Chapter 2. Business environment in Central Asia: Access to finance

This chapter explores the demand- and supply-side issues relating to access to finance for firms in Central Asia, ranging from stringent collateral requirements to high interest rates and limited financial literacy. The OECD has helped several countries in the region to enhance access to finance for private businesses, including Mongolia, Kyrgyzstan and Tajikistan. The findings from this work suggest that Central Asian governments could enhance data collection on small and medium-sized enterprises (SMEs), further improve public financial instruments via greater involvement of the banking sector, and implement financial literacy strategies for SMEs.

Setting the stage

Firms in Central Asia face barriers in accessing finance, particularly SMEs

Firms and entrepreneurs in Central Asia often identify difficulties in access to finance as a major barrier to starting, sustaining and growing their businesses (OECD, 2015[1]). As in OECD countries, SMEs in Central Asia face strong headwinds in accessing finance. Around one-quarter of SMEs in Central Asia[1] identify access to finance as a major constraint to doing business. The numbers vary strongly by economy, with more than one-third of Mongolia's SMEs struggling with access to finance, while just 4% of Uzbekistan's SMEs cite this as an issue (Figure 2.1.) (World Bank, 2017[2])[2]. In particular, small and medium-sized enterprises (SMEs), generally face higher interest rates and tighter borrowing terms, and they are more likely to be credit-rationed than large firms and have less access to formal sources of finance (Beck, Honohan and Demnirguç-Kunt, 2007[3]).

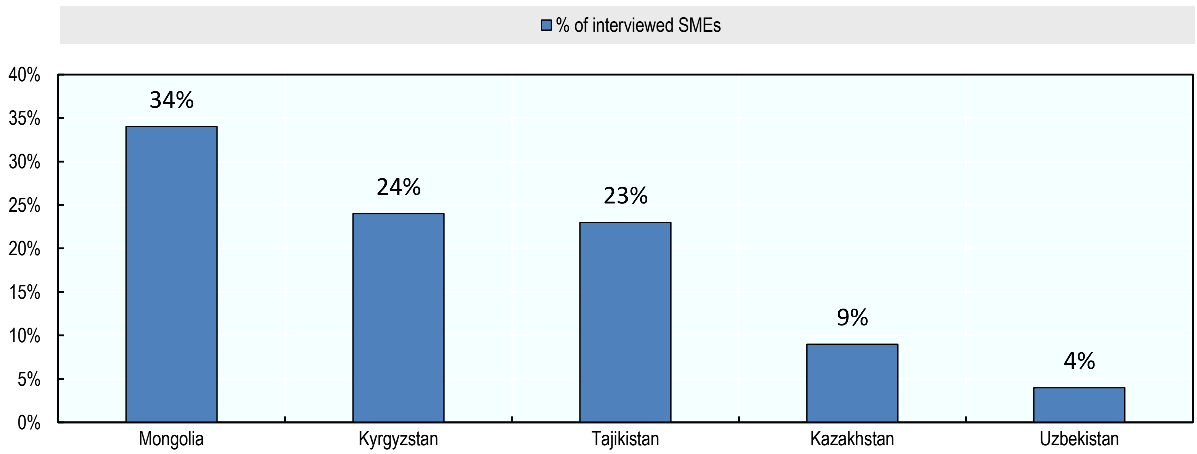
On the supply side, financial institutions see lending to SMEs as riskier. This is often due to the opacity of SME operations and their high transaction costs, under-collateralisation, limited credit history and, in many cases, lack of knowledge of financial products and lack of the expertise needed to produce sophisticated financial statements (OECD, 2006[4]; 2017[5]).

On the demand side, SMEs are also more sensitive to complex and cumbersome administrative and lending processes (OECD, 2015[1]). Agricultural SMEs, which represent the bulk of SMEs in the region, often face risks related to high collateral requirements that can barely be met by farmers whose main asset are land and buildings, which are usually located in remote rural areas and hence without significant market value. The need for collateral to secure loans also constrains innovative start-ups and SMEs whose business models rely on intangible products (OECD, 2004[6]).

While SMEs often rely on personal finance, bank finance is the most widely used external financing tool in Central Asia. However, only a small number of SMEs in Central Asia are actively using banks to finance their working capital and investment. With the exception of Mongolia, less than 25% of companies are using banks to finance their working capital, compared to around 30% in middle income countries and 33% in OECD countries (World Bank, 2017[2]). In the region overall, credit to the private sector stood at 28% of gross domestic product (GDP) in 2015 compared to 147% of GDP in OECD countries and 95% of GDP in middle-income countries (World Bank, 2017[2]) Other options for financing, such as early stage financing through business angels, venture capitalists or credit unions, are very limited.

Microfinance institutions (MFIs) are active in all countries of Central Asia with more than 100 MFIs in each country of the region, but their importance varies across countries (Box 2.1). They represent a limited share of assets in most of the region (under 5% of total assets), but account for up to 17% of outstanding loans in Tajikistan. Their role in supporting the local economy should not be underestimated, especially for regions where bank branches are scarce and for underserved populations, like women entrepreneurs. The sector shows high growth prospects but also faces several challenges, including raising more funding denominated in local currencies, diversifying product lines (various loan products, deposits, money transfers, remittances), and further consolidating and strengthening the financial management of existing institutions.

Figure 2.1. Share of Central Asian SMEs identifying access to finance as a major constraint



Note: Data for Turkmenistan were not available
Source: (World Bank, 2017[2])

The perception among banks that lending to SMEs is high risk is a major hurdle. To cover this risk, banks in Central Asia systematically impose high collateral requirements. Limited availability of information and a lack of financial infrastructure such as credit bureaux and collateral registries contribute to high collateral requirements for SMEs in the region (OECD, 2015[1]). Between 85% and 100% of loans require collateral and the value of the collateral required ranges from 170% to 227% of the loan amount (Figure 2.2) (World Bank, 2017[2]). Private and public credit registries in Central Asia cover between 27% and 52% of adults (World Bank, 2017[2]).

OECD/G20 high-level principles on SME financing provide a framework to support access to finance for SMEs

In 2015, at the request of the G20, the OECD developed high-level policy principles on SME financing, outlined in Box 2.2. The principles aim to support government efforts to enhance access to a diverse range of financing instruments for SMEs, including micro-enterprises, and entrepreneurs. The principles are cross-cutting and build on existing international financial principles and guidelines. They consist of 11 actions that should help SMEs gain access to finance.

Most OECD members have established additional financing institutions and programmes to help SMEs access finance (OECD, 2016[7]). Figure 2.3 provides an overview of the instruments and levers available to policy makers.

Box 2.1. Overview of microfinance institutions in Central Asia

In Kazakhstan, the Association of Microfinance Organizations of Kazakhstan (AMFOK) aims to ensure sustainable access to financial services for the population to reduce poverty and support economic growth. According to AMFOK, 136 microfinance institutions are active in the country. As of April 2017, their total assets amounted to KZT 135 478 million (Kazakhstani tenge; EUR 370 million) and had increased by 7% since the beginning of 2017.

In Kyrgyzstan, the microfinance sector was established with the help of international donors. The Association of Microfinance Organisations of Kyrgyzstan was founded in 2005 to create an enabling environment and support capacity building in the sector. According to the National Bank of Kyrgyzstan, the sector consists of 5 microfinance companies, 232 microcredit companies, 74 microcredit agencies and 172 credit unions.

Mongolia's microfinance sector is mainly supported by the Microfinance Development Fund. In 2002, the Mongolian Parliament enacted laws defining the roles and responsibilities of non-bank financial institutions and legalising savings and loan co-operatives. In 2001, a consortium of these institutions became XacBank, 47% of whose customers were rural clients. From 2002 to 2010, XacBank's assets grew by 26 times, loans increased by 43 times and savings by 25 times and it held assets worth over MNT 2 257 billion (Mongolian tugruk; EUR 773 million) as of 2016.

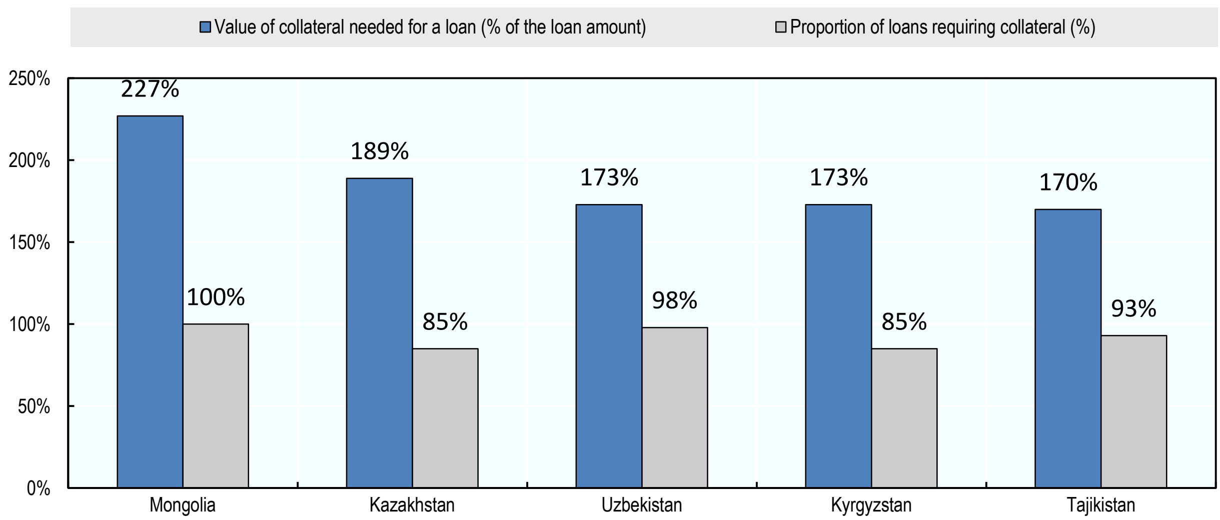
In Tajikistan, microfinance institutions are mainly grouped under the Association of Microfinance Organizations of Tajikistan. MFIs represent a key player in financing the Tajik economy, holding 17% of outstanding loans. Tajikistan's MFIs, which have increased to a total of 124 institutions in 2012, bear a special commitment to social goals and women's empowerment. Women account for 39% of their clients and 32% of loan disbursements.

In 2011, Turkmenistan passed legislation on "microfinance institutions and microfinance" intended to help attract financial resources. However, the institutional framework related to the microfinance sector is not fully developed, and information remains limited on the sector.

In Uzbekistan, the government is directly involved with microfinance operations through several micro-lending programmes managed through specific funds as well as through a number of commercial banks. In 2006, the government reorganised the state-run Tadbirkor Bank as the first specialised microcredit bank. Overall the country has 28 microcredit organisations, while non-bank credit organisations had assets amounting to more than UZS 123.7 billion (Uzbekistani som; EUR 27 million), 46% more than in 2015 (Central Bank of Uzbekistan, 2016[8]).

Sources: (AMFI, 2017[9]; AMFOK, 2017[10]; Central Bank of Uzbekistan, 2016[8]; National Bank of Kazakhstan, 2017[11]; UNDP, 2016[12]; Investment and Export Promotion Agency Kyrygzstan, 2017[13])

Figure 2.2. Collateral requirements for SMEs in Central Asia



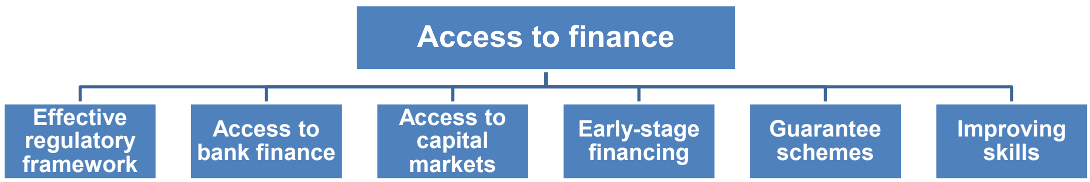
Note: Data for Turkmenistan were not available
Source: (EBRD, 2017[14]; World Bank, 2017[2])

Box 2.2. The G20/OECD high-level principles on SME financing

1. Identify SME financing needs and gaps and improve the evidence base
2. Strengthen SME access to traditional bank financing
3. Enable SMEs to access diverse non-traditional financing instruments and channels
4. Promote financial inclusion for SMEs and ease access to formal financial services, including for informal firms
5. Design regulation that supports a range of financing instruments for SMEs, while ensuring financial stability and investor protection
6. Improve transparency in SME finance markets
7. Enhance SME financial skills and strategic vision
8. Adopt principles of risk sharing for publicly supported SME finance instruments
9. Encourage timely payments in commercial transactions and public procurement
10. Design public programmes for SME finance which ensure additionality, cost effectiveness and user-friendliness
11. Monitor and evaluate public programmes to enhance SME finance

Source: (OECD, 2015[1])

Figure 2.3. Access to finance policy framework



Source: (OECD, 2011[15])

The repertoire of access-to-finance instruments is now quite diverse and very well developed in some OECD countries:

- **Access to bank finance:** Dedicated SME banks and agencies provide direct lending to SMEs with a premium and help improve loan conditions for SMEs. They should address market failures, and bring additional financing over existing bank financing.
- **Guarantee schemes:** Credit guarantee schemes further increase trust and risk-sharing by addressing the lack of collateral that SMEs can offer and by insuring banks against potential credit losses and insolvencies by SMEs.
- **Improving skills:** Financial education programmes for SMEs help them become aware of financing opportunities and financial risks and opportunities. This enables them to make informed business plans and manage their financial records, planning and risks effectively.
- **Effective regulatory framework**: The legal and regulatory framework for bankruptcy helps to protect creditors' rights and to support debt recovery in case of insolvency. Credit and collateral registries also help to reduce information asymmetries by providing potential lenders with reliable information on the existing credit exposure of entrepreneurs and companies.
- **Early-stage financing:** several instruments that help start-ups, small farms and entrepreneurs. **Microfinance** institutions and **co-operatives** can help facilitate access to finance in underserved populations, particularly in the agricultural sector. **Supply chain financing** can help facilitate access to finance for companies that lack collateral, particularly in the agricultural sector where warehouse receipt systems can help overcome this barrier. **Business angels and venture capital** are important sources of capital for start-ups, as they provide initial capital and advice.
- **Access to capital markets**: capital markets can help SMEs raise funds to finance their development. SMEs can issues equity or debts securities on the main capital market or on dedicated stock exchanges. The small size of stock markets in Central Asia is however a strong barrier to this policy option in the region at this stage.

OECD work on SME financing in Central Asia suggests a need for better data, improved governance of SME support institutions and greater financial literacy

Peer reviews on access to finance in Kyrgyzstan and Mongolia were carried out at the OECD Eurasia Competitiveness Roundtable in 2013 and 2016 respectively, as well as a monitoring on Tajikistan in 2017. The example of Mongolia provides insight into how to enhance a full set of financial institutions supporting for access to finance for SMEs. Tajikistan has supported the development of early-stage financing, in particular micro-finance institutions, to help SMEs and entrepreneurs. Kyrgyzstan has designed warehouse receipt systems to facilitate supply chain finance and hence access to finance in the agricultural sector. Key recommendations that could benefit other countries in the region include:

- **Better data collection on SME access to finance:** reliable, precise and coherent data will help inform policy making on access to finance. Mongolia, Kyrgyzstan and Tajikistan could consider adhering to the OECD financial scoreboard to enhance the quality of data on SMEs, and better monitor SME business financing conditions. They could also benchmark their existing situations and programmes on access to finance for SMEs against other countries.
- **Increasing public-private co-operation in managing institutions and instruments that affect access to finance:** public financial institutions need to further involve banks and non-banking financial institutions as well as SMEs and business associations. Mongolia could improve the product offer and scope of its SME Development Fund, as well as the risk management of its Credit Guarantee Fund by further involving banks. In Tajikistan, associations of micro-finance organisations play a pivotal role in reforming the sector, and could be involved with other business associations in the governance of public funds. In Kyrgyzstan, the Chamber of Commerce and Industry and banking associations have been active in designing warehouse receipt financing (WRF), and further support will be needed from them as the WRF is implemented beyond the pilot phase.
- **Expanding financial literacy among SMEs:** aligning national strategies and initiatives with the good international practices of members of the OECD International Network on Financial Education (INFE) could foster local SMEs' understanding of financial instruments and documents, ultimately helping them to get better access to finance. For example, Mongolia needs to implement its financial literacy strategy and add a specific section and actions on SMEs. Tajikistan could help entrepreneurs, especially returning migrants, train on business cases and financial options. Kyrgyzstan could develop capacity building sessions to mobilise and train agricultural SMEs on the new financial instruments.

Table 2.1. Access to finance instruments in Central Asia

	Kazakhstan	Kyrgyzstan	Mongolia	Tajikistan	Uzbekistan
SME funding agency	Enterprise Development Fund (DAMU), the SME funding agency of Kazakhstan, provided loans to 24 000 borrowers	Not in place	SME Development Fund of Mongolia providing loans to SMEs, but operations could be improved	The Entrepreneurship Support Fund (ESF) provides subsidised loans to SMEs, but better governance is needed	Dedicated export support funds for SMEs through the Export Promotion Fund (EPF)
Public credit registry	In place	Not in place	In place	Not in place	Not in place
Private credit bureau	In place	In place	In place	In place	In place
Credit guarantee schemes	Credit guarantee scheme for SMEs under DAMU	A new local credit guarantee fund has been established. The Asian Development Bank (ADB) provided grants to create a credit guarantee scheme	The Mongolian Credit Guarantee Fund has been established, and is expanding with the support of the ADB	Credit guarantee fund in place under the name of Credit Guarantee Fund Tajikistan (CGFT)	A credit guarantee fund (the Small Entrepreneurship Guarantee Fund) is in place
Financial literacy programmes	The Ministry of Finance created the financial social network www.1ccc.kz to support entrepreneurs and increase their financial literacy. KazMicroFinance (KMF) implemented projects to enhance people's and SMEs' financial literacy.	The National Bank of Kyrgyzstan (NBKR) implemented the 2016-2020 Programme for the Increase in Financial Literacy of the Population and created the online platform www.finsabat.kg.	A draft National Financial Literacy Strategy has been prepared, and a dedicated working group set up. The Bank of Mongolia has joined the OECD / INFE	Financial literacy strategy being drafted by the National Bank of Tajikistan with the support of the World Bank. Many projects implemented by Tajik institutions along with international development partners.	Several activities organised under the framework of the project Increase in the Financial Literacy of the population in Uzbekistan, co-ordinated by the Central Bank of Uzbekistan.
Insolvency framework	Strong insolvency framework: ranks 37th in the Doing Business (DB) ranking for this dimension. Recovery rate of 41.4 cents in the dollar, 1.5 years needed to resolve insolvency.	Weak insolvency framework: ranks 130th in DB for this dimension. Recovery rate of 34.3 cents in the dollar, 1.5 years needed to resolve insolvency.	Robust insolvency framework: ranks 91st in DB for this dimension. Recovery rate of 17.1 cents on the dollar, 4 years needed to resolve insolvency.	Weak insolvency framework: ranks 144th in DB for this dimension. Recovery rate of 35.9 cents in the dollar, 1.7 years needed to resolve insolvency.	Robust insolvency framework: ranks 77th in DB for this dimension. Recovery rate of 39.5 cents in the dollar, 2 years needed to resolve insolvency.
Supply-chain finance	Various supply chain financing initiatives, including warehouse receipt financing for grain producers.	Successful pilot warehouse receipt mechanism, currently being expanded; legislation being drafted		Discussions to reform the secured lending legal regime under way	A collateral registry was established in 2015
Early stage financing	Active micro-credit institutions. Existing network of credit co-operatives (RCC) managed by state holding Kazagro AKK	Important role played by micro-finance and micro-credit organisations and credit unions	Limited microfinance institutions and network of co-operatives. Business angels and venture capital mostly active in the mining sector	Active associations of MFIs, current consolidation of MFIs	

Source: (OECD and ADB, 2014[16]; ADB, 2013[17]; ADB, 2015[18]; Business World, 2017[19]; Central Bank of Uzbekistan, 2017[20]; CGFT, 2017[21]; KMF, 2017[22]; Pressreader, 2017[23]; National Bank of Tajikistan, 2017[24]; Sultanov, 2017[25]) (World Bank, 2016[26])

Mongolia: Enhancing access to finance for micro, small and medium-sized firms

Access to finance is a crucial issue for micro, small and medium-sized enterprises (MSMEs) in Mongolia. In 2016, the OECD prepared five main recommendations that include: diversify the loan products on offer, improve the risk assessment tools of the Mongolian Credit Guarantee Fund, streamline the administrative procedures involved in applying for a loan and build the financial literacy of MSMEs. This sub-chapter also looks at how these recommendations could be applied to the cases of the cashmere and textile sector.

Context: Resource dependence and vulnerability

In 1990, Mongolia's peaceful revolution put an end to 70 years of one-party communist rule, opening the doors to the democratic multi-party system that has since been in place. The ensuing economic transition proved extremely difficult. In 1987 around 97% of Mongolia's trade was with Soviet-bloc countries (Earnshaw, 1987[27]), so when the Soviet Union collapsed, a severe contraction followed: real GDP fell by more than one-quarter over four years. The country turned to the international financial institutions for help and for a time Mongolia became the fifth-highest recipient of international aid per capita in the world, while undertaking deep and wide-ranging market reforms in order to secure multilateral support.

After the recession bottomed out in 1993, Mongolia's economy started growing again, driven mainly by the mining sector. Growth averaged 3.2% per year from 1994 to 2000, rising to 7.2% per year from 2001 to 2008 on the back of rising global commodities prices. Following a brief contraction in 2009 (-2%), Mongolia's economy became one of the fastest-growing in the world with real GDP growth averaging +11% per year from 2010 to 2014, driven largely by rapid growth of its mining sector – before slowing sharply to 2.3% in 2015. Declining Chinese demand for mining products and falling commodity prices, however, slowed real GDP growth to 2.3% in 2015, and to 1.0% in 2016 (IMF, 2016[28]; World Bank, 2017[29]).

Today the mining sector accounts for 17% of GDP. Most of the coal, copper and ore dug from the country's vast mineral reserves are exported to China, which is the destination for 88% of all Mongolia's exports. This dependency on a single sector and export destination is a crucial economic challenge for the country. Diversifying the economy is an urgent priority for achieving sustainable growth.

Most of the large companies operating in the country are concentrated in the mining sector, while micro, small and medium-sized enterprises (MSMEs) are the main players in all other economic sectors, especially agriculture, wholesale trade and manufacturing. Overall they generate 25% of GDP and 52% of employment (National Statistical Office of Mongolia, 2016[30]). Policies to build their educational and financial capacity could therefore be one key to diversifying the economy.[3]

A 2015 Bank of Mongolia (BoM) survey of MSMEs revealed that their main constraints were related to their "social, political and macroeconomic environment" (Bank of Mongolia, 2015[31]): 1) the limited purchasing power of the majority of the population;[4] 2) political instability, which has been the norm since 1990, with a new government every two years on average; 3) widespread mistrust of state institutions, which are often perceived as corrupt by the population and by MSMEs;[5] and 4) high vulnerability to external economic conditions. Along with these macro-level issues, access to finance was reported by MSMEs as the main micro-level constraint to doing business (Bank of

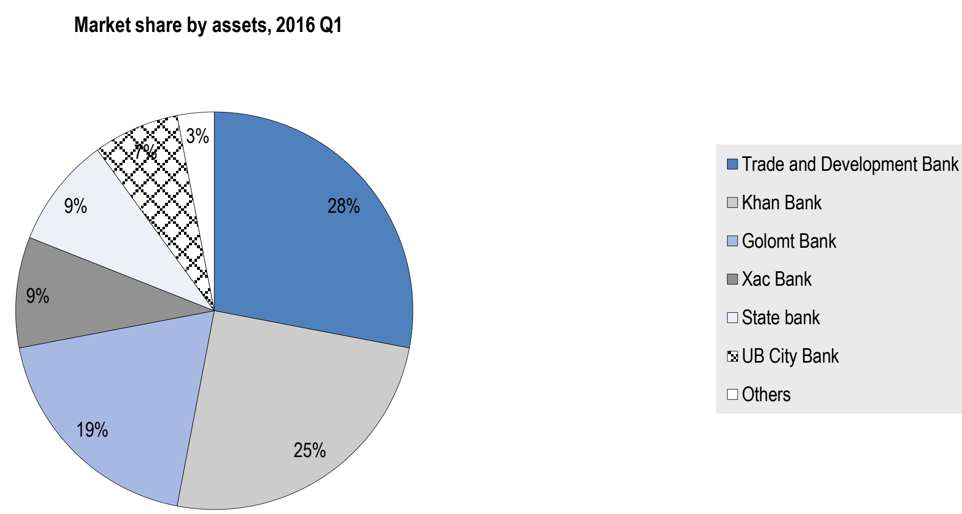
Mongolia, 2015[31]; 2015[32]; 2015[33]). A recent joint survey by the European Bank for Reconstruction and Development (EBRD) and the World Bank also found that access to finance was the barrier most frequently cited by MSMEs (31% of respondents), followed by tax rates (12%) and inadequate education of the workforce (9%); (EBRD and World Bank, 2015[34])). In 2015, domestic credit to the private sector as a percentage of GDP was 55%, compared with averages of 96% for Europe and Central Asia, and 147% for the OECD. Loans to MSMEs accounted for less than one-fifth of the total (17%), compared to 39% in Turkey and a median value of 44% in OECD countries (OECD, 2016[7]; Bank of Mongolia, 2015[33]; World Bank, 2016[35]; 2016[36]).

Credit conditions and access to finance in Mongolia are naturally influenced by the monetary policy set by the BoM. The monetary base expanded rapidly in 2013-14, when the BoM directly injected liquidity into both the financial and corporate sectors. The share of BoM credit among total liabilities for commercial banks rose to 21% in 2013, from 2% in 2012. However, this share had fallen to less than 10% by the end of 2015, partially because of the phasing out of the Price Stabilisation Programme (PSP)[6] and the tapering off of the BoM's quantitative easing programmes. At the same time, the role of local currency deposits as an alternative source of funding for banks has weakened, showing negative growth in the second half of 2015. This has further strained banking sector liquidity. The rapid growth of non-performing loans – from 4.3% of outstanding loans at the end of 2012 to 8.6% in the second quarter of 2016 – is an additional indicator of a substantial deterioration in credit conditions that has been particularly detrimental to MSMEs.

The Mongolian financial sector consisted of 14 commercial banks, 17 insurance companies, 271 credit unions, 434 non-bank financial institutions (NBFIs) and 58 securities and brokerage firms as of the first quarter of 2016. The banking system provides 97% of total lending and 93% of MSME lending. Alternative sources of financing in Mongolia have a very limited role.[7] While the number of NBFIs has grown considerably since the late 1990s, they remain very small, accounting for just 2% of financial sector lending; savings and credit co-operatives account for another 1%.

The banking sector is not particularly concentrated. The top five banks (all privately owned except State Bank, the smallest of the five) held 90% of the sector's total assets of USD 9.2 billion, and 90% of the loans (out of the total USD 5 billion) as of the first quarter of 2016 (Figure 2.4), (EPCRC, 2016[37]). The Herfindahl-Hirschman index (HHI)[8], calculated as the sum of the squares of the market shares, is equal to 1 985 (in a scale from 0 to 10 000), which indicates only moderate concentration.[9] Indeed, it might be argued that concentration is lower than one would expect for such a small economy, given the economies of scope and scale in banking. In any case, bank concentration is not considered to be a reliable proxy for (lack of) competition. The theory of contestable markets in fact suggests that the main players can be non-collusive and compete with each other in an environment with prospective new entrants (Box 2.3). This could lead to desirable outcomes from a consumer welfare perspective (OECD, 2011[38]).

Figure 2.4. The relative diversity of Mongolia's banking sector



Note: 100% of banking assets = 21 557 bn Mongolian Tugruk (= 9.2 bn US Dollars, exchange rate of 24-10-2016 of USD/MNT = 2 331.5); Q1: first quarter
Source: (EPCRC, 2016[37])

Overall objective: Diversify and grow the economy by enhancing MSMEs' access to finance

To create a better business environment for MSMEs, Mongolia should focus primarily on enhancing access to finance by leveraging the role of the banking system. A system offering better loan conditions and guarantees would help to build trust among the players involved: MSMEs, financial institutions, individuals, and public institutions, such as the Mongolian Credit Guarantee Fund and the SME Development Fund. Easier credit would allow MSMEs to invest and expand both in internal and external markets, with positive effects on growth and employment.

Challenges: Access to finance

The latest Business Environment and Enterprise Performance Survey (BEEPS V) found that 56% of Mongolian MSMEs do not apply for loans because they are discouraged by the credit conditions (EBRD and World Bank, 2015[34]). MSMEs face a wide range of difficulties when accessing finance, including high interest rates (23% of respondents), collateral requirements (13%), size and maturity of loans (8%), and complex application procedures (7%) (Figure 2.5). Moreover, interviews with financial institutions operating in the market show that their ability to trust MSMEs and extend credit is hindered by MSMEs' lack of financial knowledge (EBRD and World Bank, 2015[34]).

Box 2.3. Competition in retail banking

In the absence of market imperfections, competition should drive the market towards efficiency by allocating resources in the most profitable market segments, thus encouraging agents to enter them. Banking competition should play a role in improving the loan offer for MSMEs, such as lower interest rates for loans or a lower degree of collateralisation. However, some research suggests that market power can in fact be associated with easier access to credit and better terms for small new and unknown firms. This is because large banks have the resources to create private information about borrowers that is unavailable to other players, which makes them able to lend over time on better terms and conditions (reducing the high default premium/rationing in the absence of that information). In a competitive market with frequent switches, this long-term, mutually beneficial relationship between large banks and small clients would be rarer, with increased costs for the latter.

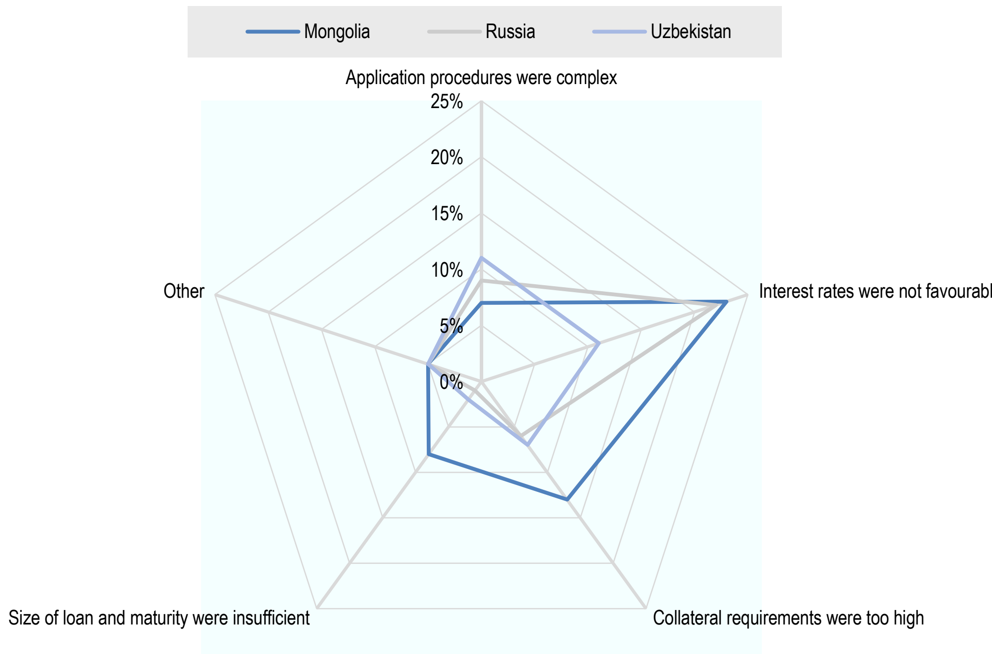
Moreover, prudential regulation often conflicts with the aim of promoting competition. The banking business is inherently based on the trust of the consumers/clients in the financial system as a whole being stable. This means that allowing retail banks to fail, as would be necessary in a truly competitive environment, may make contagion more likely than in other sectors. An individual bank's failure to internalise risks imposes an externality on all other banks, as a run on one bank can spread fear about all the others, including healthy ones.

That is why the OECD Competition Committee has concluded that a focus on barriers to entry would moderately strengthen competition in the market without putting stability at risk. In particular, a main determinant of entry barriers is consumer behaviour. Inelastic consumer demand is often directly caused by lack of understanding of complex products, of credit conditions and of financial concepts that reduce consumer confidence and raise switching costs. The OECD suggests that the most effective ways of supporting competition would be to take steps to increase clients' financial literacy and simplify the administrative procedure for switching (see recommendations to improve financial literacy in this note).

Source: (OECD, 2011[38]; OECD, 2008[39]; Petersen and Rajan, 1995[40])

Overall, these constraints can be categorised either into supply side or demand-side problems. The main supply-side issues include unattractive and costly loans, the high and ubiquitous requirement for immovable assets to be used as collateral, and the overly complicated administrative procedures. Low financial literacy is the main demand-side problem. This assessment was also confirmed by the Economic Policy and Competitiveness Research Centre (EPCRC), a Mongolian think-tank that carried out a horizontal policy assessment for the OECD in 2015-16.[10] Moreover, the lack of coherent and accessible data on MSMEs and on their financing is an additional general issue for policy makers. These issues are discussed and Box 2.7 uses the example of the cashmere and textile sector to illustrate their impact on a sector with diversification potential.

Figure 2.5. Mongolian MSMEs obstacles to access of finance



Source: (EBRD and World Bank, 2015[34])

Data on MSMEs are fragmented and lack coherence

Data on Mongolian MSMEs are gathered by a number of public institutions with limited or no co-ordination amongst them. Responsibility for data collection and analysis is currently shared by the Bank of Mongolia (e.g. data on financing, but also on behaviour and perceived difficulties of MSMEs), the National Statistical Institute (e.g. number, size, sector, geographical location) and the line ministries and their agencies, such as the Mongolian Credit Guarantee Fund (e.g. loan guarantees, SME guaranteed loans) and the SME Development Fund (e.g. financial needs, participation in government programmes). Additional data on MSMEs are gathered by the Chamber of Commerce through surveys among its members and by international organisations, such as the BEEPS survey conducted by the EBRD and the World Bank. These independent surveys offer a specific service, disseminating data to the public and to researchers; they should be encouraged.

This lack of co-ordination makes it difficult to present a clear, transparent picture of MSMEs' situation. Moreover, institutions gather data based on different definitions of MSMEs, thus creating inconsistencies among data on the various aspects of their activities and structure. The SME law of 2007 defines MSMEs on the basis of staff headcount, sector of activity and turnover, while the National Statistical Institute focuses exclusively on staff headcount. By comparison, the EU definition uses staff headcount and turnover but it does not differentiate by sector. To the extent possible, the data pulled together from different sources for this report have been selected to reflect the OECD Scoreboard on SME and Entrepreneurship Finance, which provides a comprehensive framework for assessing the financing needs of SMEs and entrepreneurs and the degree to which these are being met (Box 2.4).

Box 2.4. Key indicators for MSMEs' access to finance in Mongolia

The OECD Scoreboard on SME and Entrepreneurship Finance currently covers 37 countries, and contains data on debt, equity, asset-based finance and framework conditions. These data are complemented by an overview of policy measures to ease SMEs' access to finance (OECD, 2016[7]). Figures related to the loan offer, collateral and loan application (complexity of application procedures and financial literacy) contribute to the main challenges faced by MSMEs in Mongolia and are addressed in the next sections. Table 2.2 contains some of the data on Mongolia based on the OECD Scoreboard on SME and entrepreneurship finance.

Table 2.2. Preliminary data on SME financing in Mongolia

SME financing variable	Value	Indicator
Loan offer	14%	Share of SME loans in total business loans
	19%	Average SME lending rate (July 2016)
	USD 50 mn	SME direct government loans (annual average, 2011-2015)
Collateral	99%	Percentage of SMEs required to provide a collateral on their last bank loan
	200%	Median collateral value required for a loan
Loan application	14%	Rejection rate for SMEs

Source: (EBRD and World Bank, 2015[34]; Bank of Mongolia, 2016[41]; OECD, 2016[42])

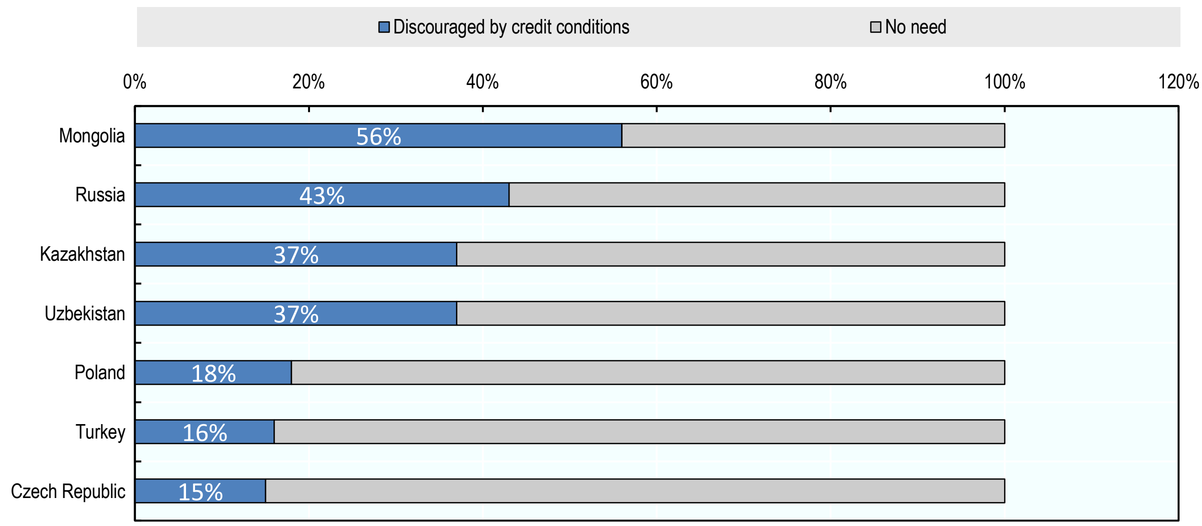
The loan offer is not suited to the needs of MSMEs

Most MSMEs report that the loans on offer from banks and NBFIs do not meet their needs in terms of interest rates and duration. Interest rates are considered too high (average 19.6% in 2016), their maturities are too short (less than a year on average) and while the loans are large enough to provide working capital, they are usually insufficient to finance investment. The BEEPS V survey confirms that the share of MSMEs discouraged from seeking loans is the highest in the region (Figure 2.6).

Undoubtedly, macroeconomic conditions influence the high rates and the profitability of lenders. With a base rate set by the Bank of Mongolia of 12% (increased again to 15% in August 2016), the interest rate spread for bank loans in Mongolia was 6.6% in 2015. This was in line with that of Russia (6.5%), but below the average for low and middle-income countries (6.9%). Moreover, since the tapering off of quantitative easing by the BoM, banks have been financing themselves with short-term, volatile and costly deposits (close to 12% on average in 2015). Their liquidity management is thus challenging, and explains their limited options for offering MSMEs the long-term loans required to invest and expand.

Figure 2.6. Credit conditions discouraging Mongolian MSMEs

MSMEs who did not apply for a loan in the last year before the survey, reasons



Source: (EBRD and World Bank, 2015[34])

Mongolia has established the SME Development Fund (SMEDF) to support financing for MSMEs. Its role includes providing long-term concessional loans for MSME operations, helping MSMEs to access production equipment through financial leasing, promoting the activities of subsidised MSMEs, organising workshops and training, and offering double guarantees for credit. However, following every election the new government changes the status, location and responsibilities of the SMEDF which leads to instability in its function and structure. Prior to 2012 it was an agency within the Ministry of Agriculture and Light Industry, while from 2014 it was a department within the Ministry of Industry. Today it operates from the Ministry of Food, Agriculture and Light Industry.

Between 2013 and 2016 the SMEDF provided MNT 276.1 billion in loans (USD 142 million) to 1 864 MSMEs. The government has recently approved another MNT 200 billion allocation to the SMEDF. However, compared to similar funds in other countries, the SMEDF has a limited portfolio of products and is less developed. Most OECD countries have set up similar public funds to finance MSMEs and to compensate for market failures. These tend to provide a better loan offer to SMEs, including credit interest rate support.

Collateral requirements are ubiquitous and restrictive

In 99% of cases in Mongolia, banks require collateral to guarantee a loan. This is the highest percentage in Central Asia and far higher than the median of OECD countries (where only 40% of SME bank loans require collateral). Furthermore, Mongolia has the highest median collateral value required in the region, at 200% of the value of the loan. In OECD member countries the median value is 148% (OECD, 2016[7]; EBRD and World Bank, 2015[34]).

These tough requirements reflect the deep distrust by financial institutions when lending to MSMEs. Means of enforcing creditor rights are not particularly strong in Mongolia.

The World Bank's Doing Business 2015 rankings give Mongolia a score of 7 out of 8 for the strength of its credit reporting systems, but only 5 out of 12 for the effectiveness of collateral and bankruptcy laws in facilitating lending (World Bank, 2016[35]). The same study finds that the recovery rate for creditors in Mongolia is 17.4 cents on the dollar over 4 years,[11] compared with an average in Europe and Central Asia of 38.3 cents over 2.3 years, and 72.3 cents over 1.7 years in OECD countries (World Bank, 2016[35]).[12] Moreover, the World Bank's survey on financial literacy reveals the inability of Mongolian MSMEs to present reliable accounts of their financial history (World Bank, 2012[43]). This is exacerbated by banks' and MSMEs' reported difficulties in assessing the value of their assets.

As an additional constraint, only immovable assets (e.g. real estate, plant) are accepted as collateral, since they are the only goods properly registered in the credit registry managed by the Bank of Mongolia. Although Mongolia lacks a registry of movable assets, a joint International Finance Corporation/World Bank project is currently developing one in co-operation with the government, through the Law on Movable and Intangible Property Pledges (MIPP law) and the Law on the Implementation of the MIPP Law. These were approved in July 2015 and have not yet come into force.

Information asymmetry is the core reason that commercial banks ration credit to MSMEs.[13] In this context, credit guarantee schemes (CGSs) can help banks accurately identify lending risk and improve their ability to make appropriate lending decisions (Levitsky, 1997[44]). Public intervention is justified, because weak co-ordination among private sector providers may prevent them entering the market for credit guarantees (De la Torre, Gozzi and Schmukler, 2008[45]). There is some evidence that CGSs are a cheaper way to expand access to finance than direct lending. CGSs are also market friendly, as the lending institution usually has sole responsibility for deciding whether to issue the guarantee (Beck, Klapper and Mendoza, 2008[46]). Moreover, CGSs can be a mechanism for risk transfer and diversification – by covering part of the default risk, the lender's risk is lowered. CGSs are particularly relevant in emerging markets and developing economies as they can encourage banks and NBFIs to get into the MSMEs market, thus improving the institutions' lending technologies and risk-management systems (World Bank, 2015[47]). Provision of credit guarantees is also the most widely used policy instrument in the 34 countries included in the OECD Scoreboard on SME and Entrepreneurship Finance which reviews policy measures to support SME finance (OECD, 2016[7]).

The Mongolian Credit Guarantee Fund (MCGF) was established in 2013. It is the main institution in charge of providing guarantees to MSMEs in Mongolia. From 2013 to 2015 it issued guarantees to the tune of MNT 31.2 billion (USD 16 million), unlocking a total of MNT 76.2 billion in loans (ADB, 2015[18]). However, limited resources and unreliable operations have hindered its capacity to support the credit market, and operations have halted since mid-2015 due to the limited guarantee funds available and the decrease in applications sent by banks (Box 2.5). Banks lost confidence since some guarantees were not repaid by the MCGF; during interviews with the OECD they underlined that no guarantee was paid by the MCGF in 2016.

MCGF representatives also stated that fees amount to 3% of the loan and coverage is up to 60% of the total amount borrowed; this is in line with the OECD average. However, at 12%, defaults appear to be higher than similar schemes in other countries, such as Turkey's Credit Guarantee Fund (around 5%), and Estonia's KredEx (around 2%). This is even more striking given MCGF's high rejection rate for applications (26% compared to

KredEx's 20%[14]). In 2016, the OECD carried out a short analysis of the MCGF's risk scoring tool. While the tool appeared robust, staff's lack of practice and capacity to use the tool to reduce the rejection and default rate appear to be a substantial problem. The fund's team is currently working on improving internal operations with the support of international organisations.

Box 2.5. Mongolian Credit Guarantee Fund's protocol for working with banks

The MCGF has a bilateral agreement that governs its relations with the banks. It also has an operational protocol with banks based on the following procedure. The MCGF establishes a co-operation agreement (called a framework agreement) with banks prior to operation. Once a bank submits an SME-borrower's loan guarantee application to the MCGF for approval, the MCGF will revise the loan application as necessary, assess the risk and decide whether to provide the guarantee. Based on the decision of the MCGF Committee, which includes representatives from banks, the MCGF establishes a tripartite agreement with the bank and the borrower. After the guaranteed loan is issued, the MCGF conducts monthly monitoring and evaluation of loan utilisation, business operations and the repayment process. The bank subsequently submits monthly reports to the MCGF on loan repayment.

Source: OECD interviews, 2016.

OECD interviews with banks suggest that there is limited trust in the guarantees offered by the MCGF. There are reported cases of the MCGF refusing to pay out the guarantee and preferring to go to trial instead. Without examining the specifics of these cases, it is apparent that trust in the MCGF can be heavily undermined in such circumstances, reducing the institution's effectiveness in sustaining the credit market. This is also confirmed by the results of the OECD survey on MSMEs, which indicates that bank officers are often not interested in the possibility of a guarantee by the MCGF as a substitute for collateral.

The administrative process to obtain a loan is cumbersome

Cumbersome procedures were the fourth most important reason given by Mongolian businesses for not applying for a loan (Figure 2.6): 7% of Mongolian businesses declare that they were discouraged from applying for a loan because of the procedures involved (EBRD and World Bank, 2015[34]). This is similar to Kazakhstan (8%) and Russia (9%), but higher than some OECD countries, including Poland (4%) and the Czech Republic (2%). MSMEs and business associations interviewed by the OECD confirmed that MSMEs need to submit five different administrative documents, often involving multiple interactions with several public agencies and certification bodies (including the tax administration, local administration, and environment agencies). According to an OECD survey of MSMEs, the complexity of this process stems from insufficient co-ordination among and within government agencies, and with the SMEDF and banks; unnecessary documents being requested; the same documents being asked for several times; the requirement for burdensome and costly notarial seals; the limited knowledge of agency staff; and lack of information provided by the administration.

MSMEs also face a complex process when applying for a subsidised loan from the SMEDF. The whole process takes between six and nine months according to MSMEs, and the uncertainty surrounding the various steps can be discouraging and make their application irrelevant. With very limited support, MSMEs must prepare a total of 30 documents for the 2 institutions (the private bank and SMEDF). Of these, seven are actually administrative documents that the MSME must submit to different public agencies (Table 2.3). Most official documents are available as online forms, except the social insurance statement which requires additional documents to be presented in person.

Table 2.3. Documents required for MSMEs' subsidised loan application in Mongolia

	Mongolian bank	SMEDF
Entrepreneurs	A copy of citizen identification card	Civil documents
	Statement of residential Khoroo[1]	Statement of residential Khoroo[1]
	Collateral information (copy of certificate)/inquiry whether it is already collateral	State registration certificate of rights to the collateral property
	Application of executive official	
	Photo size 3x4	
Project	Business plan (extensive)	Business plan (extensive)
	Agreements related to the main operations (supply, purchase")	Proposed sale plans and contracts
	Calculation of loan profit and repayment source	Loan repayment graphics
	Photos related to the main operations	List of photos of equipment
	Ordering agreement	
	Official letter for the loan request	
	Shareholders' meeting resolution	
	Calculation of loan disbursement	
	Forms and contracts related to loan request	
Company	State Registration Certificate of Enterprise	State Registration Certificate of Enterprise
	Statement of Tax Administration	Statement of Tax Administration
	Company charter	Company charter
	Brief introduction of the company	Information about current business
	Number of employee	Structure, number of employees
	Financial statements of previous years (by quarter)	Financial statement of previous year
	License for manufacturing and services	
	List of work done in the past, and estimated profit	
	Audit of financial statement	
	Annual report for 2012, 2013	
		Social insurance statement, record
		Location of enterprise
		Employees' major and professional qualification
		Annual turnover, sales, percentage of export
		Name, type and photos of products to produce
Total administrative documents required,	6	6
of which overlapping	5	5
Total other documents,	19	12
of which overlapping	8	8
Total	25	18
Total overlapping	13	13
Total of 7 administrative docs + 23 additional docs = 30 total documents to be presented by SMEs		

1. Administrative subdivision of Ulaanbaatar.
Source: (OECD, 2016[48])

This administrative process is costly for companies in both time and resources. This is particularly acute for MSMEs which do not have dedicated staff and time to deal with these procedures. Interviews conducted by the OECD suggest that in some cases the complexity of the process discourages MSMEs from even attempting to access the financial system.

Various bank officials complained about the poor quality of the projects submitted to them during interviews with the OECD, but also reported a reluctance to refuse projects that had been approved by the SMEDF. They also said that the quality and robustness of loan applications supported by the SMEDF were questionable, and they underlined the lack of transparency of the process leading to this list (Box 2.6).

Box 2.6. The SMEDF's operational protocol

In the current setup, loan applications are assessed by the SMEDF, approved by the Ministry of Industry and submitted to banks as a list of selected loan applications. Following a decree issued by the ministry, the SMEDF and ministry's SME policy officers in district offices prepare the tenders and disseminate information to the public. MSMEs prepare applications and send them to district offices. District offices select those that meet the requirements and submit them to the Project Selection Committee (and Sub-committee) of the SMEDF. These committees, mainly composed of representatives of the SMEDF and the local administration (but not of banks), review and submit the list of selected projects to the Minister of Industry for approval. After receiving the approval, this list is transferred to the commercial bank or NBFIs.

Source: (Ministry of Industry, 2016[49]).

Since 2007, Mongolia has established 41 one-stop-shops (OSSs) for citizens, with support from the Swiss Development Cooperation (SDC). These aim to increase the accessibility and transparency of public services related to social services, land, employment and notary procedures and programmes in all regions and most districts of Mongolia (ILO, 2016[50]). In the first half of 2014 they served 845 000 customers, and the rate of satisfaction was high (SDC, 2015[51]). However, they do not include business-relevant information and business associations; MSMEs interviewed by the OECD had little or no knowledge of these one-stop-shops. Various partners of the OSSs have identified areas for improvement, including streamlining bureaucratic procedures further, improving co-ordination with local authorities, and giving the OSS a wider remit than simple information provision (ILO, 2016[50]).

Box 2.7. Access to finance in the Mongolian textile sector

Cashmere is a key resource for the Mongolian economy. The country produces about 2 500 tons of raw cashmere each year, making Mongolia the world's second largest producer of raw cashmere (15% of global production) after China (75%). The sector is the top non-mining related sector in Mongolian exports, representing 6% of national exports. Annual export revenues from cashmere and textiles are close to USD 300 million but they could be higher – a significant share of production is smuggled into China. Mongolia is currently concentrating on the production and export of raw cashmere – it would benefit from further developing local manufacturing of textiles and garments, and from targeting exports of higher value-added cashmere products. Only an estimated 30% of raw cashmere is converted into finished products in Mongolia (National Statistical Office of Mongolia, 2015[52]).

Cashmere and textiles could play an important role in the diversification of the Mongolian economy. However, access to credit is holding them back. The Mongolian government has distributed USD 68.8 million to the sector in the form of Chinggis Bonds – state-issued bonds distributed through Golomt Bank. However, this approach, while benefiting SMEs, risks crowding out private investors and distorting market competition. The difficulties faced by businesses in the cashmere and textile sector when accessing finance reflect the four issues faced by MSMEs across the economy (the fifth issue – data quality – is only indirectly relevant for MSMEs):

1. **The loan offer is not suitable.** Loans have relatively short maturities and capital is expensive. For example, herder loans are provided for a maximum of two years. Interest rates on domestic currency loans fluctuate around 20%, twice the rate of foreign currency loans. Textile and garment manufacturing companies also face high interest rates, and the small sizes of loans prevent them from upgrading their equipment.
2. Herders and manufacturing companies in the cashmere sector also **lack collateral**. Herders face high risks due to climate vulnerability, nomadism and the absence of real property. Their lack of immovable collateral leads banks to undervalue assets and eventually stop lending to herders. Manufacturing companies also complain of undervaluation of their fixed assets, especially factories used as collateral. Banks interviewed by the OECD underlined the difficulty of valuing assets on the fluctuating real estate market. MCGF intermediation is therefore crucial to sustain lending to both targets. The cashmere sector represents 5% of MCGF users and 8% of guarantees, but is over-represented for high-risk loans (17%) compared to its share in national production (close to 10%). The MCGF also records a relatively high rate of non-performing loans (28%) in the cashmere sector.
3. **The procedure for obtaining a loan** can also be a barrier both for herders and textile manufacturing firms. More than 30 documents are required, and the process can take between two and nine months. More specifically, herders suffer from a lack of clear information and the difficulty of providing proof of permanent residence. Manufacturing companies interviewed by the OECD reported a lack of training and information on the part of both banks and public agencies.

4. The cashmere sector suffers from low financial literacy. There is a correlation between low financial literacy scores and high presence of herders in several regions (World Bank, 2013[53]). Financial literacy difficulties vary along the value chain. While herders lack basic financial education, especially to make savings and investment decisions, manufacturers and exporters need training in advanced financial auditing and reporting, as well as developing a global financial strategy for their expansion.

Sources: OECD analysis, questionnaires and interviews; (World Bank, 2013[53]; National Statistical Office of Mongolia, 2015[52]; UNESCO, 2013[54]) (Bank of Mongolia, 2015[31])

Understanding of complex financial concepts is limited

A financial literacy survey carried out by the World Bank in 2012 revealed that Mongolian adults had limited understanding of basic financial concepts, although the vast majority of the population was aware of financial products and had mastered basic arithmetic (World Bank, 2013[53]). For example only 39% understood inflation correctly, in contrast to an average of 44% in the other countries included in the survey and 60% in advanced economies (World Bank, 2013[53]). Another survey found that agricultural SMEs (mostly herders) were less familiar with financial concepts than firms operating in Ulaanbaatar and in regions with mining activities and companies. The Financial Regulatory Committee (FRC), the Bank of Mongolia and the Ministry of Finance have prepared a National Strategy for Financial Literacy that was approved in 2016; however, it does not include provisions explicitly designed for MSMEs. In addition, the strategy does not map the various initiatives around the country to expand financial literacy (such as the Banking Academy on the supply side and the National Incubation Centres Association on the demand side). Having an overview of these initiatives would allow them to be leveraged to unlock possible synergies and could avoid overlap (Bank of Mongolia, Financial Regulatory Commission and Ministry of Finance, 2016[55]).

Recommendations to enhance MSMEs' access to finance

In 2015, the OECD adopted the G20/OECD High-Level Principles on SME Financing, following a request from the G20 Finance Ministers and Central Bank Governors (G20/OECD, 2015[56]). These principles form the basis for much of the analysis in this sub-chapter, and the Mongolian government could consider them when developing its long-term strategy for SME development, as they give an all-encompassing view of the most relevant policy areas. These include improving the evidence base; strengthening SME access to bank financing; promoting financial inclusion; improving transparency in SME finance markets; including risk-sharing principles in publicly supported SME finance instruments; and the best way to monitor government programmes.

In particular, in order to improve the ability of MSMEs to obtain loans for their working capital and investment projects, it is recommended that the Government of Mongolia design and implement a consistent plan aimed at streamlining the loan offer and making them more affordable. At the same time, the government also has a fundamental role to play in providing entrepreneurs and MSMEs with a stronger grounding in financial planning to ensure that loans can be repaid thanks to companies' healthy financial management. Credit conditions and accessibility (especially in rural areas) should be tackled with a comprehensive national strategy that should be included in the next national SME strategy.

Specific recommendations are as follows:

- gather and disseminate more coherent and reliable data on MSMEs through a co-ordinated approach by the Bank of Mongolia, National Statistical Institute and line ministries, while also leveraging the OECD Scoreboard on SME and entrepreneurship finance;
- develop the conditions for a better and less costly loan offer to MSMEs by diversifying the products offered by the SME Development Fund (SMEDF);
- overcome the collateral issue by improving the Mongolian Credit Guarantee Fund's risk appraisal techniques and building the trust of banks;
- make it easier for MSMEs to request loans by streamlining the banks' and SMEDF's administrative processes through a one-stop-shop backed up by support and training, and enhancing the co-operation between the SMEDF and partner banks and
- increase financial literacy through public-private co-ordination, including activities for MSMEs in the National Strategy for Financial Education, and creating tailored tools to meet MSME needs, also leveraging the expertise of the OECD International Network for Financial Literacy.

The remainder of this sub-chapter provides more details on each of these recommendations. It also applies these recommendations to the case of the cashmere and textile sector.

Recommendation 1: Develop and disseminate coherent data on MSMEs

Reliable and coherent data are a necessary precondition for effective policy design. It is recommended that Mongolia increase co-ordination across the various institutions in charge of MSME data collection. To this end, the OECD Scoreboard on SME and Entrepreneurship Finance could provide a comprehensive and internationally comparable framework.

Action A: Develop a co-ordinated approach among public institutions and consider joining the OECD Scoreboard on SME and entrepreneurship finance

The varying definitions of MSMEs used by the various state institutions, in some cases differing from the 2007 SME law, should be harmonised. A whole-of-government approach will help to overcome the lack of co-ordination among the public bodies collecting and working on MSMEs data. The OECD Scoreboard could provide a basis not only for ensuring harmonisation of practice across government bodies, but also for enabling Mongolia to develop data better suited to international comparisons. A list of core indicators is presented in Table 2.4.

Table 2.4. Core indicators of the OECD Scoreboard on SME and entrepreneurship finance

Core indicators of the OECD Scoreboard	Data availability (Y/N)	Mongolia: Source of Data
1 – Share of SME loans in total business loans	Y	Bank of Mongolia
2 – Share of SME short-term loans in total SME loans	N	Not published (Bank of Mongolia)
3 – SME loan guarantees	Y	Not published (Mongolian Credit Guarantee Fund)
4 – SME guaranteed loans	Y	Not published (Mongolian Credit Guarantee Fund)
5 – SME direct government loans	Y	SME Development Fund
6 – SME rejection rate	Y	BEEPS – EBRD/World Bank
7 – SME loans used	Y	BEEPS – EBRD/World Bank
8 – SME NPLs/SME loans	N	Not published (Bank of Mongolia)
9 – SME interest rate	Y	BEEPS – EBRD/World Bank
10 – Interest rate spread between large and small enterprises	N	Not published (Bank of Mongolia)
11 – Percent of SMEs required to provide collateral	Y	BEEPS – EBRD/World Bank
12 – Venture and growth capital	N	Various privet equity funds
13 – Asset-based finance	N	-
14 – Payment delays	N	-
15 - Bankruptcies	N	-

Source: (OECD, 2016[7])

Recommendation 2: Diversify the products offered by the SME Development Fund

The SMEDF is best placed to support a better and more extended loan offer to MSMEs through direct lending and co-financing with banks. The operations of the fund are being re-organised, and the Department for Coordination of SME Policy Implementation is now under the Ministry of Food, Agriculture and Light Industry. This is expected to ensure greater stability of resources and governance, which would allow continuity in the operations and more reliability for all its partners, especially banks and MSMEs. A good example for Mongolia to follow is that of KOSGEB, the Turkish SME development organisation (Box 2.8). KOSGEB supports loans to SMEs through credit interest subsidies and has a diversified loan offer which responds to the needs of MSMEs.

Action B: Diversify SMEDF’s products

Currently the SMEDF’s offer through the partner banks is limited to a few types of loans and leases. SMEDF’s management should expand this offer to better address the needs of MSMEs throughout their life cycles (e.g. seed capital, export, cash flow, long-term investment). According to international experience, the loan portfolio should therefore include: new start-up loans, express loans (cash flow), fixed capital loans, international development loans, green loans, innovation loans and export loans, among others. Double guarantees should be designed in mutual partnership with the private sector, also including the MCGF when necessary. A single MSME should be able to request more than one type of loan, depending on the goal of its project or investment plan. Each type of loan should vary in its maturity, size, rates and collateral requirements (ideally none) to tailor it to need. In addition, specific loan programmes could be created to target priority MSME types, such as start-ups. As start-ups are particularly sensitive to external financing conditions, they may benefit strongly from programmes such as seed financing and long-term innovation loans, as well as possibly equity financing.

Box 2.8. Financial services for SMEs in Turkey

According to the OECD Scoreboard on SME and Entrepreneurship Finance, SME loans in Turkey increased by 23% in 2014 compared to 2013, to reach a total of 38% of total business loans. Non-performing loans (NPLs) have remained limited since 2010 and were recorded at 3% of total loans (OECD, 2016[7]). Public support for access to finance for SMEs in Turkey is mainly provided by KOSGEB, the Turkish SME development organisation affiliated to the Ministry of Science, Industry and Technology. It supports the development of more than 850 000 registered SMEs in the country. KOSGEB offers a wide range of financial products to improve access to finance for SMEs, including credit interest support, guarantees, training and equity.

Regarding credit interest support, KOSGEB works in close co-operation with banks. KOSGEB pays the loan interest for SMEs which receive loans from banks under a contractual agreement with KOSGEB. Loans supported by KOSGEB cover various SME needs, such as working capital, exports, investment, new employment and energy efficiency. Since 2003, more than 214 000 SMEs have benefited from the programme, representing USD 370 million in loan interest support and USD 4 billion of credit volume created.

To enhance SMEs' access to its services, KOSGEB has an extensive network of branches, 88 service centres and 33 technology development centres. It is present in all Turkey's provinces. This large network is also leveraged to offer many different forms of non-financial support to MSMEs: from enabling Turkish companies to take part in international trade fairs, to training and mentoring – especially through the adoption of the "Entrepreneurship Support Programme". KOSGEB has also signed 83 research and development innovation protocols.

KOSGEB also offers a very interesting example of financial literacy promotion. It has established e-learning infrastructure called "SME Campus", a dedicated platform for SME e-training. Moreover, an agreement between KOSGEB and the Council of Higher Education underpins university-business co-operation involving a dedicated platform (USIMP).

Sources: OECD interviews with the KOSGEB; (OECD, 2016[7])

BPIfrance, the French public bank for SMEs, gives access to a vast portfolio of loans from which SMEs can select through the website or directly in agencies. Moreover, BPIfrance has recently incorporated a private equity division that focuses on French companies with good growth potential. DAMU, the SME fund in Kazakhstan, has organised its loan offer by sector, regional presence, and target (e.g. programme to support the manufacturing industry, programme to support regional priority projects, microcredit for women's entrepreneurship).

Recommendation 3: Ease collateral demands by making the Mongolian Credit Guarantee Fund more effective

In order to reduce the need for overly demanding collateral requirements, the Mongolian Credit Guarantee Fund (MCGF) needs to improve its risk assessment techniques and product offer. It also needs to increase co-ordination with and build the trust of private sector players. This may require modifying the provisions in the current law on the Credit Guarantee Fund. International experiences may offer viable models for increasing reliability for all stakeholders (government, banks and MSMEs). Most successful CGSs in OECD countries involve frequent visits to banks' offices and exchanges with management and loan officers. For example, broad international experience in CGS management, especially appropriate funding and best practices for monitoring the fund, could be drawn on, especially the World Bank's high-level Principles for Public Credit Guarantee Schemes for SMEs (World Bank, 2015[47]). The MCGF should expand its operations to support development, and could consider including banks on its board and involving them in the guarantee appraisal. Finally, the MCGF should improve its claims management.

Action C: Strengthen trust between MCGF and banks by including bank representatives on MCGF's board, by implementing financial agreements and by sharing risk assessments

The MCGF could update its operational protocol and start co-operation with banks on risk procedures prior to drafting the framework agreement, in order to reflect agreed upon practices in the agreement. In addition, it is recommended that the MCGF engage in frequent interactions with banks to discuss and adjust risk assessment policies and to share practices and views on applications. This would ensure a mutual understanding of the guarantee assessment and provision, and better management of default. Including banks on the board of the MCGF would increase trust and allow the financial sector to have shared ownership of the instruments, with positive effects on MCGF's expansion and effectiveness. International experiences like those of DAMU and BPIfrance have illustrated the potential of this arrangement. This would be complementary to the financial capacity needed to implement the financial agreements with private players.

BPIfrance has a network of regional offices which include banks on their governing boards so they can participate in decisions on loan and risk assessment policies. Moreover, BPIfrance loan officers are required to show a good understanding of the sector and the business operations of the SME, in addition to having loan assessment skills. Staff always visit the SMEs' facilities when assessing the loan, sometimes jointly with banks. Moreover, BPIfrance meets with partner banks almost weekly to agree on the loan assessment and ensure that its processes and policies are aligned with those of each partner bank.

Action D: Enhance risk appraisal using risk assessment tools from banks and institutions with international experience

The MCGF could improve its risk assessment tools by leveraging international experiences. Most of the operational indicators of the fund are in line with international experience: the share of total MSME loans covered by guarantees is, at 1.4%, similar to DAMU and higher than Estonia's KredEx (0.5%) and Turkey's CGF (0.2%). Pricing mechanisms should be linked to risk exposure, usually charging a guarantee commission fee covering administrative and management costs.[15] The MCGF's fees can go up to 3% of the value of the guarantee, comparable to Turkey's CGF, while KredEx's go up to 1% and DAMU's to 0.1%. Coverage of the guarantees is up to 60%: this is somewhat lower than, but still in line with, international players (DAMU, KredEx and CGF of Turkey are at 70%, 75% and 85% respectively). A comparison of 70 schemes worldwide revealed an average coverage ratio of 80%, although coverage is lower for more risk-averse schemes (without public funds) or schemes exposed to higher risks (Beck, 2010[57]).

The MCGF could benefit from further capacity building and support in implementing risk assessment tools and procedures. It should also consult with banks before and during the risk assessment to align methods, and to agree on the risk-scoring results and the decision on providing (and later paying) the guarantee. This will be key for building the trust of the banks. In principle, all parties involved (SMEs, banks, credit guarantee schemes) should retain a sufficient share of the risk and responsibility to avoid moral hazard (OECD, 2013[58]). Concerning the late payment of the guarantee, the World Bank's Principles for Public Credit Guarantee Schemes for SMEs, especially Principle 13, give general guidelines for structuring an efficient claim management process, providing incentives for loan loss recovery and aligning with the legal and regulatory framework (World Bank, 2015[47]).

BPIfrance uses a dedicated computerised instrument for risk assessment, which assigns a score to counterparty risk, project risk and transaction risk. The rating obtained is only a support to decision making, which also takes into account immaterial elements, such as qualities and weaknesses of the project, the entrepreneur profile, and market perspectives. BPIfrance also leverages its extensive experience by combining statistical data on defaults of past projects, observed over long periods, to infer the most appropriate multiplier for each fund.

Recommendation 4: Streamline administrative procedures for loan applications

The government could undertake several actions to simplify the administrative process of obtaining key documents for loan applications to banks and the SME Development Fund and make it more business friendly, not least by reducing the number of required documents and making them more easily accessible.

Action E: Increase co-ordination between SMEDF and partner banks

The SMEDF should allow banks to join the decision-making process at the earliest possible stage by organising regular knowledge-sharing meetings. It may consider including them on both the loan selection committee and the board (possibly as rotating members, to ensure the independence of the institution). While loan applications are currently first assessed by the SMEDF and then by banks, the SMEDF has indicated that it might change its process for spending new funds so that loan applications would be assessed by banks before being reviewed by the SMEDF, a practice that offers considerable advantages. The review would involve regular discussions and knowledge sharing between the banks and the SMEDF. The SMEDF should hold discussions with the banks to agree on the documents and forms to be requested by each partner bank. The procedure could be aligned with that of partner banks, so that the MSME does not need to produce additional documents for the bank and for the SMEDF. This practice would not only strengthen trust relations with banks, it would also simplify the process and reduce the number of administrative documents required to apply for subsidised loans. It could mean that at least 13 documents would only have to be submitted once (instead of twice as is currently the case – see Table 2.3). It would also better align the procedure to reduce the remaining 17 documents that need to be submitted (see next action point).

BPIfrance's more established practice allows SMEs to negotiate either with the bank or with BPIfrance – the application is sent to the other co-financer once approved by the first institution. As the documents required by the banks and BPIfrance are similar, they are requested only once by the first institution in contact with the MSME to avoid duplication of procedures. This model requires deep trust between banks and BPIfrance. In the case of DAMU, the bank receives and analyses the request, and transmits it to DAMU if the case is strong enough. DAMU checks the quality of applications and either accepts or rejects the co-financing. DAMU's board membership includes its partner banks (Box 2.9).

Box 2.9. DAMU's support for SME development in Kazakhstan

The role of SMEs in Kazakhstan's economy has become more and more important in recent years. The number of SMEs more than doubled between 2005 and 2014. In the same period, SMEs' share of employment increased from 26% to about 32%. Similarly, whereas in 2005, SMEs generated 11% of Kazakhstan's GDP, by 2014 this figure had risen to about 25%. Kazakhstan's Entrepreneurship Development Fund (DAMU) was established in 1997 by the Government of the Republic of Kazakhstan. To start with, DAMU mainly managed state budget funds for the programme of measures to support domestic commodity producers. It was only in 2002 that the fund started to provide small businesses with financial resources.

DAMU has two key goals. The first is to ensure and strengthen financial support for SMEs. The increase in the volume of financial support for SMEs is achieved through co-operation with second-tier banks, the recourse to a subsidised fee rate for credits, the provision of loan guarantees, the development of the microfinance sector, and the attraction of extra funding from domestic and external markets (e.g. ADB Fund, National Fund of Kazakhstan etc.). Secondly, DAMU aims to promote SME competencies. It pursues this goal by offering training opportunities to entrepreneurs, extending the outreach of consulting services (more than 200 centres have already been set up all around Kazakhstan), and introducing new forms of distance consulting methods, such as call centres and business portal services.

DAMU provided financial support to 23 995 borrowers for a total amount of KTZ 1 391 billion (USD 4.2 billion). Furthermore, 1 484 projects for a total loan amount of KTZ 293 billion (USD 885 million) were financed from the National Fund in the manufacturing and services sector.

Sources: (DAMU, 2014[59]; DAMU, 2014[60]; DAMU, 2016[61])

Action F: Reduce the number of documents required by banks

In order to stimulate demand for loans, the government could consider reducing the number of official documents required by banks from MSMEs. In France, the number of documents required by banks is generally slightly lower, with up to 18 documents related to the project, the entrepreneur and the company. In particular, French banks only require three administrative documents to be submitted, compared to five in Mongolia (Table 2.5).

Table 2.5. Documents required to obtain a loan in Mongolia

	Mongolian Bank	French bank
Official documents required	A copy of citizen identification card	Identification
	Statement of tax administration	Recent fiscal statements / tax bill
	State Registration Certificate of Enterprise	Recent Kbis (state registration of enterprise)
	Statement of residential Khoroo[1]	
	Licence for manufacturing and service	
Total	**5**	**3**

Note: [1]Administrative subdivision of Ulaanbaatar
Source: OECD interviews with Mongolian banks (March 2016); OECD interviews with French banks (April 2016).

Action G: Consider implementing one-stop-shops for MSMEs

The principle of a one-stop-shop is to bundle in a single physical/online space all the procedures required for business administrative processes. The gain in efficiency is two-fold: a one-stop-shop should not only simplify the procedure for the entrepreneur, it should also help co-ordinate the various ministries involved in the process. Creating one-stop-shops for businesses would save the MSMEs a considerable amount of time. By providing a single interface for questions and clarification, this would strongly simplify the administrative part of the process, avoid contradictions and make the timings more predictable. It would also optimise costs for the public administration. Georgia provides a good example of a successful one-stop-shop for businesses (Box 2.10).

Mongolia could extend its current citizens' OSSs to include services to businesses. New OSSs may also be needed. To set these up, the government could consider the following steps:

- Secure high-level political support and buy-in through discussion and government endorsement. The launch of this project will also require a wide media campaign by the government to inform businesses, and will also require the support of business associations including the Chamber of Commerce and Industry.
- Give a clear mandate to the Ministry of Food, Agriculture, and Light Industry to co-ordinate the work with other administrations, and to identify which administrative processes should be handled by the one-stop shops. This could be done by selecting the processes and documents which are the most used by MSMEs, and by leveraging the procedures currently supported by the existing OSS.
- Consult widely to identify the needs, key missing procedures and access limitations for businesses in the current OSSs. Identify those procedures that can be dealt with by the OSS on behalf of businesses, revising and simplifying protocols and guidelines with the relevant administrations, and agreeing on the transfer of authority from the administration to the one-stop-shop for approving and rejecting applications.
- Agree on clear, transparent and shared business pricing and location of the shops, potentially in different locations from the existing OSSs (OECD, 2013[62]).
- Staff the OSSs by detaching staff from line ministries and providing additional staff (OECD, 2010[63]).
- Establish information technology tools and a database to address and store requests (ILO, 2016[50]).

- Launch two pilot OSSs – one in Ulaanbaatar and the other in a district outside the capital – to test the robustness of the model in two different contexts.

In the future, the government could also consider launching an electronic one-stop-shop to allow businesses to conduct all procedures online, as was done in Kazakhstan. Kazakhstan has also developed an efficient e-government system that delivers all licenses electronically through a single website. Most administrative procedures can now be conducted be online, which saves time and resources for businesses (OECD, 2014[64]).

Box 2.10. One-stop-shops for businesses in Georgia

In 2012, the Georgian government introduced a "single window principle" by creating the Public Service Hall; a large centre where all certificates needed to launch a business are provided. After creating the first one-stop-shop in Batumi, Georgia replicated this initiative across the country – to 13 other cities and regions. The large diversity of services provided, 400 in total, as well as the effectiveness of this organisation, explain its success.

Starting a business in Georgia now only requires two procedures and takes on average two days. In 2012, the Public Service Hall was awarded the United Nations Public Service Award in the category Improving the Delivery of Public Services. The World Bank Doing Business report 2016 ranked Georgia 6th in 2016 for its ease of starting a business.

Sources: (Government of Georgia, 2016[65]; OECD et al., 2015[66]; World Bank, 2016[35])

Recommendation 5: Improve financial education by ensuring the national strategy is tailored to MSMEs

Good financial literacy is an important element in improving access to finance. It is defined as the ability of individuals to make informed judgements about financial products and behaviour and to take part in financial decisions (OECD, 2013[58]). A high level of financial literacy not only contributes to financial well-being and to financial market stability, it also helps improve access to finance through a better understanding of financial products. Low financial literacy remains a major obstacle for MSMEs in Mongolia, because they are generally considered un-bankable due to their weak management skills and poor financial reporting (World Bank, 2012[43]).

In 2016 Mongolia started to implement a national strategy for improving citizens' financial literacy, further building their capability to make sound financial decisions, increasing long-term saving, and enhancing trust in the banking system and promoting long-term, sustainable economic development in the country (Bank of Mongolia, Financial Regulatory Commission and Ministry of Finance, 2016[55]). The structure of the strategy follows quite closely the High-level Principles on National Strategies for Financial Education developed by the OECD International Network on Financial Education (Box 2.11). The strategy has been approved and is now being implemented. Mongolia has set up permanent public-private co-ordination working groups, which are critical to avoid unnecessary overlap and to ensure effective and sound implementation.

The country now needs to ensure that the structure of the national strategy involves all relevant stakeholders and addresses all relevant target groups: currently it focuses only on personal and household finances. Although younger people and rural dwellers are addressed as target groups, the national strategy does not refer to entrepreneurs or MSMEs. This would also encourage competition in the banking sector, as more informed customers (citizens and MSMEs) would be able to assess more precisely which offers might be the most convenient for them and if and when it is worth switching banks/financial provider. It may also push commercial banks to develop "switching packs" that allow a smooth transition between different bank accounts.[16]

Box 2.11. OECD/INFE High-Level Principles on National Strategies for Financial Education

Within a fast-evolving financial landscape, where access to financial services is made easier as more risks are being transferred to citizens, financial literacy has become a key life skill for individuals. Financial education can help enhance financial literacy and contribute to individuals' participation in financial, economic and social life. As a complement to financial inclusion and financial consumer protection policies, financial education is also important to restore confidence and trust in financial markets, and can support financial stability. An increasing number of countries have started developing nationally-coordinated financial education policies as a way to bring together the relevant stakeholders, avoid duplication and save resources.

Mongolian public institutions involved in financial education should consider joining the OECD International Network for Financial Education (INFE). In 2012, the OECD/INFE (comprising representatives from over 110 countries, including all G20 members, and relevant international organisations) developed high-level principles addressing governments and public authorities and providing non-binding international guidance and policy options for the efficient development of national strategies for financial education. The principles provide guidance on the preparation, governance, roadmap development and implementation of national strategies. These principles were endorsed by the G20 leaders at the 2012 Los Cabos Summit.

As a follow-up to the High-level Principles, in 2015 the OECD/INFE developed a Policy Handbook on National Strategies for Financial Education to support governments and key stakeholders in addressing challenges linked to the implementation of national strategies for financial education. It provides an overview of the status of national strategies worldwide, an analysis of relevant practices and case studies and identifies key lessons learnt.

Sources: (OECD/INFE, 2012[67]; OECD/INFE, 2015[68])

Action H: Build synergies by mapping and co-ordinating all existing initiatives on financial literacy for MSMEs

The government should create a precise map of all the main initiatives carried out by public and private players in the country. These players should be involved in implementing the national strategy in order to empower them, increase their effectiveness within established structures, and find the most appropriate approach for each target group.

Several organisations are offering financial literacy training but with little (or no) co-operation with other institutions such as the SMEDF, the MCGF or the working groups on financial literacy set up by the Bank of Mongolia and the Financial Regulatory Commission:

- Many banks have launched numerous initiatives to support financial literacy – these need to be better co-ordinated. This would ensure public participation and supervision.[17]
- The Banking and Finance Academy was established in 2010 with the participation of the country's eight largest banks and supported by the Mongolian Banking Federation. In 2012 it absorbed the Bank Training Institute of the Bank of Mongolia. It aims to increase education by providing training services and certification for banking and finance professionals, including specific training for dealing with MSMEs. The academy could also expand its operations by "training trainers": training current or former banking officials, as well as employees from relevant ministries and government agencies so they can in turn train MSMEs.
- The Mongolian National Business Incubator Federation, established in 2008, includes 12 business incubators funded by the Ministry of Labour and Social Welfare. Its aim is to generate employment opportunities and alleviate poverty through financial education and support to Mongolian MSMEs. In addition, another four Small to Medium Enterprise Development Centres are funded by the Department of Agriculture.

Action I: Include financial education for MSMEs in the national strategy and consider joining the OECD International Network for Financial Literacy

Mongolia should include a dedicated pillar and implementation tools for building MSMEs' financial literacy in the national strategy. A strategy tailored to MSME needs, with appropriate tools and actions, would be more effective than hoping that building citizens' financial literacy will trickle down to entrepreneurs and MSMEs as well. Public and private training programmes for MSMEs would give them the skills required to present their financial statements and formulate reliable financial plans so that they become more "bankable". Online information and tools – either on a comprehensive national strategy website or a dedicated MSME website – could complement other measures. Various OECD countries (like Australia and Portugal) and non-members (like Indonesia) have started to target MSMEs in their national strategies (Box 2.12).

Sector focus: Enhancing access to finance in Mongolia's cashmere and textile sector

Better data on SME financing, when available to policy makers, could improve the effectiveness of policies in the cashmere sector. As of today only fragmented statistics are available especially regarding nomadic herders and their financing opportunities and capabilities.

Box 2.12. Australia's financial literacy strategy and tools

Australia aims to provide the right environment for SMEs, including financial and education conditions, as pointed out by the OECD Scoreboard on SME and Entrepreneurship Finance. Loans to SMEs represent 32% of total business loans in 2014, and interest rates declined to 6.2% in 2014, down from 8.3% in 2010. In addition to providing loan guarantees and support to SMEs, the Australian government pays close attention to consumer protection and financial education through public institutions like the Australian Competition and Consumer Commission (ACCC) and the Australian Securities & Investment Commission (ASIC) (OECD, 2016[7]).

Australia's National Financial Literacy Strategy has a section that specifically focuses on MSMEs, as part of a comprehensive approach that encompasses all Australians. The strategy uses tools designed to reach self-employed people, entrepreneurs and SMEs. An extensive website for financial literacy improvement provides information, tools and training, including:

- MoneySmart website: MoneySmart is the reference website for increasing financial knowledge and includes financial information, videos, online training and calculators.
- Being Money Smart Certificate IV: a competency that companies can obtain online that covers establishing a small business, being a contractor, business planning, and managing business finance and compliance.
- Guidance for self-employed people: MoneySmart also gives guidance on how to manage cash flow, and savings for taxes and retirement
- Online teaching resources for educators addressing students in vocational training.
- The Australian Business Portal: provides information on planning, starting and growing your own business.
- Financial reporting quiz for directors: a free 10-question multiple choice quiz to test knowledge of financial reporting. It provides explanations of answers after the test.

Sources: (ASIC, 2016[69]; ASIC, 2016[70])

Enhancing SMEDF's portfolio for the cashmere sector would ease access to finance by herders and cashmere-producing SMEs and reduce the sector's public investment dependency without setting the private sector aside. The SMEDF's portfolio could be better tailored to the sector, such as through a greater focus on cash flow history and projections, express loans, and loan maturity to match the cycle of herding activities.

The MCGF could continue to support the textile sector with customised guarantee products that would also leverage movable assets and past and future cash-flow statements. It should also refine risk assessment criteria in the sector to reduce the rate of payment defaults.

Simplifying administrative procedures of both banks and public funds would also increase the sector's access to finance. This should include clearer information and removing the need for herders to provide proof of permanent residence. The government could expand information about government programmes and training in rural regions, and centralise information and procedures in the form of one-stop shops located in both cities and rural areas.

Financial education tools for MSMEs in the sector could be tailored to herders and manufacturers respectively. For instance, online training and information on loan and saving decisions and opportunities might better suit herders, while manufacturers might also benefit from workshops on advanced financial reporting and business management. Following Australia's example (Box 2.12), the creation of an extensive financial literacy website available through smart phones and covering MSME business planning and financial management could help improve financial literacy among herders and manufacturers alike. Considering the relatively high penetration of mobile phone technology in Mongolia, including in rural areas, its use could support the dissemination of financial information, training and calculators. Facilitating the productive use of remittances and supporting return migrant entrepreneurship.

The way forward

Table 2.6 outlines an indicative roadmap for implementing the policy recommendations. This roadmap takes into account the need to strengthen co-operation among public credit institutions, to increase evidence-based policy on SME financing, to further build capacity at the public credit institutions, and to increase exposure and knowledge sharing with international experience especially by joining the OECD Scoreboard on SME and entrepreneurship finance and the OECD International Network on Financial Education.

Table 2.6. Suggested implementation roadmap for Mongolia

Recommendations	Indicative implementation timing		
	Short term < 1 year	Medium term 1-3 years	Long term > 3 years
Gather and disseminate coherent data on MSMEs			
A – Develop a co-ordinated approach among public institutions and consider joining the OECD Scoreboard on SME and entrepreneurship finance			
Diversify the products offered by the SME Development Fund			
B – Diversify SMEDF's products			
Overcome collateral issue by making the Mongolian Credit Guarantee Fund more effective			
C – Strengthen trust relations between MCGF and banks by including bank representatives on MCGF's board, by implementing financial agreements and by sharing risk assessments			
D – Enhance risk appraisal using risk assessment tools from banks and institutions with international experience			
Streamline administrative procedures for loan applications			
E – Increase co-ordination between SMEDF and partner banks			
F – Reduce the number of documents required by banks			
G – Consider implementing one-stop-shops for MSMEs			
Improve financial education by ensuring the national strategy is tailored to MSMEs			
H – Build synergies by mapping and co-ordinating all existing initiatives on financial literacy for MSMEs			
I – Include financial education for MSMEs in the national strategy and consider joining the OECD International Network for Financial Literacy			

Tajikistan: Facilitating the productive use of remittances to finance entrepreneurship

Remittances play an important role in the economy of Tajikistan. The government should develop policies to facilitate their productive use in the domestic economy and boost access to finance for entrepreneurs and SMEs. The OECD developed recommendations in this area in 2014 and monitored their implementation in 2017. This sub-chapter is the result of that monitoring. It records the progress made and suggests further solutions to better use remittances to finance small firms and entrepreneurs in the country, such as improving the banking of remittances and enhancing financial literacy and business skills.

Context: Remittances as a driver of growth

Remittances play a key role in Tajik economy and amounted to 31% of gross domestic product (GDP) in 2016. This is lower than the 44% registered in 2013, mostly due to the depreciation of the Russian rouble (RUB) as most remittances are denominated in roubles (ADB, 2017[71]; World Bank, 2017[72]).

Unemployment remains high, at 11%, and limited job opportunities continue to encourage workers to migrate. The bulk of Tajik migrants still work in Russia, where 79% of the Tajik diaspora resides, followed by Ukraine (5.0%), Germany (4.9%) and Kazakhstan (2.7%) (United Nations, 2015[73]). As a result, 76% of the USD 2 259 million remittances sent to Tajikistan in 2015 came from Russia, significantly more than the flows from Kazakhstan (6.3% of the total), Ukraine (4.0%) and Germany (3.7%) (World Bank, 2017[72]). The slowing of the Russian economy has reduced the number of labour migrants from 800 000 (16% of the working population) in 2013 to 467 000 (9%) in 2016, with a corresponding negative effect on remittances.

Studies conducted on a wide set of emerging economies show that a consistent flow of remittances promotes financial development, which in turn stimulates growth and poverty reduction. In particular, financial development is connected to the effect of remittances on the aggregate level of deposits and credit intermediated by the local banking sector (Aggarwal, Demirguç-Kunt and Martinez Pería, 2010[74]). The use of the formal financial sector to transfer remittances plays an important role by increasing transparency and accountability.

However, the use of the formal financial sector might be unpopular in the absence of incentives for migrants, as money transfer organisations (MTOs) cost less to use and there is no deposit insurance scheme (Grigorian and Kryshko, 2017[75]). Incentives are particularly important in Tajikistan, as the 2015 banking crisis inflicted a severe blow to public trust in the stability of the financial system. In fact a significant, if decreasing, share of migrants' remittances are still transferred through MTOs (Figure 2.7).

The banking crisis that hit Tajikistan during the monitoring period (Box 2.13) worsened conditions for migrants' families receiving remittances. It pushed many to withdraw their bank deposits and reduced their willingness and ability to save, as well as reduced Tajikistan's already low levels of financial inclusion. The National Bank of Tajikistan (NBT) recently surveyed the population about their savings and 68% of respondents said that they were not able (56%) or not willing (12%) to accumulate savings, 20% that they kept them under their pillow and only 12% said that they were keeping their money in credit institutions or banks (National Bank of Tajikistan, 2017[76]).

Box 2.13. The banking crisis in Tajikistan

Traditional banks in Tajikistan are facing severe capital issues, as the ratio of capital to risk-weighted assets fell to just 5.4% in 2015, against the required 12%. In December 2016, the government recapitalised four banks, to a total of USD 400 million (7.1% of GDP). Turmoil in the financial sector has tightened credit conditions for small and medium-sized enterprises (SMEs). Borrowers have already been hit hard by the depreciation of the Tajikistani Somoni (TJS), which lost almost half its value between the end of 2014 and May 2017, as almost 60% of outstanding loans are denominated in USD. The share of non-performing loans (NPLs) in bank portfolios jumped to 55% in 2015, from 30% in 2014. Credit to the private sector shrank from 23% of GDP in 2015 (in line with Kyrgyzstan's share but well below Kazakhstan's 38%) to around 10% at the end of 2016.

Sources: (World Bank, 2017[77]; ADB, 2017[71]; National Bank of Tajikistan, 2017[76])

Nevertheless, there is evidence that receivers of remittances are subject to a wealth effect which makes them more likely to invest their savings in micro-enterprises, usually in self-employment, overcoming liquidity constraints (Woodruff, 2007[78]; Mesnard and Ravallion, 2006[79]). The studies do not suggest that the majority of remittances are used for productive investment, but over time their cumulative impact is still significant. Most remittances were and are used for consumption, but the OECD recommendations focused on how these financial resources could be used productively, in particular as a form of internal financing of SMEs (OECD, 2015[80]).

Overview of 2014 recommendations

In 2014, the OECD recommended taking advantage of migrants' remittances and returning migrants' skills to improve access to finance and support entrepreneurship. The 2014 OECD recommendations focused on ways to enhance access to finance for SMEs, by designing and implementing policies to support both the supply side (loan offers) and demand side (financial literacy) (OECD, 2015[80]).

Recommendation 1: On the supply side, facilitate the banking of remittances

Most remittances in 2014 were channelled through MTOs such as Western Union, Money Gram and Golden Crown. Money was withdrawn directly in cash, without passing through Tajikistan's financial system. The OECD recommended three specific steps (OECD, 2015[80]):

- To create a technological platform to connect these MTOs to the financial system and link the country's payment system[18] to migrant destination countries' payment systems, especially Russia's. This would also have the effect of encouraging financial inclusion and the take up of official bank accounts. At present only a very small minority of the population (12%) has a bank account (World Bank, 2017[81]).
- To consolidate the microfinance institution (MFI) sector to allow MFIs with stronger capitalisation to offer better products to SMEs, transform themselves into micro deposit institutions (MDIs) or even request banking licences.

- To improve the operational management of the Entrepreneurship Support Fund to offer better financing alternatives to SMEs in the country.

Recommendation 2: On the demand side, support business creation and create a one-stop-shop for migrants

The 2014 review suggested two steps to the government (OECD, 2015[80]):

- To organise and promote financial literacy in the country, both for the general population and for SMEs. Citizens and returning migrants with better financial skills would be keener to open bank accounts, hold savings and access credit. The OECD's principles on financial education and awareness could be leveraged to structure a sound National Financial Literacy Strategy (OECD, 2005[82]; OECD/INFE, 2012[67]). International conferences, leaflets, television shows and other marketing tools could all prove useful in extending the reach of initiatives by public agencies and private-sector associations.
- To provide practical and project-based entrepreneurial training to equip return migrants with the skills needed to start a business, including through dedicated centres (one-stop-shops). The creation and management of courses tailored to migrant needs should be promoted by public and private training institutions. Support should also continue after the training, with counselling and coaching activities offered at all stages of business creation and development.

Findings of the 2017 monitoring assessment

The Government of Tajikistan has made progress in acting on the OECD recommendations, but much remains to be done to implement them. On the supply side, the NBT is establishing a payment structure to allow remittances and other financial flows to be channelled into the official financial system. However, the impact of these measures will depend critically on the authorities' success in dealing with the banking system's troubles and re-establishing a measure of confidence in the soundness of banks and other financial institutions. On the demand side, financial literacy has become a priority for the government, and the NBT drafted a National Strategy for Consumer Protection and Financial Literacy with the support of the World Bank, to provide a framework for the many different initiatives currently carried out with the support of international organisations (IOs).

Monitoring of Recommendation 1 finds efforts to improve the banking of remittances but access to finance for entrepreneurs remains challenging

Recommendation 1: On the supply side, facilitate the banking of remittances

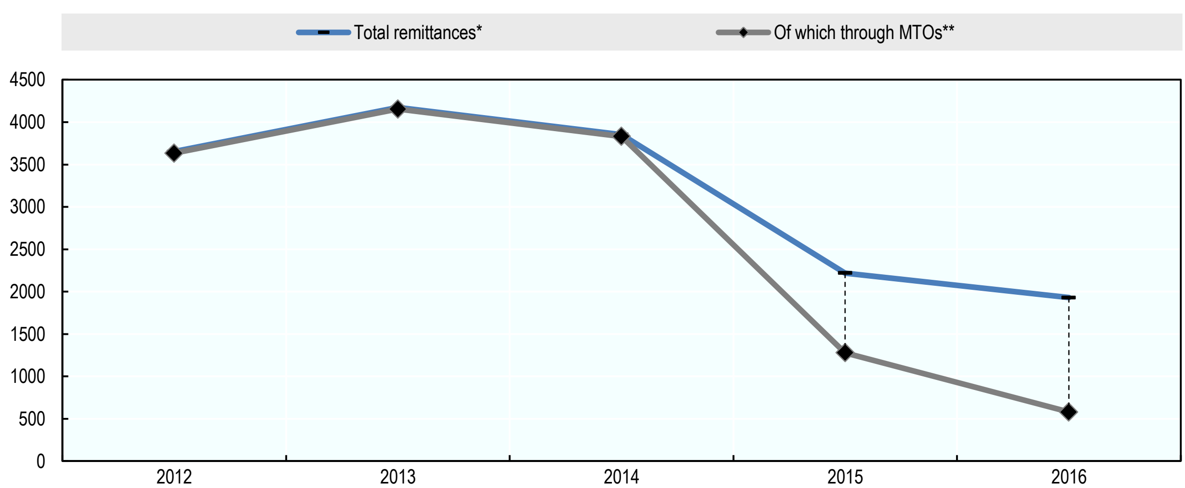
The banking of remittances has partly improved thanks to new regulation

The NBT, with the support of the World Bank's Payment System Modernization project, set up a national payment system policy framework in October 2014, "that prioritises legal, regulatory, institutional and infrastructural reforms required for the promotion of electronic payments in the country" (FIRST, 2015[83]). The National Processing Centre is now handling 80% of debit card transactions in Tajikistan, reducing the country's dependence on other countries' payment systems. The inefficiency of having all card payments cleared outside the country (mainly in Kazakhstan and Russia) was pushing local banks to invest in their own systems and thus creating additional fragmentation. Moreover, reducing additional costs and promoting the safety of payments increases trust in the financial sector, which is particularly relevant to supporting deposit mobilisation, especially in the current crisis.

In 2016 the NBT also started working with the Russian authorities to connect the country's payment system to the Russian one, to support the transfer of remittances through the official financial system. The resulting reduced costs and greater reliability encouraged many migrants to modify their behaviour. Data from the Central Bank of Russia show that in 2016, remittances from Russia to Tajikistan totalled USD 1.9 billion and that no more than 30% of this (USD 579 million) was transferred through MTOs. This is a considerable shift, as MTOs transferred close to 100% of remittances in the preceding years (Figure 2.7).

Figure 2.7. Remittances from Russia to Tajikistan

USD mn



1. Includes cross-border wire transfers of income from physical persons resident and physical persons non-resident to physical persons resident and physical persons non-resident carried out with and without accounts in credit institutions. It includes also remittances via money transfer systems.
2. Includes payment made through ANELIK, BLIZKO, CONTACT, InterExpress Western Union, Zolotaya Korona, Sberbank (Hummingbird), International Money Transfers LEADER, UNISTREAM, and the Russian post.
Source: (Central Bank of the Russian Federation, 2017$_{[84]}$).

The NBT has also taken additional supply-side measures to increase the penetration of financial products in rural areas, where most migrants and their families comes from. A new NBT regulation[19] led to the opening of an estimated 1 420 Banking Service Units (BSUs), which are smaller than bank branches but provide a range of basic banking services, all around the country. MTOs now often operate through the BSUs around the country, with their staff working in the same buildings. Moreover, the regulation requires that all remittances in RUB must be converted into TJS for withdrawal by citizens at an official rate and that half of the foreign currency must be resold immediately to the NBT.[20]

Several banks have started offering deposit-related savings products tailored to migrants' needs. A bank account can be opened before the migrant departs and the migrant's family has access to it. There have only been limited information campaigns promoting these products, a fact that contributes to their limited use, and their precise impact has not yet been evaluated. Recent turbulence in the banking sector has certainly slowed their uptake.

The National Bank of Tajikistan has triggered a consolidation in the microfinance sector

To encourage consolidation and strengthen the financial stability of MFIs, the NBT introduced higher capital ratios in 2016, raising them from TJS 1 million to TJS 4 million for MFIs (from USD 125 000 to USD 500 000) and from TJS 4 million to TJS 6 million (USD 500 000 to USD 750 000) for micro deposit organisations (MDOs). This measure has put some of the smallest and least active MFIs out of business, reducing their number by 15% to 91, of which 38 were MDOs. The sector, initially supported by IOs (Box 2.14), needed consolidation. The number of microfinance borrowers fell from 561 000 in 2014 to 480 000 in 2015 and 366 000 in 2016, showing that the lack of trust in the banking sector might have spread to the microfinance sector.

Box 2.14. International donors' support for access to finance

The Government of Tajikistan has also worked extensively with international organisations to implement programmes aimed at enhancing access to finance for SMEs. In particular, a project by the Swiss State Secretariat for Economic Affairs (SECO) focused on improving the provision of financial services to micro-enterprises through an improvement of the microfinance sector, including through new regulations and certification process. The Asian Development Bank (ADB) and Kreditanstalt für Wiederaufbau (KFW) established a Microfinance Fund which is a revolving fund refinancing financial institutions with an independent board. Moreover, in 2014, the ADB invested USD 14.4 million to provide equity to AccessBank Tajikistan in order to enhance the access to finance of unserved farmers and SMEs.

Source: (ADB, 2014[85])

However, according to the AMFOT (Microfinance Association of Tajikistan), the technical difficulties involved in integrating the operations and records of small players into bigger systems, and the lack of reliable accounts of past operations, have hindered consolidation attempts. Since 2015, only a few MDOs have obtained banking licences from the NBT, partly due to the current difficult banking market conditions. The only example in 2016 was the MDO Standard Malia, which became the CJSC Bonki Beynalmilal Toimiston (the International Bank of Tajikistan).

The Entrepreneurship Support Fund was established to improve access to finance for SMEs but its governance hinders its effective operation

The State Committee for Investment and State Property Management (SCISPM) established the Entrepreneurship Support Fund (ESF) in 2015,[21] which provides subsidised loans at low interest rates (around 7% against the average market rate of 23%) to SMEs engaged in strategic sectors. The management of the fund has been moved under the Cabinet of Ministers. To date, the fund has supported 132 projects totalling TJS 120.3 million (USD 15.2 million).

International experience shows that transparent, well-managed public credit institutions can support the development of SMEs (OECD, 2016[86]). However, Tajikistan's business associations are not involved in the management of the fund and their levels of trust in it are low, according to interviews carried out by the OECD, both in bilateral meetings and during the open discussion in the Public Private Working Group organised in Dushanbe. They report a lack of consistency and transparency in decision making on loans, and an unclear process for the selection of projects. They also find it difficult to reach the fund, which still lacks a website and a widely available phone number. Moreover, while no official figures are available, the percentage of loan repayments is reported to be very low (less than 50%), which would imply an inadequate risk management system and possible mismanagement of funds.

The opaque decision-making process of the ESF limits its role as a key player in the development of access to finance for SMEs in Tajikistan. The OECD's experience with similar public financial vehicles in other countries in the region suggests that reforming the fund could bring significant improvements for SMEs (OECD, 2016[86]). Involving the private sector more in the management of the fund, making its selection process more transparent and strengthening its risk-management policies could have a big impact on its efficiency and ultimately on the access to finance of SMEs. The PARE 1+1 programme in Moldova shows how the state might co-finance projects in strategic sectors or areas, matching private investments with public funds (OECD, 2015[80]).

Monitoring of Recommendation 2 highlights major efforts to enhance financial literacy and business skills

Recommendation 2: On the demand side support business creation and create a one-stop shop for migrants

The government and the NBT have started to develop some initiatives to promote financial literacy with the support of international organisations

Ministries and government agencies, supported by IOs, have been active in promoting financial literacy through some initiatives. At the beginning of 2017, the NBT elaborated a National Consumer Protection and Financial Literacy strategy with the support of the World Bank, and it is now working on the Action Plan to implement it. This is a particularly welcome initiative, as multiple ministries, government agencies and IOs are currently working on separate projects with similar objectives.

The NBT and the Ministry of Education have been active since 2014, with the support of international organisations. For example, the International Organization for Migration (IOM) is promoting increased productivity of remittances through education and investment. The project offered financial education to 1 500 migrants' families, with 65 to 70 households receiving basic training in business development. Resource Centres in 15 communities also received training to provide better information about labour migration and 15 migrant household associations were set up under each Resource Centre to serve as a link between labour migrants and their communities of origin in order to facilitate the flow of remittances. The private sector has also been active, with financial education training offered by AMFOT, by the Banking Association and by business associations (Box 2.15).

In 2017, the government joined a project run by the OECD and its International Network on Financial Education (OECD/INFE), with financial support from the Ministry of Finance of the Russian Federation. Building on the OECD/INFE's internationally recognised expertise, the project seeks to support the development, implementation and evaluation of evidence-based national strategies for financial education in six Commonwealth of Independent States (CIS) countries, to measure the level of adult financial literacy in each country, and to address the financial education needs of specific target audiences, including migrants and their families.

Box 2.15. Main projects to promote financial literacy in Tajikistan

Projects to promote financial literacy, by improving the financial literacy of the population in general, are expected to also improve the financial literacy of migrants and their capacity to set up a business. During the monitoring programme, the main such projects were:

- The NBT drafted a National Consumer Protection and Financial Literacy Strategy at the beginning of 2017 with the support of the World Bank. The World Bank's support also extends to the production of information material and videos posted on the NBT website, and helping credit institutions to offer financial literacy courses around the country.
- The Ministry of Education and Science and the NBT, with the support of the German Society for International Co-operation (GIZ), organised events aimed at high school teachers in August 2016. The programme developed draft guidelines on financial education on the subject of the "Basis of Economics" in secondary schools, and provided training to 24 trainers, who should in turn prepare 3 000 secondary school teachers to teach this course.
- The NBT, together with credit organisations, the association of banks and the microfinance association (AMFOT) organised the International Week of Financial Literacy in March 2016, with the aim of increasing public confidence in the banking system and expanding awareness of possible financial solutions in the country. In 2015, the previous edition reportedly included 689 students in secondary and high schools of Dushanbe and Khujand, as well as in 8 districts of Khatlon province. The event held in Dushanbe is part of a global initiative called the Global Money Week organised by Child and Youth Finance International. The event engaged an estimated 5.6 million schoolchildren in 2015.

In addition, the State Committee on Investments and State Property Management (SCISPM) created Tajinvest. One of its main of functions is to develop business skills among the population, including returning migrants. In 2016 the SCISPM held 10 business forums and roundtables, inviting young entrepreneurs. The SCISPM also worked with the World Bank on a project to offer capacity building among young entrepreneurs, which consisted of 150 days of training for 3 838 young people in 66 cities and villages in Khatlon, Sughd Regions, RRS and Dushanbe.

The Ministry of Labour, Migration and Employment is updating and has started implementing the country's migration strategy but training centres could offer better entrepreneurship support

The Ministry of Migration, Labour and Employment of the Population (MoLME) is now updating the National Strategy on Labour Migration of Tajik Citizens Abroad for 2016-2020.[22]

To support migrant entrepreneurship, the ministry is offering free and paid-for training to new and returning migrants and their families. The courses offer training in 96 different professions, through a network of 73 training centres all around the country, including Dushanbe, Khorog, Khujand and Kurgantyube. The vocational training offered is usually short term, lasting 1, 3 or 6 months. During the monitoring period a total of 373 098 job-seekers and returning migrants were trained in institutions of primary vocational education (101 117 in 2014, 101 209 in 2015, 105 815 in 2016 and 64 957 in the first half of 2017). The data shared by the MoLME show that in the first 6 months of 2017, 12 259 people were trained in the vocational training centers, and it is interesting to note that 75% of them were women. The certificates attainable at the end of the training are recognised in all CIS countries, but business associations argue[23] that the quality of the courses could still be improved. Moldova offers a good example of how this could be done effectively.

Moreover, entrepreneurship training programmes could be targeted more specifically for women, as they are the predominant group of remittance recipients. To achieve this goal, a more extensive local network would be useful – maybe with the support of local community leaders, who could also be incentivised in connecting and share experience among themselves. More use could be made of the experience of non-governmental organisations (NGOs) working at community level, with the goal of increasing the accessibility of the training.

The way forward

Financing options for SMEs remain tight and the financial crisis in Tajikistan has not helped improve the situation. Rebuilding trust in the financial system must be a core priority for policy makers. The government should focus on rebuilding the population's trust in the banking system as an essential precondition to enhanced financial inclusion. Moreover, a new regulation proposed by the NBT could, if implemented, improve the payment system in the country by permitting new players to enter the market, particularly mobile operators. In any case it would be useful to adopt a systematic mechanism for the transfer and delivery of remittances and expand the range of financial services available (such as "account-to-account" systems, PC banking, mobile banking or ATM banking) increasing competitiveness and reducing costs.

The microfinance sector could be strengthened by pushing the application of the Microfinance Financial Reporting Standards (MFRS) elaborated by the Small Enterprise Education and Promotion Network (SEEP), particularly among small MFIs, to make them more transparent and thus open the door to their possible consolidation and entrance into the formal economy. This framework includes a core set of ratios to measure and analyse financial performance and risk management, and is used by NGOs, non-bank financial institutions or companies, credit unions and co-operatives (SEEP Network, 2010[87]). Banks and MFIs should increasingly focus on creating value for customers by launching new transparent credit products and schemes for migrants, with special packages including preferential rates and benefits related to productive investments in entrepreneurial activities.

The government and the NBT should push forward their efforts on financial literacy, especially by implementing the National Strategy for Consumer Protection and Financial Literacy, specifically addressing migrants and their needs (the inclusion of remittances in the formal financial system and their productive use, including by creating new businesses), and by monitoring and evaluating the impact of current and future financial education and business skills initiatives. Participation in the technical assistance project co-ordinated by the OECD/INFE would be a way of addressing some of these issues.

Box 2.16. Promoting entrepreneurial training: The case of Moldova

The government of Tajikistan could consider the development and promotion of entrepreneurial training programmes and disciplines both in school and through training centres. In the Republic of Moldova, the Fundamentals of Entrepreneurship course is taught in the vocational, specialised and higher secondary education system in order to give students the skills, values and attitudes needed to meet to the challenges and demands of the contemporary labour market and financial system.

Entrepreneurship education is one of the policy directions included in the Consolidated Strategy for the Development of Education for 2011-15 as set out in the Bruges Communiqué on Promoting Entrepreneurship. As a course of study, Fundamentals of Entrepreneurship is a component of the national curriculum as an optional course recommended by the Ministry of Education. The implementation of the given course in pre-university education is carried out through the Junior Achievement Moldova Association (JA Moldova) in co-ordination with the Ministry of Education.

According to the Framework Plan for Primary, Secondary and High School Education for the academic year 2016/17, approved by the Order of the Minister of Education no. 242 of March 25, 2016, Economic and Entrepreneurial Education was included in the list of optional courses recommended for grades I-IV, V-IX and X-XII in high school and contains the following courses: Business Ethics, Consumer Protection, Entrepreneurship, Economic ABC, My Finances, School Company, School Ministries, Entrepreneurship, Economic Education, Applied Economics and Key to Success.

Throughout 2016, Basics of Entrepreneurship was taught in all technical vocational education institutions in the country: 120 hours (96 hours of theory / practice and 24 hours of consultations) in secondary vocational technical education institutions and 90 hours in post-secondary technical vocational institutions.

Source: (Ministry of Education of the Republic of Moldova, 2017[88]; Government of the Republic of Moldova, 2010[89])

The MoLME could further develop its training centres to offer returning migrants business development services. These could include finding possible investors, matching with mentors, sharing knowledge with other businesses and returning migrants, creating links with business associations such as the Chamber of Commerce and expanding the list of public services delivered in the current training centres such as business registration, taxation and licensing, so that the centres would act as well-rounded one-stop shops for returning migrants willing to embark on entrepreneurship initiatives. A good example is the Repat initiative in Armenia (Box 2.17).

Box 2.17. RepatArmenia initiative

The Repat Armenia Foundation is an NGO, established in August 2012 and based in Yerevan. The organisation aims to inform, initiate and actively support the return of high-impact (professional, entrepreneurial) individuals and families to Armenia, leveraging a worldwide network of supporters. The three key principles behind its actions are:

- to promote the concept of repatriation
- to provide individual repatriation support
- to influence government policies for repatriation.

The foundation manages a website, RepatArmenia.org, which provides information about business regulation, education, healthcare and real estate in Armenia. For those who are considering a move to Armenia, the RepatArmenia Foundation also offers one-on-one consultations, networking opportunities during informal monthly events and connection with the Armenian Repatriates Network. It also assists potential repatriates by introducing them to professional service providers that can help them with employment, setting up a business or other aspects of integration.

Source: (Repat Armenia, 2016[90])

Kyrgyzstan: Improving supply-chain financing in agriculture

Agriculture is one of the main sectors in Kyrgyzstan economy and small firms represent the bulk of companies in the sector. Access to finance has been reported as a major obstacle to their development. The OECD made policy recommendations in 2013 to enhance access to finance for SMEs in agriculture that focused on the development of warehouse receipt financing (WRF). The OECD monitored the implementation of the recommendations in 2016. This sub-chapter analyses progress since 2013. It provides additional policy options and actions to further implement the recommendations, including finalising the law and bylaws on WRF, and further promoting this new tool and the storage business.

Context: Obstacles to agricultural SMEs' access to finance

Agriculture in Kyrgyzstan accounted for over 30% of employment and 17% of its gross domestic product (GDP) in 2014 (National Statistical Committee of the Kyrgyz Republic, 2016[91]; World Bank, 2016[92]). The sector is also socially important, being the main source of employment for most of the country's poorest people (Dubashov, Ismailakhunova and Kruse, 2015[93]). Output and productivity increases in agriculture could therefore have a strong impact on Kyrgyzstan's poverty rate.

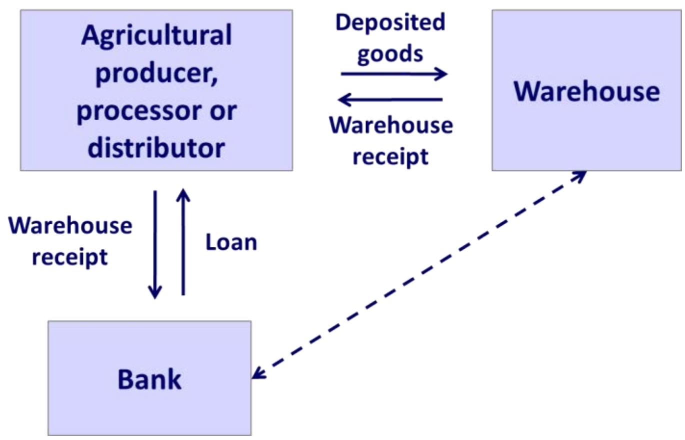
Access to finance was a key barrier to SMEs in Kyrgyzstan in 2013, as most SMEs had to rely on internal funds as well as credit provided by families and friends. Farmers and agricultural SMEs were particularly credit-constrained. Overall, only 18% of companies in the sector were using bank finance; 79% of respondents to an OECD sector survey reported using internal funds to finance their working capital (OECD, 2014[94]). In addition to high interest rates, ranging from 18% to 24%, one of the sector's key challenges was the difficulty of providing adequate collateral when seeking a bank loan (OECD, 2014[94]). In 2013, 80% of agricultural companies seeking credit were asked to provide collateral equivalent to 120% or more of the total loan amount, usually in the form of real estate. Warehouse receipt financing (WRF) was selected as a financial tool with the potential to alleviate part of the collateral constraints and thus facilitate access to finance in the sector.

Overview of 2013 recommendations

WRF can increase access to finance as it allows farmers to pledge movable assets and inventory to obtain financing for working capital. In addition, WRF allows the farmer to pledge fixed assets for long-term financing for capital expenditures and investments (OECD, 2014[94]). The basic operation of a WRF scheme is described in Figure 2.8.

The benefits associated with WRF extend beyond bridging the collateral gap. By providing the infrastructure to easily store, aggregate, and – over the long term, also package – goods, it can enable farmers to overcome seasonal price fluctuations and thus sell their produce at higher prices. It can also increase the integration of the agribusiness supply chain as a whole, facilitating co-ordination between farmers, traders, input suppliers, and processors.

Figure 2.8. The framework of warehouse receipt financing



Source: (OECD, 2014[94])

The OECD review in 2013 made three recommendations for introducing WRF to Kyrgyzstan (OECD, 2014[94]):

Recommendation 1: Set up a pilot WRF scheme

A pilot WRF scheme at the local level was proposed to allow for a viable assessment of WRF in practice, as well as to gain the support of farmers and banks. The pilot was thought to be useful to build trust between different stakeholders, such as farmers, warehouse operators, traders and banks.

Recommendation 2: Establish a regulatory framework for WRF

In 2013 Kyrgyzstan had a law on collateral that regulated moveable assets, as well as a central collateral registration system. Some other elements of a regulatory environment for warehouse receipts were also already in place. For example, the civil code contains basic legal norms that characterise warehouse certificates and warehouse receipts (Legislative Assembly of the Kyrgyz Republic, 1998[95]). However, there were no provisions for the use of warehouse receipts as collateral for credit. Therefore, there was a need to develop a legal framework for WRF to allow it to be streamlined at a national level. Setting up the legal background for the registration, certification and inspection of warehouses not only involved adopting the relevant legislation, it also required an agency to oversee these tasks and ensure compliance with financial and technical standards (Box 2.18).

A sustainable system for collecting and disseminating agricultural information and prices was also needed, and existing insurance products needed to be standardised to protect producers and banks from large swings in agricultural prices. Finally, an indemnity fund was expected to help protect banks from warehouse defaults (OECD, 2014[94]).

Box 2.18. Agencies implementing the regulatory framework: Bulgaria

While laws supporting WRF are a necessary prerequisite, they also need to be complemented by additional structures to ensure its smooth functioning. The Bulgarian Government has established public warehouses, an indemnity fund and a specialised agency under the Ministry of Agriculture, in addition to the basic legal framework.

The newly created agency, the National Grain Service of Bulgaria, organises, implements and controls the licensing process for public grain warehouses. Its functions also consist of:

- maintaining public registers of public grain warehouses
- carrying out initial and periodic checks of the financial, operational and technical conditions of public grain warehouses, as well as the quality and quantity of the stored grain
- collecting orders for printing warehouse receipts.

By effectively controlling the public warehouses and their performance, the National Grain Service helps to build trust among stakeholders, and is a key enabler of WRF in Bulgaria.

Source: (Winn, Miller and Gegenbauer, 2009[96])

Recommendation 3: Promote the storage business to attract potential investors

Storage capacity in Kyrgyzstan was unevenly distributed around the country, and few warehouses had more than basic equipment. The WRF solution requires sound and modern storage facilities. Achieving this meant further promoting the storage business and attracting investment. The 2013 review suggested that investment promotion for the storage business could be added to the national investment promotion strategy (OECD, 2014[94]). One way to support the development of storage businesses would be through public-private partnerships, for example to provide land or facilities.

Findings of the 2016 monitoring assessment

The Government of Kyrgyzstan, with the support of the German Society for International Co-operation (GIZ) and the Asian Development Bank (ADB), has made substantial progress in preparing the appropriate regulatory framework for WRF. A pilot has been conducted and has demonstrated the potential of WRF. The expansion of the scheme is threatened, however, by the poor state of warehouse infrastructure in the country.

Monitoring of Recommendation 1 shows a successful pilot WRF scheme

Recommendation 1: Set up a pilot WRF scheme at sub-national level

The launch of a pilot WRF was supported by the GIZ, which held meetings and interviews with 32 warehouse owners in 2 oblasts (Chui and Issyk-Kul) to identify possible pilot warehouses. As no comprehensive register of warehouses existed, warehouses were identified based on information from local authorities, bank branches, and existing donor projects involving warehouses. Twenty of the warehouse owners interviewed agreed to co-operate in pilot credits (Abakirov, 2014[97]).

Three banks – the Commercial Bank of Kyrgyzstan, Bank Asia and OJSC Aiyl Bank – agreed to participate in pilot activities. Local branch managers of these banks were briefed on the functioning and benefits of WRF. Co-operation was established between these local banks and ADB's project on women entrepreneurship in Kyrgyzstan (ADB, 2013[98]). The project channels funds for innovative financial solutions to women entrepreneurs through intermediary financial institutions. Aiyl Bank identified WRF as an innovative financial solution and was therefore able to provide loans through WRF at an interest rate of 12%. Nine loans were agreed during the pilot phase (the harvest season of 2014-15) worth a total of KGS 3 million (Kyrgistani som; USD 55 000).

The pilot also included the creation of initial warehouse certificates modelled on good practices by other countries. Receipts were signed by all parties and contained key information such as the type of produce, quality, price of storage, dates, parties responsible, etc. Other pilot activities included awareness-raising events, initially to inform the financial institutions of the potential benefits of WRF.

The successful implementation of the pilot, although limited in scope, demonstrates the potential of WRF to help agricultural SMEs access finance.

Participants in the pilot mentioned the following challenges and lessons:

- The lack of a legal basis for WRF. This was the main stumbling block as it increased the level of risk for banks, forcing them to set aside additional reserves and decreasing profit margins.[24]
- The lack of a clear system for warehouse licensing.
- The fact that the majority of warehouses were poorly equipped for WRF.
- The lack of a risk insurance system for warehouses, banks and farmers.

The key lessons learnt from the pilot phase were used to inform the discussions and to develop a regulatory framework for WRF in Kyrgyzstan (see next section).

Monitoring of Recommendation 2 reveals the development of a draft regulatory framework

Recommendation 2: Establish the legal and regulatory framework for WRF

The regulatory framework for WRF was developed by a working group (WG) under the leadership of the Ministry of Economy, supported by the OECD and GIZ. The WG was established during the peer review of Kyrgyzstan in 2013, and had helped to develop the original policy recommendations. It outlined the aspects which needed to be covered by the new legislation:

- standards for the warehouses to be included in the register, as well as procedures in case of a violation of the standards;
- the creation of a registry of warehouses and an agency to implement the regulatory framework;

- the rights and obligations of all parties involved, including warehouse owners, bankers and farmers;
- specification of the content and information provided in the different types of warehouse receipts and
- the transfer of rights, and the termination of warehouse receipts and certificates.

The work of the WG was supported by policy practitioners from Ukraine and Bulgaria, based on good practices and key lessons learnt in these countries (Box 2.18). The WG's efforts led to the drafting of a new law that closely resembles the Bulgarian system.

Business associations, especially the Union of Bankers, participated in and supported the drafting of the law. The draft law was subject to public discussions during a roundtable organised in Bishkek on 23 May 2016. It was also circulated for discussion by stakeholders in other cities in Kyrgyzstan (Osh, Jalal-Abad and Naryn). This public-private dialogue approach is expected to help the new policy instrument be broadly accepted and to decrease potential risks associated with WRF.

While Kyrgyzstan's progress in developing the legislation for WRF is commendable, its progress in establishing an environment conducive to the development of WRF is lagging. The most critical gap is the lack of widespread information on market prices for agricultural produce, which are crucial for a well-functioning WRF system. Although government websites provide general information on agriculture, the level of detail is limited. Exact and current prices as well as forecasts are necessary to assess the value of collateral and to decide the optimal date for selling produce.

Similarly, there are no standard insurance products for WRF at this stage. To build confidence in the system, insurance products need to be expanded to protect against bankruptcy and fraud. Insurance companies were contacted to participate in the initial phase of the pilot. While they signalled general interest, in the absence of a regulatory framework they preferred not to insure WRF or to create appropriate products. They also expressed doubts about the quality of the warehouses.

Finally, the government should consider establishing an indemnity fund, which would work like a credit guarantee fund (CGF) tailored to WRF. This would provide an additional level of protection for the banks involved in WRF by providing an additional guarantee. This fund would be complementary to other insurance products, as it would fully reimburse damages and cover cases of default instead of insuring against large price swings.

Monitoring of Recommendation 3 highlights poor investment in warehouses

> *Recommendation 3: Promote the storage business*

The quality and quantity of warehouses that are fit for WRF appear to be limited. Suitable warehouses need to be found and modernised if this financial tool is to fulfil its potential. However, information on warehouses in Kyrgyzstan is outdated: the 2003 agricultural census provides the latest reliable nationwide data. It identified 1 476 facilities in Kyrgyzstan each with a capacity of more than 500 tonnes.

To obtain more accurate information and to assess the readiness of warehouses for WRF, a survey was undertaken with the support of GIZ. The survey did not aim to cover all warehouses nationwide, but rather to obtain reliable, detailed and accurate data on the condition of warehouses that could be eligible for WRF. This identified 50 warehouses with a storage capacity of more than 500 tonnes. These were contacted for interviews.

Initial interviews revealed that 20 of the 50 warehouses did not meet the basic infrastructure requirements for WRF. Besides the technical issues, the survey also identified a number of challenges:

- The warehouses require substantial investments and renovation, as most of them were built during the 1970s.
- Most lack additional services that would add value (e.g. sorting, consolidation, splitting of goods and produce, or transportation services).
- Some warehouses lack minimal security, such as fences.
- Several warehouses were not equipped with refrigerators, thus increasing the risk of losses due to decay.
- Written contracts between owners of warehouses and owners of produce were rare – trust-based oral agreements were more usual.

Due to a lack of warehouse capacity, a number of producers and traders reported that they are building new warehouses with refrigeration equipment (Abakirov, 2014[97]). For example, in the Kochkor region the authorities have allocated 17 hectares of land for warehouse construction. In addition, several banks have shown interest in investing in warehouses and providing credit for their construction once there is an established WRF regulatory framework. Warehouse owners who were interviewed by the OECD argued that investments in warehouses paid off. Several of them have further invested in modernising equipment by purchasing cooling and security technology.

The way forward

The finalisation of the law on WRF is the necessary next step for the full roll out of WRF. Once adopted, the government will need to implement the Law on Warehouses and Storage Certificates, adopt a number of regulations, and monitor the development and impact of WRF and warehouses. It will be crucial to ensure the safety and quality of the first warehouses selected. After a few years following the initial harvest seasons, further support and adjustments might be needed to effectively roll out the instrument to the whole country. Turkey has lessons to share on the continuous efforts needed to improve a WRF system (Box 2.19).

Once the legal framework has been established, further work should also include the creation of a proper insurance product for WRF. Such products can help prevent losses from inappropriate storage and thus improve the solvency of the overall WRF system. In the long term, such efforts can be further facilitated through the creation of a specialised credit guarantee fund for WRF.

Special training needs to be conducted, particularly for staff of the Ministry of Agriculture and Land Reclamation, the body which will keep the register and monitor the warehouses. Carrying out promotional and information activities for the operators of warehouses and agricultural producers is equally important to increase knowledge of and interest in this new product.

Box 2.19. Improvements to Turkey's WRF system

In Turkey, banks have traditionally been large users of warehouse-receipt financing to support the country's important tobacco exports. Many Turkish banks have set up their own warehousing subsidiaries to store the goods that they are financing. Nevertheless, in the large domestic grain market, which was heavily regulated until the late 1990s, warehouse receipt financing was rare.

To support policy liberalisation, a warehouse receipt system was developed as part of the World Bank-funded Agricultural Reform Implementation Project. The programme aimed to reduce distorted incentives and government subsidies, and substitute them with a support system to provide agricultural producers with incentives to increase productivity in response to real comparative advantage. Warehouse receipts presented an alternative approach to costly government price support. Turkey developed proper licensing and inspection procedures, and built institutional capacities in this area. A Law on Licenced Warehousing adopted in 2005 defined the procedure for the authorization and oversight of warehouses (including ministry-issued licences and insurance schemes for stored goods) and gave legal content to the warehouse receipt, which could then be pledged as a guarantee.

This legal framework has been improved through subsequent regulations: the 2011 Regulation on Electronic Warehouse Receipt facilitates the issuing of e-warehouse receipts, and the 2013 Regulation of Agricultural Products Licensed Warehousing consolidates the legal framework for commodity-specific exchange. These organised markets (most of which already owned warehousing infrastructure) received financial and technical support to improve their capacity and use of warehouse receipts in their daily transactions. Large exchanges also invested in building more storage facilities, which provided potential opportunities for growth of the warehouse receipt system.

Source: (FAO/EBRD, 2015[99])

Current efforts and investments to improve the quality and quantity of storage facilities in Kyrgyzstan appear insufficient. In the short term, and once the legislative framework is in place, banks might be willing to provide loans for creating storage areas and use them for providing WRF. This could mitigate the problems of non-existent insurance products for WRF and limited trust in the system. In the long term, the newly created Investment Promotion Agency and increased efforts to implement public-private partnerships could attract investment in storage infrastructure.

Notes

[1] Here defined as Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan and Uzbekistan.

[2] Other constraints (such as the informal sector and tax) were perceived as more important by SMEs surveyed by the Business Environment and Enterprise Performance Survey (BEEPS).

[3] Government policies to facilitate diversification and quality upgrading include many areas than other access to finance, such as infrastructure, accumulation of human capital, establishment of trade networks, functioning of factor markets etc.

[4] Rising inequality due to fast economic growth is fuelling social tension, even if poverty is being reduced (World Bank, 2015[365]; Theunissen, 2014[330]).

[5] Mongolia ranked 72nd out of 168 countries in Transparency International's Corruption Perception Index in 2015 (Transparency International, 2016[47]). Mongolia is part of the OECD Anti-Corruption Network for Eastern Europe and Central Asia. The country has started a number of important reforms including in the anti-corruption area, but they are still far from producing sustainable results (OECD, 2015[360]).

[6] The PSP aimed to decrease supply-driven inflationary pressure, especially for the main consumer goods such as meat, flour, retail gas and apartment construction. It did so by directly financing SMEs operating in the sectors. The outstanding programme loans amounted to MNT 714.1 billion at the end of 2013, MNT 633.8 billion at the end of 2014, MNT 232.3 billion at the end of 2015 and are forecast to be down to MNT 27.3 billion at the end of 2016 (Bank of Mongolia, 2015[106]).

[7] Mongolia's experience with microfinance has a long history, being developed in the late 1990s with the support of international organisations. In 2002 the Mongolian Parliament enacted laws to define the roles and responsibilities of non-bank financial institutions and legalising savings and loan co-operatives. In 2001, a consortium of these institutions became XacBank They also created the specialised division XacLeasing, which is introducing the practice of leasing in the SME market. The penetration percentage for leasing as a means of financing in the equipment sector is still low. The EBRD's SME Leasing Policy Initiative has been designed and implemented to support the development of the practice in the country (UNDP, 2016[86]).

[8] In the literature, there are other more direct measures of bank competition, such as the Panzar and Rosse H-Statistic, the Lerner index and the so-called Boone indicator. These indicators try to represent actual player behaviour in the market, but their fragility resides in the necessity for very reliable firm-level statistics that can allow the researcher to calculate input costs precisely. This leads to very restrictive assumptions about banks' cost functions.

[9] According to the US Department of Justice and Federal Trade Commission 2010 Horizontal Merger Guidelines, the agencies will regard a market in which the post-merger HHI is below 1 500 as "unconcentrated", between 1 500 and 2 500 as "moderately concentrated", and above 2 500 as "highly concentrated".

[10] The EPCRC analysis focused on four dimensions: access to finance for MSMEs; institutional and regulatory framework for SME development; skills for SME development; and SME internationalisation tools.

[11] This takes into account the time, cost and outcome of the most common insolvency proceedings and their regulation.

[12] In particular, Mongolia was ranked 59th out of 182 countries in the "Getting Credit" ranking and 89th in the "Resolving Insolvency" ranking, scoring 11 out of 16 for the "Strength of the Insolvency Framework" index.

[13] Gathering information to assess the credit worthiness of MSMEs is challenging and costly for banks, and this leads to strong uncertainty when calculating the expected rate of returns from the loan. Stemming from this imperfect information, the interest rate a bank charges may itself affect the riskiness of the pool of loans by sorting potential borrowers (adverse selection effect) and affecting the action of borrowers (incentive effect; (Stiglitz and Weiss, 1981[329])).

[14] These data refer in particular to the construction sector.

[15] This fee can be calculated as a percentage of the loan or of the guarantee. It can be either paid directly by the MSME to the MCGF, or paid upfront by the lender (OECD/INFE, 2012[140]).

[16] These "switching arrangements" can reduce the administrative burden on the customer as the banks perform a considerable part of it. These arrangements typically stem from a self-regulatory code between banks (OECD, 2011[30]).

[17] See also the OECD/INFE Guidelines for Private and Not-for-profit Stakeholders in Financial Education (OECD and INFE, 2014[328]) regarding conflicts of interest of private stakeholders in the provision of financial education.

[18] The payment system is the interconnected system of technologies, procedures, rules and money transfer systems, providing the circulation of money in the country. Its main function is the realisation of money transfers between credit organisations through correspondent accounts, opened within the National Bank.

[19] Instruction No. 221 in October 2015

[20] This measure is part of the monetary policy aim of building up foreign reserves to stabilise the exchange rate. To sterilise the effect on inflation the NBT has increased its sales of central bank securities and treasury bills from 3.7% of GDP in 2015 to 7.9% of GDP in 2016 (ADB, 2017[144]).

[21] The fund was established with the Order of the Government of the Republic of Tajikistan N.34 of February 5 2013, but operations started with the approval of the regulation for the fund, Order N.62 of February 14, 2015.

[22] The previous one was approved in 2000.

[23] Statement based on OECD interviews and discussion during the Public-Private Working Groups in Dushanbe in May and July 2017.

[24] National Bank of the Kyrgyz Republic regulations limit the maximum loan amount granted in the scope of WRF to KGS 100 000 (USD 1 800). More specifically, the lack of a dedicated regulatory framework forced the National Bank to treat WRF credits as unsecured credits, thus limiting the amount of credit awarded. WRF were applied as collateral of up to KGS 100 000; any amounts in excess of this threshold were secured with "regular" forms of collateral.

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