

SECTOR ASSESSMENT (SUMMARY): SMALL AND MEDIUM-SIZED ENTERPRISES

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. If small and medium-sized enterprises (SMEs) are to fulfil their potential to boost Mongolia's economy and job opportunities, government policy needs to change to create the right environment for them to thrive. The current legal and business environment is having a negative impact on SMEs. Of particular concern are issues related to the establishment of businesses, the licensing of operations, inspections, payment of taxes, cross-border trading, access to finance, and the procedures for restructuring or closing SMEs. It has been very costly and time-consuming to set up a business in Mongolia, and entrepreneurs have faced several regulatory obstacles before starting operations. The government's new e-registration and e-payment systems, set up in 2014 promises to make doing business easier. However, reforms are still needed to reduce the licenses and permits required and to bring the costs of obtaining them more into line with the expected business benefits.

2. Once in operation, SMEs are subject to inspections aimed at monitoring compliance with government public health, safety, and environment standards, as well as their payment of business taxes. While generally necessary, they absorb precious time and disturb day-to-day operations. Inspections need to be made more efficient and effective to ensure that public objectives are met with the minimum disruption imposed on SMEs. Inspecting agencies also need to be more transparent and accountable for their actions.

3. Government reforms in 2006 reduced tax rates and broadened the tax base, but a progressive corporate income tax rate structure imposes high costs on the economy. This approach fails to encourage incorporated SMEs to grow, while providing an incentive for larger companies to split themselves up into smaller ones. The government needs to adhere more closely overall to the principles and best practices of a modern tax system—neutrality, equity, and simplicity—to minimize the social costs of the tax system and make it more efficient.

4. Mongolia has eased tariff and non-tariff barriers to international trade but its administrative procedures for exporting and importing remain cumbersome. They prevent SMEs from taking full advantage of opportunities for foreign trade that are particularly important due to the small size of the domestic market. The government initiated implementation of a risk-based clearing system and broader use of an automated information system in 2013 and it has yet to be fully introduced. The system allow customs to accept, process, and issue import and export clearances through online submission. This is expected to lead to efficiency gains in cross-border trading.

5. Bankruptcy is currently one of the most common solutions Mongolia's SMEs pursue when they face financial difficulties or become insolvent. Yet businesses in distress may still be viable and simply need to restructure. Doing this can be facilitated by an efficient insolvency regime, but Mongolia has made no progress on reforming its insolvency legislation, which is ambiguous in this area and provides virtually no room for reorganizing distressed but viable enterprises. This issue needs to be addressed through legislative reform so that distressed business have more options and the economic resources of non-viable businesses can be rechanneled into more viable entities.

6. SMEs find it hard to access finance. Information of their credit histories is scarce because the Bank of Mongolia has a narrow credit registry, and an already established private credit bureau is still awaits licensing by the Financial Regulatory Commission in order to begin full operations. When SMEs offer collateral for proposed loans from commercial banks, these institutions normally assign excessively low values to immovable property and accept movable property as collateral only infrequently. These practices add to SMEs' difficulties in obtaining loans.

7. Mongolia has several different definitions of SMEs.¹ Statistical information is also lacking as a result. This makes it impossible to know the precise size of the SMEs sector or its contribution to gross domestic product (GDP) and employment generation. However, the Statistical Office of Mongolia collects data regularly on registered and active small enterprises, which it defines based on the number of people employed (50 employees or less). This data showed that 55% of registered small enterprises were not in operation in 2013. In 2014, more than 58,000 of these micro and small firms were active, but annual growth in their numbers had peaked in 2011, when it reached 17%. It had been on a downward trend since then and declined by 5.6% in 2014. Mongolia has only 20 small enterprises per 1,000 inhabitants, compared with 70 per 1,000 people in such developed countries as Italy, Sweden, and the United Kingdom. The World Bank estimates that the SME sector accounted for only 20% of GDP in 2014 even though it employed 70% of the workforce.²

8. Micro enterprises, defined by the Statistical Office of Mongolia as firms with 10 or fewer employees, dominate the SME segment in terms of numbers. Survey results in 2015 during the project preparatory technical assistance for the Supporting the Credit Guarantee System for Economic Diversification and Employment Project showed that they made up 58% of the SMEs. The low annual turnover figures of micro enterprises illustrate the small place occupied by them as part of the SME sector in the overall economy. For 75%, annual turnover was below MNT250 million (about \$132,000) in 2014. Most SMEs (82%) focused on the domestic market, and the share of exports in the total turnover for the 47% that did export was less than one-quarter. The survey showed that SMEs in general have difficulty overcoming the obstacles to their growth in the current legal and business environment.

9. The SME segment is highly concentrated in urban areas (mainly in Ulaanbaatar). In fact, 61% of SMEs are located in urban compared to 39% in rural areas. Survey results find that two thirds of SMEs are engaged in the manufacturing sector, particularly in food production, followed by the manufacture of construction materials and garments.

10. The barriers SMEs face in accessing finance compared with larger enterprises interfere with the establishment of their businesses and their efforts to build productive capacity, compete, and create jobs. The problems are both internal and external. Lenders find SMEs to be more opaque than large firms and their business capabilities more difficult to assess. Their financial statements are less informative, and their credit histories are usually shorter than those of bigger firms—when they exist at all. This and the high fixed assessment and monitoring costs banks face in transactions with SMEs make it inevitable that financing for SMEs tends to dry up more rapidly during economic downturns than for large companies. The deficiencies in and

¹ Mongolia's laws define SMEs in several ways that vary by sector: industry and retail trade—firms with a maximum of 199 employees and a maximum turnover of MNT1.5 billion, trade—149 employees or less and a maximum turnover of MNT1.5 billion, and services—a maximum of 49 employees and maximum annual turnover of MNT1 billion.

² International Finance Corporation. 2014. *SMEs and Women-owned SMEs in Mongolia: Market Research Study*. Washington.

overall underdevelopment of the banking system, financial intermediation, and credit information infrastructure create another overall hurdle that SMEs find it hard to overcome.

2. Government and ADB's Sector Strategy

11. The Ministry of Industry (MOI) was established in December 2014 and is the focal agency for the government's plans to develop SMEs. It also coordinates SME policies across ministries. The MOI has launched a working group to explore new models to fit to the financing demands from SMEs. The group includes the Ministry of Finance, the Financial Regulatory Commission, and the Mongolian Stock Exchange. In 2013, the government adopted a SME development program for 2014–2016 that set goals and objectives in the areas of enhancement of the legal environment, cluster development, research to develop innovation, capacity building, access to finance, and support for market development. The MOI is also the implementing agency of the government supported SME Development Fund that provides SMEs with loans through commercial banks, and the Soum Development Fund that provides SMEs with direct loans. The SME Development Fund was allocated state budget funds of MNT500 million in 2013 and MNT1 billion in 2014. These funds were allocated for use in each province in Mongolia equally.³

3. ADB Sector Experience and Assistance Program

12. **ADB assistance.** Two ADB agriculture and rural development projects and associated technical assistance—one approved in 2008 and another approved in 2015—share the aim of helping Mongolia's develop its SMEs.⁴ Additional ADB financing for further technical assistance under these projects will mainly help Mongolia increase value addition in its rich but underutilized livestock and agricultural resource sectors. This will be achieved through (i) value chain investments by agro-enterprises and cooperatives; (ii) capacity strengthening for primary producers and processors; (iii) strengthening of the marketing and technical capacity of agro-enterprises and cooperatives; and (iv) development of Mongolia's product brand. The additional financing is expected to generate employment opportunities and help diversify Mongolia's economy, which has been dominated by its mining sector.

13. **Khan Bank.** In 2007, ADB approved a senior unsecured loan of \$10 million with a maturity of 6 years to Khan Bank. The objectives were (i) to catalyze the growth of the country's businesses by facilitating lending and thereby helping to diversify the economy, and (ii) to help improve finance sector efficiency and depth by enabling Khan Bank to offer loans with longer maturities and grow its corporate banking business. The 2013 annual review of this loan rated it *successful* overall.⁵ In 2014, further funding was approved to provide better access to bank financing for the country's micro, small, and medium-sized enterprises (MSMEs). The \$40 million senior loan was aimed at expanding Khan Bank's MSME portfolio to 35% of its total loans by 2020 from 26% in 2013 and creating jobs.⁶

³ Equal amounts were allocated across provinces for the SME Development Fund until 2014, but proportions differed in 2015.

⁴ ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Asian Development Fund Grant and Technical Assistance Grant to Mongolia for the Agriculture and Rural Development Project*. Manila; ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant for Additional Financing to Mongolia for the Agriculture and Rural Development Project*. Manila.

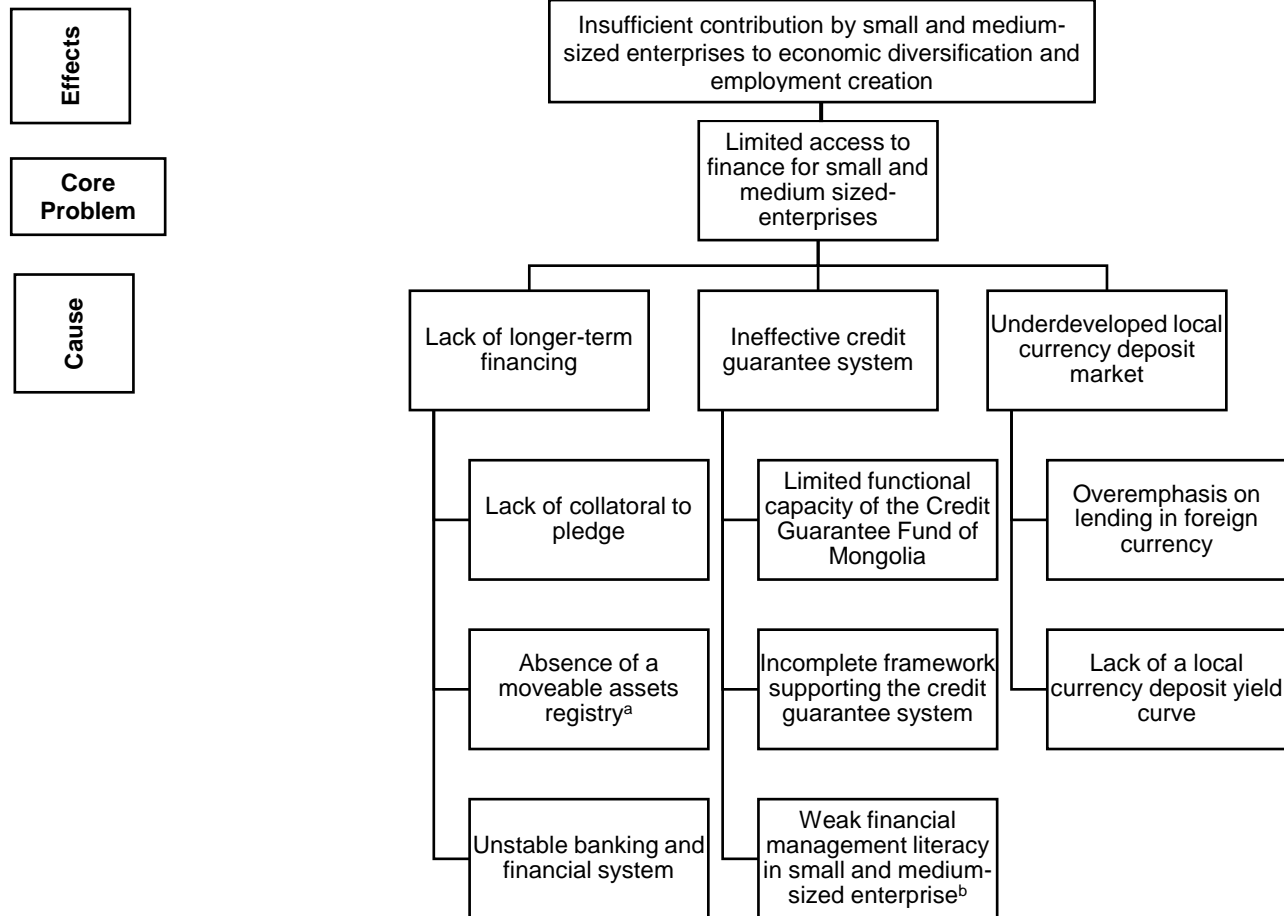
⁵ ADB. 2013. *Extended Annual Review Report: Senior Unsecured Loan Khan Bank (Mongolia)*. Manila.

⁶ ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loan Khan Bank Supporting Micro, Small and Medium-Sized Enterprises (Mongolia)*. Manila

14. **Xac Bank.** In 2013, ADB approved unsecured senior loans to XacBank of up to \$30 million and to TenGer Financial Group of up to \$10 million (for onlending to XacLeasing). This project aims to support MSMEs through subloans by XacBank and leases provided by XacLeasing.⁷

⁷ ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loans XacBank and TenGer Financial Group Supporting Micro, Small, Medium-Sized Enterprises and Leasing Finance (Mongolia)*. Manila.

Problem Tree for Small and Medium-Sized Enterprises Sector



^a On 25 March 2014, the International Finance Corporation signed a cooperation agreement with the Ministry of Justice to reform the secured transaction system by establishing a proper legal framework for secured transactions through a new law on pledging, an online registry for moveable property, and training and awareness raising for industry professionals.

^b Since 2012, the Japan International Cooperation Agency has implemented a two-step loan project that has provided lending and capacity development to financial institutions that support small and medium-sized enterprises (SMEs). Since January 2012, a European Bank for Reconstruction and Development program has been helping to develop SMEs by supporting policy and legal reforms, developing organizations that support SMEs, and providing advice to entrepreneurs.

Sector Results Framework (Small and Medium-Sized Enterprises Sector, 2015–2021)

Country Sector Outcome		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	Indicators with Targets and Baselines	Outputs with ADB Contribution	Indicators with Incremental Targets	Planned and Ongoing ADB Interventions	Main Outputs Expected from ADB Interventions
SMEs' access to finance expanded	<p>By 2021:</p> <p>(i) The share of new SME loan accounts opened in rural areas compared to urban areas increases between 2015 and 2021 to 20.0% (Baseline 2011: 17.3%)</p> <p>(ii) SME loan accounts opened by women SMEs account for half of total SME loan accounts opened. (Baseline 2014: 46%)</p> <p>(iii) Number of active enterprises with fewer than 50 employees increases at a 10% annual average rate during 2016–2021 (Baseline 2014: 8.8% average annual rate of increase from 2006 to 2014)</p>	Increased job creation in non-mining related sectors	<p>(i) At least three new credit guarantee products are issued by the CGFM with at least one supporting women entrepreneurs by the end of 2018 (Baseline 2014: 0 new products)</p> <p>(ii) At least \$58.63 million of funding is channeled to PFIs using CGFM guarantees by the end of 2021 (Baseline 2015: 0)</p> <p>(iii) At least 4 PFIs participating in the CGFM program regularly offer time deposits in local currency of at least a 5-year maturity by 2021 (Baseline 2015: 0)</p>	<p>Planned target subsectors SME development (10% of funds) SME access to finance (90% of funds)</p> <p>Ongoing projects with approved amounts (i) Agriculture and Rural Development Project (ADF: \$14.7 million) (ii) Senior Loan to Khan Bank for Supporting Micro, Small, and Medium-Sized Enterprises (Nonsovereign: \$40 million) (iii) Senior Loans to XacBank and TenGer Financial Group for Supporting Micro, Small, Medium-Sized Enterprises and Leasing Finance (Nonsovereign: \$30 million) (iv) Agriculture and Rural Development Project (additional financing) (ADF: \$15 million, and OCR: \$35 million)</p>	<p>Planned target subsectors Longer-term financing for SMEs increased. Quality of CGFM and the credit guarantee system improved. A longer-term bank deposit market developed.</p> <p>Planned key activity and pipeline projects Subloans to enterprises provided for improvement of their value chains and/or enhancement of their production and productivity</p> <p>XacBank's and XacLeasing's financial capacity to service MSMEs and leasing customers expanded</p> <p>Ongoing projects Value chains improved for 10 agro-processing companies</p> <p>Availability of financing from Khan Bank increased and tenor of MSMEs loans lengthened</p> <p>XacBank's and XacLeasing's financial capacity to service MSMEs and leasing customers expanded</p>

^a Businesses identified as run by women for this project are businesses that meet at least one of three criteria, i.e., that (i) they are at least 50% owned by women, (ii) at least 60% of their senior managers are women; and/or (iii) at least 50% of the registered employees are women. ADB. 2014. *Gender Toolkit: Micro, Small, and Medium-Sized Enterprise Finance and Development*. Manila.

ADB = Asian Development Bank, ADF = Asian Development Fund, CGFM = Credit Guarantee Fund of Mongolia, GDP = gross domestic product, MSMEs = micro, small, and medium-sized enterprises, OCR = ordinary capital resources, SMEs = small and medium-sized enterprises, TA = technical assistance.

Source: Asian Development Bank.