MONGOLIAN NATIONAL CHAMBER OF COMMERCE AND INDUSTRY

TRAM Trade Related Assistance for Mongolia

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EUROCHAMBER MONGOLIA

ЕВРОП МОНГОЛЫН ХАМТАРСАН ХУДАЛДАА АЖ ҮЙЛДВЭРИЙН ТАНХИМ

Export financing for Mongolian SMEs

Options to mitigate COVID–19 impact and for medium–term capacity development

August 2020

Executive summary

To direct investment and entrepreneurs towards manufacturing is a critical stage of economic development. In successful Asian countries, governments pioneered new ways to promote accelerated technological upgrading in manufacturing that were conditioned on export performance. Export focus and discipline takes industrialisation to new levels. The significance of policies to support economic development and industrialisation by a relentless focus on export cannot be overestimated. A consistent set of government policy interventions makes the difference between long-run success and failure, and creates and sustains globally competitive manufacturing. Natural resource wealth in itself does not create sustainable and inclusive economic growth or widespread welfare of the nation. The development of economic sectors and players, which contribute to export must be nurtured. To achieve inclusive economic growth, companies need to sell their products internationally and become globally competitive. Creation of value-added production and selling to protected domestic markets is not sufficient. Companies that do not meet export qualifications, or which fail to meet even the most basic standards of global competitiveness do not qualify for export promotion. The investment of public funds and resources for export promotion should be directed to companies, initiatives and structures which enable, promote and sustain export capacity or are successful in utilizing opportunities in export markets. The companies which can contribute to more export competitiveness, like distributors of foreign produced capital equipment, need to be enabled and supported as they are, at this stage of economic underdevelopment, critical enablers of export creation.

The overwhelming presence in the Mongolian economy of export of non- or only minimally processed natural resources, unwashed coal, low-processed cashmere, un-scoured wool and wet blue animal hides, and the observation that a country so rich with natural resources needs to import e.g. leather, illustrates the weakness or failure of Mongolia to enable and promote exports of value added products. One cause for this is the absence of support in the form of export promotion and especially of export insurance and financing.

This study illustrates the essential need for Mongolia to direct its financial, human and educational resources towards export of added value products and to create mechanism for more effective export financing.

The key findings and recommendations of the study can be summarized as follows:

- Mongolia continues to have a yet unrealized strong potential for fast economic growth, driven by higher value added products export in both mining and the non-mining sector.

- Export financing solutions are close to non-existent and unused as of now, with very few exceptions

- Exporters see opportunities to increase their export volumes on average by approx. 80%, if affordable and suitable export financing solutions would become available.

- The institutional framework of export promotion needs to be established and fostered. The establishment of an Export Credit (Guarantee) Agency (ECA) is a critical cornerstone to the development of an export-oriented industry, as experience from more than 100 countries with an ECA shows.

- Political consensus on establishment of an ECA is to be reached soonest by the Mongolian Government and Parliament, across the political spectrum.

- Details of preparation / size and shape of the future ECA need to be worked out in a subsequent, specialised research study.

- Besides the policy, legal and financial aspects, fast know-how build-up will be necessary to ensure a successful launch of operations of the ECA. Training, know-how transfer through related projects will surely contribute positively in this respect.

- Improvements can be achieved rather fast, when utilizing appropriate / most comparable experience and expertise from other countries e.g. EU member states in Central Europe.

- The legal framework needs to be improved to enable private sector export financing solutions and usage of export financing banking products commonly used in international markets (factoring, forfaiting etc.)

- It is strongly recommended to improve BOM and MinFin regulation, e.g. to exclude foreign funding for export financing from withholding tax and excessive minimal reserves requirements, to decrease cost of funding for trade and export financing.

- COVID-19 impact on exporting companies is expected to be strong in 2020. Company survey results indicate an average decrease of the export volume by 47%, while one third of companies expect a drop of even more than 75%. This shortfall can be partially offset by fast improvements in access to finance for exporters. However, the export financing measures proposed in this study can counter-balance this development only partially, as the key reasons are administrative (border closure etc.) and market related (demand decrease).

- The risk appetite and thus willingness of international banks to finance Mongolian Trade (import and export) is very limited, due to a combination of several factors, including:

  a) country/political risk (reflected in sovereign rating of B),

  b) low bankability of Mongolian commercial banks (governance, capitalization, credit quality being main issues), thus very few banks have access to international funding and

  c) very low bankability of Mongolian corporations and SMEs (low quality of corporate governance, strategy, financial reporting, capitalization and profitability/cash flow).

- Access to (export) financing by SMEs and corporates can be improved by dramatic and fast improvements of transparency, financial reporting, strategy/planning, as well as systemic improvements of the credit bureau information system.

- Some of the issues demand systemic, longer-term effort and solution, other could be tackled and resolved in relatively short period of time.

- Capacity building, education and know-how transfer on all levels (legal and regulatory framework, commercial banks, large corporations and SMEs) will foster healthy development towards quality and reliability on government, banks and companies level, which in turn will enable the success of export-oriented industries and companies.

- One of the outcomes of the study is that Development agencies' and Donors' technical support and funding may become necessary for the establishment of a Mongolian ECA besides the Mongolian initiative and resources.

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Keywords

For the purpose of this Study, the authors have used the following meaning of key words:

1. Export Financing: banking products specifically used for the financing of export of goods and services (discounting of letters of credit, factoring, forfaiting, suppliers credit, buyers credit, ECA covered loans, …)

2. Pre-Export Financing: banking products specifically used for the financing of the production and capital investment in the phase before the actual export of goods and services takes place.

3. Export Credit Agency (ECA): as defined by the International Union of Credit & Investment Insurers (known as Berne Union)[1] is a usually government owned (or otherwise sponsored) institution aimed at insuring political, commercial and credit risks arising from export contracts (and related pre-export financing). In some countries the ECA also provides financing of such insured exports. An ECA is a typical and strong tool of national export promotion and economic policy.

4. Export Credit Insurance: as defined by Berne Union. The insurance of credit, commercial and/or political risks arising from export contracts and/or the financing thereof. – https://www.berneunion.org/Stub/Display/17

5. Trade finance: Trade finance signifies financing for trade, and it concerns both domestic and international trade transactions. A trade transaction requires a seller of goods and services as well as a buyer. Various intermediaries such as banks and financial institutions can facilitate these transactions by financing the trade.

6. Credit line: a line of credit is a credit facility extended by a bank or other financial institution to a government, business or individual customer that enables the customer to draw on the facility when the customer needs funds.

7. Fixed assets pledge: export contract and/or export receivable are usually not sufficient to obtain an export / working capital line of credit.

8. Forfaiting: in trade finance, forfaiting is a service providing medium-term financial support for export/import of capital goods. The third party providing the support is termed the forfaiter.

9. Factoring: factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable to a third party at a discount.

[1] https://www.berneunion.org/

10. Arithmetic average: In mathematics and statistics, the arithmetic mean, or simply the mean or average when the context is clear, is the sum of a collection of numbers divided by the count of numbers in the collection.

11. Prudential norm: "Prudential norms" are definitionally the guidelines and general norms issued by the regulating bank (the central bank) of the country for the proper and accountable functioning of bank and bank-like establishments.

12. Country risk: Country risk refers to the uncertainty associated with investing in a particular country, and more specifically the degree to which that uncertainty could lead to losses for investors. This uncertainty can come from any number of factors including political, economic, exchange-rate, or technological influences.

13. Bankability of companies: indicates that a business is sufficiently healthy, meeting requirements usually demanded by lenders/banks to qualify for receiving a credit (or guarantee) product or service.

14. Credit management: Credit management is the process of granting credit, setting the terms it's granted on, recovering this credit when it's due, and ensuring compliance with company credit policy, among other credit related functions.

15. Ancillary risks and products: The definition of ancillary is “providing the necessary support to the primary activities or operation of an organization, institution, industry, or system.” Ancillary benefits with health insurance are no different. They are simply secondary products that are available to help enhance insurance plans.

16. S&P: Standard & Poors Global Rating Agency - assesses the potential direction of a long-term credit rating over the intermediate term

17. Moody's: Investors Service's ratings system, securities are assigned a rating from Aaa to C, with Aaa being the highest quality and C the lowest quality.

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List of Abbreviations

AML/CTF	Anti-Money-Laundering/Counter-Terrorist Financing
ADB	Asian Development Bank
AML/CTF	Anti-Money Laundering and Counter Terrorism Financing
AQR	Asset Quality Review
BOM	Bank of Mongolia
DBM	Development Bank of Mongolia
DIF	Development Financial Institution
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECA	EXPORT CREDIT AGENCY
EFF	Extended Fund Facility
EU	European Union
FATF	Financial Action Task force
FDI	Foreign direct investment
GDP	Gross Domestic Product
IFI	International Financial Institution
IMF	International Monetary Fund
LatAm	Latin America
MBA	Mongolian Bankers Association
MinFin, MoF	Ministry of Finance
MLT	Medium/Long term
MNCCI	Mongolian National Chamber of Commerce and Industry
MOFALI	Ministry of Food, Agriculture And Light Industry
NBFI	Non-bank financial institution
NPL	non-performing loans
PDL	Principal Deficiency Ledger
PXF	Pre-export financing
PXF	Pre-export financing
SME	Small & Medium Enterprise
TDBM	Trade and Development Bank of Mongolia
TRAM	Trade Related Assistance for Mongolia
UBCB	Ulaanbaatar City Bank
VAT	Value Added Tax

1 Introduction

1.1 Description

- **Objectives**: This Study aims to describe the current situation in respect of the capacity of Mongolian SMEs and large corporates to export their products (and services), and especially to obtain financing to achieve this. The Study aims to present measures and proposals to create infrastructure and support for this purpose. These measures and proposals would mitigate some of the impact of COVID-19 in the short term and at the same time create medium term capacity in the field of export financing.

- **Scope**: The scope of this Study is to make general recommendations to improve the access to financing of export by Mongolian SMEs and corporations.

- **Out of scope**: A detailed proposal for the creation of an export credit promotion scheme falls outside of scope of this Study, as it calls for alignment of key stakeholders, and requires resources in excess of the Authors Team capacity. This Study also excludes the focus on export of low-value added natural resources. Detailed macroeconomic statistics and analysis are also omitted, as they are sufficiently available through other sources.

1.2 Methodology

The Team used a mix of desk research, stakeholder in-person interviews and written surveys to generate base-line data. Expert judgement and experience were used to analyse and draw conclusions and to propose actions.

1.3 Stakeholders

The following are the identified key types of stakeholders with relevance for the area of research. The research team engaged with them during the implementation of the study.

- Export companies and business association, representing the sector, including MNCCI.
- Domestic commercial banks (systemic, involved in trade finance) and MBA, representing the sector.
- International commercial banks.
- International Development Finance Institutions.
- Government of Mongolia: Ministry of Finance, Ministry of Foreign Affairs, Ministry of Food, Agriculture and Light Industry.
- Banking system regulator – Bank of Mongolia
- Delegation of the European Union in Mongolia.
- EU Trade Related Assistance for Mongolia (TRAM) project team.

2 Macroeconomic introduction - Foreign trade and export

The world's most successful countries and economies have achieved their economic and financial standing largely on the back of a rigorous focus on the export of high-value added products and services. Compared to these countries, Mongolia has so far hardly been able to shift away from exporting natural resources and raw materials almost as they are found in nature and underground. This is the case for all natural resources, including gold, unwashed coal, and even for a large share of sheep wool, goat cashmere and animal skins. In the absence of an economic focus on added value, combined with insufficient capacity of the domestic banking system to support processing and export financing appropriately, and in light of a largely absence of governmental structural support for value-added export, the vast majority of SMEs (and indeed also of the country's largest manufacturing companies) have been unable or experience severe difficulties to invest in capital equipment to create such added value, let alone to create capacity for import substitution.

2.1 Current situation – Macroeconomic baseline data

Mongolia is one of the most open economies in its region and foreign trade accounts for 123% of GDP (2018, World Trade Organization). The country's trade policy aims at adopting market-oriented reforms and reducing dependence on the mining sector – which is happening very slowly.

Macroeconomic projections - Mongolia as of 6/2020

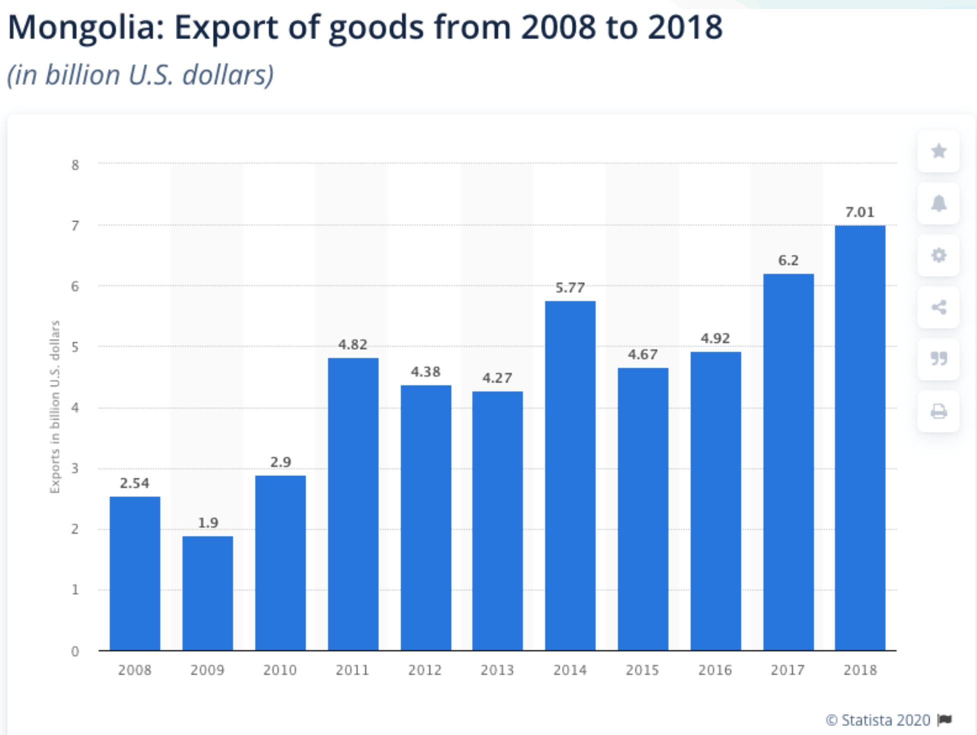
Baseline scenario

	Unit	2018	2019	2020 proj	2021 proj	2022 proj	2023 proj
Gross domestic product	billion MNT	32 411	36 898	37 250	42 230	45 775	50 038
Economic growth	by percent	7,2%	5,1%	-1,0%	7,7%	5,0%	6,5%
Inflation	by percent	8,1	5,2	8,0	7,0	6,0	6,0
Trade turnover	million USD	12 887	13 748	11 671	14 070	13 965	14 909
Goods export	million USD	7 012	7 620	6 095	7 893	7 342	7 893
Export growth	%		8,7%	-20,0%	29,5%	-7,0%	7,5%
Goods import	million USD	5 875	6 127	5 575	6 178	6 623	7 016
Trade balance	million USD	1 137	1 493	520	1 715	719	876
Trade balance growth	%		31,3%	-65,2%	230,0%	-58,1%	21,9%

source: Ministry of Finance, Mongolia

Since the start of operations of the Oyu Tolgoi open pit mine, Mongolia started to record trade balance surpluses, which is an achievement in itself. However, the overall structure of exports is not favourable.

2.2 Key Export Statistics and evaluation



In general, Mongolia displays a successful development of total export: in the last decade (2009-2019) the USD value of export quadrupled, i.e. grew on average 15 % annually. If we calculate the growth from 2008 to 2019, exports grew 3 times, or 12 % annually. The issue with Mongolian exports is concentration, in two ways: geographical (92 % go to China) and structural (commodity/minerals driven = 88% are minerals).

2.2.1 Mongolia's exports 2018 by country

The total exports of Mongolia reached USD 7 billion in 2018, and USD 7,62 billion in 2019 representing an 8.7% growth).

The top export destinations of commodities from Mongolia in 2018 were:

- China with a share of 92% (6.5 billion US$)
- United Kingdom with a share of 2.46% (172 million US$)
- Russia with a share of 1.22% (85 million US$)
- Italy - 54 million US$
- Singapore - 30 million US$

- Japan - 26 million US$
- Other Asia, - 25 million US$
- Korea - 21 million US$
- Germany - 12.2 million US$
- Hong-Kong - 11.8 million US$

The structure of exports from Mongolia in 2018 comprised the following main commodity groups:

- 45% (3.21 billion US$): Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes
- 38% (2.67 billion US$): Ores, slag and ash
- 5.17% (362 million US$): Wool, fine or coarse animal hair; horsehair yarn and woven fabric
- 2.7% (189 million US$): Salt; sulphur; earths and stone; plastering materials, lime and cement
- 2.07% (145 million US$): Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal and articles thereof; imitation jewellery; coin
- 1.22% (86 million US$): Meat and edible meat offal
- 1.17% (82 million US$): Copper and articles thereof
- 1.13% (79 million US$): Preparations of meat, of fish or of crustaceans, molluscs or other aquatic invertebrates
- 0.543% (38 million US$): Articles of apparel and clothing accessories, knitted or crocheted
- 0.306% (21 million US$): Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof

As can be seen processed or manufactured goods make up only a small portion of total exports, i.e. 4% in 2018 and 2019, and the share further dropped to 3% within the first six months of 2020, mainly due to COVID-19 impact. Details can be seen in the table below:

Table 2. Exports of goods /million USD/

Category	2018			2019			2020			Δ (2019/2018)			Δ (2020/2019)		
	Volume (k.unit)	Value	%	Volume (k.unit)	Value	%	Volume (k.unit)	Value	%	Value	Change	%²	Value	Change	%²
1. Mining products		**3,165**	**88%**		**3,483**	**88%**		**2,625**	**93%**	**318**	**10%**	**9%**	**(858)**	**-25%**	**-22%**
1.1. Copper ores and concentrates	734	1,014	28%	749	1,062	27%	676	741	26%	48	5%	1%	(321)	-30%	-8%
1.2. Coal	18,024	1,405	39%	18,030	1,540	39%	8,653	690	24%	136	10%	4%	(850)	-55%	-22%
1.3. Crude oil	3,299	212	6%	3,177	180	5%	951	34	1%	(33)	-15%	-1%	(146)	-81%	-4%
1.4. Iron ores and concentrates	3,373	156	4%	4,115	252	6%	4,124	283	10%	96	61%	3%	31	12%	1%
1.5. Non-monetary gold /kg/	3,432	144	4%	4,665	196	5%	10,974	606	21%	51	36%	1%	410	210%	10%
1.6. Zinc ores and concentrates	62	108	3%	72	107	3%	67	80	3%	(1)	-1%	0%	(27)	-25%	-1%
1.7. Fluorspar, leucite, nepheline etc.	196	64	2%	286	93	2%	314	76	3%	29	44%	1%	(17)	-18%	0%
1.8. Molybdenum ores and concentrates	3	23	1%	3	25	1%	3	21	1%	2	10%	0%	(4)	-15%	0%
1.9. Tungsten ores and concentrates	0	2	0%	0	2	0%	0	0	0%	(0)	-3%	0%	(2)	-99%	0%
1.10. Silver /tonnes/	0	0	0%	0	-	0%	109,148	60	2%	(0)	0%	0%	60	0%	2%
1.11. Other	260	35	1%	83	26	1%	32	34	1%	(10)	-27%	0%	8	31%	0%
2. Animal products	235	**269**	**8%**	203	**291**	**7%**	143	**122**	**4%**	**22**	**8%**	**1%**	**(169)**	**-58%**	**-4%**
2.1. Live aminals, meat	11	24	1%	11	23	1%	3	7	0%	(2)	-6%	0%	(15)	-67%	0%
2.2. Hide, skin and leather	212	11	0%	178	10	0%	131	6	0%	(2)	-15%	0%	(4)	-41%	0%
2.3. Casing	0	4	0%	0	4	0%	0	4	0%	1	14%	0%	0	3%	0%
2.4. Cashmere	7	222	6%	6	244	6%	4	100	4%	22	10%	1%	(144)	-59%	-4%
2.5. Wool, other hair	4	7	0%	5	10	0%	3	4	0%	3	45%	0%	(6)	-59%	0%
2.6. Other	1	1	0%	2	1	0%	0	0	0%	(1)	-45%	0%	(0)	-62%	0%
3. Horticultural products	12	**3**	**0%**	26	**6**	**0%**	19	**6**	**0%**	**3**	**116%**	**0%**	**(0)**	**-5%**	**0%**
4. Manufacturing goods	159	**144**	**4%**	216	**159**	**4%**	135	**75**	**3%**	**14**	**10%**	**0%**	**(84)**	**-53%**	**-2%**
4.1. Food	12	35	1%	12	29	1%	3	7	0%	(6)	-16%	0%	(22)	-77%	-1%
4.2. Cashmere goods	0	10	0%	0	13	0%	0	9	0%	3	33%	0%	(4)	-29%	0%
4.3. Other apparel, footware etc.	2	6	0%	1	5	0%	2	6	0%	(1)	-12%	0%	1	13%	0%
4.4. Mining products	29	57	2%	71	52	1%	11	36	1%	(5)	-8%	0%	(16)	-31%	0%
4.5. Electronic goods	0	2	0%	0	0	0%	0	0	0%	(1)	-70%	0%	(0)	-8%	0%
4.6. Machinery, equipment and their parts	2	33	1%	1	55	1%	1	14	0%	22	69%	1%	(41)	-75%	-1%
4.7. Other	115	3	0%	131	3	0%	119	2	0%	1	26%	0%	(1)	-32%	0%
5. Other	0	**0**	**0%**	0	**0**	**0%**	0	**1**	**0%**	**(0)**	**-3%**	**0%**	**0**	**30%**	**0%**
Total		**3,581**			**3,939**			**2,828**		**358**	**10%**		**(1,111)**	**-28%**	

%² - Contribution to total growth

Source: Bank of Mongolia, Foreign Trade Review 6/2020.

During the first half of 2020, total exports decreased by 28% (or USD 1,111 million) year on year. The decrease of mining products export reached 25%, animal product export fell 58% and manufactured goods export fell 53%. This alarming drop of non-mining exports can be attributed to the impact of COVid-19 related events and government measures.

2.2.2 Evaluation of the statistics and future outlook.

- Due to the absence of capacity to properly finance exports there is no or limited capital investment and low added value for the economy. The number of successful exporters of meaningful size is very limited.
- Traders and producers very often depend on foreign buyers (export of raw commodities or partially processed wool/cashmere is financed by Chinese traders and represents nearly the totality of export). This fact creates a dependency of Mongolian companies on foreign buyers / traders, usually to a detriment to Mongolian companies.
- The establishment and development of an effective export promotion and financing scheme(s), public and private, will counter-act this negative development and serve wider, longer-term Mongolian national interests.

2.3 Financing of foreign trade (especially export)

The leading systemic banks (Khan Bank, TDBM, Golomt Bank, Xac Bank) have been involved in trade finance since several decades. However, trade finance in the Mongolian context means almost exclusively import financing (of both capital and consumer goods.) Based on the finding of the research team, as documented especially by domestic systemically important commercial banks, specific "Export Financing" is almost non-existent in Mongolia as of now.

Trade finance constitutes approximately 5-7% of total corporate and SME financing provided by systemic banks. Thereof, 95+% is import finance, thus only a very small fraction (below 0,5%) of corporate and SME financing constitutes export finance.

It is our understanding that the Development Bank of Mongolia (DBM) has a mandate to provide export financing, anchored in the Law on DBM. However, specific export financing products and services are not provided by the Development Bank. Closest to export supporting financing are loans to cashmere and/or gold producers, offered via domestic commercial banks. This structure, in our view, does not meet the requirements of "export financing" by international standards.

The financing of exports and exporting companies (both by commercial banks and DBM) is mostly conducted in form of general working capital credit lines, and usually in domestic currency (MNT), while financing in foreign currency is used in 20-35% of cases only. Commercial banks do also request for strong collateralization with fixed assets pledge, (i.e. export contract and/or export receivable are usually not sufficient to obtain an export / working capital line of credit.)

Internationally widely used export financing techniques like forfaiting and factoring are rarely used in Mongolia. This is due to deficits in the legal framework which is insufficiently developed and unclear (unavailable assignment of receivables and/or other movable/non-tangible assets and rights) to allow banks to fully rely on such legal/financing structures.

Domestic non-commercial banks (e.g. DBM, or SME support fund) do not provide specific export financing products. It can be argued that the government supported cashmere financing program, which is offered annually by DBM either directly to borrowers or via commercial banks, partially plays the role of export (in fact mainly pre-export) financing.

Financing of commodities / commodity exports:

One of the few areas where international banks are involved in export / pre-export financing is the pre-financing of commodity exports, conducted by few reputable commodity traders or by direct exporters.

International banks do not get involved in direct transactions with the vast majority of domestic Mongolian companies for a variety of reasons, mainly insufficient financial reporting reliability, transparency, audit, financial strength of companies.

2.4 Conclusions

a) Restart and maintain export volume growth, both in mining and non-mining sectors. Minerals exports will continue to form the backbone of the Mongolian economy.

- Strive for higher share of domestic processing, (this will enable geographical diversification)
- Improve export financing (better access to it, volume, conditions)
- Increase the competitiveness of Mongolian exporters, and decrease dependence on Chinese traders and their (pre)financing, usually at high (hidden) cost.

b) Foster non-mining export industries

- Create export support scheme(s) and the required policy framework
- Improve the availability and volume of export financing solutions offered by Mongolian commercial banks
- Support value added processing and manufacturing as well as product development

3 Status of the national export industry – Companies' perspective

3.1 *Description of the current situation*

The Author team created an online and directly mailed survey questionnaire, to collect data and to establish a basic understanding of the situation, mainly from non-mining exporters. In cooperation with MNCCI, the Mongolian National Chamber of Commerce and Industry, 240 exporters were identified. Thereof, 67 companies responded to the online questionnaire, of which 13 to the emailed (extended) version. Thus, the response rate is 28%, which is below the research team expectations, but may have been partially caused by the preoccupation of companies due to the COVID-19 induced crisis. However, the diverse composition of respondents by size and industry **provides a reasonably representative sample of Mongolian non-mining export industry**.

In addition, the Authors conducted individual interviews with representatives from leading large exporters active in coal mining, cashmere, food and beverage sectors, which enabled a small, but representative cross section of views.

The results of the survey are in detail summarized in the following chapter.

3.1.1 *Which industry does your company belong to?*

According to our survey results, the three largest exporting industry sectors represented by the respondents of the survey are manufacturing (17.9%), cashmere (16.4%), and agriculture as well food and beverages with (10.4%). Other significant industries represented in the survey are textile and apparel (9%) and trade and export (7.5%). The remainder is shared by smaller sectors such as cosmetics, leather production, etc. Mining companies form 4.5% of respondents.

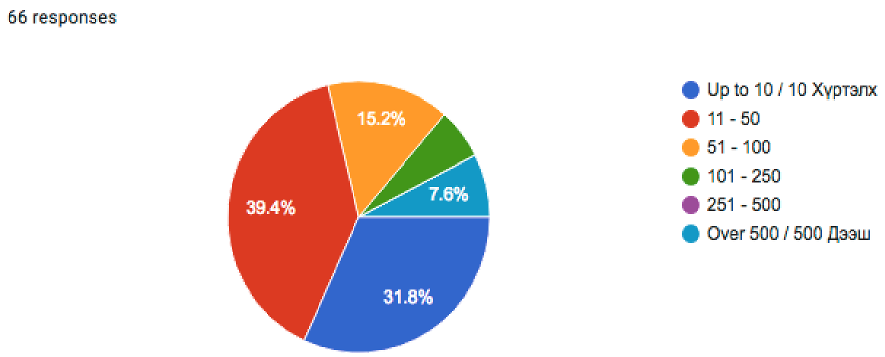
Figure 1. Industry

3.1.2 *How many employees does your company have?*

The employee numbers of the survey participants range from 10 to over 500. Most of the companies have an employee size from 11-50 (39.4%) and up to 10 employees (31.8%). Thus SME companies below 50 employees constitute 71% of respondents.

However, also 5 large companies with over 500 employees responded to the survey and represent the view of major exporters.

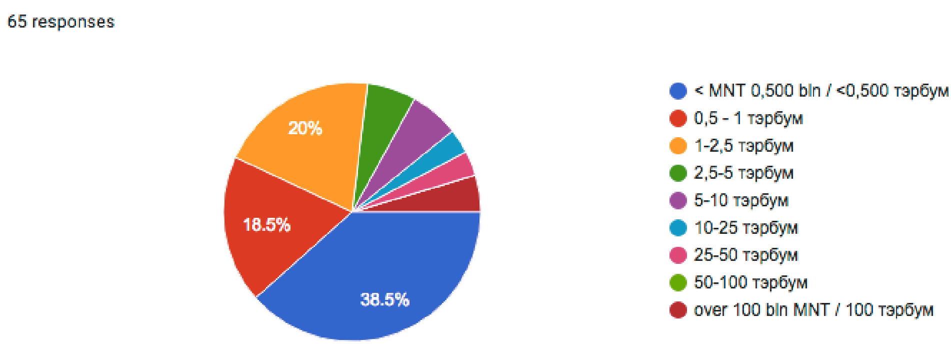
Figure 2. Employee numbers



3.1.3 *What is the size of your company (2019 sales revenue in MNT bln)?*

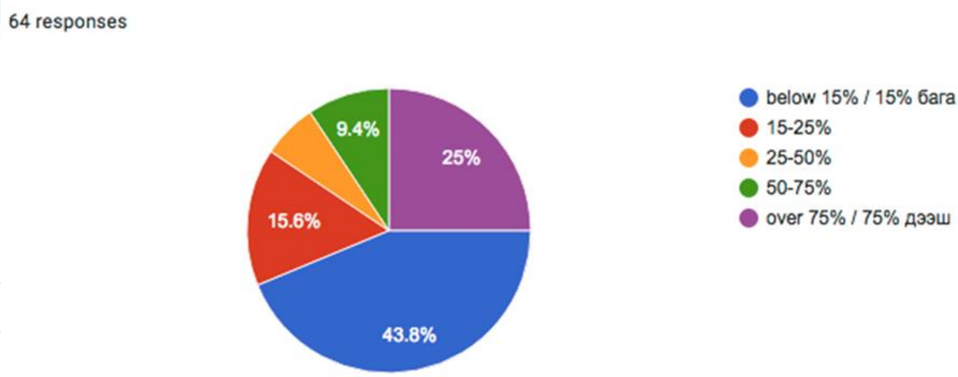
Over three quarters of respondents are SMEs with revenue size under 2.5 billion MNT. The smallest companies with sales under 0.5 bln MNT form the largest group (38.5%). Other significant revenue sizes are from 0.5-1 billion MNT (25%) and 1-2.5 billion MNT (20%). There were three participants with over 100 billion MNT in revenue in 2019.

Figure 3. Revenue size in MNT



3.1.4 What is the share of your export sales (%)?

Figure 4. Export sales in %



We can see a two-fold split of export shares among our survey participants.

A) 43.8% of companies have below 15% in export shares which means that these companies are starting to export and may have chances to increase the export share in future.

B) 25% of companies state over 75% of export share, meaning that these companies are well established in international markets.

3.2 General observations

In a structural view, we can conclude that the survey respondents represent mostly non-ming, SME type of companies, from very diverse industries. Thus we can consider the survey results to be representative and significant.

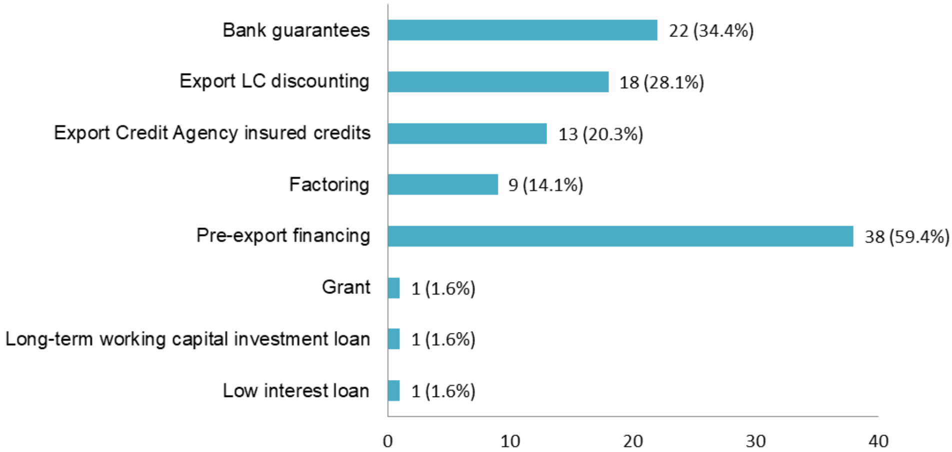
The vast majority of all respondents expressed very similar views and concerns, providing fairly high level of homogeneity.

3.3 Exporters' Expectations

Most issues, cited by the exporters, are related with financing for the companies. Lack of lending and pre-export financing makes it harder for exporters to operate effectively and profitably. High interest rates or volatile foreign exchange rates are the largest financial burden to the majority of exporting companies.

3.3.1 What are the most suitable banking products available or to be introduced in MNG to meet your needs regarding export financing?

Figure 5. Export financing needs



Interestingly, only one respondent stated low interest (subsidized) loans to be important in this section, in contrast to the next one.

3.3.2 What type of export support would you need from the Government?

Below are the top responses by frequency of answers to this question (57 respondents in total).

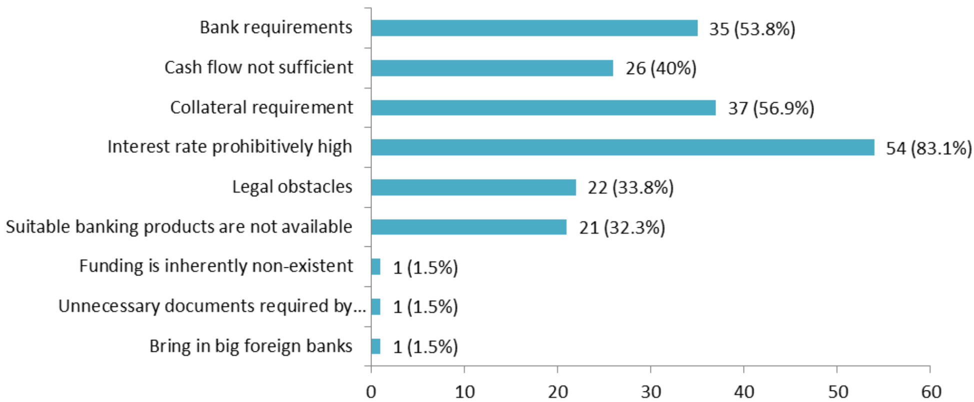
1. Low interest loans with longer duration (42% of responses)
2. Border and customs ease of processing on export and import (12%)
3. Tax benefits (11%)
4. Support of Mongolian manufacturing sector with financing and legal environment 7%
5. Removal of VAT (Value-added tax) on export and import products (5%)

3.3.3 What type of export support would you need from commercial banks?

1. Low interest loans (73% of responses)
2. Ease of bank requirements on exporting companies (14%)
3. Special purpose loans for export financing (13%)
4. Affordable factoring products (10%)
5. Financial advisory (5%)

3.4 What are the main obstacles to access export financing in Mongolia?

Figure 6. Obstacles to access export financing:



According to the survey results, the **main obstacle for access to export financing in Mongolia is the high-interest rate; 83.1%** of the participants highlighted this as the main issue. Other significant reasons include: commercial bank requirements (53.8%), of which mainly collateral requirements (56.9%). **One third of companies mentions the lack of suitable banking products.**

On the other hand, 40% of companies say that their insufficient cash-flow poses an obstacle for them to obtain credit.

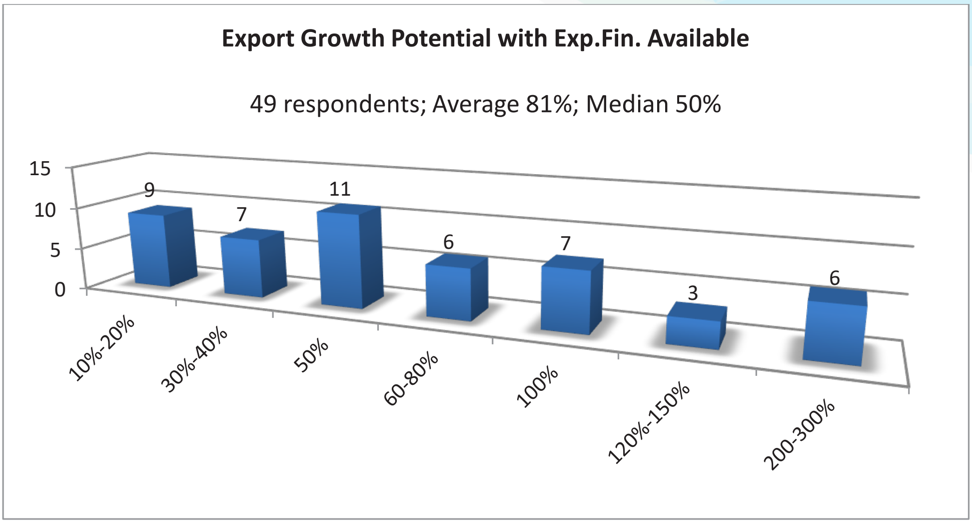
Legal obstacles are cited in 33.8% of cases.

3.4.1 Please specify any other or particular obstacles and impediments to access export financing:

1. Government bureaucracy and special permits
2. Shipment and courier system is under developed
3. Legal environment issues
4. Time consuming customs and boarder control processes
5. Lack of HR, and specialist in export and global trading fields

3.4.2 If export financing would be more freely available, by how much could you increase your exports within one year (in % of your existing exports)?

- The responses range from 25% to 300% of potential export increase.
- The arithmetic average of 49 responses was 81%, and the median was 50% of potential export increase; remaining 18 companies did not respond to this question.



This is a very important result of the survey and supports the view of the Authors that export financing is a critically important aspect how to increase export potential of Mongolia.

3.5 Exporters' recommendations

Based on discussions with selected exporters, and in the judgment of the authors of the study, recommendations were grouped as follows:

- High – the greatest potential for impact / improved respondents' satisfaction
- Medium – greater potential for impact / improved respondents' satisfaction
- Low –potential for improvement of respondents' satisfaction

	Recommendation	Effect
1	Open a channel for an affordable loan with lower interest rates.	High
2	Establish an export guarantee fund to insure exporters.	High
3	The Government of Mongolia should create a favorable tax environment for exporters.	High
4	The Government of Mongolia should create a favorable legal and regulatory environment for exporters.	Medium
5	Local banks should extend the loan payback period to exporting companies.	Medium
6	Banks should improve the factoring products to make it more favorable and ease of access to exporting companies	Medium
7	Improve cross border transport logistics and make it more affordable for SMEs or beginning to export companies.	Medium
8	Establish consulting agencies to help and direct exporting companies or aiming to export companies in future.	Low

The summary of the above prioritized recommendations from exporting companies appears rather clear:

1. **Available and affordable** (more structured, more accessible, and longer term) **export financing**

2. **Creation of an ECA**, which would serve the previous goal as well, and

3. **Improved tax and legal framework**, supportive of export companies.

3.6 Expected impact of Covid-19 on Mongolia SMEs

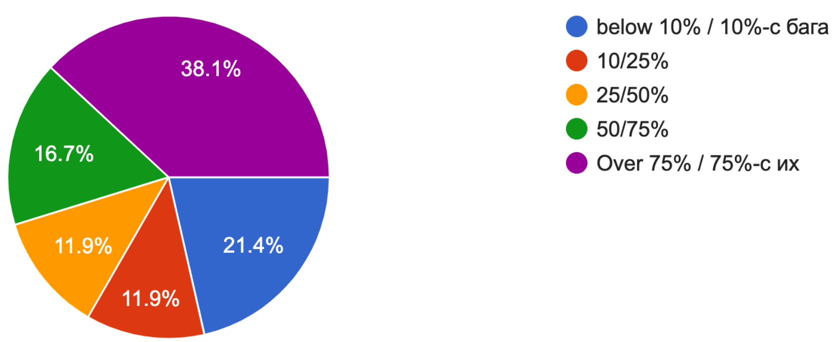
3.6.1 What is the expected decrease of your export volume in 2020 compared to 2019 (%), due to COVID-19 crisis?

COVID-19 affected hard on the export businesses. With the closure of the borders and strengthened/slowed-down customs processes, exporters are facing an unprecedented decline in their export activity. On average, the respondents expect exports in 2020 to reduce by 47%. Almost 40% of the survey participants expect export volumes to decline by more than 75% due to COVID-19 related problems.

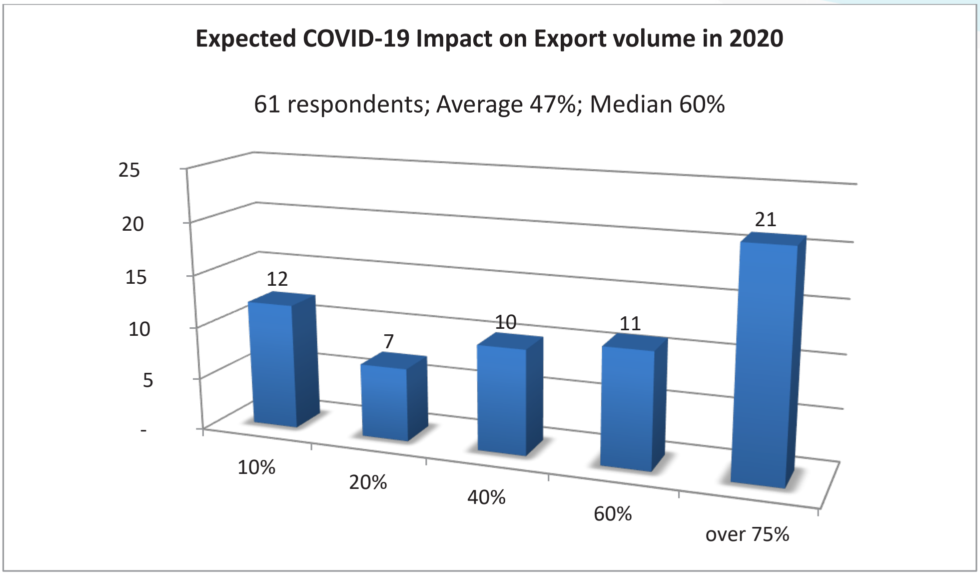
On the slightly positive side, 1/3 of exporters expect exports to decrease by not more than 25%.

This is an interestingly close result of survey, compared to the 56% year on year decrease of non-mining exports during the first half of 2020 (NSO/BOM report).

Figure 7. COVID-19 crisis effects on export volume of companies



The extent of COVID-19 impact on export volumes is diverse:



3.6.2 *Any other information about the Covid-19 impact on your company that you want to share?*

1. Directly impacts the revenue
2. With closed borders it is getting harder to buy supplies from global market
3. Banks are not providing more loans for exporters
4. International procurement halted partially or completely
5. Air shipment and other shipment channels on halt or significantly slowed-down
6. Government support measures have not been effective or targeted enough

3.6.3 *Conclusion*

Export and global trade play an important role in Mongolia's economy. Mongolia, in its pursuit of economic stability and diversification, has been making efforts to ensure strong international trade and export. There are potentials for Mongolian companies to tap on foreign and domestic credit funds. However, the Mongolian government and local banks need to work with exporters to ensure affordable lending products, ease on taxing, ease on customs processes, and unconditional sharing of information regarding export-related financial products and opportunities.

Exporters perceive that the government is not providing sufficient tangible support to them.

Also, export-related banking products availability and accessibility for SMEs and larger companies (loans, guarantees) is difficult and limited. The lack of pre-export financing and export credit insurance are reported as most pressing issues, while prohibitively high interest rates and general as well collateral demands by banks are counter-productive, from exporter's point of view.

At the same time, exporters see opportunities to grow their export volumes on average by approx. 80%, if accessible and affordable export financing would become available.

These findings, supported by the companies and banks' survey results (see below) as well as EuroChamber team's expert views and findings from individual interviews, **do support strongly the need and necessity of a coherent pro-export policy by the government, including the establishment of an ECA of the "Berne-union type".**

4 Banking Sector

4.1 Domestic banking system

Structure and Overview

The domestic banking system can be categorized as follows:

Total number of banks (as of May 2020)	13
State-owned banks	2 including one promotional bank
Commercial banks	12
Systemic banks	5
Non-systemic banks	7

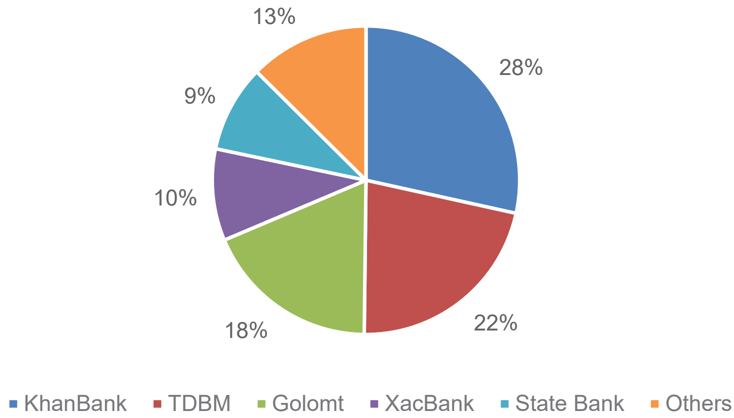
As of May 2020 there are 13 banks in Mongolia, of which 2 are state-owned and 11 are privately-owned commercial banks. In June/July 2020 TDBM and UBCB have merged. Five banks are systemic, that is they are defined as banks whose total assets has accounted for more than 5% of the total assets of the banking system for the last 6 months. The systemic banks have an aggregate equity of about USD 1.25 billion. With a prudential norm for a single borrower limit of 20% of equity, a maximum of about USD 40 million per economic group would be available from the largest bank in the country. This is insufficient for the ongoing and reliable financing of exports of natural resources or other sizeable exporters of manufactured goods.

The 5 systemic banks are (in order of size):

Bank name	*Ownership*	*Profile*
Khan Bank	private	primarily retail
Trade and Development Bank	private	primarily corporate
Golomt Bank	private	balanced retail/corporate
XAC Bank	private	retail and SME
State Bank	state	primarily retail

The respective market share of banks by total assets as of December 2019 is illustrated below.

Figure 8. Banking Sector by Assets



Source: Bank of Mongolia

Of the state-owned banks Development Bank of Mongolia (DBM) is a promotional bank. The mandate of DBM is to provide project financing for infrastructure, energy and industrial parks, as well as export financing. State Bank is focused on retail banking. The state-owned banks do not play a role in international trade finance.

There are 7 non-systemic banks. Of these, only 2 have total assets > 1 billion MNT (362 million USD). These are Ulaanbaatar City Bank and Capitron Bank. The 5 smallest non-systemic banks have total assets each of < MNT 500 billion (USD 181 million). Non-systemic banks control only 12.6% of the banking system's total assets. The non-systemic banks do not play a role in international trade finance.

Conclusion: Only the 4 privately-owned systemic banks Khan Bank, Trade and Development Bank, Golomt Bank and XAC Bank have expertise and capacity to provide international trade finance to Mongolian companies.

At the same time, "Trade Finance" in the Mongolian context refers almost totally to import financing (of both consumer and capital goods). **All systemic banks display a very similar picture with regards to Export finance: it virtually does not exist in their portfolios/ product offering.**

<u>Capacity of the Banking System</u>

Over the last 3 to 4 years, the domestic banks have become weaker as a result of a number of factors which will be briefly described.

In May 2017 Mongolia entered into an Extended Fund Facility (EFF) program with the International Monetary Fund (IMF). This program expired in May 2020 but was already frozen in July 2019. Under the initial terms of this program, all banks went through an Asset Quality Review (AQR) conducted by an external auditor appointed specifically for this purpose. Stress testing was applied to the results of this AQR and this resulted in recapitalisation requirements for 6 banks. The required equity injections were not in all instances completed in an appropriate or sufficient manner. This has meant that today some of the systemic banks do not have financial capacity to accommodate the financing requirements of the country's companies, including trade finance. This is best illustrated by the fact that in 2019 Khan Bank, the largest bank in the country, significantly expanded its dominance of the sector and generated 95% of the whole sector's net profit, up from 65% in 2018.

Over the same period, the ratio of non-performing loans (NPL) in the sector increased from 7.43% in 2016 to 10.34% early 2020, despite the fact that 2018 and 2019 had seen a solid GDP expansion. This increase of NPLs is further limiting the capacity of local commercial banks to expand their financing for companies in general and for trade finance in particular. An increase of NPLs reduces the amount of capital available for asset growth. It is widely expected that the impact of the COVID-19 induced economic slowdown will drive the NPL ratio of Mongolian banks even higher, possibly close to 15-20%.

Conclusion: the capacity of local banks to provide trade finance to Mongolian companies has weakened over the last years, and is expected to possible deteriorate further in 2020, before it can improve.

4.2 International commercial banks

There are no operational foreign bank legal entities or branches in Mongolia. There are currently 5 representative offices of foreign banks in the country.

Bank of Tokyo Mitsubishi UFG
Sumitomo Mitsui Banking Corporation
Bank of China
Industrial and Commercial Bank of China
ING Bank

The activities of these representative offices are limited to correspondent banking and selected trade finance. The Japanese banks however restrict their trade finance support to transactions which are connected with Japanese exporters. ING Bank will close its office by 15 September 2020, and has terminated all trade finance and correspondent banking activity with Mongolian banks.

The absence of operational foreign banks in the country greatly limits the availability and capacity to provide international standard bank products and finance, of which trade finance is a primary instrument.

Non-resident foreign banks occasionally have some activities in the country, and leading Chinese and few European banks are known to still have trade finance facilities in place for some of the systemic domestic banks.

Conclusion: Given the country rating and ratings of domestic systemic banks (S&P: B stable, Moody's: B3 with negative outlook as of June 2020) limits the appetite of international banks to provide financing to Mongolian companies – via domestic banks, or directly. Only the largest and best-managed Mongolian companies/conglomerates meet customer acceptance criteria of international banks.

The small size (by international standard) of most Mongolian SME and corporate companies does disqualify them from direct access / interest to conduct financing directly by international, non-resident banks.

4.3 International Risk Appetite

In addition to the problems related to the domestic banks as described above, since Summer 2016 international risk appetite for the country significantly reduced. This is the result of a number of factors, such as prolonged uncertainty about capital adequacy in the banking sector, scandals in the state-owned banks, the issues with the IMF program and, the expectation of and actual grey-listing in October 2019 by the Financial Action Task force (FATF) for strategic deficiencies in Anti-Money Laundering and Counter Terrorism Financing (AML/CTF).

With the high-risk-country-listing by the European Union in May 2020 the situation even further deteriorated. For a long period of time international trade finance would only be available either directly from International Financial Institutions (IFIs) such as the European Bank for Reconstruction and Development (EBRD) and Asian Development Bank (ADB). In practice there are 2 ways companies can access trade finance from these IFIs:

- Direct trade lines
- Guarantee credit facilities

In the latter case, an international commercial bank provides the regular financing to the domestic bank, on the basis of trade documents such as a letter of credit, which then provides the funding to the local company (importer or exporter, but importer in the overwhelming number of cases), under the transactional guarantee of the IFI. This structure is more complex, because more parties are involved, and more costly, because a guarantee fee needs to be paid on top of the regular cost of financing, but in the absence of direct trade lines from international banks it is still a very common structure.

The limitation of the latter structure is that the IFI must have credit lines available for the domestic banks. This is not always the case, and amongst the systemic banks in Mongolia there are some which do not meet the risk appetite of the IFIs, typically because of insufficient corporate governance and/or capital adequacy.

Conclusion: Over the last years insufficient international trade finance credit facilities have been available to Mongolian banks and consequently to the companies. The number of international banks providing credit lines has been decreasing. This issue is exacerbated by the fact that not all systemic banks qualify for IFI trade finance facilities.

4.4 *International Development Financial Institutions*

The presence and work of international / multinational development banks in Mongolia is very essential, especially given the above described low risk appetite of international commercial banks. Their presence has been instrumental in providing medium to long term financing to leading corporations, and SME and other targeted credit lines to selected systemic commercial banks. DIFs advisory and capacity building activities are a very important contribution to the development of the Mongolian financial market and companies, incl. SMEs.

Besides, ADB, EBRD and IFC do offer ”Trade Facilitation” or similar facilities and products. These are almost exclusively used to facilitate the financing and/or risk mitigation of imports to Mongolia (via Mongolian commercial banks, very rarely directly to importing companies). The volume is collectively approx. USD <175 mil limit, and the term usually up to one year.

DFIs choose to work with a select small group among Mongolian systemic banks (and one or two NBFIs), while some of the local banks don’t meet risk acceptance criteria currently.

4.5 Access to Finance

One of the critical complications of financing international trade in Mongolia is the concentration of credit on local large corporates and businesses in the supply chain of the mining industry. Over 80% of total corporate credit in the banking system is directed to only a few large companies. Over 90% of individual borrowers were only eligible for small loans (up to MNT 20 million or USD 7,500). Small and medium sized companies (SMEs) have limited access to finance. Mongolia has an official definition of SMEs in its SME Law which varies by sector. Industry, retail, trade: maximum 199 employees and maximum turnover of MNT1.5 billion; trade: maximum 149 employees and maximum turnover of MNT1.5 billion; services: maximum 49 employees and maximum annual turnover of MNT1 billion. While almost 90% of registered businesses in Mongolia are SMEs, only 10% of about 37,000 SMEs regularly access finance through banks because of a combination of obstacles including: high interest rates, collateral requirements and the lack of funding available for longer term loans, as well as low creditworthiness of these potential borrowers (due to weak corporate governance and management, accounting, capitalization, profitability etc).

This concentration of credit is a risk for the banking system, a hindrance for economic diversification and an obstacle for the healthy development of trade finance.

4.6 Pre-Export Financing (PXF)

It is critical for exporters to receive payment for their exports in an effective, transparent and timely manner. To enable the purchasing of raw materials and to invest in the necessary capital equipment to continuously upgrade facilities for creation of the highest possible added value, exporters require financial resources before the actual export of the goods.

This is done by requesting a bank or a group of banks to provide funds to the exporting company by presenting sales contracts and invoices. Typically commodities are purchased by globally recognized trading companies with large purchasing and sales networks. They enter into supply contracts with mining companies which typically cover one year of production and export. based on these off-take agreements the exporter can obtain the proceeds of the sale of the goods before they are exported, or indeed well before they are mined. As the proceeds are received in advance, the mining company can invest in further exploration, equipment, logistics, washing facilities etc.

Some countries, like Mongolia, have insufficient international financial credibility and therefore international banks are reluctant, or simply refuse to provide the financing within the legal territory of the country. To make pre-export financing possible, exporters are then required to centralise their off-take agreements and the payments of these contracts offshore. For Mongolia this is typically done in Hong Kong, but other international finance centres can also be used, as long as there is a sufficiently large group of international banks present and interested in participating in such financing structures. The off-takers are required to pay for their purchases on the offshore bank account of the exporter.

Banks require such offshore structure because they want to avoid what is usually called “country risk events”, such as capital controls preventing exporters from repaying foreign currency loans.

The above options could also be useful for the export of non-mining products. However, due to small size of such export transactions (by international standards) and usually low competitive position f of these Mongolian exporters, such option is hardly offered by the international buyers and/or by their banks.

As illustrated above, the Mongolian commercial banks do not have the financial and technical capacity to provide such large pre-export financing facilities to exporters. In principle, the maximum loan for one borrower that can be obtained in the Mongolian banking system is below USD 40 million. But usually the loan amounts are very much smaller. This is insufficient to pre-finance the export of natural resources and minerals. Even if local banks would work together (which has never happened) the loan amounts would be insufficient.

The additional problem with PXF facilities is that even among offshore financial structures the credibility of the exporters and consequently the risk appetite has reduced to almost nothing. That is not due to a shortage of financial resources, but because the ultimate risk of the PXF banks is performance risk i.e. the insecurity if the exporter will have the capacity and willingness to fulfil the sales contracts of the international buyers. If there is no actual supply of goods, there is no revenue and the advances under the PXF credit cannot be repaid. Failure to deliver under off-take contracts can occur due to internal reasons (inability to obtain raw materials, low product quality, management failure) or due to external reasons (political interference, invasive measures related to country risk events). And there has been a history of such delays or under/non-performance by Mongolian exporters in the not so distant past.

As a result, the availability of large scale international PXF even for Mongolia's mining sector has dried up. Then it is even harder for non-mining companies to obtain these financial resources.

An exception to this is the on-going multibillion USD PXF for Oyu Tolgoi (OT) which remains active and available. That is because the international lenders assume that the importance of the project for the country is so big that no country risk event will be allowed to occur.

The banking consortium is led by EBRD and IFC (each with USD 500 mil commitment) under tranche A and tranche B was syndicated among [15] international commercial banks.

The structure involves collection of export receivables in offshore jurisdiction (eliminating Mongolian country /transfer risk), as the source of repayment of the capital investment and working capital loan. The success (up to date) of this financing demonstrates that such transactions and structures are possible. However, the market witnessed also attempts to revisit the structure (in 2018-2019) by the Parliament/ Government of Mongolia.

4.7 Obstacles to Export Financing (EF) in Mongolia

Based on the results of the survey and individual interviews with domestic as well as international commercial banks and IFIs, we can summarize the different types of impediments to EF as follows:

- Bankability of companies

  This is by far the most cited main reason by domestic and international banks. The level of quality, creditworthiness and reliability of (potential) borrowers is seen as generally low and is also evidenced by the high NPL/PDL ratio of the banking system. With few exceptions this level decreases with the size of companies and SMEs appear on average less creditworthy / bankable than large corporations.

  The main aspects of "bankability" of companies are:

  - Corporate governance, transparency, management
  - Financial stability, profitability, capitalization, cash flow
  - Disclosure / accounting / audit
  - Quality of products, production volume, market demand

  E.g. less than approximately 100 Mongolian companies undergo annual audit of their financial statements by reputable international audit companies (Big 4)

- Bankability of domestic banks

Similar issues, just on a higher level of sophistication, are relevant to domestic commercial banks, as cited by international commercial banks and by IFIs.

  Main aspects of "bankability" of domestic commercial banks are:

  - Corporate governance, transparency, management
  - Financial stability, profitability, capitalization, credit quality and insufficient loan loss provisioning

- "High" requirements from international banks to provide credit lines for trade financing (relates to above points on "bankability" of domestic banks)
- Non-existence / limited know-how of EF products and services by domestic commercial banks (and no market incentives to change this situation)
- Low competition among banks as well as insufficient demand (and knowledge/sophistication) on borrower's side
- International (non-resident) commercial banks unable or uninterested to provide direct financing and to accept the risks of Mongolian exporters due to the small size of transactions in combination with limited ability to conduct remote credit/risk assessment and monitoring.

- Regulatory framework:

The BOM regulation is currently discouraging foreign funding in two ways:

a/ minimal reserve requirement of 15% on received foreign funds (up to 2 years of tenor) and

b/ withholding tax burden. (mostly 10% for countries with double-tax-agreement, otherwise 20% of interest cost, in few cases 5% (Singapore, Korea)

In total, these two aspects increase the cost of foreign funding by about 2% p.a. (for a USD loan borrowed at 8% p.a.)

This fact a) makes the funding for trade (incl. export financing) more expensive and b/ limits the access to financing due to the higher costs. In the absence of affordable medium to long term foreign currency domestic funding for commercial banks, it is not fostering trade or export financing. Most domestic foreign currency deposits have an average duration below one year.

Recommendation: We strongly recommend BOM and MoF to upgrade or fine-tune the above mentioned regulations, e.g. to exclude foreign funding for export financing from these burdens, thus enable commercial banks to pass-on the cost saving to borrowers. High interest rates have been cited as number one obstacle and grievance by exporters.

- Legal framework
    - Questionable rule of law and independence of courts as well as enforceability of court decisions.

The above deficits have been repeatedly cited as reasons why the international investors and banks' risk appetite is low or non-present, and why domestic banks prefer to rely on "hard collateral" and over-collateralization, instead of on cash flow-based lending.

Conclusion:

Each and every aspect item described above should be resolved and improved, to enable Mongolian companies, small and large, to gain better access to export financing.

Some of the issues demand systemic, longer-term efforts and solutions, some could be tackled and resolved in relatively short period of time.

Capacity building, education and know-how transfer on all levels (legal and regulatory framework, commercial banks, large corporations and SMEs) will foster the required steady development towards quality, reliability and consequently bankability.

5 Synopsis of export financing schemes - Applicable models for Mongolia

5.1 Public sector support through ECA or Export Credit Insurance

Credit insurance is insurance for companies against the risk that their business customers do not pay for goods or services they bought. It may also cover other risks, such as currency or political risks.

The credit insurance market

Credit insurance was created at the end of the nineteenth century, but it was mostly developed after the First World War. Customers include companies of all sizes, as well as banks and factoring companies that finance the trade of these companies.

Credit insurance can be offered by private credit insurance companies, public Export Credit Agencies (ECAs) and multilateral institutions. Most of the developed and emerging markets, and some of the developing countries, have at least one credit insurer operating in their territory.

As a trade association, the Berne Union mainly focuses on covering risks related to cross-border trade. Of all international trade in the world (around 20 trillion dollars annually) the Berne Union members provide insurance coverage for about 13%.

What is credit insurance used for?

<u>The direct benefits of credit insurance:</u>

1. Risk mitigation: It protects the exporting company against payment losses, thus safeguarding its continuity
2. Credit management: Thanks to a more stable cash flow, it makes planning and budgeting for companies easier
3. Financing: It improves the access to credit for the exporter and the buyer. When credit insurance is available – either as a collateral or as direct coverage to the bank, banks are more prepared to finance working capital, sales and exports as it reduces the capital which banks need to set aside for these credits.

The wider benefits are:

1. It makes marketing by the exporter more efficient. If a credit insurer has rejected to cover a credit with regard to a potential buyer due to its weak creditworthiness, then the exporter does not need to invest further in sales opportunities to that buyer. The seller can then focus on other creditworthy buyers, which are able to obtain the coverage of the credit insurance.

2. It opens up opportunities with less-known buyers or in less-known markets

Types of credit insurance

There are several ways to distinguish between types of credit insurance.

A first distinction by time is between:

- Short-term credit insurance, i.e. typically credit insurance for trade of goods and services.
- Medium/Long term credit insurance, i.e. credit insurance for capital equipment transactions and infrastructure projects.

Another split by frequency is:

- Whole-turnover or revolving cover: The insurance of a company's entire turnover or large parts of it. The seller company receives a framework insurance policy under which it applies for credit limits on companies it wants to sell to. This cover is mostly used for short-term credits.
- Single situation or single transaction cover: The insurance of credit risk of a specific transaction. This cover is mostly used for structured and medium/long term credits.

A further dichotomy by type of covered risk is:

- Insurance against commercial risk, i.e. the risk that a receivable is not paid due to insolvency of or protracted default by a private company
- Insurance against political risk, i.e. the risk that a receivable is not paid by a public buyer or due to political events, such as
    - Force majeure, e.g. war, political violence, natural disasters or health risks (pandemics)
    - Inability to transfer currency
    - A government-imposed moratorium on payments

A fourth distinction by coverage duration can be made between:

- **Pre-credit / Pre-Export** (or manufacturing) risk: The risk that manufacturing costs are not reimbursed if the buyer has become insolvent before delivery of the goods, or if political events in its country prevent delivery

- **Credit risk**: The risk that the buyer will not pay after delivery of the goods or services

Lastly, a split could be made in terms of scope between:

- Domestic credit insurance, i.e. the insurance of credit risk under sales contracts between buyers and sellers in the same country

- Credit insurance of cross-border (or export) transactions. This often includes insurance against political risk in the buyer country.

Short term credit insurance

This is typically insurance for credit terms ranging from 1 to 360 days. These credits are known as supplier credits. Usually the credit term is related to the economic life of the goods. Fresh flowers would attract shorter payment terms than e.g. machinery.

About 90% of trade credits are short term, reflecting the composition of the types of goods traded worldwide. Most short-term credit insurance is on whole-turnover basis. By providing insurance cover to an entire company's portfolio, the insurer has a better spread of risk and the premium per transaction can be lower.

In many high-income countries there is a well-developed private insurance market for short-term risk which can be offered direct or through specialized brokers. In emerging markets, and to a lesser extent also in developed markets, ECAs play an important role in short-term credit insurance as well.

Medium/Long Term credit insurance

Medium/Long term (MLT) credits range from 1 year to over 15 years. This type of cover is mostly offered by ECAs and multilateral institutions, although the capacity of private insurers for longer term credits has been growing.

As selling companies usually do not want to wait that long before receiving payment, banks finance these transactions by providing a loan to the buyer. The selling company is paid out of this loan during the manufacturing period or at the latest at delivery. These loans are known as buyer credits. In this case the bank is the insured party for the credit risk. The typical insurance form for MLT business is the single transaction insurance.

Ancillary risks and products

Financial risk of trade transactions is not only characterized by (pre-)credit risk. There are several other risks which credit insurers can provide cover for, including:

- Bond cover: The seller sometimes must provide bank bonds (e.g.for an advance payment). Insurers can cover the risk that the buyer wrongfully calls these bonds. This cover frees up financing capacity with the seller's bank.

- Currency risk cover: In the case of export transactions, sometimes the buyer pays in a different currency than the currency in which the seller has made manufacturing costs. This currency risk can often be covered in addition to credit risk cover.

Further information on the above topic can be obtained from the website of the Berne Union (https://www.berneunion.org/).

5.2 Products for pre-export finance

As it can be seen on the example of Central European countries from the 1990s to early 2000's, (a period comparable to the situation in Mongolia 2015 to 2020), when financial strength of most companies, esp. SMEs was low, (high vulnerability, low capitalization, high financial leverage, need to invest all/most of free cash flow into fixed assets and/or working capital to sustain expansion), both the government as well as private sector commercial banks recognized the bottleneck for higher/faster export growth – low working capital / inability of companies to fund their export contracts, even if they had developed a competitive product and landed an export contract.

Therefore, a specific approach to pre-export financing has been developed and adopted in the form of pre-export financing products and their insurance by ECAs. Pre-export financing and the insurance thereof by an ECA is a crucial instrument to support the production for export, while minimizing the risks of commercial bank in such transactions.

The existence of a "Berne-Union type of export credit and insurance agency (with capacity to insure pre-export financing) has proven as an essential catalyst for export growth, domestic banking system development, as well as an important instrument of governmental economic policy. This is illustrated by the successful examples of Czech Republic, Slovakia, Hungary or Poland, to name a few "small/mid-sized" countries, as well as USA, Germany, France, Japan and China.

6 Recommendations

Based on the analysis and summarization of findings from interaction with all involved stakeholders, the research team proposes to focus on the following areas, in order to effectively and impactfully support the export capacity of Mongolian companies.

6.1 Establishment of a state-owned ECA

The key conclusion of this study is that the Mongolia needs an ECA, backed and funded by the Government, to enable the establishment and development of export credit instruments.

Main area of product development in the ECA should be to provide **credit guarantees**, in contrast to providing export loans directly. It appears that liquidity in the Mongolian commercial banking system is sufficient, and there is no need to establish another government-owned lender, which would compete with existing commercial banks. We can see in the example of DBM that state-owned/run banks without clear or narrow mandate and professional management and qualified oversight do more harm than good to the financial system and its (especially international) reputation.

The Mongolian ECA should focus on three main lines of products:

a/ guaranteeing export (i.e. post-shipment) financing, which is provided by Mongolian (and/or international) commercial banks to Mongolian exporters (main products: supplier credit, buyers credit)

b/ guaranteeing pre-export financing (i.e. pre-shipment), which is provided by Mongolian (and/or international) commercial banks to Mongolian exporters for the production phase of an export contract (main products: short-term pre-export working capital line/credit, medium-term pre-export credit).

c/ guaranteeing export related guarantees, provided (issued) by Mongolian (and/or international) commercial banks on behalf of Mongolian exporters (main products: bid bonds, performance bonds, retention bonds).

Choice of industries:

In order to foster sustainable growth manufacturing and other higher value-adding industries and products should gain preference over un- (or only partially) processed raw materials and commodities.

At the same time, given the high share of mineral commodities on total export, these should not be omitted in the access to services (guarantees) from the future ECA. Setting rules for portfolio structure/weighting and/or commercial conditions and pricing of the ECA will be an essential, practical tool of economic policy of the Government. In any case it would be advisable that the ECA has at any time sufficient capacity to respond to the needs of exporters of non-mining products.

The ECA will need to develop capacity to recognize, assess, measure and manage several types of risks:

a/ commercial/financial/ performance risk of Mongolian companies/exporters

b/ financial risks of foreign buyers/importers (counterparts of Mongolian exporters)

c/ financial risks of foreign banks (serving the foreign importers)

d/ country risks (political, transfer, currency etc.)

The appropriate functioning of the ECA will depend on developing:

- The supportive legal framework
- Employing a professional team
- Enabling appropriate, impartial oversight
- Ensuring accountability

Structural and legal considerations

It remains to be analysed and decided, whether the Government should set up a new institution to serve the ECA purpose, or to reorganize or redirect improve any of the potentially suitable existing entities. Especially DBM can be considered, as its legal mandate includes providing of export financing. However, DBM has fulfilled this part of its role neither sufficiently nor well.

One main aspect of the future ECA is its reputation. It is of critical importance that the institution gains rapidly the trust and recognition not only of domestic banks, but also international banks and other stakeholders. In order to achieve this, the authors team strongly recommends to set up a new entity which is not tainted or burdened by a negative history.

Another structural aspect is related to the structure of shareholders and the responsible ministries. International experience and practice is diverse and ranges from single shareholder to many ministries/agencies owning or overseeing the ECA. In the context of the Mongolian governmental, public institutions and banking sector structure, the authors lean towards a simple, concentrated ownership by one (or two) ministries (Ministry of Finance, potentially accompanied by MOFALI and/or Ministry of Foreign Affairs), with very clear competence and oversight as well as cooperation rules.

It is advisable to reach out to suitable partner-ECAs for consultancy and partnership support in developing such an institution effectively, efficiently and in the required short period of time.

The size of Government financial commitment and initial capital for establishment of an ECA has to be researched in more detail, after reaching an initial consensus among the key stakeholders. The research team's initial estimation, based on comparative analysis and expert judgment from consulted foreign ECAs, shows that capital of approximately EUR 100 to 150 million can be sufficient in the initial stage.

6.2 Commercial banking solutions (factoring and other forms of trade finance)

In order to develop export financing products offered by commercial banks the following recommendations are made:

- Execute the needed changes to legal framework: improve assignment of receivables and similar instruments (Promissory notes etc).
- Adopt improved BOM regulations, to favour export financing products with lower risk weighting (which supports the capital adequacy of commercial banks).
- Improve transparency and creditworthiness of commercial banks to a level acceptable to wider range of international lenders, to enable broader and more competitive funding sources for domestic Mongolian banks. This will in turn allow them to provide more and competitively priced export financing products and solutions, mainly in foreign currency.

6.3 Options for export financing of SMEs

It is not realistic to expect, that international banks will be able and willing to directly finance Mongolian exporting SMEs, as has been explained above. Therefore, the pre-dominant source of export financing for Mongolian SMEs are and will be Mongolian commercial banks.

It is recommended to strengthen the ability and capacity of domestic commercial banks to develop specific export financing products and services, to develop and deploy a sector specific credit/risk assessment methodology and to attract foreign funding at competitive rates. This will determine the ability of these banks to serve their SME customers appropriately.

6.4 *Advice to the Mongolian Government and to other public sector organisations*

Based on the responses from all stakeholders, i.e. international banks and IFIs, as well as domestic exporters and commercial banks, the following areas appear to be most important for development and maintenance of a successful pro-export oriented business environment:

- Develop into a competitive destination for FDIs (through know-how transfer, growth of professional capacity of companies to develop export-competitive products and services, improvement of foreign currency reserves for more currency stability)
- Dominance of transparency / rule of law / good AML/CTF – ending of grey listing (resulting in better “bankability” of the country and domestic banks)
- Development of a medium to long term Export support & development strategy as critical component of Government economic policy
- Establishment of an ECA, as part of the above strategy
- Transparent, regulation of domestic commercial banking sector (no forbearance)
- No (or limited) competition from government-owned banks/ institutions toward private sector banks.

7 Conclusions

i. Mongolia continues to have a yet unrealized strong potential for fast economic growth, driven by high(er) value added products export.

ii. Export financing solutions are close to non-existent and unused as of now, with very few exceptions

iii. Exporters see opportunity to grow their export volumes on average by approx. 80%, if affordable export financing would become available.

iv. Institutional framework of export promotion needs to be established and improved; The absence of an Export Credit (Guarantee) Agency is a critical obstacle to the development of export-oriented industry

v. Non-partisan political consensus on establishment of an ECA is to be reached soonest

vi. Details of preparation / size and shape of the future ECA need to be worked out in a subsequent, broader/deeper study

vii. Besides the policy, legal and financial aspects, fast know-how build-up will be necessary to ensure a successful launch and start of operations of the ECA. Training, know-how transfer and related project will surely contribute positively in this respect.

viii. Improvements can be achieved rather fast, when utilizing appropriate / most comparable experience and expertise from other countries (Central Europe, LatAm – commodity driven, selectively)

ix. Legal framework needs to be improved to enable private sector export financing solutions and usage of export financing banking products commonly used in international markets (factoring, forfaiting etc.)

x. It is strongly recommended to improve BOM and MinFin regulation, e.g. to exclude foreign funding for export financing from withholding tax and excessive minimal reserves requirements, to decrease cost of funding for trade and export financing.

xi. One of the outcomes of the Study is the finding that Development agencies' and Donors' support and funding may become necessary for the establishment of a Mongolian ECA.

xii. The risk appetite and thus willingness of international banks to finance Mongolian Trade (import and export) is very limited, due to combination of several factors, including: a/ country/political risk (reflected in sovereign rating of B), b/ low bankability of Mongolian commercial banks (governance, capitalization, credit quality being main issues), thus very few banks have access to international funding and c/ very low bankability of Mongolian corporations and SMEs (low quality of corporate governance, strategy, financial reporting, capitalization and profitability/cash flow).

xiii. Access to (export) financing by SMEs and corporates can be improved by dramatic and fast improvements of transparency, financial reporting, strategy/planning, as well as systemic improvements of the credit bureau information system.

xiv. Some of the issues demand systemic, longer-term effort and solution, some of them could be tackled and resolved in relatively short period of time.

xv. Capacity building, education and know-how transfer on all levels (legal and regulatory framework, commercial banks, large corporations and SMEs) will foster healthy development towards quality and reliability on government, banks and companies level, which in turn will enable success of export-oriented industries and companies.

xvi. COVID-19 impact on the (non-mining) export industry is expected to be severe, with export volumes dropping by 47% on average in 2020. The export financing measures proposed in this study can counter-balance this development only partially, as the key reasons are administrative (border closure etc.) and foreign-born (demand decrease).

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