a large increase from 1100 in 2004) many of whom are organized into 42 audit firms.
  - The Institute issues guidance but is not viewed as very effective in promoting high and consistent standards among its members. Auditing standards are similarly weak and the quality of auditors is extremely variable. Independence appear to be an issue particularly for the smaller auditing firms and working practices and record keeping is often poor.
  - Auditors in Mongolia are organized as limited companies and not as partnerships so their potential liability for producing inadequate or misleading accounts is limited.

Problems and Challenges in Access to Finance for SME

- In Mongolia, even though there is some initiative to establish Credit Guarantee Fund, there is no legal basis for operating Credit Guarantee Fund so far.
- Credit Guarantee Fund needs for start-ups and other SME which does not have collateral although they have good business plan and potentials.
- Without supports from the Government, it is impossible for start-ups to grow further as they can not obtain credit for their investment since they do not have any collateral items.

Concluding Remarks and Policy Recommendations

- International experiences advocate that governments should provide public goods that level the playing field for financial institutions to innovate services for all segments of the market.
- These public goods entail a sound financial sector policy framework; investing in building sound institutions; and investing in a supportive information infrastructure, such as credit bureaus and accounting standards.
- International experience has also shown that government programs that use market mechanisms to support SME development have a much higher rate of success. Direct interventions, such as provision of funds at below market rates to SME, can often lead to weaker financial discipline by SME and distorted credit risk assessment of these SME's by their creditors.
- The Government should provide sound legal environment in creating Credit Guarantee Scheme as drawing lessons from international experiences.
  - It includes Private-Public partnership

Concluding Remarks and Policy Recommendations

- There is need to improve CIB in Mongolia
- Better coordination between the existing CIB and the industry's plans for a new bureau will be important to ensure development of an information system which can effectively serve supervisory and industry needs.
- The BOM should consider undertaking a few urgent measures to better respond to the current need of the industry, improve information reliability and enhance the central bank's capacity to monitor the rapid credit expansion:
  - Improve information timeliness. The regulation covering the existing CIB provides for penalties on delays in submitting required data and misreports of credit information.
  - Improve data quality and coverage. The BOM should undertake measures to improve the existing CIB's capacity to identify errors in data inputs and outputs and consolidate by unique borrower identification all new credit information and their updates. In consultation with the industry and the other BOM departments, the CIB should consider expansion in type of data collected and upgrading of reporting modules.
  - Improve system interoperability. The linkage with other government databases can significantly improve data adequacy of the public credit registration system. However, as the credit information system has been locally developed, there may be an interoperability problem requiring ongoing modifications, with associated costs and opportunity losses. A more standard and compatible system upgrade could be considered.

Concluding Remarks and Policy Recommendations

- Though the penetration of banks in rural areas has improved, many non-banks and savings and credit cooperatives continue to focus their operations close to urban areas.
- The government should continue to encourage development of new products and services which can support the development of micro-, small- and medium-sized enterprises.
- The government and donor programs to improve access to financial services in rural areas and for enterprises need to be designed to ensure that these services are sustainable on market principles after the completion of the programs.