

# **The Role of Secured Transactions Law in Economic Growth: The Need for Legal Reform in Mongolia**

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## ABSTRACT

This paper analyses why the secured transactions reform is needed and how it is expected to contribute to economic growth of Mongolian economy. Analysis of current legal framework shows that poorly drafted laws limit the access to credit and influences economy negatively.

In this paper it is asserted that the secured transactions reform improves access to capital market for small and mid –scale businesses by improving the terms of loans and increasing the total volume of credit in the economy. Another important result of reform is that better terms in lending shifts investment of businesses from service industry to manufacturing industry; thereby the reform increases productive investment and enhances the economic growth.

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## **The List of Abbreviations**

EBRD	European Bank of Reconstruction and Development
GDP	Gross Domestic Product
IFC	International Financial Company
LRRIP	Law on Registration of Rights over Immovable Property
SME	Small and Mid-scale Enterprises
TDB	Trade and Development Bank of Mongolia
UCC 9	Article 9 of Uniform Commercial Code

## INTRODUCTION

Fast economic growth is the most important way for economies which are trying to decrease the difference in economic prosperity between developing countries and developed countries. Many prescriptions have been proposed to those developing nations in order to catch up with the rest of the world. Among those prescriptions, improving the financing methods of investment by establishing well-organized capital market is of essence. In most of developing countries, there is no effective capital market to offer a substitute for bank lending. Banks accept only immovable as collateral; the reason is that monitoring collateral in form of immovable is easier and less costly than monitoring collateral in form of movables. However using movables as collateral for credit is another important way of financing economic activity. The importance of well-developed secured transactions system has already been recognized by developing countries all over the world. The reform in legal framework covering secured transactions has been adopted by many new countries. Some countries adopt comprehensive reform whereas some changed their secured transactions system piece by piece. The success of the reforms varied from country to country.

Mongolia is a landlocked country in Central Asia with a population of 2.9 million; neighbored by two big countries China and Russia. Until 1990, Mongolia was a socialist country; its economy was centrally planned. After the political democracy was introduced to the country in 1990, economy was regulated no more – almost

every aspect of economy was liberalized. Mongolia now is assessed to be a lower middle income country with a GDP per capita of 3672 USD.<sup>1</sup> The main source of production and export in Mongolia is mining and agriculture sector. The biggest mine “Oyu Tolgoi” is owned by Rio Tinto group. Mongolian economy and the currency Tugrug is very dependent on agriculture and mining production and their price on international market. According to B.Tuvsintugs, an economic proffessor in Mongolian National University, it is very likely for Mongolians to become more and more dependant on mining sector since Oyu Tolgoi has started operations. As the mining production increases, dependance of the economy on mining sector will increase as well. ( UB Post, Mongol News, 7 January 2013 ) To decrease the dependancy, the motor of the economic growth need to be shifted from mining to another sector.

The private sector investment, domestic and foreign, is an important aspect for economic growth in a country. Foreign direct investment is very sensitive to economic, political and legal environment of country. Because of recent political and economic uncertainties in Mongolia, the foreign direct investment is flowing out of the country. This situation leads to a major setback for growth of Mongolian economy. As the foreign direct investment is not under control, Mongolia needs to boost the entrepreneurship in domestic section to decrease the dependency on mining sector. Sir Suma Chakrabarti, the president of the EBRD, before his visit to Mongolia in 2013, said that the current global economic environment requires Mongolia to encourage the private investment in every sector of economy. ( EBRD – News, 30

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<sup>1</sup> World Bank, Mongolia Country Brief, <http://data.worldbank.org/country/mongolia>

August 2013 ) But the main obstacle to the private sector investment is access to credit. According to Enterprise Survey held by IFC and EBRD, among the problems identified by the firms as a main obstacle for their operation, the most vital problem was access to credit<sup>2</sup>. The situation was same for firms of all sizes; even large firms (operating with 100 or more employees) indicated that access to credit is the largest problem. ( Enterprise Surveys – Mongolia Country profile, 2009 ) The main reason of access to credit being the biggest problem in Mongolia is that the financial sector is dominated by operation of banks. Banks require sufficient collateral (immovable, land or car and others) for securing the loan they provide. Reason for only immovable being accepted for collateral is lack of fully functioning secured transactions system in Mongolia. In country law assessment conducted by EBRD, it was identified that Mongolian current legal framework does not allow for usage of personal property as collateral and for the further development of the capital market it is required to take steps toward secured transactions reform. The current provisions regulating the security interest in movable collateral is not implemented in market practice. It is also stated that enforcement and judicial processes are very slow and inefficient (EBRD, 2009, p.14) Therefore it is impossible to get a loan from banking industry by offering movable as collateral.

Due to inconsistency between assets those are in the inventory of businesses and assets those are accepted as collateral, businesses are not able to acquire the credit. For example, according to data collected in December 2012, 50.1 percentage of total collateralized loan is backed by immovable including houses and apartments;

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<sup>2</sup> See Enterprise Surveys Mongolia Country Profile, 2009, page 4 – Business Environment Obstacles



movables hold 8.4 percentage of the total asset backed credit, receivables constitute only 0.7 percent, 1.1 percent of total pledge is intellectual property rights and only 0.7 percentage of credit is secured by machinery. 262754 pledges were filed to State Registry and only a very small amount is related to personal property; the situation is very inadequate. During the period of 2012-2014, total number of filings for registration of movable asset as collateral was 37 according to State Registry of Mongolia. ( 2014 )

The aim of this research is to stress the importance of role of secured transactions law in economic growth. In the first chapter, the linkage between the secured transactions law and the economic growth will be established. The chapter will continue by explaining the importance of access to credit for fast economic growth in developing economies. By the comparison of secured transactions laws of developing countries and those of developed countries, reasons for difference in access to credit will be researched. Success of secured transactions reform will be researched by comparing the usage of personal property as collateral before and after reform in China and Romania.

The second chapter of this paper will analyze the current legal framework of Mongolia in secured transactions. Apart from analysis of legal framework, the economic impacts will be discussed. Current terms of bank lending will be assessed to understand the level of access to credit in Mongolia. Answering to those questions will help me understand whether a legal reform in the context of secured transactions is needed in Mongolia or not.

Secured transactions reform steps have been taken in Mongolia. The legislatures drafted comprehensive law on secured transactions with the help of IFC and EBRD. For the last chapter functional analysis of the Draft Pledge Law of Mongolia will be done. The chapter will provide the assessment of proposed draft law's capacity to eliminate the problems observed in developing countries. Expectation from the draft law is to solve all the current problems.

## **Chapter 1 – Secured Transactions Law and Economic Growth**

This chapter explains how the well-functioning secured transactions system contributes to economic growth of the country. Appropriate legal system can enhance development of financial market; therefore it leads to economic growth. Secured transactions law allows for firms to offer their assets other than land and immovable as collateral for loan. The secured transactions system is an important part of financial system of. Well-drafted legal framework regulating financial sector means increased access to credit for businesses. My analysis will be focusing on SMEs and investment made by them.

### ***1.1 Secured Transaction Law and Access to Credit***

Freedman and Click, in their study, said that accessing to credit is easier for firms operating in developed countries than for those in developing countries. In developed countries financial system functions efficiently; domestic and foreign savings are mobilized and allocated to the most efficient businesses. On the other hand, in developing countries financial system is usually limited to banks; non-bank financial sector almost do not exist. ( 2006, page 281-282 ) The reason for well-functioning capital market in developed countries is a sound legal framework which defines the rights of parties without leaving any doubt and protects parties from abusive behaviors of other parties. As a part of financial market, secured transactions have an important role in external funding of firms. EBRD study shows that movable property is an essential way of financing for most of businesses; it constitutes more than half of the capital stock of enterprises. Obsolete legal system and institutions cause restrictions in usage of movables as collateral for credit

acquisition.<sup>3</sup> ( 2008 ) Poorly designed legal framework makes collateral lose its function to mitigate the lender's risk.

Until now it was said that secured transactions law is a key feature to improve the access to credit for enterprises. So we have to define the difference in access to credit between countries. In developed countries enterprises get larger loans with a lower interest rate when compared to those in developing countries. Even the length of the loans differs drastically. Credit size relative to cash flow or income of the enterprises in developing part of world is much smaller and the enterprises have to pay back the loan more quickly. These differences in terms of loans stem from several reasons. But one of the most important reasons is that the legal framework for secured transactions. Credit suppliers will only lend when they have a reason to believe they will be paid. Collateral that is offered for credit is important for lenders. But movables hold important place in asset portfolios of producers. Without good secured transactions law, due to the inconsistency of assets offered and accepted as collateral producers cannot get the real advantage from collateral.

There are several advantages generated by collateral. First of all for secured loans collateral serves as insurance for lender against the default of the debtor and uninsured risk<sup>4</sup>. However the success of insurance function of collateral depends heavily on legal regime and institutions of the country. Even when secured creditor has a priority over an asset and its proceeds, if the judicial and enforcement system in a country is slow the success of insurance function of collateral will be damaged.

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<sup>3</sup> See *Economics of Collateral*, 2008, page 81 Figure 3.5

<sup>4</sup> Uninsured risk – a risk where damage is inevitable

In addition to that, collateral in secured loan addresses adverse selection<sup>5</sup>. With the collateral, lenders are able to evaluate the ability of borrowers to pay back the loan by assessing the value of the collateral. Determining value of the collateral is easier rather than determining capacity of debtor to repay the loan. Due to lack of information about the potential debtor, potential creditors choose to lend to those they knew for many years. This situation of asymmetric information prevents many borrowers from accessing the credit market. Because of those functions of collateral mentioned above, borrowers in developed countries get all the advantages: developed secured transactions laws and institutions that provide information about borrower in developed countries create friendlier environment for those who offer movable assets as collateral. Firms in developed countries have better access to credit: size of the loan is larger; interest rate is lower; and finally they acquire credit with longer payback periods.

As I mentioned above, without sound secured transactions system there will be inconsistency between the assets in inventories of firms and assets accepted as collateral by lenders in developing countries. This mismatch of the assets is a major obstacle to access to credit for small and middle-size enterprises. A research by World Bank Group shows that the problem does not lie in the asset composition of firms in developing countries. Assets owned by firms can be accepted as collateral in developed industrial countries. Study continues by stating that the importance of collateral for acquiring credit is also not the problem. It is known to the actors of capital market in developing countries. The only problem blocking the access to

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<sup>5</sup> Adverse selection in credit market - The tendency of high risk borrowers to get credit. In order to fight adverse selection, lenders reduce size of loans and diversify by lending to many borrowers.

credit is that the legal regimes in developing countries do not allow benefits of collateral extend to movables. ( Heywood, Safavian, Pena; 2006 page 8 ) Firm level surveys conducted by World Bank in developing countries show that the mostly observed reason for rejected credit applications is insufficient or unsuitable collateral. Even further research showed that many small businesses did not even apply for credit; they were aware that they cannot meet the collateral requirement. ( World Bank Group, 2010 ) Small and middle size enterprises in countries which have well-functioning secured transactions law have better access to credit and they have more potential to grow and to increase their productivity.

## **1.2 Access to Credit and Economic Growth**

If the secured transactions law allow for small and medium size enterprises to acquire loan at lower interest rate and at higher amount, how does this situation leads to economic growth? Small and medium size enterprises constitute large part of an economy. An empirical study showed that the relationship between importance of SMEs and the GDP per capita is not only statistically significant, but also economically meaningful. Prosperous SMEs are one of the characteristics of fast growing economy. ( Demirguc-Kunt, Maksimovic, 2006 ) In many developing countries, access to credit is one of the main constraints for economic growth. As the access to credit becomes easier, the economic growth rate increases. According to Levine and King ( 1993a ), there is a statistically significant positive correlation between the size of the private sector directed credit and real GDP per capita. Financial development is not a response to economic growth, but the financial development is a cause to economic growth. ( Levine, 2004 ) Furthermore, it is shown that the initial development of financial system is a good indicator of the long-

run economic growth. ( King and Levine, 1993b ) It is also shown that firms in a country with stronger capital market grew faster than they would have if they were located in a weak financial system country. ( Demirguc – Kunt and Maksimovic, 1996 ) The similar result is achieved by Rajan and Luigi Zingales. Conclusion from their study showed sectors dependent on external financing grows faster in well-developed financial system. The empirical studies had been done to understand the relationship between economic growth and level of credit given to the private sector; the results showed that higher level of credit given to private sector correlated with higher rate of economic growth. Even modest rise in credit level was associated with a rise in GDP significantly. ( Levine, 2000)

Economic growth in an economy is measured by growth in real GDP. Investment as a basic component of GDP can promote economic growth. Credit directed at the private sector is converted to investment in the economy and eventually into additional production in the country. According to growth model developed by Harrod and Domar, as investment in an economy increases it leads to accumulation of capital stock. Economic growth is generated by investment by the way of capital stock accumulation. Investments used in efficient fields of economy boost economic growth. ( Harrod 1939, Domar 1946 )

The evidence of good secured transactions law contributes to economy positively can be seen from success of secured transactions reform in several countries. Studies made by IFC and World Bank Group show that secured transactions reform has been success in Romania and lately People's Republic of China. Obviously, Romanian reform was encouraging for other countries. According to a paper by Heywood Fletsig cumulative filings after the secured transactions

reform have reached 1,000,000 by 2006 in only 6 years. The gains from reform were US\$ 12 billion, nearly 10% of Romanian GDP. (Fletsig, 2006 ) For this period average economic growth in Romania was 6.3 percent with a maximum of 9.1 in 2004. Before the reform the average economic growth of Romania was 3.4%. ( World Bank Data )

Another study shows that after Romanian reform, private credit rose to 15% of GDP from 10% in only 4 years. ( Fleisig, Safaian, Pena, 2006 ) Second example is data from Chinese secured transaction reform. According to evaluation paper, after adopting the reform both the number and volume of commercial loans involving movables have risen significantly. Number of filings for registration has surpassed 380,000 representing financing of USD 3.5 trillion in 4 years period. ( Alejandro Alvarez de la Campa, 2012 )



## Chapter 2 – Current Legal Framework and Economic Implications

### 2.1 Current Secured Transactions Laws in Mongolia

Analysis of current legal framework concerning secured transactions is important to show why this kind of transactions is very uncommon in Mongolia now. The legal framework for secured transactions is scattered and currently there is no separate and comprehensive law regulating secured transactions in Mongolia. Transactions those we can include under umbrella of secured transactions are mostly regulated by Civil Code of Mongolia. Also the Law on Registration of Rights over Immovable Property gives some important insights for attachment and perfection of security rights over property. Although the provisions of related laws are inconsistent with each other and they leave a space for confusion. Because of the inconsistency and impracticability of provisions applicable to security interest in property, it is not implemented to market practice. Market practice that relate to secured transactions are only limited to newly-developing leasing industry and pawnshop industry in Mongolia. There is a separate regulation for leasing industry. However pawnshop industry is governed by Civil Code 2002.

When it comes to the terminology Mongolian term “барьцаа” is translated as “pledge” to English. However “барьцаа” is not limited to the term pledge (possessive security interest) in common law system; it can be both possessive and non-possessive security interest in certain asset. “Барьцаа” is used to describe security interest in a broad sense. Also the term “барьцааны эрх үүсэх” means attachment of security interest. The current legal system of Mongolia does not have a term for “perfection”.

### 2.1.1 Attachment, Perfection and Registration

According to UCC Article 9, attachment of security interest to collateral occurs immediately after the security agreement between debtor and the creditor. For creation of security interest perfection is very important for the creditor as well. Time of perfection is the main tool for determining the priorities of creditors who have security interest in same collateral. It is very clearly stated in UCC Article 9, how and when security interest is attached and perfected. Perfection is in most cases done by filing a statement to local registry offices. However in Mongolian legal system it is very unclear that when and how the security interest in collateral becomes enforceable.

Provisions of Civil Code are silent about how the attachment of security interest occurs. But it is stated that the contract describing the nature of collateral and identities of parties must be present. It is also stated that the contract must be registered in the State Registry Office. Section 1 of LRRIP mentions that for the attachment of security interest to collateral ( “барьцааны эрх үүсэх” ) debtor and the creditor must have a written contract. The contract must express that the creditor has a security interest in collateral and they must identify the collateral in detail. However another provision in same section of LRRIP says that until the registration of collateral in State registry Office, the contract will be unenforceable. Obviously, in Mongolia security interest in collateral does not attach immediately after the agreement of parties as in UCC Article 9. In fact in accordance to LRRIP, attachment and perfection of security interest occurs at the same time when the contract is registered.

For the purposes of determining priority between several creditors for same collateral, the registration time of the contract to State Registry Office is the main tool. The debtor must inform future creditors about the state of collateral; if the collateral has security interest of other creditors. Each time a new contract is registered, an additional record must be made to the previous registrations. ( LRRIP, Article 6 ) In addition to that debtor must inform the previous creditors about existence of security interests of new creditors. Unfortunately, in practice the registry system in Mongolia is not transparent enough to check the existing security interests in collateral. The complexity in attachment, perfection and registration process leads to impracticability of use of personal property as collateral and deters creditors from accepting.

### **2.1.2 Leasing Industry in Mongolia**

In 2004, new legislation was passed in order to assist the development and expansion of leasing industry in Mongolia. The Law on Financial Leasing distinguished the financial leasing from other types of secured transactions that are governed by Civil Code 2002. From 2004, financial leasing has become one of important ways of financing. There has been some improvements in the legal environment of financial leasing with the Law on Financial Leasing ( 2004 ). Before 2004, leasing agreements were only allowed to be made for two parties under Civil Code. Rights of parties to the leasing agreement are well-established. With the new law, participation of third party made possible. Also the Civil Code does not have provisions regulating the repossession of asset by the lessor in case lessee defaults. The lessor had to wait for judicial decision unless it is stated otherwise in the contract. The situation was taken care of with the new law; lessor can lawfully

repossess the asset without any court procedures. Another obstacle in the development of leasing industry was that financial institutions had to obtain special license from State Registry Office to operate in leasing industry. After 2004, the requirement for special license was eliminated. With all these improvements in the legal environment, leasing industry in Mongolia has grown significantly. Statistical data show that in 2003 financial leasing constituted only 0.5 percent of total credit in the economy and only 0.1 percent of GDP. Within the years of 2004 to 2007, financial leasing has risen in volume six times within total volume of credit; in year of 2007 three percent of total credit in Mongolia was financial leasing. Percentage of total financial leasing in GDP reached 1.6 percent. ( Central Bank of Mongolia, Balance of Payments, 2006 )

Despite of all these improvements, there are still some problems in legal framework of financial leasing. First of all, some inconsistencies and clashes exist between the provisions of Law on Financial Leasing and other legislations. Within the current legal environment, it is uncertain if banks and other financial institutions are allowed to conduct financial leasing service. The Law on Financial Leasing has caused several amendments into the Law on Banks and Law on Financial Institutions; financial leasing is no more listed under services to be conducted by banks and other financial institutions<sup>6</sup>. Now that financial leasing has been eliminated from services allowed, banks and other financial institutions are not supposed to work as a lessor. However another provision in Law on Banks and Law on Financial Institutions allow for banks and other financial institutions to conduct

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<sup>6</sup> Section 3, article 18 of Law on Banks was amended in 22.06.2006;

any other lawful financial services. Following this provision would allow financial institutions to run financial leasing service with other services.

Another obstacle for development of financial leasing is that there's no registry system to track leased assets. The registry system will help reduce the risk of lessor. Even though it is required for the lessee to obtain permissions from lessor to use the leased asset as collateral to another credit, without a registry system it is difficult for the lessor to monitor the behaviors of lessee. The law has a provision on voluntary registration of leased assets; however there is currently no institution to provide the registration service in Mongolia. Even when parties of lease agreement agreed on registration of the collateral to mitigate the risk of lessor, no central office for registration is available.

In order for leasing industry in Mongolia to develop further, changes must be done for inconsistent laws. It is also very important to introduce new registry system in electronic environment to help the lessor establish priority over the leased asset. So far now, with the relatively developed leasing industry many lease providers are offering financial leasing service for acquiring machinery and other valuable assets to businesses. Especially for SMEs, development of leasing industry opened up a whole new potential to purchase new equipment and to grow in size.

### **2.1.3 Pawnshop Industry in Mongolia**

Pawnshop industry is a branch of secured transactions system, which, according to definition of Black's Law Dictionary, allows an individual to get a loan, after providing personal property, of an equivalent value, as collateral. The

pawnbroker keeps the personal property until the loan is paid back fully. Pawnshop service is a possessory security interest. The definition in Civil Code 2002 of Mongolia is similar to the definition above. There are only two documents governing the pawnshop industry: Civil Code of Mongolia and Standard on Pawnshops. Civil Code regulates the relationship of lending and borrowing. Requirements for operating lawful pawnshop are listed in the Standard on Pawnshops MNS 5274:2003.

In practice in spite of the documents regulating pawnshop industry, major violations can be seen. First of all, Civil Code defines the pawnshop service as offering loans to public in return of a personal property offered as collateral. If collateral is a property other than personal property, the service is no longer under the umbrella of pawnshop industry. Provision 6.7 in Standard on Pawnshops also forbids allowing immovable as collateral. But in practice, many people had to offer their real estate to acquire loan from pawnshops. Moreover the interest rate for pawnshop industry is to be negotiated by parties of transaction. ( Civil Code, 286.2 ). However, most people come to pawnshops with urgent need for cash. Pawnshops in Mongolia are taking good advantage of the situation and the interest rate is determined by only for the good of pawnshops. Offering fixed but extremely high interest rate for the loan can amount to economic duress and it is unlawful. Article 286 of Civil Code also mentions that at the end of period of loan payback, if the principal amount plus the interest rate is not paid fully, pawnshop must notice the debtor in writing that the his/her property will be sold to cover the loan. Within 10 days after sending the notice, if the debtor did not fulfill the obligation, pawnshop can sell the property and return the surplus to the debtor. In practice pawnshops indicate

during the contracting period with debtor that the property will be sold after 5 days due date of payment. This clause is unlawful and the contract is unenforceable. In addition, pawnshops do not notice the debtor about potential sale of the property.

By February 2013, there are 1097 pawnshops on territory of Mongolia<sup>7</sup>. The economic rationale behind existence of pawnshops in Mongolia is that pawnshops provide relatively cheaper and faster service in urgent need for short-term loans. People can immediately satisfy their financial needs with the pawnshops compared to banks and other financial institutions. Applying for credit in banks requires lots of paperwork; assessment period takes long time and after the assessment period it is not guaranteed that the credit will be given. For these reasons pawnshop industry seems rather convenient for those in need of short term loan in small amounts. In spite of its convenience, due to insufficiency of legal framework and supervision pawnshop industries cause a serious problem for the country. For the society of Mongolia, pawnshops have turned into an opportunity for loansharking. Many people are becoming victims of the obsolete legal environment. To fix this situation, Mongolia needs to raise the awareness of laws regulating pawnshop in the society. Establishing supervisory agency is important as far as concerning pawnshop industry. Even though people are aware that pawnshops are violating Civil Code and the Standard on Pawnshops, there are no agencies or state offices to deal with the problem.

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<sup>7</sup> Data from State Registry Center, 2013

## **2.2 Impacts of Current Legal Framework on Economy**

As discussed in 2.1 current legal framework hardly permits personal property to be used as collateral for loan. Even though the law does not explicitly forbid the usage of personal property as collateral, uncertain results of this kind of usage is deterring capital market actors from allowing as collateral. Almost only industry that allows personal property as collateral for private sector is leasing industry in Mongolia. But the leasing service holds very little place in total credit volume. Widespread service of pawnshops is usually for household sector; the size of the loan provided by pawnshops is small. Therefore current obsolete legal framework in secured transactions system of Mongolia serves as a main obstacle for one of the most important opportunities of financing businesses. For the purpose of analyzing economic impacts of current legal system, main focus will be on SMEs in Mongolia.

According to Enterprise Survey held by International Financial Organization, access to finance was the most common obstacle for businesses in Mongolia. Not only the SMEs, but also large firms employing more than 100 people listed access to finance as the main obstacle to business environment. The survey also indicates that internal financing constitutes almost 80% of financing average businesses. Bank lending is very low at about 17% of total financing sources. ( IFC, 2009 ) Very low external financing can signal inefficient and underdeveloped financial market.

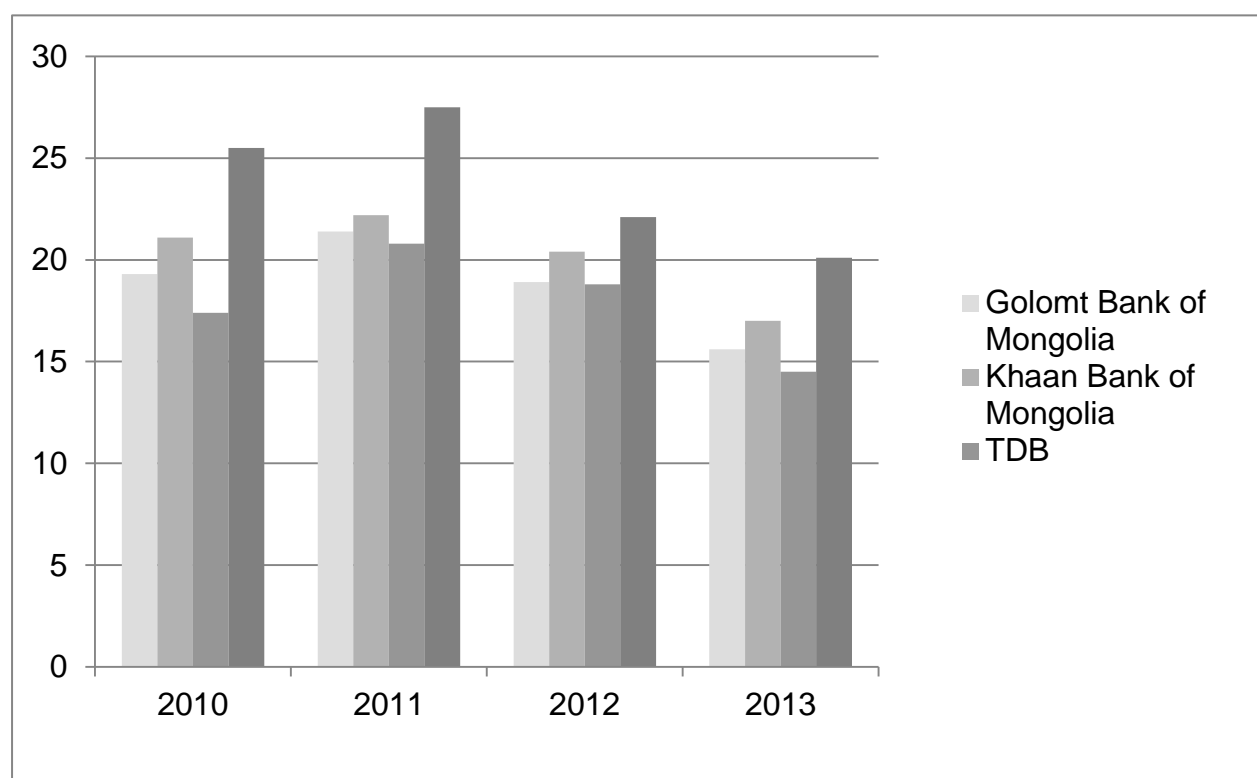
### **2.2.1 Bank Lending for SMEs**

To analyze the bank lending for SMEs in Mongolia I have chosen 3 biggest commercial banks in Mongolia: Khas Bank, Golomt Bank and Trade and



Development Bank of Mongolia. The reason for choosing those 3 banks is that these banks have good reputation among consumers and have the biggest shares of banking industry. Also with the volume of credit and active balance of the banks are big. First of all, average interest rates of these three banks for are compared for the period of 2010-2013.

**Figure 1: Average interest rate of Banks (2010-2013)**



*Source: Annual Statistical Bulletin of Mongolia 2013*

The average interest rate has been decreasing since 2011. The reason for higher interest rate in Khaan Bank of Mongolia is that it has advantage of more access to countryside. As for Khas Bank of Mongolia, it has a public image for friendly bank for SMEs.

**Table 1: Interest rate, size and length of loans offered to SMEs 2014**

		Khas Bank	Khaan Bank	Golomt Bank	TDB
Loan for SMEs	Max length of Loan	4 years	2 years	3 years	3 years
	Max size of the Loan	50 million MNT <sup>8</sup>	Depend on some factors <sup>9</sup>	20% of capital stock	1 trillion MNT <sup>10</sup>
	Monthly interest rate	24.2%-30%	18%-26.4%	26.96%	12%-22%

*Source: Data from Central Bank of Mongolia. 2014*

As we can see from the table, the interest rate of loan for SMEs is much higher than the average interest of banks. Among four banks only Khaan Bank and Khas Bank of Mongolia accept personal property as collateral. Golomt Bank and Trade and Development Bank of Mongolia do not explicitly require real state; property sufficient in value must be offered. Longer the term of the loan, the higher requirements for acquiring loan. Personal property cannot be regarded as sufficient in value for long term loans. In addition, the requirement of operating successfully for 1 or more years indicate that banks are not opens credit for new businesses<sup>11</sup>. It can be concluded that only Khas Bank of Mongolia gives loan to start-up businesses.

<sup>8</sup> 27,000 USD - Converted to USD at official exchange rate of Central Bank of Mongolia; 31.05.2014

<sup>9</sup> Financial capacity, capital stock and size of the company are the most important factors taken into account.

<sup>10</sup> 540,000 USD - - Converted to USD at official exchange rate of Central Bank of Mongolia; 31.05.2014

<sup>11</sup> Data collected from banks during research, 2014

The “start-up loan” from Khas Bank of Mongolia is given for 2 years with monthly interest rate of 2.3%-2.7% ( 27.6% - 32.4% for a year ). Collateral offered can be both in forms of immovables and personal property.<sup>12</sup>

It can be concluded from previous paragraphs that interest rate is rather higher and length of the loan is short. The high interest rate, shorter loan term and high requirements of collateral from banks lead SMEs to operate in service industry. One of the reasons is that initial capital requirement for service industry is relatively lower. According to statistics of National Statistics Center of Mongolia, 86% of total SMEs are in retail businesses and service industry. Only 14% are operating in manufacturing. The length of the loans provided from commercial banks in Mongolia is classified as a middle-term loan by Central Bank of Mongolia. ( Central Bank of Mongolia, 2008 ) Survey conducted among SMEs in 2009 shows that owners of SMEs are considers the high interest rate, short term, insufficient valuation of property and inconsistency between property owned by SMEs and property accepted by banks as the main obstacles for getting a loan. The situation is still the same today. According to same survey, appropriate loan will be given for up to 10 years at monthly interest rate of 2% or lower ( 24% and lower ).

### **2.2.2 Capital Composition of SMEs and Collateral Requirements of Lending**

As mentioned in 2.2.1, SMEs participated in survey by Central Bank of Mongolia listed inconsistency between assets of SMEs and property accepted as collateral by banks was the third main obstacle to the access to external financing. It is worth

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<sup>12</sup> Loan services 2014.05.31 [www.khasbank.mn](http://www.khasbank.mn)

looking at the composition of assets owned by SMEs to compare it with the requirements of banks.

**Table 2: Composition of assets of SMEs<sup>13</sup>**

	SMEs <sup>14</sup> / Total active businesses %	SMEs currently indebted/ Total SMEs %	SMEs who has real estate/ Total SMEs %
2007	96%	15.9%	11.7%
2008	96%	14.3%	9.7%
2009	97%	11.6%	10.0%
2010	97%	9.8%	-

*Source: General Department of Taxation, National Statistical Office of Mongolia*

The survey results from Central Bank of Mongolia showed that 89% of total bank loans opened to SMEs was collateralized by immovable. ( 2009 ) But as it can be seen from the table above that only small part of total SMEs own real estate. SMEs those are currently indebted are in average 13%. This scenario is consistent with the survey results from Central Bank as most of the time only immovable is accepted as collateral.

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<sup>13</sup> The latest available data from General Department of Taxation has been used to generate the count of SMEs who own real estate.

<sup>14</sup> 50 employees or less.

The economic impacts of results from 2.2.1 and 2.2.2 is that SMEs are not able to get external financing because of the high interest rate, short payback term and difference in the nature of the property owned by SMEs and required by banks. Most of SMEs need the loan for expanding their operation. However they are not able to get external financing due to the obstacles mentioned above. Moreover high interest rate and short term loan cause SMEs who managed to get loan from banks to choose to operate in rather unproductive sector of economy. Investment in service industry is not the efficient field to invest in for the purposes of economic growth. Service industry does not create added value to the economy. Investment in rather productive industries like manufacturing would have better impact on economic growth of Mongolia. In the first chapter it was discussed that well-functioning secured transactions law decreases the interest rate and lengthens the loan term. It can be said that as a result of obsolete legal framework for secured transactions, investment of private sector is concentrated in service industry. Introducing secured transactions reform can shift private investment, especially investment of SMEs, from service industry to manufacturing industry. Comprehensive legal reform on secured transactions is needed to see the positive impact on Mongolian economy.

## Chapter 3 – Draft Pledge Law of Mongolia

Recently with the assistance of IFC and EBRD, Ministry of Justice of Mongolia has been working on a draft law to reform the current secured transactions system. In this chapter, the Draft Pledge Law of Mongolia will be analyzed in order to see if the current problems are eliminated with the new draft law. As for the analysis, only main building blocks will be discussed. Tajti identifies list of main building blocks of secured transactions law: unitary concept of security interests, public notice – registration, concept of floating lien, priority system, enforcement out of court system and complementary role with other fields of law. ( 2002 ) According to Fleisig and Pena, there should be 4 requirements that secured transactions law should meet: creation, priority, publicity and enforcement. ( 2003, p.21 )

### 3.1 Creation of security interest and concept of “floating lien”

Fleisig and Pena identify the problem with creation of security interest in developing countries as gaps in coverage, limitation to inventory financing and weak continuation of the security interest. ( 2003, p.23 ) The article 7 of new draft law permits for all kinds of personal property to be used as collateral. The types of assets cover tangible and intangible assets, future assets, rights that can be transferred to others. The new law permits of broad coverage in personal property. Second problem, weak continuation of security interest can mean serious problem to perfected creditor. It caused the perfected creditor to lose the priority in the proceeds of collateral. The continuation of security interest to the proceeds of collateral is allowed in the draft law. According to the article 12, if the security interest in property is perfected it continues to exist in the proceeds of property. Problems which arise in

developing countries for security interest seems to be partially solved by the draft pledge law of Mongolia. The only problem seems that it restricts the general definition of collateral, which limits the possible usage of “floating lien” for financing.

Another problem with creation of security interest is limitation to inventory financing, in other words requirement for detailed description of property. The general description of property is important for floating security interest. The concept of “floating lien” is an important part of secured transactions law. It makes possible for debtor to issue a security agreement by using its inventory and account receivables as collateral. Within concept of floating security, items in the inventory of debtor can change in time. Detailed description of property used for securing loan will limit the financing to only the properties currently in debtor’s inventory. The draft law of Mongolia requires description of each property to be written in security agreement. With the limitation of general description, the floating lien concept is not allowed in Draft Pledge Law of Mongolia.

### **3.2 Priority Rules**

Priority rules establish the order to satisfy the claims of creditors against same property. The claims of creditor who gained first priority will be satisfied before claims of other creditors. If the priority rules are not clear cut, the success of secured transaction system in a country will be damaged. In the current legal framework of Mongolia regarding secured transactions, the system for determining priorities is inefficient. The draft law offers rather detailed rules for determining priority. It indicates that perfected security interest will always be satisfied before unperfected security interest. If there are several unperfected security interest, date of attachment

of security interest will be taken into account. Among several perfected creditors, the first priority will belong to the one who perfected his/her the security interest the earliest. This priority ranking will also be true for the proceeds of the property. Perfection of security interest occurs in two ways: by possession and by registration of security interest. However there is no provision regulating the case of conflict between two possible perfection methods.

According to Tajti ( 2002 ) priority system is not just a “ first to perfect rule ”. It also reflects the policy choice in a country. Super-priorities will be given to some type of creditors to protect them from losing security interest against floating security and from other lien holders. There are two types of “super-priority” rights identified in the draft law. One of the super-priorities has been given to creditors who gave loan for purposes of nurturing and healing of stock-animals and who has perfected his/her security interest in those stock-animals. These creditors will also have first priority in satisfying claims from the proceeds of same stock-animals. Second super-priority belongs to creditors who have security interest in agricultural products. It can be said that drafters of pledge law wants to promote agriculture and livestock industry. Traditionally these two are main industries for export products.

### **3.3 Registration and Publicity**

The importance of registration, in other words public notice, is that it is used as a weapon against “secret liens” in the property. ( Tajti, 2002 ) Fleisig and Pena defines successful publicity system which allows for lender to discover prior claims against the certain property. Lender should also be able to its ranking in the priority. The same paper indicates the difference between registry system and notice filing



archive. It mentions the advantages of public filing system as less costly and publication of minimum information. (2003, p.29)

The registration of security interest is run by State Registry Office of Mongolia. The filing for registration will be over internet, keeping the process simple and almost cost-free. Parties of security agreement are obliged to enter precise information to the system. In case of untrue data, whom he recorded the entry will be responsible for all the losses of other parties. It is also explicitly stated in the draft law that the registration of security interest is only for the purposes of public notice and further information can be requested from parties of the security agreement. The data of registered security interest will be readily available to public. ( The Draft Pledge Law, 2014 ) The registration system in the draft law fits in the category of notice filing archive. The transparency of information on all registered security interests helps lenders to check all prior claims against certain property and determine the priority rank of his/her claim. The system that is going to be introduced seems efficient.

## Conclusion

This paper was dedicated to stress the positive impacts of well-functioning secured transactions system on economic growth. By the comparison of secured transactions laws of developing countries and that of developed countries it was shown that legal framework creates a difference in development of financial sector. The level of access to credit differed drastically in those two groups of countries. For the firms in countries with sound legislation governing secured transactions, access to credit markets was easier. In other words the requirements of acquiring credit were lower. If the firm with similar capital structure in developing country applied for a loan, the terms of loan would be worse: relatively higher interest rate, smaller loan size and shorter term. By improving the access to credit and increasing total volume of private lending, well-drafted secured transactions law will contribute to economic growth. Experiences of reform from countries indicated success. In those countries, after the reform of secured transactions system use of personal property as collateral for loans has increased significantly. The economic gains from reform must not be ignored. The average growth rate was relatively higher after the reform.

The analysis of current legal framework of Mongolia in secured transactions showed that it was insufficient. Only leasing and pawnshop industries were developed in Mongolia. Due to poor legislations, bad loan terms offered by commercial banks in Mongolia were preventing SMEs from getting loan. Also it was shown that there was inconsistency between the assets owned by firms and properties accepted by financial institutions as collateral. All of these factors considered, the legal reform in the context of secured transactions is needed in Mongolia.

Reform steps have been made in Mongolia. The legislatures drafted comprehensive law on secured transactions with the help of IFC and EBRD. Functional analysis of the Draft Pledge Law of Mongolia showed that most of the problems encountered by developing countries was solved. The draft law allowed usage of personal properties in a broad sense as collateral. However the concept of “floating lien” is limited by a requirement of detailed description of property in security agreement. The registry system was efficient enough to allow for cheap and simple registration of security interests. Also the transparency of registration data is one of the best features of draft law. Anyone with access to internet can look up previous registered security interests in certain property. The Pledge Law seems to be drafted well. It is expected from the reform of legal system and registration system to improve access to credit in Mongolia. With better access to credit, SMEs are expected to contribute to economic growth by investing in more productive industries rather than service industry.

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