

**APPRAISAL DOCUMENT FOR
XAC MONGOLIA**

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Consultative Group to Assist the Poorest - CGAP
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ACCRONYMS

ACDI/VOCA	Agricultural Cooperative Development International/ Volunteers in Cooperature Assistance
ADB	Asian Development Bank
BOD	Board of Directors
CGAP	Consultative Group to Assist the Poorest
DAI	Development International
EBRD	European Bank for Reconstruction and Development
FC	Field Coordinator
IFC	International Finance Corporation
IT*	Information Technology
LAC	Loan Approval Committee
LCO	Lead Credit Officer
LEOS	Liberal Women's Brain Pool
LGDF	Local Governance Development Fund
LTSP	Local Technical Service Provider
MBB	MicroBanking Bulletin
MBS	Micro Banker System
MFI	Microfinance Institution
MHSW	Ministry of Health and Social Welfare
MIS	Management Information System
MOU	Memorandum of Understanding
MSM	MicroStart Mongolia
MWF	Mongolian Women's Federation
NAMAC	National Association of Mongolian Agricultural Cooperatives
NBFI	Non Bank Financial Institution
NGO	Non Governmental Organization
NIM	Net Interest Margin
SCC	Savings and Credit Cooperatives
TDB	Trade Development Bank
UNDP	United Nations Development Program
UNDP/SUM	United Nations Development Program Special Unit for Microfinance
XAC	Golden Fund for Development (in translation)

Acknowledgement

Our admiration goes first to Genghis Khan, the great Khan from the 13th century, who founded the prestigious Mongol empire stretched from Hungary to Korea and remains a source of inspiration and proud for the Mongol people today.

Our acknowledgement goes to XAC leader. We have been impressed by the enthusiastic and dynamic leadership provided by the executive Director Ch. Ganhuyag and the United Nations Development Program (UNDP) Advisor, Robert Cater.

We also acknowledge UNDP who initiated this institution and still maintains a leadership role. We feel that the MicroStart Mongolia (MSM) project was remarkably well designed and set an example of donor best practices. The UNDP Special Unit for Microfinance (UNDP/SUM) has provided adequate monitoring and efficient support to XAC. As an example, using the same appraisal format, Heather Clark and Maria Paula Carvajal from the UNDP SUM conducted the first appraisal of the institution in June 1999. The appraisal team has found this document to be very useful and has liberally drawn from it.

Finally, we would like to thank all XAC staff for their time and kindness during this institutional appraisal journey. We have been impressed by their dedication, skills and team spirit and we definitely think that it is the most valuable asset for the future of the institution.

1. Executive summary

Introduction

XAC applied for CGAP funding in September 1999 and was selected for institutional appraisal in November 1999. At the same time, XAC was identified as a possible investment by the International Finance Corporation (IFC). CGAP and IFC decided to coordinate their action and to provide XAC with a joint technical assistance package to strengthen the institution. CGAP support focused on external audit and internal control and was provided by M. Khantiko Kong.

CGAP secretariat staff Xavier Reille conducted an evaluation of XAC in July 2000. The purpose of this appraisal was to evaluate XAC operations and performances using the CGAP appraisal format, which is becoming one of the standards for the field.

The intended audience for this document is primarily XAC staff including its Board of Directors and management. But we hope that this appraisal could also be useful for XAC potential investors to sharpen their analysis and support their investment decision. Finally, the report could serve to document the transformation process of this impressive and promising MFI for the microfinance community.

Table 1: Summary of Key data

ITEM					PROJECTED		
	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1. Number of active <u>loan clients</u>	363	1,276	1,514	2,138	3,624	5,707	7,746
2. Total <u>outstanding loan balance</u> (US\$)	39,953	159,017	241,310	389,667	637,737	1,570,953	2,552,475
3. <u>Average loan balance</u> per client (2/1)	110	125	159	182	176	275	330
4. Number of <u>voluntary savings clients</u>	-	-	-	-	-	598	2,038
5. Total <u>balance</u> of voluntary <u>savings accounts</u> (US\$)	-	-	-	-	-	5,976	37,727
6. <u>Loan loss rate</u>	2.1%	1.7%	1.4%	0.3%	2.2%	2.9%	1.5%
7. <u>Delinquency rate</u> (portfolio at risk basis > 30 days late)	0.0%	0.7%	0.9%	0.6%	4.3%	5.0%	5.0%
8. <u>Administrative efficiency</u>	435.2%	155.9%	78.8%	71.3%	122.4%	92.9%	34.5%
9. <u>Portfolio yield (annualised)</u>	15.9%	71.6%	84.7%	68.5%			
10. <u>Operational self-sufficiency</u>	28.1%	59.2%	128.3%	122.5%	95.4%	108.7%	136.9%
11. <u>Return on assets (annualised)</u>	-26.6%	-28.7%	11.6%	8.9%	-2.4%	3.4%	13.1%
12. <u>Adjusted return on assets</u>	-103.0%	-42.3%	-6.9%	-12.7%	-16.1%	-4.7%	5.6%
13. Year-end free market <u>exchange rate</u>	950.00	1,014.73	1,072.37	1,065.00	1,111.42	1,200.33	1,296.36
14. <u>Per capita gross domestic product</u> (US\$)	359	347	335	358	346	357	369

1.2 Summary of Major Conclusions and Recommendations

CGAP secretariat member Xavier Reille with the support of CGAP consultant Khantiko Kong and UNDP Mongolia officer Ms Gaamaa Hishigsuren conducted an evaluation of XAC in July 2000. This appraisal report is based on their field visit.

Golden Fund For Development or XAC (pronounced HAS in English) is a very dynamic and entrepreneurial MFI using a unique individual loan methodology to provide loans to microentrepreneurs in Mongolia. Although a start-up MFI, XAC is highly professional and dedicated to viability. XAC is the first Non Bank Financial Institution in Mongolia (NBFI) and the first regulated microfinance institution.

In just 2 years of operations, XAC has shown impressive performance. The institution has established a network of 11 branches, managed a loan portfolio of US\$ 375,000 serving over 2,200 clients. Furthermore, XAC has maintained an excellent portfolio quality (PAR 30 days is 0.6 % as of June 2000) and reached operational sufficiency after 18 month of operations.

Yet, XAC's success goes beyond the institution's performance. It impacts Mongolian society as a whole. XAC has been instrumental for the development of an appropriate regulatory framework for NBFIs and for the promotion of a sound business environment for microenterprises, through its interactions with the Mongol government and parliament, the central bank and the university.

These performances are impressive in any context, but they are still more remarkable in Mongolia, a country with one of the lowest population densities in the world, poor infrastructure, and a transitional economy.

XAC is still in a honey moon period and enjoys the dynamism of a startup business. The challenges ahead for this young institution are to position XAC for its next phase of growth, from 2,000 to 7,000 clients, from a small MFI to a full fledged commercial bank, from a small committed team to a staff of over 120 people.

XAC's main weaknesses are currently the following:

- Weak governance, the board lacks experience in business, banking, and is not able to fully play its overseeing role.
- Lack of standardization and enforcement of procedures and internal control that could expose XAC to operational deviations and mismanagement.
- Inadequate Management Information System (MIS) that is not reliable enough, nor able to cope with the growth of the institution.
- Low efficiency. XAC operational efficiency is low compared to microfinance best practices for individual loans. XAC needs to significantly improve its efficiency to boost its profitability.

The CGAP Secretariat recommends that XAC review its business strategy to address the above weaknesses. In particular, XAC needs to better define its marketing strategy, its branch model both in rural and urban areas, and reengineer its operations to improve efficiency.

Institutional investors like Triodos Bank, IFC or KFW are considering investing significant resources in XAC to fund the growth and the transformation of the organization. The CGAP secretariat's role is to support this process so XAC can become a fully viable and independent institution.

CGAP will continue to provide assistance to the IFC to facilitate its investment in XAC and will coordinate with IFC and Triodos for any further technical assistance support to strengthen XAC operations.

2. Institutional Factors

2.1 Legal structure

In October 1999, XAC registered as the nation's first non-bank financial institution (NBFI) and the first legally registered microfinance institution. XAC is supervised by the Central Bank of Mongolia and is authorized to provide loan services anywhere in the country. Savings mobilization and other financial transactions are excluded.

It should be noted that XAC management was influential in shaping the legal and regulatory environment for NBFIs in Mongolia. It worked closely with the Central Bank on the initial passage and subsequent modification of regulations for NBFIs.

2.2 History

2.2.1 Start up

XAC's origin comes from the MicroStart Mongolia project (MSM). The Microstart Mongolia project started in 1997 but became operational in 1998 with the arrival of UNDP MSM advisor, Robert Cater. Sant Maral, a local NGO provided the legal umbrella for the initial operation.

The UNDP advisor worked with local NGOs to design and test a loan methodology based on international best practices, but adapted to Mongolia. Microstart provided capital grants to three local NGOs (Sant Maral, Liberal Women's Brain Pool (LEOS) and Mongolian Women's Federation (MWF)) to start operations. Sant Maral acted as the project umbrella and provided central office and staff support.

2.2.2 Institutional development

A. Transition to a private company

In April 1999, MicroStart Mongolia began a concerted effort to consolidate and rationalize its project under the leadership of the UNDP MSM advisor, Robert Cater. The first step was to consolidate the project into a private company providing technical support and serving as a central office for NGO lending. XAC was established for this purpose on May 18, 1999 by two NGOs, LEOS and MWF.

During this period XAC was governed by an ad hoc Board of Directors made up of five members, two members from each of the founding NGOs and one from the National Association of Mongolian Agricultural Cooperatives (NAMAC).

An Executive Director, M. Ch. Ganhuyag, was hired and the UNDP MSM advisor progressively started to step down as the institution's leader to take more of a coaching and technical assistance (TA) function. M. Ch. Ganhuyag, graduated in Hungary, was previously the MSM project's financial manager. During this phase the MSM advisor and the executive director worked hard with UNDP, the local NGOs, the government, the Central Bank and XAC staff on a comprehensive plan to convert XAC into the first NBFI in Mongolia.

B. Transition to a Non-Bank Financial Institution

The company successfully managed its transformation into a Non Bank Financial Institution. In October 1999, four additional NGOs received funding from UNDP and became shareholders of XAC. They are the Mongolian Open Society Institute (an affiliate of the Soros Foundation), the National Association of Mongolian Agricultural Cooperatives (NAMAC), the Local Governance Development Fund (LGDF), and The Rotary Club of Ulaanbaatar. At the same time, the Mongolian Central Bank registered the company as the country's first NBFi.

The transition process has been remarkably well managed and planned. All staff resigned from their NGO positions and reapplied for new positions in XAC. Legal contracts were signed between each founding NGO and UNDP to regulate the transfer of assets between the NGOs and XAC. During that period, the institution has grown significantly from a loan portfolio of US\$ 159,000 and a network of five branches (June 1999) to a loan portfolio of US\$ 386,000 and 11 branches (June 2000).

A new Board of Directors was elected in October 1999 and trained with the support of the UNDP MSM advisor. The Microstart Advisory Committee (originally composed of seven members from the government, the private sector and the NGO community) transferred its oversight responsibility to the XAC Board of Directors.

Another business plan with the vision to transform XAC into a full-fledged commercial bank has been designed with the participation of the staff and Board members. The plan was approved by the General Assembly in April 2000. Finally, contacts with international investors including IFC and Triodos Bank intensified in the year 2000 with the objective to secure equity and loan capital to fund the growth of the organization.

2.3 Ownership and Board of Directors

2.3.1 Ownership

The company is owned by 6 local NGOs:

- The Liberal Women's Brain Pool
- The Mongolian Women's Federation
- The Mongolian Open Society Institute (Soros Foundation)
- The National Association of Mongolian Agricultural Cooperatives
- The Local Governance Development Fund
- The Rotary Club of Ulaanbaatar

The founding NGOs were selected and approached by UNDP based on their reputation and track record. The 6 founding NGOs are representative of the Mongolian civil society.

As of June 2000, the company's paid up capital is Tug 180 million -- 18,000 shares of 10,000 Tugs each. Each of the founding NGOs holds 3,000 shares and has contributed 30 million Tugs. Their equity participation has been fully funded by UNDP and they have individually signed memorandums of understanding (MOUs) with UNDP. The MOUs set up the terms and conditions of the donations. In the agreement, the founding NGOs agreed not to receive dividends on their UNDP donation for a minimum period of 2 years and to grant UNDP an advisory seat on the Board of Directors.

The current ownership structure is weak considering that none of the shareholders has money at stake in the institution. But this structure is temporary and may be appropriate for the start-up phase in the context of Mongolia. However, the shareholder structure will require substantial effort in diversification over the medium term to ensure true ownership and a balance of skills and competence. It is suggested that the shareholder be opened up to include Mongolian private investors and international investors sharing a similar orientation (i.e. IFC, Triodos).

2.3.2 Board of Directors

The Board of Directors is composed of seven members elected by the shareholders general assembly in October 1999. The detailed list of Board members is presented in Annex II. The seven voting members include two banking professionals, a private sector leader, an agriculture cooperative specialist, two national leaders of the women's movement and a community development/local governance specialist. The chair of the board, Ms. Tsend Enkh TUYA is the Board member of the Liberal Women Brain Pool and a respected civil society leader with good political connections with the previous government. She is also consulting for various international organizations in the area of rural development including the AsDB and the World Bank. During her mandate, she has demonstrated a consistent and high level of leadership and commitment.

Board meetings are held frequently (at least every month) and attendance at the meetings has been high (over 80% for the year 2000). The working relationship between the Board and the Executive Director has been effective. The newly elected Board confirmed the appointment of the Executive Director in October and designed a scheme to monitor and evaluate his performance.

All Board members have signed a statement on ethics in which they commit among other things not to receive loans from the company and not to engage the company in self-serving political activities. Board members have attended training sessions organized by the UNDP MSM advisor. The training covered roles and responsibilities of the Board, its organization and monitoring system. Several exposure trips have also been organized for board members to introduce them to company issues and operations.

An Audit committee composed of three members has recently been established and is meeting regularly to discuss audit and internal control issues and develop a working program for the newly hired internal auditor.

The involvement and sense of ownership seem to be high as demonstrated by the board meeting attendance and by the participation of the Board members in several company activities like visiting branches facing problems, attending the openings of new branches, and participation in company retreats. Although Directors have no money at stake in the institution their reputation and image is engaged.

Overall, we feel that the Board is committed and well organized for a young MFI. We recognize that the UNDP MSM advisor has played an important role in building and training a strong and transparent board. However, board members are lacking experience in the field of business and finance and are not competent enough in business issues to play their oversight role effectively. The Board often follows XAC management recommendations and lacks the necessary skills and experience to challenge management initiatives and projects.

2.4 Alliances

XAC has made alliances with the following organizations:

Local Organizations

- The six participating NGOs have a strong presence and reputation in Mongolia. This provides XAC with a good image and immersion in local communities. (see section 2.3.1)
- The Central Bank. XAC has established an excellent working relation with the Central Bank. XAC has been influential in the development of an appropriate regulatory framework for NBFIs in Mongolia. It has made several recommendations and among other things has proposed a standard accounting chart. XAC has been participating in working groups organized by the Central Bank and has also conducted several trainings on microfinance issues for Central Bank supervisors.
- Other NBFIs. XAC has revived an informal group of industry players including both NBFIs and commercial banks involved in small business and micro loans. XAC management regularly meets and exchanges information with them.
- The University of Ulaanbaatar. XAC has developed a very successful and strategic collaboration with the University of Ulaanbaatar's School of Economy and Finance. XAC has designed and delivered a comprehensive microfinance course for third year students and it is offering an internship program for outstanding fourth year students.
- Private sector. The institutional linkage with the private sector has had mixed results. Attempts at linking private sector consultant firms with XAC clients for enterprise development and training proved ineffective.

Donors

Table 2: Donor support

Organization name	Funding in US\$
UNDP	567,726
Mongol Bank	1,399
Soros Foundation	4,345
Local NGOs	171,226
Total	744,695

XAC has received over US\$ 740,000 in direct grant funds.

- UNDP initiated the program and provided the primary source of funding and technical support. Although UNDP's role is likely to decline in the future, so far it has kept a leadership role.
- The Government of Finland funded the second phase of the UNDP MicroStart Mongolia project with US\$ 600,000.

- The Central Bank (Mongol Bank) funded a microenterprise trade fair organized by XAC.
- The Mongolian Open Society (an affiliate of the Soros Foundation), which is a shareholder of XAC, funded four international exposure trips for XAC staff.
- CGAP and IFC (through a Dutch Trust fund) jointly funded a technical assistance program to strengthen the organization in the area of external audit, internal control, business planning and governance.

International Investors

For a two-year-old organization worth US\$ 500,000, XAC has successfully marketed its image and its performance. XAC managed to generate interest from the following investors:

- IFC. The IFC has expressed an interest in investing in XAC and it conducted a first appraisal mission in August 2000. IFC is preparing its investment with the support of CGAP.
- Triodos Bank from Holland is considering providing XAC with a convertible loan. A separate appraisal mission was made in July 2000 and Triodos approved an investment of US\$ 400,000.
- The European Bank for Reconstruction and Development (EBRD), GTZ and KFW from Germany, and the Asian Development Bank (private sector group), have all visited XAC and have been impressed by XAC's management and performance.

2.6 Human Resource Management

Table 3: Human Resources Statistical Summary

	Actual				Projected		
	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
Number of total staff , end of period	15	24	30	49	63	111	128
Average staff (for computation only)	8	20	27	40	56	87	120
Number of staff hired during period	15	9	8	23	19	56	28
Number of staff who left during period	-	-	2	4	5	8	11
Turnover rate (staff who left over avg. number of staff)	0%	0%	7%	10%	9%	9%	9%
Number of loan officers , end of period	4	10	13	25	31	45	52
Percent loan officers of total staff	27%	42%	43%	51%	49%	41%	41%
Number of administrative staff , end of period	11	14	17	24	32	66	76
Number of line staff , end of period	4	10	13	25	31	45	52
Average annual loan officer compensation in current US\$	1,125	1,389	1,609	2,124.08	1,993.63	2,299.59	2,893.66
Typical annual compensation for veteran loan officers (annualized in US\$)	-	1,389	1,534	2,124.08	1,993.63	2,299.59	2,893.66
Avg. loan officer compensation as multiple of per capita GDP	3.1	4.0	4.8	5.9	5.8	6.4	7.9
Avg. loan officer compensation as multiple of avg. outstanding balance per loan	10.2	11.1	10.1	11.9	11.3	8.4	8.8
Staff training expenditures as a % of annual administrative budget (excluding financial and loan-loss costs)	0.1%	0.4%	0.9%	1.1%	3.2%	3.5%	3.5%

2.6.2. Structure and Profile:

As of June 2000, XAC employs 49 staff (excluding the UNDP MSM advisor and local consultant). The staff is highly educated and committed. Almost 90% of the total staff are university graduates, including 7.5% with master degrees. The staff is also quite young, the average age is 30.

Women represent a large majority (77% of the total staff is female), although only 20% of department managers are women.

Head Office

There are 15 staff members at the head office (32% of total staff representing 51.1% of total salary expenses). Head office staff is distributed in 4 departments: Operations (4), Finance (5), Administration (4) and Internal Audit (1). A Human resources department is under development.

Branch level

Each branch consists of a lead credit officer, a credit officer and an accountant. 6 branches have hired an additional credit officer and voluntary staff due to rapid expansion. 91% of lead credit officers are women selected from the communities in which they work, giving them a better knowledge of the clients and respectability within the community.

Credit officers are generally young, the majority of them hired immediately after finishing university normally with a degree in either accounting or finance and banking.

2.6.3 Recruitment

XAC's recruitment policy has been developed progressively since June 1999 with the support of the UNDP advisor. XAC hiring procedures are standardized and comprehensive. Candidates are subject to a thorough review including group interview, written tests and individual interview.

XAC has been able to attract committed and highly promising staff thanks to an aggressive and innovative recruitment policy. XAC has developed an innovative collaboration with the University of Ulaanbaatar's School of Finance and Economics to attract outstanding students through three programs:

- a scholarships program for low-income, high-performing students who are interested in Microfinance;
- an internship program for fourth- year students, that includes one-on-one mentoring over a two month period. In the year 2000, eight students were selected as interns and four joined the company.
- an elective microfinance course for third year students, this course designed and delivered by XAC staff is quite successful, 80% of the students signed up in 2000.

The effectiveness of staff recruitment is also demonstrated by the low staff turn-over. Only four staff left the institution in 2000, three were dismissed and one resigned to join an international program abroad.

It is also important to mention that all new employees have to adhere to a code of conduct presented in Annex III.

As the institution grows, XAC needs to fill more and more management positions. Most of the new positions are filled internally and this has lead to a very high job rotation in management positions. On average XAC managers have occupied their position for less than six months. This provides staff with good career opportunities but it also creates tension and tends to reduce the overall productivity. To give an example, during our assessment mission the chief accountant had just been transferred to the operations department and no proper replacement was available to answer detailed accounting questions.

Recommendation

XAC may need to pay more attention to staff rotation among management, ensure proper training and coaching for new managers, and capitalize on skills and know how through procedures and manuals.

2.6.4 Training

All new employees receive a week-long training at the Central Office. This training is built around XAC's vision and objectives, its personal ethical standards and rules, and general training in banking. After this in-house training, further training comes directly from the lead credit officer on site. Training is also given when a new branch is started.

Finally, the organization is also sending staff with high potential to major international microfinance training workshops. Three senior staff have been sent to international training in the year 2000 including the New Hampshire microfinance training (USA), a training workshop on bank management (Ireland) and the Bank Akademie training offered in Frankfurt (Germany).

2.6.5 Salaries and Incentives

The company has a well-defined system of evaluation and compensation. Staff performance evaluations are conducted once a year and include a self-evaluation and an action plan for improvement.

The compensation system is dynamic and includes:

1. A basic salary
2. An Employees' Stock Option Plan (ESOP)
3. A well designed incentive system
4. An annual best employees award
5. Training opportunities in Mongolia and abroad for staff with high potential
6. Staff Loans

The credit officer's salary is divided between a basic salary and a bonus. The bonus is determined by the total score the branch has received at the end of each quarter according to a pre-defined criteria (score-based performance appraisal system). The criteria include a set of 10 indicators covering portfolio quality, branch profitability, loan officer efficiency, and compliance with procedures and staff innovation.

Recommendation

While this system is complex and may be costly to manage (especially for qualitative indicators), it provides all staff with a credible incentive. The new MIS should be developed to help automate the incentive scheme and gain efficiency.

Nominally, the credit officers and accountants have relatively high salaries when compared with similar positions in the government or in the private sector. An accountant or a loan officer at the local commercial bank, Trade Development Bank (TDB) earns an average of US170 a month (compare with US 180 in XAC branches in the capital city). However, TDB staff enjoys a number of benefits that the staff at XAC does not yet have, such as housing benefits. And the new NBFIs supported by international donors (Credit Mongol and Gobi Start) are now offering attractive salaries (US \$450 for a Branch manager and US \$300 for a loan officer) that may affect XAC competitiveness.

Recommendation

We recommend that XAC management keep track of labor market trend and adjust salary when necessary. XAC should avoid losing key staff, particularly lead credit officers and department managers.

2.6.6 Leadership

The leadership provided by the Executive Director is excellent. The Executive Director is creative and dynamic. He has been able to take tough decision when needed (dismissal of employees, repayment crisis) and is excellent in marketing and public relations. He is also open and eager to learn from other experiences. However, he may still improve his management and communication skills and should put more efforts into building a competent and proactive middle management.

The organisation's second leadership position is the UNDP MSM advisor, Robert Cater. As the institution's first Executive Director, his influence is still important even though he is now clearly positioned as an external advisor. Robert Cater plays a critical role especially in the following areas: coaching the executive director and branch managers, human resource development, business planning, corporate governance. The contract of the UNDP MSM advisor is expiring on June 2001 but might be renewed.

The Executive Committee of XAC meets every Friday and there are staff meetings every Monday morning including a 15- minute training session on a pre-defined topic given by one of the staff.

2.6.7 Atmosphere

XAC enjoys the atmosphere of a start-up business. The staff is young, highly committed and is working countless hours. However, the staff seems over-stretched and some tensions are apparent among departments at the head office or more commonly between branches and the head office. XAC management has developed an open, transparent and learning atmosphere, staff are encouraged to collaborate and share their knowledge. The organization is also open to share its experience with microfinance actors in Mongolia and abroad. There is a clear focus on the client and on delivering good quality service. The staff seems to be motivated by the desire to create a professional organization that maintains a social orientation.

2.6.8 Human Resource Plan

The development of human resources has been an absolute priority of XAC since the very beginning. The organization has recently completed a human resource development plan for the year 2000 and 2001 with the following objectives:

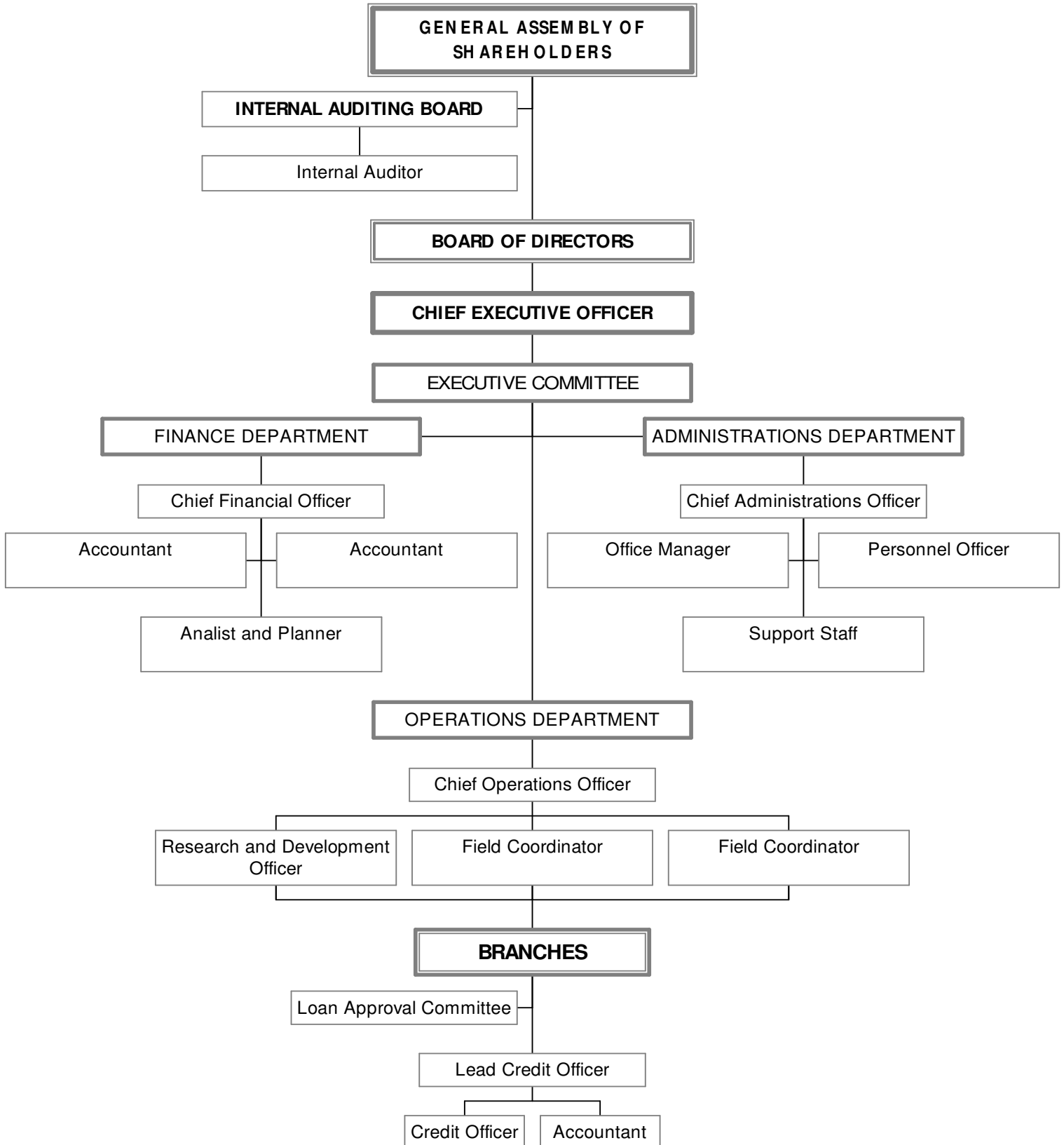
1. Establish a human resource department to be staffed by two employees by March 2001
2. Improve employee competence through a comprehensive in- house training program based on 45 basic skills
3. Monitor team and individual performance and conduct annual performance reviews for all staff
4. Develop staff loyalty and motivation through various programs and incentive systems including an employee stock ownership plan.
5. Enhance recruitment by developing the university program and improve recruitment in rural areas.

2.7 Organizational Structure

The latest organizational structure as of June 2000 is presented below.

Each employee has a personal file including an identification card, job contracts and job description. But job descriptions are not always up to date due to the rapid growth of the organization.

X.A.C. ORGANIZATIONAL STRUCTURE



Decentralization and Standardization of Procedures:

XAC has developed an impressive list of manual of procedures and training materials presented in Annex IV.

Branches do not strictly follow uniform operating procedures. In that sense there is a lot of decentralization of operations but this is perhaps not at its optimal level. Communication between branch offices and headquarters is not always efficient. The central office needs to address the potential conflicts that could develop with the branches during the expansion phase. The operations manager is aware of this situation as resentment is beginning to appear, because the central office is being perceived as not responsive. The Executive Director and the operation managers need to visit branches regularly to listen and effectively communicate company goals and strategy.

Loans are approved at the branch level by an external loan approval committee (LAC). This committee is normally formed by an average of five members. The branch staff in consultation with the central office chooses the members. They are distinguished members of the community who are available and willing to meet twice a month for about three hours and who know the community well.

Each branch is treated as a cost and profit center but no costs are imputed to Headquarters. Monthly branch financial statements are consolidated at the central level. A healthy competition is encouraged among the branches by sharing results, holding common training and sharing experiences. The central office costs will eventually be charged to the branches.

2.8 Management Information System

2.8.1 Hardware and Software

XAC has the following MIS configuration:

- Each branch is equipped with a stand-alone PC, Microsoft Office package and Micro Banker System (MBS). MBS is used to manage the loan portfolio, and to record accounting entries. But, XAC is still using Excel spreadsheets to produce financial reports on a monthly basis. These double entries are still considered necessary due to the recent installation of MBS (1999) and its limitation for creating reports.
- At the central office level 12 PCs are connected through a Local Area Network (LAN). Four are in the Finance department, three in Operations, three in Administration and two in the office of the resident technical service provider and Internal Auditor. Two laptops are available for the Executive Director and the Finance Director.

2.8.2 Reports

At the branch level, two types of reports are prepared and sent to the central office (Finance department):

- Loan activity package: is composed of the loan disbursement list, list of loans by status, cycle, purpose, gender and officer, monthly balance listing, list of installments about to fall due, analysis of recoveries, report of restructured loans and loans delinquency report.

- Financial package: contains the balance sheet, income statement, trial balance, cash flow statement, general ledger, inventory report, cash report, fixed asset report, depreciation calculation sheet, loan provisioning sheet, expense accumulation sheet, salary sheet and cash flow projection for the following month.

These reports are prepared monthly by the accountant and reviewed by the lead credit officer. On a weekly basis, a report on repayment and delinquency is also communicated by phone to the operations department for analysis and follow-up.

At the central office level, the finance department inputs into Excel all the data received from each branch in order to control the accuracy of figures and to produce the consolidation reports of loan activity and the financial package.

Moreover, the finance department produces the management package on a monthly basis including:

- 31 Ratios, including 10 financial sustainability ratios, 10 operating efficiency ratios, 6 portfolio quality ratios and 5 data related to active clients, loans outstanding, and loans disbursed.
- Balance sheet (comparison to previous month and % of change)
- Income statement (comparison to previous month and % of change)
- Performance indicators, as compared to budget, divided in two parts:
 - Financial performance indicators (projected and actual figures)
 - Loan activity indicators (projected and actual figures): loans disbursed, outstanding loan portfolio and portfolio quality ratios
- Loan portfolio report by type: beginning balance of loans outstanding, loans disbursed for the period, amount due, income, ending balance of loans outstanding, average outstanding balance of loans, payments in arrears, restructured loans, outstanding balance of loans with payments in arrears and other information such as number of new clients, clients by cycle, number of active female clients.
- Loan delinquency by branch: total amount and number of payments past due during the period, restructured loans, portfolio at risk, write-off loans, rate of on-time repayment.

2.8.3 Use of the reports

We think that existing reports cover most of XAC's need to monitor the current operations but *XAC's existing Management Information System is not flexible and reliable enough to handle the projected increase of accounting transactions and activities.*

At the branch level, the double entries into Micro Banker System as well as into Excel spreadsheets give staff less time to analyze financial reports, specifically at month end. We have also noticed discrepancies between accounting figures at the branch and the Headquarters level.

At the central office, the re-input of data from each branch into Excel spreadsheets is also time consuming. As a result, nine working days are necessary to produce the monthly consolidation package and the management reports.

Recommendation

One of XAC's greatest challenges is to design and implement a MIS strategy.

- In the short term XAC needs to improve the current system, avoid double entry between Excel and MBS, improve data security and report generation.
- In the medium term, XAC should analyze its needs and develop a new MIS project to cope with the growth of the organization. This new MIS must look at user requirements and needs, regulatory and legal aspects, new products to be developed, and technology available. Software maintenance and upgrade and local support should also be taken into consideration. We suggest creating a project team manned by representatives from each department (operations, finance and administration) and reporting to the executive director. We also recommend securing the support of an international information technology (IT) expert to benefit from other MFI experience and avoid repeating the same mistakes.

2.8.4 Staff

In general, XAC staff has a good knowledge of personal software, specifically of Excel and Word. The MIS is under the responsibility of the finance director. He was trained on the Micro Banker System for one week by a consultant from the Philippines.

Currently, as the number of PCs grows, XAC is planning to recruit one person to maintain the network and all the PCs installed in the branches. A local consultant specialized in information analysis has been contracted to improve the functionality of MBS.

2.8.5 Security

At the branch level, each staff has a specific code to access the Micro Banker System. But according to our field visits Excel files and Micro banker files are not backed up on a regular basis.

At the central office, no back-up procedure is written or applied. Even if all staff are honest and computer literate, the potential risk of losing information is high.

Recommendation

We recommend establishing a back up procedure including the following:

- Back-up should be done on daily basis, with two copies (one in the safe and one outside of the institution)
- Different diskettes should be used for daily back up (one for each day)
- Same procedure should be applied to end of month data
- Test of data recovery must be planned to ensure that the back-up procedure is applied properly
- In case it is impossible to access PCs, an emergency plan should exist with another institution to use one of its PCs
- Adequate training sessions for all users should be planned.

2.9 Internal Control System, Audits, and Supervision

2.9.1 Internal Control System

The description of the internal controls in place is divided into controls done at the branch level and at the central office level.

At the branch level

We have identified three main issues for discussion here.

1. Segregation of Duties: Branch offices have a lead credit officer (LCO), a credit officer and an accountant. Generally, the loan officer prepares the loan application, cash receipts and loan disbursement. The accountant is responsible for accounting and some treasury functions. The lead credit officer is responsible for processing loans, authorizing financial transactions and internal control. But in practice, the branch staff are sharing their duties and exchanging tasks and there is no real segregation of duties. This creates a serious operational risk.

Recommendation

To compensate for this weakness, we recommend clarifying the role of the LCO. As manager of the team, the LCO has the responsibility of ensuring that all daily transactions are correctly processed and booked. The LCO should also be responsible to validate reconciliation (cash journal, MBS and cash book) and the cash position *on a daily basis*.

2. Cash Management: Each branch is supposed to have its own bank account (either with Trade Development Bank or with Mongol Post Bank) but as many as four branches had no bank account as of June 2000. The cash in the safe should be limited to an amount up to 200,000 Tug for the branches. But these rules are not enforced among all branches and we have visited some branches with more than 1,000,000 Tug in their safes.

3. Bank Reconciliation: Currently, Bank reconciliation is only done a quarterly basis. This issue has already been raised by the external auditors in their management letter. Bank reconciliation is an important element of control and should be done on a monthly basis.

In general, we recommend that XAC review its cash management procedures both within the branch and with external entities (central office or bank).

At the central office level

Here we highlight two issues.

The **Field Coordinator (FC)** is the central office's first level of control for the branch operations. The FC is not only in charge of monitoring branches from a delinquency standpoint but also needs to ensure that all transactions are processed correctly according to XAC policies and procedures.

We suggest that the FC improve the methodology of control in line with the internal auditor. These improvements should be based on the techniques discussed during the training seminar on internal control.

Finance Department: The chief accountant checks the data received from each branch to ensure the correctness of the coding. After consolidation, a comparison is done to analyze the gap between actual and budgeted figures. XAC is in the process of establishing budget procedures for each department. However, budget control will be fully efficient only once financial reports will be fully computerized. With the current system, budget control is heavy and time consuming.

Recommendation

XAC needs to develop an internal control manual to improve and standardize its internal control procedures. The new internal auditor should develop the manual and discuss it with the Executive Director and the Internal Audit Committee.

2.9.2 Accounting System

As of May 2000, the accounting unit was manned by three staff, one chief accountant and two accountants. During our visit, the chief accountant was in New York for training and was supposed to be transferred to the operation department in August 2000.

XAC uses the chart of accounts defined by the Central Bank for NBFIs. It should be noted that it was XAC that proposed this chart of accounts (adapted from the CGAP format) to the Central Bank.

Since February 2000 and following the Central Bank's inspection, XAC is accruing interest for loan income. Investment income and operational expenses are still based on cash accounting. No provision is made on accrued interest.

Recommendation

XAC's current accounting manual was developed in January 1999 and is now obsolete due to the growth and changes in the organization. A new accounting manual is under development but is not available yet.

The new manual should cover the following items:

- Accounting principles
- Accounting chart
- Financial statements
- Accounting system
- Types of operations (loans, payroll, fixed assets, expenses, cash)
- For each type of operations
 - List of accounts used (balance sheet accounts and profit and loss accounts)
 - Accounting documents concerned
 - Accounting process by event (initiation of deal, disbursement, payment, end of month, closing)

2.9.3 Internal audit

An internal audit committee (IAC) was created in the first semester of 2000. The IAC is composed of three members and a recently hired full-time internal auditor, Mrs Chimgey. Mrs Chimgey, a CPA has an excellent reputation in , she was working previously for the local audit company Itgelt.

The IAC reports to the shareholder general assembly. Its role is to control the administrative, financial and economic activities of XAC. Due to the recent creation of the IAC, we could not fully assess its performance but we noticed that all IAC members lack of in-depth experience in audit. They, however, are willing to learn audit techniques and have attended the two-day seminar on "MFI external audit" organized by CGAP consultant.

Recommendation

In order to prepare the audit of the year 2000, we suggest

- Organizing a meeting with external auditors to prepare the audit planning
- Identifying the tasks to be done before the auditor visit (manuals, documents)
- Following up on the management letter issued by the external audit firm

- Organizing the internal audit working papers in order to facilitate the exchange of information with the external auditors.

2.9.4 External audit

XAC's financial statement has been audited for two consecutive year by Itgelt, one of the major local audit firms. Itgelt was the first audit firm licensed by the Central Bank to conduct bank and financial institutions external audits. The external audit process was supported by CGAP and UNDP through the UNDP MSM advisor. The terms of reference of the audit were carefully designed and based on CGAP audit handbook. CGAP also provided some on line advice through its consultant M. Khantiko Kong.

However, the external audit conducted in 2000 is still weak according to international audit standard and does not fully comply with the audit term of reference. The audit industry is new in Mongolia and Itgelt's audit approach is more transactions control oriented and lack of understanding of the microfinance business specific risks.

In its management letter for the year end 1999, Itgelt raised the following issues:

- Need to recruit an internal auditor
- No accounting procedure manual
- Non segregation of tasks in the branches
- No calculation of accrued interests for loans
- Several Bank reconciliation missing
- Weakness in cash control

Recommendation

We recommend that Itgelt develop its knowledge of the microfinance industry and get more familiar with the CGAP audit handbook. We also recommend that Itgelt work more closely with XAC internal auditor to plan and facilitate the audit review. However in Mongolia, external audits are not yet used to work with internal auditors.

2.9.5 Fraud control

So far, XAC has detected two cases of fraud. In both cases XAC management has dealt firmly with the problem. On one occasion in the Darhan branch, an accountant had not transferred to the cashier 464,000 Tugs related to the anticipated repayment of five loans. The fraud was detected by the LCO and the accountant was immediately dismissed and jailed. In the Chingeltei branch, a client satisfaction survey conducted in October 1999 revealed several cases of fraud, some clients did not receive the loan amounts stated in their contract. The requirements for collateral were also not followed closely. The credit officer was fired in November 1999.

There have been two cases of petty robbery. Though there have been no major robberies thus far there is reason for caution. For example, at the branch level when the cashier counts the cash receipts in front of the clients they invariably keep their drawer which holds all the money open. This can turn into a potential opportunity for robbery.

2.9.6 Public and Prudential Supervision

The regulation on non-bank financial institutions (NBFI) was passed on April 1, 1999 and regulates the activities of financial institutions that are not banks. The law defines the kind of activities that are permitted to NBFIs (savings mobilization is strictly excluded), sets out licensing requirements, and defines the supervisory role of the central bank. The Mongol Central Bank has the right to determine prudential ratios, perform off-site and on-site inspection and require public disclosure of NBFI financial statements. NBFI shall send regulatory reports to the Central Bank every three months, the report includes financial statements and specific loan portfolio and business information.

The bank of Mongolia is developing its supervisory and regulatory capacity. The Mongol Bank conducted its first on site inspection for a NBFI in XAC on February 2000. Two inspectors reviewed the company books and operation for four weeks and visited the head office, rural branches and urban branches.

The main recommendations stated in the central bank supervisory report are the following:

1. Communicate to the central bank any change in the equity position of the institution
2. Improve segregation of duty at the branch level
3. Adopt accrual accounting system

2.10 Financial Manager

The financial manager is responsible for the accounting unit, the finance unit and MIS. The challenges of setting up the information system, reviewing the accounting procedure, improving the cash management and implementing the budget procedure are very demanding. The recruitment of a chief accountant to support the financial manager is a priority.

XAC has been growing rapidly and will continue on this trend. Despite the financial director's deep understanding of the business, he needs to upgrade his knowledge and be trained on some specific issues such as project management, MIS, management control and international accounting standards.

2.11 Other Donor Experience

XAC was initiated by UNDP MicroStart which has provided the primary source of funding and technical assistance. UNDP SUM director Heather Clark, who conducted an appraisal of XAC in June 1999, is impressed by XAC's performance and by the quality of its management. She considers that XAC is one of the best successes of the MicroStart program currently operating in 25 countries.

Socially responsible investors are showing a growing interest in XAC. Triodos has conducted an appraisal mission and is likely to invest in XAC through a convertible loan. The IFC has also identified XAC as a potential investment.

3. Services / Clientele / Market

3.1 Services

3.1.1. Loans

The institution currently has two loan products: individual or working capital loans and investment loans¹. One new loan product Small /Medium Enterprise loan is under development. XAC's distinctive feature is that it offers an integrated service by combining credit provision with basic business training.

Table 4: Loan Portfolio Profile

Loan Portfolio as of June 2000	Number of Loans	% of Total Loan Value
Working Capital Loans	2,072	86.5%
Investment Loans	66	13.5%
Total	2,138	100%

A. Working Capital Loans

Loan conditions²

The maximum initial loan size is Tug 150,000 (US\$140). The conditions for the loan are as follows:

- Duration. During the first three cycles, the maximum length of loan is three months. Starting from the third cycle, loan length can increase to four months and up to six months after the fifth cycle.
- Interest Rate. The effective interest rate paid by the client is 72% per year calculated on a declining balance (6% a month).
- Collateral. The client has to provide collateral representing at least 150% of the loan value. Due to a high level of customer dissatisfaction, a previous policy of collateral insurance has been abandoned. As yet there is no standard for collateral valuation. Relations associated with the collateral are regulated by a separate Collateral Policy. It provides a list of properties that can be accepted as collateral, issues related with the evaluation, documentation, cease and sale of collateral.
- Repayment schedule. Loan payments are calculated and agreed to with the clients during group training on a case-by-case basis. Minimum payments are 15% at the end of the first month, 35% at the end of the second month and the remaining payment at the end of the third month.

Loan Processing

The information requested in the application for first cycle loans is:

- Basic personal information including name, age, gender, identification number, home address, work address, profession and telephone number.

¹ X.A.C. has completely phased out a previous product – group loans. These loans were offered through a group solidarity methodology and involved lower transaction costs and no collateral requirements. Despite these favorable conditions, disbursement of this product never exceeded 1% of the total portfolio.

² All figures are calculated at a rate of 1,070 tg: US\$ 1.00

- A list of the assets owned by the applicant. Monthly family expenses including rent, utilities, food, transportation, education and support to relatives.
- A description of the current business activities, including a simplified balance sheet and income statements.

It takes an average of fourteen (14) days for the applicant to receive the loan. During those fourteen days, the credit officer will visit the business and home of the applicant to verify the information, and the loan application will be submitted to the Loan Approval Committee, which usually meets twice a month. The process to receive a second loan still takes between 10 to 12 business days on average. Repeated loans (same amount to same client) do not require LAC approval and can be granted in a shorter time (4 to 5 business days).

Required Training

The institution currently offers two compulsory training sessions as part of the requirements for receiving a loan. Training is required for the first and second loan. The first loan training consists of two three-hours sessions that are held on consecutive days. The topics covered are:

1. Loan Terms
2. Interest
3. Collateral
4. Repayment
5. Incentives / Penalties
6. Business Plan

The training is divided into two sessions, topics 1 through 5 are covered in the first session and the development of the business plan is covered during the second session. Branch office staff conduct the training sessions. The clients do not pay a direct fee for this service. The institution does not separately budget the time of the credit officer or the rent of the premises as a cost of the training.

Business plan training is intended to provide clients with tools such as profit and loss statements, and cash flow projection to better manage their business. Participants are given sample forms but they are free to adapt them to fit their business needs. Business training has produced mixed results depending on branches.

Training for the second cycle is also six hours long and covers the following topics:

- * Exchange of experiences between clients
- * Update on company policies, procedures and institutional changes
- * Business Principles (through games and analysis)
- * Cash Flow and P&L Statement Analysis
- * Legal and Regulatory Environment for Small Businesses

The second cycle business training is indeed a deepening of the subjects covered in the first cycle's training. Even though during our field visits, we noticed that most of the clients were not using XAC business forms, clients seem to highly value the importance of such training.

During all subsequent cycles no formal training is provided. Instead all branch offices convene clients in a focus group format to share their ideas and experiences. It is a cost-effective form of training that builds client trust and confidence. XAC regularly takes feedback from the participants and modifies the training content and methodology according to their comments.

B. Investment Loans

Investment loans are exclusively an internal graduation loan for clients who have successfully completed a minimum of 8 months of on-time repayment of loans. As such, existing working capital loan clients are well aware of this loan product prior to achieving eligibility. The loan product name is somewhat misleading, as clients may use the preceding loan both for working capital as well as fixed asset acquisitions.

Loan Conditions

- * The maximum initial loan size is US\$ 1,869
- * The average value of the loan disbursed is approx. US\$ 985
- * Maximum length of a loan is 10 months
- * The effective rate varies between 60.5 – 61.8 % depending of the term of the loans (5 % a month).
- * An upfront commission of US\$ 4.67 is required for processing
- * Collateral requirements are the same as that of working capital loans

Loan Processing

Clients fill out an application form that is more detailed than that for working capital loans. A more detailed business plan and cash flow analysis is also required. The credit officer engages in a more comprehensive review and counseling of the client's business during this time. Despite the requirement for increased amounts of information, the processing time for investment loans does not normally exceed 14 days. The Loan Approval Committee must review and approve all investment loan applications.

Training

Training for investment loans is minimal and is provided during the loan application/review process. The demand for advanced business training for investment loan clients is high. The company does not want to engage in enterprise development service and has instead attempted to link with other business support services.

Dropout or retention:

XAC does track client drop-out and retention and conduct regular survey among drop-out clients but does not publicly report on these number. XAC management does not consider client retention to be a principal organizational goal because a large number of clients drop-out during the first and second cycle as part of XAC screening process.

XAC management is planning to track clients' drop-out from loan cycle 3 and above but this indicator is not yet available for analysis. We feel it is important to monitor closely this indicator to track clients drop-out, evaluate clients satisfaction.

Evaluation of the loan methodology

1. The loan methodology is detailed, comprehensive and prudent. XAC is very selective in choosing and graduating its. The remarkable quality of the loan portfolio reflects the depth of the credit risk analysis and the strength of the methodology.
2. The loan processing time is long (over 14 days for the first loan) and costly. Loan officers have to visit both the client's business and home during the loan appraisal and the clients have to come to the branch office 4 times before receiving their first loan and 3 times for subsequent loans. XAC may need to reengineer its loan methodology to improve its

efficiency and reduce its transaction costs. It is also recommended to track the clients transaction costs

3. The business training provided during the first and second cycle loan is innovative but its impact needs to be assessed more thoroughly. The complete training cost (including staff costs) has to be tracked and monitored. Additionally, XAC should conduct an independent assessment of its training impact on its client's business.
4. The Local Approval Committee needs to be redefined as XAC business and portfolio evolves. We recognize that LAC members' responsibilities go beyond loan approval. LAC members currently play a critical role in linking the branch to the broader community and in overseeing the branch operation. But the loan approval process needs to be reviewed. There are usually too many proposals for each member to read during the loan approval committee. LAC members cannot easily assess risks independently and end up approving over 90% of the loans presented. Furthermore, there is a lack of clear loan approval and selection criteria. Ideas for improving the LAC include the introduction of automatic approvals for repeat loans and increase focus on delinquency management and big risks (loans over 500,000 TUG).

3.1.2 New Products

As per the approved five-year business plan, the company will diversify its range of financial products to include at least one savings product (time deposits beginning in 2001) and Small/Medium Enterprise Loans (to be piloted during the last quarter of 2000. The new SME loan is targeted to XAC clients with strong credit records and who need more financial resources to expand their business. In 2000, the company planned to disburse 9 loans with an amount of Tug 36,000,000 (US\$ 32,391). The annual effective interest rate for this loan is 60.9%. The new savings product will be offered in 2001 to XAC clients. Projections for savings mobilization seem to be very conservative and lack of rational. Time deposits represents only 1,3% of total assets in 2002 and no further details on the product design, costing and marketing Plan are yet available.

Table 5: Summary of New Products

Market	Product	Purpose	Channel
Economic entities, cooperatives, and internal graduation clients	SME loans	To support XAC clients with clear business objectives and sound track-record	Specific department to be created in October 2000
XAC current clients	Time deposit	To create new type of saving service to encourage clients to make savings	All branch offices except

3.1.3. Non-financial Services

The company does not consider the first and second cycle working capital loan training as a non-financial service, but instead as an integral part of the loan methodology. XAC feels the need to offer further business training services to its clients but a partnership with a local organization has not materialized yet.

However, XAC has organized several trade fairs at the branch level and in UlaanBaatar to promote the institution and its client's business. The National Trade Fair organized in December

1999 was a great success. 350 companies presented their goods and sold over four million Tugriks. 12,000 visitors attended the events including the Prime Minister. This event was complemented by a two-week public relations campaign aggressively launched through the television, radio, newspapers.

3.2 Outreach

3.2.1 Branch Structure

XAC currently has 11 branches under the support of one central office. By the end of the year 2002, XAC intends to open 10 more offices. Of the 11 current branches, five operate in the capital city, Ulaanbaatar, one in Darhan city and the remaining five operate in rural areas.

Table 6: Branch Profile

Location	Population	Distance from UB	Start date	Number of Clients (as of Jun, 2000)
Shainshand, Dornogobi province	18100	10 hrs by train	09/28/98	302
Airag, Dornogobi province	3100	8 hrs by train	10/6/98	96
Chingeltei, UB	95600	In UB (farthest sub-district is 20km)	10/30/98	236
Herlen sum, Hentii province	16500	10 hrs by car	10/31/98	255
Bayanzurkh, UB	104,000	Geographically largest district in UB	3/9/99	199
Songinohairhan, UB	119,000	Population wise largest district in UB	8/11/99	252
Darhan, Darhan-Uul province	79,000	3 hrs by car	8/12/99	212
Suhbaatar, UB	74,248	In UB	3/31/00	105
Han-Uul	70,200	In UB	4/5/00	97
Sukhbaatar, Selenge province	101,800	9 hrs by train	4/21/00	91
Arvaiheer, Uvurhangai province	117,390	9 hrs by car	4/20/00	192
Choyr branch, Airag	14,000	5 hrs by train	4/10/00	101

To open new branches, XAC considers three factors: the market potential and the competition, the business projection and profit forecast, and the level of support from the local government and other local organizations.

XAC inherited five of its 11 branches from its NGO founders. Those five branches had more of a social orientation and were not set up according to the above criteria.

Table 7: Regional Distribution of Institution

	Actual				Projected		
	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
Branch Offices	4	5	7	11	13	18	21
Posts (service-providing units not located in permanent, dedicated quarters)	-	-	-	1	-	-	-
Village (or Communal) Banks	-	-	-	-	-	-	-
Employees per Branch (total no. of staff/no. of branch)	4	5	4	4	5	6	6
Loan Officers per Branch	1	2	2	2	2	3	2

XAC plans to significantly increase its number of branches from 11 as of June 2000 to 21 as of December 2002. The growth model is based on a very lean branch structure with only 3 staff per branch serving on average only 368 clients (December 2000). This model seems to be more adapted to rural areas with limited market potential than to urban areas where the market is larger and allows for branch expansion. This growth model is also not efficient and puts a heavy and costly management control burden on the head office for branch monitoring.

Table 8: Loan portfolio

	Actual				Projection (annualized)		
	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
LOAN #1: Working capital							
Number of active loans at end of period	363	1,276	1,503	2,072	3,500	5,203	6,954
Percentage of clients who are women	90%	80%	78%	75%	75%	75%	75%
Average balance per loan (specify currency)	98	119	156	160	151	176	189
Average balance/per capita GDP	27%	34%	46%	45%	44%	49%	51%
LOAN #2: Investment loan							
Number of active loans at end of period	-	-	11	66	115	381	557
Percentage of clients who are women			64%	69%			
Average balance per loan (US\$)	-	-	817	780	664	657	638
Average balance/per capita GDP	-	-	244%	218%	192%	184%	173%
LOAN #3: SME loan							
Number of active loans at end of period	-	-	-	-	9	123	270
Percentage of clients who are women							
Average balance per loan (US\$)					3,591	3,289	3,760
Average balance/per capita GDP					1038%	921%	1020%
TOTAL							
Number of active loans at end of period	363	1,276	1,514	2,138	3,624	5,707	7,746
Percentage of clients who are women	89%	80%	78%	75%			
Average balance per loan (in US\$)	110	125	159	179	176	275	330
Average balance/per capita GDP	31%	36%	47%	50%	51%	77%	89%

As of June 2000, XAC working capital loan accounts for 96% of total loan accounts. The average loan balance for working capital loan is US\$ 160 (or 45% of the estimated GDP per capita). There are only 66 investment loans with an average loan balance of US\$ 780. XAC is planning to disburse significantly larger SME loans during the next semester with an average balance of US\$ 3,591.

Table 9: Outreach Indicators

June 2000	Number of loans	% of Total Loan Value
Location		
Urban (ending balance of loan outstanding)	51.5%	50.4%
Rural (ending balance of loan outstanding)	48.5%	49.6%
Gender		
Male	31.1%	-
Female	68.9%	-
Type of Business Activities	100%	100%
Trading	65.7%	62.5%
Production	21.2%	20.6%
Agriculture	1.1%	0.9%
Service	8.5%	10.3%
Other	0.2%	0.3%
Mixed	3.3%	5.5%

XAC's clientele is balanced between urban and rural areas. The total value of loans to urban clients makes up 50.4% of its total loans and loans to rural clients represent 49.6%. XAC is serving mainly women (70% of the active clients are women). Finally, the majority of the loans go to trading (62%) and production (20.6%). Loans to service-related activities represent 10% of the loans outstanding.

3.3 Market and Clientele

3.3.1 Markets

Mongolia has a population of 2.3 million that is widely dispersed in towns and rural areas with large distances linked by poor roads between city centers. Ulaanbaatar accounts for about 27% of the population with the three largest urban centers accounting for 34% of the population. The rest of the population lives in rural areas. The population density of Mongolia is 1.5 people per square kilometer, one of the lowest in the world.³ A large proportion of this population lives as semi-nomadic herders. Of the urban population between 35 to 45% of the economically active population is engaged either part time or full time in the informal sector⁴. This figure is much higher amongst rural populations. With an estimated 570,000 families in Mongolia and at least 45% of the population engaged either part time or full time in the informal sector, one could conservatively estimate a target market for the microfinance sector of 77,625 clients⁵.

³ EIU Country Profile Mongolia 1998 –1999

⁴ World Bank study mentioned in Xac Business Plan

⁵ 33% of an estimated 258,750 families engaged either part or full time in the informal sector. From the Xac Business Plan.

A recent report (April 2000) from the consulting firm DAI concluded that there is significant demand for credit in the microenterprise sector. DAI stated that microenterprises obtain the vast majority of their finance from family/personal savings (82%) and from other individuals (11%). Bank loans are very limited and account for less than 1% of the total financing to the sector. Finally some enterprises seek financing from one of the more than 400 pawnshops in Mongolia which charge exorbitant interest rates (10% to 15% a month).

Marketing Strategy

Considering the small size of the microfinance market, XAC's marketing strategy is both vertical and horizontal.

- The institution plans to expand its network of branches to improve its market coverage and to serve more clients. XAC currently intends to create 10 more branches principally in Ulaanbaatar and in major city centers throughout the country.
- The institution also intends to develop new products to extend its client base. XAC will soon offer loans to SMEs. Savings products are also discussed but would require a bank license.

However, XAC's business plan puts more emphasis on geographical coverage than on branches' individual growth and market deepening. The marketing strategy should be revisited and analyzed in more details. Over the next 3 years, XAC should consider focusing its marketing efforts on Ulaanbaatar and other urban areas in the country where the institution's efficiency can be maximized through the creation of larger branches. We feel that XAC needs to have a dominant position and build a profitable clients base in the Ulaanbaatar market to sustain over the long term.

XAC marketing and public relation skills are good. The company has been excellent in promoting its products and in building its image. XAC has launched a clever advertising campaign with the slogan "Mongolians do repay their loan" on local radio and national television. This campaign encourages financial discipline and promotes the company image. The National Trade Fair organized in December 1999 and attended by more than 100,000 visitors was also an important step to establish XAC's recognition and credibility.

3.3.2 Financial Sector

The financial sector is comprised of commercial banks and NBFIs such as XAC. There are 12 legally registered commercial banks, one stock exchange, a number of currency exchange houses, and four specialized finance companies (NBFIs). Commercial banks are the primary providers of financial services but many have been poorly run.

Currently, Mongolia has a very low level of financial intermediation. Bank assets were equivalent to about 18% of GDP at year-end in 1999, with lending to private sector entities accounting for only about 5% of GDP.⁶ According to the Central Bank Risk Center, approximately 99% of all commercial lending activities were reaching less than 1% of the population (with more than 95% of this activity concentrated in Ulaanbaatar City).⁷

⁶ Moyes, Tom and Ira Singh "Mongolia Microfinance Market Assessment: Towards an Efficient and Private Sector-led Microfinance Market" (draft for discussion only) Development Alternatives, Inc., June 2000.

⁷ From the XAC Business Plan

Traditionally, the formal commercial banking sector has not targeted microenterprises or SMEs. However, recently two banks (Golomt Bank and the Agricultural Bank) have shown an interest to move down-market.

3.3.3 External Threats and Opportunities for Market Penetration

Competition

XAC started with no serious competition, but a number of competitors are now entering the market. The competition in the sector is likely to broaden and deepen.

-Other Specialized Finance Companies (NBFIs)

There are two new NBFIs starting their operations. Goviin Ehlel got its license from the Central Bank in March 2000 and is capitalized with US\$ \$700,000 from USAID. It targets the Govi region and had disbursed four loans as of July 3, 2000. Credit Mongol got its license in April 2000 and is capitalized with US\$ 210,000 from the European Union. Credit Mongol has disbursed three loans as of July 3, 2000. Loan duration is from two months to two years. Credit Mongol is not restricted geographically.

-Commercial Banks

Currently bank loans represent only a small source of SME and informal sector financing. This situation might change in the future, two local banks are considering to move into the microfinance sector.

-The Agriculture Bank is a state-owned bank that is the conduit for government pension payments through its network of 280 branch offices. Although it is currently insolvent, there is a plan to restructure and recapitalize the Bank with German and USAID funds. The plan calls for the development of new products including microfinance loans (under \$ 1,000).

-Golomt Bank is an aggressive, progressive and well capitalized private bank. Golomt Bank has launched its own experimental microlending program in UB. This microlending program is currently operating in one branch and it is too early to evaluate its success.

-SCC

Savings and Credit Cooperatives (SCCs) first appeared in 1996 and now number more than 50. They may become a significant source of funding for the urban middle class and SMEs. SCCs are currently unregulated and there is a discussion about which agency should provide supervision.

Opportunities

The microfinance market in Mongolia is small but untapped. As the leader and first entrant in the market, XAC has the opportunity to build a strong client base and a dominant market position.

The market is highly literate and educated although entrepreneurs have limited business experience and very little experience with institutional borrowing.

Finally, XAC can charge high interest rates (currently 68% real interest rate) to its clients and is not limited by legal restriction.

Threats

Market saturation is a potential threat to XAC's profitability. In some rural branches, the market potential is limited to only 300 to 500 customers. Competition from the Agricultural Bank and its 280 branches pose a very serious threat.

3.3.4 Clients and Poverty Targeting

XAC assesses the level of poverty of clients through regular and independent client surveys or through loan officer visits in the clients home. There are four basic categories that clients are classified into: Vulnerable Non-Poor, Moderate Poor, Poor, and Extreme Poor. Classifications are based on ownership of housing, condition of housing, furniture (color TV, fridge, modern cooker and so on), household income, own car, and usage of business income.

Based on XAC's classification, the following is the distribution of its sample clients:

Table10: Result of XAC Client Survey 1999/ Poverty Targeting

Category	Active clients	Drop-out clients	Applicants rejected for loans
Vulnerable non-poor	30.5	33.3%	1.9%
Moderate poor	58.5%	60%	58.5
Poor	9.8	6.7	26.4%
Extremely poor	1.2%		12.2%

The perception is that the majority of clients of the institution are moderate poor and low-income people who have a business already and need working capital. There are a few clients who are very poor, but overall collateral requirements and an active business tend to limit clients from this income group. Some clients are interested in accessing larger loans, but given the lack of available services, they begin with small loans and pay them rapidly in order to graduate to a higher level. From Table 10 it is evident that the vulnerable non-poor have the greatest probability of being accepted as XAC members as only 1.89 percent of their applications are rejected. While the greatest percentage of loan applications rejected are for those who are moderately poor, the moderate poor also make up the greatest proportion of active clients. Thus, in a sense they are the largest demanders of XAC services.

3.3.5 Client Feedback

XAC generates feedback from its clients in both an informal and a formal way. Most of the feedback is provided by the clients during loan applications and follow up visits.

Training services are also regularly assessed. After each training, the staff asks clients to fill in a survey where they are asked about the appropriateness of the training and to offer suggestions for improvement. Each branch provides this information to the central office, which in turn is able to adapt the products and services according to demand.

Finally, XAC conducts client satisfaction surveys regularly. As of June 2000, XAC commissioned three client satisfaction surveys, which were all conducted at low costs (less than US\$ 3,000) by outside consultants. The client surveys have shown clients to be satisfied with the services that XAC provides.

Although the survey methodology is not standardized and can be improved, we find XAC client satisfaction survey valuable and cost effective. Surveys have helped detect fraud, branch management problems and drops in service quality.

During our assessment we have visited 10 clients in the UB/Bayanzurhk and the Sainshand branches, generally clients were very satisfied with XAC services. Some had accumulated enough working capital to run their business and were not considering to take new loans other were asking for larger loan to expand their activities. XAC loan officers had a good knowledge of their client business and a professional attitude.

4. Strategic Objectives

4.1 Mission and objectives

XAC's name and logo nicely reflects the country culture and beliefs. XAC is a Mongolian acronym for Golden Fund for Development. This word finds its origin in Tibetan Buddhism with the swastika symbol and means eternal development. The swastika symbol also appears in XAC's logo.

The mission statement, and company principles, as defined in XAC's bylaw is "to contribute to the socio-economic development of Mongolia by providing financial services to those who were not previously able to access services from the banking sector, in a socially oriented and business like manner."

The Company will carry out its mission strictly adhering to the seven XAC principles:

1. **Social Orientation** with a **Business Mentality**
2. **Transparency** and **Accountability** in financial and program management
3. **Flexibility** in Approaches
4. Strong **Discipline** at both the Operational and Client Levels
5. The Establishment of **Partnerships** amongst and between the owners, the stakeholders and national and international collaborators
6. **Client-appropriate** and Driven Approaches in the design of financial services
7. A **Decentralized and Process-Oriented Management Structure** conducive to achieving financial success.

The mission statement clearly shows the social orientation of the company and notably the clients' drive. The business orientation seems less clear and the word profit is not even mentioned. A clear balance between social and profit orientation has yet to be found. After discussing with XAC management and the Board, we believe that XAC is in fact driven by a common dream, the dream to set up a new type of organization, a successful commercial bank serving the poor in Mongolia.

4.2 Objectives for the near to medium term

The medium term objectives presented below are based on the business plan approved by the Board of Directors in April 2000 and revised in September 2000 following CGAP and Triodos mission. The plan reflects the company's double bottom line : social mission and drive to reach sustainability.

- support the business activities of micro and small-entrepreneurs of Mongolia
- increase outreach and maintain a good quality of services
- introduce and instill a new culture of financial discipline to Mongolia
- strengthen internal systems and the culture of the organization, ensure market sensitivity
- introduce a computerized Management Information System
- maintain the quality of the portfolio while sustaining growth
- collaborate with governments, donors and private sector institutions

XAC is still searching for a way to operationalize its mission statements into a clear business strategy. Over the last year, XAC has spent a lot of effort in developing a business plan (staff retreat with Board members, internal meetings, work on financial projection). But XAC's staff have slightly different views on the medium-term objectives of the institution and some tensions are apparent in middle management. Some managers would like to put more emphasis on reaching the poorest others are more concerned by XAC's business performance. This tension may also exist at the board level.

The main challenge is to position XAC for its next phase of growth, from 2,000 to 7,000 clients, from a small NBF to a full fledged commercial bank, from a small and highly committed team to an organization with over 120 staff. This next phase entails developing a clear and effective business strategy, reviewing the management structure, developing the organization systems and procedures, improving MIS and internal control.

However, XAC management is aware of its weaknesses and is working on it. A new business incorporating CGAP and Triodos inputs has been completed in September 2000 and the management is working hard on a comprehensive plan to improve the institution MIS.

4.2.1 General direction

Over the next three years, XAC plans to multiply by five its assets base (up to US\$ 3 million) to serve 7,000 clients. This represents about 10% of the estimated microfinance market in Mongolia. This plan will be achieved through branch expansion and considerable build-up of the institution's system and human resources.

Table 11: Key indicators of scale and outreach

		Actual				PROJECTED		
		Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1.	Total outstanding loan balance in US\$	39,953	159,017	241,310	389,667	637,737	1,570,953	2,552,475
2.	Number of active loan clients	363	1,276	1,514	2,138	3,624	5,707	7,746
3.	Average loan balance per client in US\$	110	125	159	179	176	275	330
4.	Total balance of voluntary savings accounts in US\$	-	-	-	-	-	5,976	37,727
5.	Number of voluntary savings clients	-	-	-	-	-	598	2,038
6.	Average voluntary savings balance (US \$)					#DIV/0!	10	19
9.	Number of staff	15	24	30	49	63	111	128
10.	Number of branch offices	4	5	7	11	13	18	21

4.2.3 Key changes

The key targets and milestones of the new business plan are the following:

- The transformation into a full-fledged commercial bank
- The development of new products: SME loan and savings products
- The opening of 10 new branches, especially in densely populated area
- The recruitment and training of over 100 staff, including 30 back office staff and 70 loan officers
- The mobilization of US\$ 3 million from international and local investors

4.2.4 Business planning and financial modeling

XAC is using Microfin, a business planning software developed with the support of CGAP, to monitor its cash flow and for financial projection. The UNDP advisor and the financial manager both have a good knowledge of this software and are regularly using the on-line support service offered to get updates and troubleshooting.

Microfin has been very useful to XAC both for managing cash flow and for business planning. If we compare April 2000 projections to actual performance, XAC reached 106% of its loan disbursement targets, 110% of revenue targets and 81% of expense targets.

The business planning model is based on a number of assumptions (loan growth, delinquency, drop out etc.) which have been discussed with the executive committee and the UNDP ADVISOR.

4.2.5 Challenges

As XAC faces the future, it must address the following issues before launching a new phase of growth.

- Improve Procedures and internal control. Procedures are too flexible and seem to vary among branches. There is a need to standardize and enforce core procedures. The nascent audit function has to be developed. Finally segregation of duties needs to be improved at the branch level.
- Develop MIS. MIS is one of the major weaknesses of the institution. The current system is limited and can't cope with the growth plan of the organization. The MIS strategy should be two-fold: a) in the short term improve the current MBS/Excel b) in the medium term develop an MIS plan with the support of an international expert to address the medium and long-term needs of the institution.
- Efficiency. XAC's efficiency is low compared to XAC's MicroBanking Bulletin peer group. Gains of productivity are important to win the nascent competition, gain market share and improve profitability. We feel that XAC has room to boost efficiency by adopting a more

business-oriented strategy and by reengineering its branch business model and loan methodology.

- Build middle management. XAC should build top and middle management (especially branch manager and executive committee). In particular, XAC should continue to promote an open and transparent company culture, provide regular training and retain key staff.
- Review the business model. XAC plans to create 10 new branches and manage a network of 21 branches by 2002. This rather horizontal growth strategy should be reconsidered. The current branch model of a lean structure manned by three officers serving 200 clients is not efficient, risky and costly to manage from the head office. XAC needs to review its branch model and develop larger branches especially in urban areas.

5. Financial Performance

5.1 Income statement and balance sheet

Tables 12 and 13 contain XAC's income statement and balance sheet. These financial statements are presented in Tugrik (TUG), the local currency.

Financial statements are based on cash accounting and have been adjusted for grant and in-kind donations. XAC's fiscal year runs from January 1 to December 31.

The audit firm Itgelt has reviewed financial statements as of December 31, 1999. Financial statements as of June 2000 are un-audited but approved by the management.

Financial statements for December 2000, 2001 and 2002 are based on XAC's own projections.

Table 12: Income Statement (in local currency)

	Actual				Projection		
	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
OPERATING INCOME							
1. Interest and fee income from loans	2,792,769	30,375,982	86,809,678	123,965,799	195,686,448	828,370,670	1,607,020,121
2. Income from other finance-related services	-	-	-	-	-	-	-
3. Income from investments	2,860,183	2,660,664	2,231,798	7,937,516	9,691,210	15,112,063	56,097,779
4. Total Operating Income	5,652,952	33,036,646	89,041,476	131,903,314	205,377,658	843,482,733	1,663,117,901
OPERATING EXPENSES							
5. Interest and fee expense				58,333	-	99,814,487	203,612,370
a. commercial loans				58,333		99,675,000	201,600,000
b. saving deposits						139,487	2,012,370
6. Loan loss provision expense	379,557	1,768,755	3,845,930	2,008,983	11,783,728	51,327,706	131,790,483
7. Administrative expense -- Personnel	7,206,454	25,177,738	37,313,577	59,312,606	109,463,573	348,997,092	524,419,581
8. Other administrative expense	12,528,903	28,813,403	28,233,663	46,302,909	93,931,458	275,726,253	355,349,887
rent	2,301,434	4,734,900	6,370,639	9,019,946	12,743,000	24,958,933	19,739,629
office materials and supplies	1,688,467	2,596,059	3,102,468	3,771,390	5,974,351	19,407,305	29,301,529
transportation and travel	2,807,893	6,734,905	4,038,919	8,772,208	13,900,713	53,890,350	74,173,907
utilities	528,549	1,166,215	2,065,370	4,106,043	5,218,046	16,799,576	24,797,912
publicity and publications		105,900	26,210	108,383	-	-	-
Staff training	20,000	204,325	586,915	1,129,574	6,425,000	21,679,088	30,613,315
repairs and maintenance		35,000	206,500	1,017,200	-	-	-
bank charges	695,395	268,896	103,816	226,960	450,000	483,314	-
depreciation	2,413,984	5,106,081	6,898,564	9,287,224	16,464,466	51,648,137	73,310,287
other	2,073,181	7,861,122	4,834,262	8,863,981	32,755,882	86,859,550	103,413,308
9. Total Operating Expenses	20,114,914	55,759,896	69,393,170	107,682,832	215,178,759	775,865,538	1,215,172,321
10. NET OPERATING PROFIT (LOSS)	(14,461,962)	(22,723,250)	19,648,306	24,220,483	(9,801,101)	67,617,196	447,945,580
NON-OPERATIONAL INCOME							
11.							
12. Cash donation	-	62,013,188	15,992,623	-	-	-	-
Total Non-Operational Income	-	62,013,188	15,992,623	-	-	-	-
13. Income tax	-	-	4,295,198	4,168,319	-	10,142,579	154,178,232
14. TOTAL CONSOLIDATED PROFIT/LOSS	(14,461,962.04)	39,289,937.82	31,345,731	20,052,164	(9,801,101)	57,474,616	293,767,348

In the year 2000, operational costs are tripling (compares to 1999) and are growing faster than operational income. This trend is reversing in 2001 and 2002, the growth is slowing down and operational incomes are growing faster than operational expenses.

Table 13: Balance Sheet

	Actual				Projected		
	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
ASSETS							
15. Cash and due from banks	37,095,320	137,828,349	192,569,752	214,388,589	33,391,732	69,768,410	101,313,427
16. Reserves in central bank		-	-	-	-	3,586,800	12,226,800
17. Short-term investments in market instruments		-	-	-	30,963,121	867,643,264	136,495,107
18. Total loan portfolio	37,955,700	161,359,708	258,773,639	414,994,965	708,793,869	1,885,662,282	3,308,926,387
19. (Loan loss reserve)	(379,557)	(1,994,562)	(5,098,947)	(6,346,198)	(18,632,408)	(54,722,108)	(96,317,738)
20. Other short-term assets	1,461,775	2,207,293	14,167,701	32,305,748	14,167,701	14,167,701	14,167,701
21. Long-term investments					-	-	-
22. Net fixed assets	24,922,088	31,883,616	38,509,163	63,423,790	178,732,702	261,787,565	306,583,179
23. TOTAL ASSETS	101,055,325	331,284,404	498,921,309	718,766,894	947,416,717	3,047,893,914	3,783,394,863
LIABILITIES							
24. Savings accounts: compulsory							
25. Savings accounts: voluntary						7,173,600	48,907,200
26. Time deposits							
27. Loans: commercial					-	972,180,972	1,372,180,972
28. Loans: central bank							
29. Subsidised loan						-	-
30. Other short-term liabilities	575,575	1,851,895	7,926,691	70,499,072	7,926,691		
31. Other long-term liabilities							
32. TOTAL LIABILITIES	575,575	1,851,895	7,926,691	70,499,072	7,926,691	979,354,572	1,421,088,172
EQUITY							
33. Paid-in equity from shareholders		60,000,000	180,000,000	180,000,000	180,000,000	1,988,232,876	1,988,232,876
34. Donated equity -- prior years, cumulative	-	114,941,712	244,604,534	254,820,911	460,328,286	-	-
35. Donated equity -- current year	114,941,712	129,662,822	10,216,377	139,593,800	276,329,890	-	-
36. Prior years' retained earnings/losses	-	(14,461,962)	24,827,976	53,800,946	32,632,951	22,831,850	80,306,468
37. Current year retained earnings/loss	(14,461,962)	39,289,938	31,345,731	20,052,164	(9,801,101)	57,474,616	293,767,348
38. Other capital accounts							
39. TOTAL EQUITY	100,479,750	329,432,510	490,994,617	648,267,822	939,490,026	2,068,539,343	2,362,306,692
40. TOTAL LIABILITIES AND EQUITY	101,055,325	331,284,404	498,921,309	718,766,894	947,416,717	3,047,893,915	3,783,394,864

Balance sheet distribution

Table 14: Balance Sheet Distribution in %

	Dec-98	Jun-99	Dec-99	Jun-00
ASSETS				
15. Cash and due from banks	37	42	39	30
16. Reserves in central bank	-	-	-	-
17. Short-term investments in market instruments	-	-	-	-
18. Total loan portfolio	38	49	52	58
19. (Loan loss reserve)	(0)	(1)	(1)	(1)
20. Other short-term assets	1	1	3	4
21. Long-term investments	-	-	-	-
22. Net fixed assets	25	10	8	9
23. TOTAL ASSETS	100	100	100	100
LIABILITIES				
24. Savings accounts: compulsory	-	-	-	-
25. Savings accounts: voluntary	-	-	-	-
26. Time deposits	-	-	-	-
27. Loans: commercial	-	-	-	-
28. Loans: central bank	-	-	-	-
29. Loans: subsidized				
30. Other short-term liabilities	1	1	2	10
31. Other long-term liabilities	-	-	-	-
32. TOTAL LIABILITIES	1	1	2	10
EQUITY				
33. Paid-in equity from shareholders	-	18	36	25
34. Donated equity -- prior years, cumulative	-	35	49	35
35. Donated equity -- current year	114	39	2	19
36. Prior years' retained earnings/losses	-	(4)	5	7
37. Current year retained earnings/loss	(14)	12	6	3
38. Other capital accounts	114	35	49	35
39. TOTAL EQUITY	99	99	98	90
40. TOTAL LIABILITIES AND EQUITY	100	100	100	100

As of June 2000, the loan portfolio represents only 49% of the total assets, this figure is not optimum but it allows the institution to have a reserve of cash to fund the rapid growth of its loan portfolio.

The institution is currently funded through equity (convertible grants from UNDP⁸). There is no leverage from commercial loans or other kind of commercial liability yet. However, XAC management is planning to secure US\$ 1.8 million from commercial entities and socially responsible investors to fund the company growth.

5.2 Adjustment for inflation and subsidies

5.2.1 Shadow prices

Table 15 gives the price and inflation rate information used for adjusting the financial statements. These figures are based on the Central Bank of Mongolia statistics and on interest rate figures collected from local banks.

The prime rate paid by commercial bank borrowers is the average prime rate from two major commercial Banks (Golomt Bank and TDB). This rate gives an indication on the rate at which XAC could access commercial funding from banks in the local market. Projection for December 2001 and December 2002 are based on a rate of 20%, this figure is also used for cost of funds adjustments.

GDP projection is based on a 3.2% growth per year. It should be noted that inflation and interest rates are rising, putting further pressure on the local currency. Mongolia remains an uncertain environment and assumptions about future statistics should be treated with caution.

Finally, the exchange rate between the US\$ and the local currency the Tugrik per period used in this report is also presented in the table below.

Table 15: Shadow Prices

	ACTUAL				PROJECTED		
	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
Inflation rate (annual changes as reported by the Central Bank)	6.0%	8.6%	10.0%	15.5%	13%	8%	8%
Central Bank refinancing rate	23.3%	17.5%	11.4%	13.2%	n/a	n/a	n/a
Prime rate paid by commercial bank borrowers(APR)	29.4%	29.5%	29.5%	27.0%	20%	20%	20%
Per capita GDP in US\$	359.1	347.2	335.3	358.3	346.0	357.1	368.5
Exchange rate (LC/US\$) used by XAC at the end of Period	950.00	1,014.73	1,072.37	1,065.00	1,111.4	1,200.3	1,296.36

⁸ For the purpose of our trend analysis, UNDP capital grants have been classified as equity donation. However, technically and according to the legal documentation, UNDP grants should be booked as convertible loans. UNDP can indeed claims its capital grants back if XAC does not meet its performance targets and so far only US\$ 180,000 have been formally converted to equity.

5.2.2 Adjustments

Table 16: Adjustment for inflation and subsidies

	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1. Unadjusted Operating Expenses	20,114,914	55,759,896	69,393,170	107,682,832	215,178,759	775,865,538	1,215,172,321
2. Inflation Adjustment							
a. Average Equity	80,351,300	202,098,142	384,830,021	548,935,260	793,878,924	1,504,014,684	2,215,423,017
b. Average Fixed Assets	23,394,354	30,257,422	38,189,743	50,944,539	121,078,246	220,260,134	284,185,372
c. Inflation*(avg. equity - avg. fixed assets)	3,417,417	4,926,101	17,332,014	38,594,281	44,068,444	102,700,364	154,499,012
3. Subsidized Cost of Funds Adjustment							
a. Average funding liabilities	-	-	-	-	-	489,677,286	1,200,221,372
b. Opp. cost of funds*avg. funding liabilities	-	-	-	-	-	97,935,457	240,044,274
c. b. - actual cost of funds	-	-	-	-	-	(1,879,029)	36,431,904
4. In-kind Donation Adjustment							
a. Personnel	5,700,000	12,176,760	12,868,440	14,852,000	13,337,040	60,016,500	64,818,000
b. Other	-	-	2,441,000	8,495,906			
5. Adjusted Operating Expenses	29,232,331	72,862,756	102,034,623	169,625,018	272,584,243	936,703,372	1,470,921,237
6. Adjusted Operating Profit (Loss)	(23,579,379)	(39,826,110)	(12,993,148)	(37,721,704)	(67,206,585)	(93,220,639)	192,196,664

Table 16 shows adjustment for inflation and subsidies. No adjustment is made on liability until December 2001. In kind donation adjustment includes part of the cost of the UNDP MSM advisor (valued at US\$ 2,000 a month⁹) and some small donations to support XAC activities (trade fair, consulting).

5.3 Profitability

XAC has the potential to be a very profitable MFI. Table 17 indicates that XAC reached operational sufficiency in 1999 and is set to be fully viable by December 2002.

If portfolio quality stays under control and if efficiency is improved, the institution can be very profitable, an adjusted ROE over 15% is realistic for December 02.

⁹ The UNDP advisor is valued at the price of XAC top managers to express the long term needs of the institution. Total actual in kind adjustment from UNDP represents around US\$ 100,000 a year.

Table 17: Profitability

		Actual				Projected		
		Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1.	Return on Assets	-26.6%	-28.7%	11.6%	8.9%	-2.4%	3.4%	13.1%
2.	Adjusted Return on Assets	-60.7%	-42.3%	-6.9%	-12.7%	-16.1%	-4.7%	5.6%
3.	Adjusted Return on Equity	-29.3%	-19.7%	-6.8%	-13.7%	-16.9%	-6.2%	8.7%
4.	Operational Self-Sufficiency (excluding cost of funds)	28.6%	61.2%	135.8%	124.9%	101.0%	135.0%	189.0%
5.	Operational Self-Sufficiency (including cost of funds)	28.1%	59.2%	128.3%	122.5%	95.4%	108.7%	136.9%
6.	Financial Self-Sufficiency	19.3%	45.3%	87.3%	77.8%	75.3%	90.0%	113.1%

5.4 Efficiency

5.4.1 Indicators

Table 18 presents key efficiency indicators for XAC. XAC's costs are quite high compared to international best practice for individual loans. XAC's administrative efficiency ratio is of 65% for the last period to compare with a MicroBanking Bulletin¹⁰ individual loan peer group between 19% (MFI with broad market) and 29% (MFI on the low-end market).

The administrative efficiency ratio is expected to improve slightly in the following years through increase in staff productivity and average loan sizes. However, costs remain very high.

Table 18: Efficiency

		Actual				Projected		
		Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1.	Administrative Efficiency (administrative costs excluding financial costs as % of avg. net portfolio)	435.2%	155.9%	78.8%	71.3%	122.4%	92.9%	34.5%
2.	Operational Efficiency (total operational costs as % of avg. net portfolio)	441.7%	160.1%	82.6%	72.4%	129.1%	113.4%	46.8%
3.	Administrative Cost per active client (US\$)	443	159	108	133	135	122	108
4.	Personnel costs as % of total administrative costs	50.7%	56.5%	62.1%	57.5%	56.7%	59.7%	62.4%
5.	Number line staff as a % of total staff (end of period)	26.7%	41.7%	43.3%	51.0%	49.2%	40.5%	40.6%
6.	Number of active loan clients per staff member (end of period)	24	53	50	44	58	51	61
7.	Number of active loan clients per loan officer (end of period)	91	128	116	86	117	127	149
8.	Outstanding portfolio per loan officer (end of period)	9,988	15,902	18,562	15,587	20,572	34,910	49,086
9.	Number of clients per branch office (end of period)	91	255	216	194	279	317	369

5.4.2 Contributing factors

Although, XAC has a very lean operational structure, its administrative efficiency is low. Several factors can explain this disappointing performance.

- The business environment is not favorable. XAC operates in an environment with a very low population density, adverse climate and weak infrastructure (roads, electricity).
- Staff productivity is low (around 100 loans per loan officers) and below international standards (around 250 loans per loan officers). There is definitely room to improve staff productivity. For example, we noticed that loan officers spend an average 50% of their time

¹⁰ Microbanking bulletin, Issue No 4, February 2000, page 43.

in the office handling administrative tasks (reporting, cashier..). Loans officers have also no means of transportation and spend a lot of time on the road waiting for public transportation.

- The loan methodology is quite labor intensive with compulsory training for all clients and loan officer visits to both clients' home and business.
- Finally, the branch business model, a lean structure manned by 3 to 4 staff but serving only 194 clients (June 2000) and 331 clients (December 2002), is not efficient and heavy to manage. XAC loan officers/total staff ratio is low (51% as of June 2000) and is deteriorating over time.

Productivity improvements have to come with a reengineering of the methodology, better information system and the rationalization of loan officer work.

5.5 Loan portfolio analysis

5.5.1 Portfolio data

Table 19 presents consolidated data for the whole loan portfolio. Portfolio quality figures are excellent.

As of June 2000, the PAR over 30 days is at 0.6%, improving from 0.9% as of December 1999. Graduation loans are more risky (PAR 30 days at 1.2%) than working capital loan (PAR 30 days at 0.5%).

These rather good figures are not unusual for young and well managed MFIs. XAC's challenge will be to maintain this portfolio quality while at the same time scaling up its loan portfolio.

Table 19: Portfolio analysis (local currency)

	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
LOAN #1: Working capital							
1. Total principal balance outstanding, end of period	37,955,700	161,359,708	248,924,252	352,753,313	588,014,882	1,099,762,675	1,702,731,822
2. Number of active loans (clients) at end of period	363	1,276	1,503	2,072	3,500	5,203	6,954
3. Average principal balance per client (line1/line2)	104,561	126,457	165,618	170,248	168,004	211,371	244,848
4. Average principal balance outstanding over the period	18,289,425	93,320,945	211,756,779	323,927,323	496,690,686	886,110,357	1,521,308,856
5. Loan losses written off over the period	-	525,000	595,295	1,168,382	735,939	9,881,985	45,984,147
6. Increase in loan loss reserve over the period	379,557	1,615,005	3,008,691	472,107	9,302,286	17,137,577	17,622,692
7. Loan loss rate: (6) as a % of (4)	2.1%	1.7%	1.4%	0.1%	1.9%	1.9%	1.2%
8. Total outstanding balance associated with loans that are:	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
On time (and never refinanced)	100.0%	97.3%	97.5%	98.7%	96.0%	95.0%	95.0%
On time (but have been refinanced)	0.0%	0.3%	0.4%	0.4%	0.0%	0.0%	0.0%
Late (at least 1 payment) 1 - 30 days	0.0%	1.7%	1.2%	0.4%	0.0%	0.0%	0.0%
Late " 31 - 60 days	0.0%	0.7%	0.2%	0.1%	2.4%	3.0%	3.0%
Late " 61 - 90 days	0.0%	0.0%	0.3%	0.1%	1.0%	1.3%	1.3%
Late " 91 - 180 days	0.0%	0.0%	0.5%	0.3%	0.6%	0.8%	0.8%
Late " 181 - 360 days	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Late " a year or more	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9. Portfolio-at-risk delinquency rate > 30 days late	0.0%	0.7%	1.0%	0.5%	4.0%	5.0%	5.0%
LOAN #2: Graduation loan							
1. Total principal balance outstanding, end of period			9,569,387	54,822,201	84,859,636	300,289,054	460,666,446
2. Number of active loans at end of period			11	66	115	381	557
3. Average principal balance per client (line1/line2)			869,944	830,639	737,910	788,160	827,049
4. Average principal balance outstanding over the period			3,323,231	33,683,292	53,171,352	182,740,830	405,304,146
5. Loan losses written off over the period			-	-	212,681	2,316,448	8,146,817
6. Increase in loan loss reserve over the period			95,694	775,145	1,264,477	6,579,104	4,654,168
7. Loan loss rate: (6) as a % of (4)			2.9%	2.3%	2.4%	3.6%	1.1%
8. Total outstanding balance associated with loans that are:			100.0%	100.0%	100.0%	100.0%	100.0%
On time (and never refinanced)			100.0%	98.8%	96.0%	95.0%	95.0%
On time (but have been refinanced)			0.0%	0.0%	0.0%	0.0%	0.0%
Late (at least 1 payment) 1 - 30 days			0.0%	0.0%	0.0%	0.0%	0.0%
Late " 31 - 60 days			0.0%	0.0%	2.4%	3.0%	3.0%
Late " 61 - 90 days			0.0%	1.2%	1.0%	1.3%	1.3%
Late " 91 - 180 days			0.0%	0.0%	0.6%	0.8%	0.8%
Late " 181 - 360 days			0.0%	0.0%	0.0%	0.0%	0.0%
Late " a year or more			0.0%	0.0%	0.0%	0.0%	0.0%
9. Portfolio-at-risk delinquency rate > 30 days late			0.0%	1.2%	4.0%	5.0%	5.0%
LOAN #3: SME loan							
1. Total principal balance outstanding, end of period					35,919,352	485,610,552	1,145,528,120
2. Number of active loans at end of period					9	123	235
3. Average principal balance per client (line1/line2)					3,991,039	3,948,053	4,874,588
4. Average principal balance outstanding over the period					11,987,079	182,078,994	892,581,245
5. Loan losses written off over the period					90,023	3,039,573	36,063,889
6. Increase in loan loss reserve over the period					1,718,448	12,374,019	19,318,770
7. Loan loss rate: (6) as a % of (4)					14.3%	6.8%	2.2%
8. Total outstanding balance associated with loans that are:					100.0%	100.0%	100.0%
On time (and never refinanced)					90.0%	95.0%	95.0%
On time (but have been refinanced)					0.0%	0.0%	0.0%
Late (at least 1 payment) 1 - 30 days					0.0%	0.0%	0.0%
Late " 31 - 60 days					6.0%	3.0%	3.0%
Late " 61 - 90 days					2.5%	1.3%	1.3%
Late " 91 - 180 days					1.5%	0.8%	0.8%
Late " 181 - 360 days					0.0%	0.0%	0.0%

5.5.2 Delinquency measurement

Table 20: Delinquency

	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
LOAN #1: Working capital loan							
Total outstanding balance associated with loans that are:	37,955,700	161,359,708	248,924,252	352,753,313	588,014,882	1,099,762,675	1,702,731,822
On time (and never refinanced)	37,955,700	156,947,563	242,590,655	348,327,733	564,494,287	1,044,774,541	1,617,595,231
On time (but have been refinanced)	-	475,910	1,003,303	1,323,726	-	-	-
Late (at least 1 payment) 1 - 30 days	-	2,750,980	2,939,407	1,359,743	-	-	-
Late " 31 - 60 days	-	1,168,875	505,000	318,250	14,112,357	32,992,880	51,081,955
Late " 61 - 90 days	-	-	693,516	461,761	5,880,149	13,747,033	21,284,148
Late " 91 - 180 days	-	16,380	1,192,371	962,100	3,528,089	8,248,220	12,770,489
Late " 181 - 360 days	-	-	-	-	-	-	-
Late " a year or more	-	-	-	-	-	-	-
LOAN #2: investment loan							
Total outstanding balance associated with loans that are:	-	-	9,569,387	54,822,201	84,859,636	300,289,054	460,666,446
On time (and never refinanced)	-	-	9,569,387	54,163,800	81,465,250	285,274,602	437,633,124
On time (but have been refinanced)	-	-	-	-	-	-	-
Late (at least 1 payment) 1 - 30 days	-	-	-	-	-	-	-
Late " 31 - 60 days	-	-	-	-	2,036,631	9,008,672	13,819,993
Late " 61 - 90 days	-	-	-	658,401	848,596	3,753,613	5,758,331
Late " 91 - 180 days	-	-	-	-	509,158	2,252,168	3,454,998
Late " 181 - 360 days	-	-	-	-	-	-	-
Late " a year or more	-	-	-	-	-	-	-
LOAN #3: SME loan							
Total outstanding balance associated with loans that are:	-	-	-	-	35,919,352	485,610,552	1,145,528,120
On time (and never refinanced)	-	-	-	-	32,327,416	461,330,025	1,088,251,714
On time (but have been refinanced)	-	-	-	-	-	-	-
Late (at least 1 payment) 1 - 30 days	-	-	-	-	-	-	-
Late " 31 - 60 days	-	-	-	-	2,155,161	14,568,317	34,365,844
Late " 61 - 90 days	-	-	-	-	897,984	6,070,132	14,319,101
Late " 91 - 180 days	-	-	-	-	538,790	3,642,079	8,591,461
Late " 181 - 360 days	-	-	-	-	-	-	-
Late " a year or more	-	-	-	-	-	-	-
Total outstanding loan balance	37,955,700	161,359,708	258,493,639	407,575,514	708,793,869	1,885,662,282	3,308,926,387
On time (and never refinanced)	37,955,700	156,947,563	252,160,042	402,491,533	678,286,953	1,791,379,168	3,143,480,068
On time (but have been refinanced)	-	475,910	1,003,303	1,323,726	-	-	-
Late (at least 1 payment) 1 - 30 days	-	2,750,980	2,939,407	1,359,743	-	-	-
Late " 31 - 60 days	-	1,168,875	505,000	318,250	18,304,150	56,569,868	99,267,792
Late " 61 - 90 days	-	-	693,516	1,120,162	7,626,729	23,570,779	41,361,580
Late " 91 - 180 days	-	16,380	1,192,371	962,100	4,576,037	14,142,467	24,816,948
Late " 181 - 360 days	-	-	-	-	-	-	-
Late " a year or more	-	-	-	-	-	-	-

XAC uses 3 main measures of delinquency:

- 1) a synthetically consolidated ratio report, this report shows rate of repayment, portfolio rescheduling (cumulative), portfolio at risk more than one day, portfolio at risk more than 30 days, loan loss ratio (for the year 2000) and reserve ratio
- 2) an arrears aging report by branch is used to track arrears for management purposes. Note that this report also provides an analysis by type of activities, by type of products, by loan cycle and by sex.
- 3) aging of the portfolio at risk by branch The aging of the portfolio at risk is used for provisioning. Note that this report also provide an analysis by loan officers.

The portfolio monitoring system, a three page Excel sheet, is comprehensive and very detailed. The core information is updated on a weekly basis through telephone calls with the branch offices and a complete report is produced on a monthly basis. However, based on our observation, few managers and staff are able to fully analyze the data and provide detailed interpretation. Some more synthesized sheet and trend analysis may help to give all staff a better picture of the institution's performance.

5.5.3 Delinquency management

Delinquency is carefully managed and monitored by the management.

- Every week on Thursday the branches send (generally through telephone) their portfolio performance to the head office.
- The delinquency report is analyzed by the operations manager who provides recommendations for the executive committee
- The report is discussed (every Friday) during the executive committee meeting and appropriate actions are taken.

Management has stepped up firmly when delinquency rose (eg in the Ayrag sum branch) and took the following actions:

- Transferring or demoting loan officers, either temporarily or permanently
- Limiting authority to issue new loans
- Contracting police or professional agent
- Visit of Board members with a good knowledge of the community

5.5.4 Provisioning

XAC's provisioning policy is based on portfolio at risk, according to the following schedule:

- 0-30 days 1% of the loan balance outstanding
- 31- 60 days 25% of the loan balance outstanding
- 61- 90 days 50% of the loan balance outstanding
- over 90 days 100% of the loan balance outstanding

In the case of the Graduation Loan, provisioning frequency is 60 days, instead of 30. The provisioning policy takes into account loan rescheduling or refinancing, which is provisioned at 25%. Provisioning occurs on a monthly basis.

Since the provisioning policy is not based on the historical behavior of the loan portfolio, it is not clear whether it is appropriate or not.

Every month, XAC writes off loans with arrears over 120 days past the final maturity date of the loan. In addition, special write-offs of particularly problematic loans take place once a month. The Executive Committee has sole decision-making authority for writing off loans within the context of the write-off policy, and does not seek board approval. There are no specific reports on loans that are written off.

As it currently stands, XAC may over provision its loan portfolio. And as of June 2000, the loan loss reserve represents 2.7 times the portfolio at risk 30 days. XAC should consider changing the provisioning policy to base it on historical risk. The provisioning policy could then be fine-tuned to reflect actual experience. Since XAC is a relatively new institution, management may want to conduct this analysis every quarter for the next year to have more stable data on which to base its policy.

The monthly write-off policy may result in excessive write-offs. XAC may consider writing off less frequently, perhaps every quarter or six months, and report write offs to the Board.

5.5.5 Refinancing

XAC is both rescheduling and refinancing some of its loans. Refinancing and rescheduling procedures have been established but branches have shown flexibility in their application.

Refinancing. The institution has refinanced 2 loans in the year 2000 and 5 in total. Refinancing is really exceptional and has to be approved by the central office. Refinancing is generally granted on social grounds for clients facing very difficult situations.

Rescheduling. Rescheduling is more common (24 loans have been rescheduled in 2000). Rescheduling is generally originated by the branch and has to be reported to the central office on a weekly basis.

Despite criticisms from CGAP and UNDP, XAC has decided to maintain loan rescheduling but only in a few cases when the client business is still profitable and only with the head office's approval. In theory loan rescheduling should be avoided, but we recognize that XAC is cautious about it, and track separately refinanced or rescheduled loans.

5.5.6 Collection

Each month, loan officers receive a list of all clients expected to make payments on each day of the month.

The following collection procedures were adopted:

- One installment late (30 days)

- 1) Loan officer visits, agree on an appointment to come in and pay (within three days of installment missed)
- 2) Loan officer sends letter to clients (one week after installment missed)
- 3) Loan officer pays second visit with LAC members or a policeman

-Two installments late (60 days)

At this stage the loan is categorized as "contentious," and a penalty on the principle and interest balance is charged.

The loan collector pursues the following steps:

- 1) Summons client to come to XAC to pay
- 2) Takes the collateral with the support of LAC members or police

The social pressure from LAC members or local policemen seems to be effective in most of the cases, but XAC's collateral contracts are also enforced. XAC has been able to mobilize 8 collaterals from its clients so far. Six have been sold for a total value of 643,000 tug. 2 collaterals remains on XAC balance sheet but are fully depreciated (gross value is 270,000 tug).

The institution has been quite tough on loan recovery. Despite the expense, XAC does not give up on loan recovery, even for very small amounts. XAC is building the reputation for never giving up on delinquency.

5.5.7 Crisis

The institution experienced one repayment crisis in 1999 in the Ayrag Sun Branch. The management stepped up firmly and took the following actions:

- Stopped new loans disbursement
- Put the branch under conservatorship for 2 to 3 weeks, an officer from the head office was sent to manage the branch

- Contract enforcement with the help of the LAC and local police
- Rescheduling of loans and sell off debt to other clients

After 6 months, operations have returned to normal and as of June 2000, Ayrag Sun Branch portfolio at risk is 30 days at 0.9%.

The crisis was the result of a management problem at the branch level over actual vs. planned disbursement lack of adequate supervision from the head office.

5.5.8 Conclusion

XAC has adopted a good system to manage delinquency and management has proven its ability to step up and take firm action when delinquency arises. But above all, it is the well-established culture of zero tolerance for delinquency, which is making the difference. Management has successfully instilled this new culture inside the institution and promoted financial discipline outside the institution through the awareness-raising advertising campaign "Mongolians do repay their loans."

The challenge lies ahead. XAC will need to maintain this zero tolerance culture and adapt its delinquency management system to cope with the portfolio growth and product diversification.

5.6 Liquidity management

XAC currently does not experience liquidity problems. XAC has been funded by UNDP, which provided enough capital to fund the portfolio growth, the technical assistance needs and the start-up costs. UNDP funds are disbursed on a semester basis and cash represents 30% of the total assets as of June 2000.

According to XAC's Executive director; the current UNDP grant of US\$ 543,400 covers XAC's needs up to February 2001. After this date, the institution needs to find other sources of funds and secure new resources from investors (IFC, Triodos).

5.7 Interest rate analysis

5.7.1 Actual compared with theoretical interest yield

Table 21 shows that XAC's yield gap is remarkably low (3.33% on the January-June 2000 period). This small gap is the result of the quality of the information system and the quasi absence of delinquency (PAR 30 days as of June 2000 is 0.6%).

Table 21: Expected APR vs. Actual Yield (calculated on the January-June 2000 period)

		Jun-00
LOAN #1: Working Capital Loan		
1.	Theoretical interest yield (APR)	36%
2.	Percentage of total outstanding (average) net loan portfolio	91%
3.	(1) times (2)	32.6%
LOAN #2: Investment loan		
1.	Theoretical interest yield (APR)	30%
2.	Percentage of total outstanding (average) net loan portfolio	9%
3.	(1) times (2)	2.8%
4.	Total Weighted theoretical interest yield (APR)	35.4%
5.	Actual yield on portfolio	34.2%
6.	Yield Gap Ratio: (5) as a percentage of (4)	96.67%

5.7.2 Rate setting

XAC enjoys a very high Net Interest Margin (NIM is 72% as of June 2000). This high interest margin is the result of the high effective rate charged on its loan portfolio and the quasi absence of liability.

The NIM is expected to significantly decrease in the future because of competition pressure and rising cost funds.

To cope with the contraction of the interest margin, XAC's management has to be prepared to significantly improve operational efficiency.

5.7.3 Legal constraints

There are no legal constraints in Mongolia that limit the interest XAC can charge on its loans.

5.7.4 Comparable rates

XAC's effective interest rates are significantly higher than those charged by NBFIs in a slightly higher market niche (Credit Mongol is charging an effective rate of 36% per year in local currency for SME loan over US\$ 1,000). But XAC's rates are lower than rates charged by moneylenders or Pawnbrokers (between 120-180% in Ulaanbaatar) or credit unions which charge as high as 60% per year in US\$.

5.8.1 Composition of Liabilities

XAC has no commercial liabilities at this time. However, in May 2000, XAC negotiated a bridge loan from a local commercial bank with an effective rate of 43.6%.

The Business Plan considers mobilizing US\$ 1.8 million in loans from socially responsible investors and commercial investors.

It is also worth to mention that XAC is planning to offer savings accounts (time deposits) to its clients starting in 2001. However, the impact of this product seems marginal, the projection for time deposits represents only 1.3% of the total assets in December 2002. XAC would need to get a banking license to launch such a product and develop a comprehensive product development plan (including pricing, costing, marketing plan and MIS/accounting implication).

5.8.2 Cost of funds analysis

As shown in Table 22, XAC's liabilities for the year 2001 and 2002 are subsidized. XAC average cost of funds for loans in local currency is 10% in 2001 and 17% in 2002 while the assumed commercial rate in the local market varies from 20% to 40% (adjustment on liability has been made with a rate of 20%).

Considering Mongolia country risk and the currency risk, it might be difficult to attract commercial and socially responsible investors over the long term with an interest rate below 20%.

Table 22: Cost of Funds Analysis

		Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1.	Interest and Fee Expense	-	58,333	-	99,814,487	203,612,370
2.	Average Funding Liabilities	-	10,000,000	823,962,207	955,933,065	1,200,221,372
3.	(1) as a percentage of (2)		42.0%		10.4%	17.0%

5.8.3 Commercial liabilities

As of June 2000, there are no commercial liabilities. Considering the limitations of the local financial sector and the cost of funds in the local market, XAC is planning on leveraging a mix of loans from socially responsible investors and banks in Mongolia as soon as 2001.

Table 23: Commercial liabilities

		Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1.	Commercial Liabilities	-	-	-	-	-	972,180,972	1,372,180,972
2.	Donor/Government Guarantees							
3.	Net Commercial Liabilities	-	-	-	-	-	972,180,972	1,372,180,972
4.	Total Assets	101,055,325	331,284,404	498,921,309	718,766,894	947,416,717	3,047,893,914	3,783,394,863
5.	(3) as a percentage of (4)	0.0%	0.0%	0.0%	0.0%	0.0%	31.9%	36.3%

5.9 Capital management (solvency)

5.9.1 Equity multiplier

Table 24 gives XAC's leverage position over time. XAC is currently funded through equity, which represents over 90% of the institution's assets (we have treated all UNDP capital grants as equity donation). The institution's plan is not to maximize its leverage (up to 4 or 5) to improve profitability but to increase its capital base to reach the minimum capital requirement (US 2 million) necessary to apply for a banking license. As a consequence, the equity multiplier is increasing only slightly up to 1.8 as of December 2002.

Table 24: Equity Multiplier

	Dec-98	Jun-99	Dec-99	Jun-00	Dec-00	Dec-01	Dec-02
1. Total Assets, end of period	101,055,325	331,284,404	498,921,309	718,766,894	947,416,717	3,047,893,914	3,783,394,863
2. Total Equity, end of period	100,479,750	329,432,510	490,994,617	648,267,822	939,490,026	2,068,539,343	2,362,306,692
3. (2) divided by (1)	99.4%	99.4%	98.4%	90.2%	99.2%	67.9%	62.4%

5.9.2 Sources of equity

Currently, 90% of XAC's \$608,000 in equity consists of UNDP funds. US\$ 180,000 represents UNDP grants to the founding NGOs to finance their participation in XAC, while the remainder are capital grants convertible to equity subject to XAC's performance (UNDP a performance based contract signed with XAC). Finally, a small but growing proportion of XAC's equity comes from retained earnings.

5.9.3 Capital planning

XAC needs to build its equity base. Current plans include:

- 1) Triodos Bank (\$ 400,000). XAC is negotiating with Triodos Bank, a small bank based in Holland, with affiliates in Germany and Belgium. Triodos is one of a leading socially responsible investors in Europe involved in microfinance. Triodos undertook an appraisal mission in Mongolia in July 2000. A convertible loan of US\$ 400,000 is scheduled to be released before the end of the year. The investment decision was taken at the end of August 2000 and the terms of the loan contracts are currently under negotiation.
- 2) IFC (\$500,000). IFC identified XAC as a possible investment in September 1999. The preliminary appraisal mission conducted by IFC in August 2000 has been positive and IFC is preparing an investment proposal for its investment committee. IFC is considering an investment in the form of equity or quasi-equity of US\$ 500,000. It is worthwhile to mention that IFC in collaboration with CGAP is also providing XAC with a technical assistance package of US\$ 300,000 to strengthen the institution's governance, internal control and external audit. This technical assistance program started in June 00 with a CGAP-sponsored mission on internal control and will continue in 2000 and 2001 with short-term missions on governance and business planning to be conducted by the consulting firm FACET. Finally IFC has started to discuss with XAC another technical assistance package to strengthen the institution's MIS and governance for the year 2001 and 2002.
- 3) Other. XAC also had a preliminary discussion with the Asian Development Bank, (private group) the European Bank for Reconstruction and Development, German KfW and the Soros Foundation.

ANNEX I: PEOPLE MET DURING OUR MISSION IN MONGOLIA

1- XAC – CENTRAL OFFICE

Mr. GANHUYAG Chuluun- *Executive Director*
Ms. DOLJINMAA Dorjpurev- *Operation's Manager*
Mr. BAT-OCHIR Dugersuren - *Finance Manager*
Ms. ERDENECHIMEG Dorjgotov – *Internal Auditor*
Ms. DELGERJARGAL Bayarjargal – *Research and Development officer*
Ms. BATAA Byambadorj – *Office Manager*
Ms. BOLORMAA Gansuh – *Planning and Analysis Specialist*
Ms. PUREVSUREN Dorjpalam - *Accountant*
Ms. ZULAA Ganzorig - *Personnel Officer*
Mr. BATBOLD Aryasuren – *Administrations Officer*
Mr. ROBERT CATER –*UNDP MSM Senior Advisor*

2- XAC BOARD OF DIRECTORS

Ms. Ts Enkhtuya - *Board Member of LEOS, Chair and Founding member of Moncord Credit Savings Cooperative, Chair of the Board of Directors of X.A.C. LLC.*
Ms.Ch.Doljinjav – *Former Executive Director and Member of the Board of Local Governance Development Foundation and Lecturer of the Tsetsee Goun Management College*
Mr. N.Nadmid – *President of National Association of Mongolian Agricultural Cooperatives.*

3- XAC INTERNAL AUDITING COMMITTEE

Mr. Jargalsaikhan, *Chair of Internal Audit Committee and Advisor of TASIC project*
Ms. Darisuren – *Director of Technotrans Co.LTD.*
Ms. Odonchimeg –*Project Officer of Mongolian Women's Federation*

4- INTERNATIONAL ORGANIZATIONS AND FINANCIAL INSTITUTIONS

Ms. D. Sukhjargalmaa – *Assistant Resident Representative UNDP Mongolia*
Mr. Natsuki Hiratsuka – *Deputy Resident Representative, UNDP Mongolia*
Ms. Shannon Atkeson, - *Resident Representative, IFC*
Mr. Munhbat, - *Fund Manager, Mongolian Small Business Fund (Credit Mongol)*
Mr. Suzuki, - *Chief Executive, Goviin Ehlel Company, Ltd.*
Ms. Oyunjargal, - *Chief Operating officer, Goviin Ehlel Company, Ltd.*
Mr. Javhlan, - *Agricultural Bank*
Mr. Ganhuyag, - *Director of Relations Relations, Golomt Bank*

5- GOVERNMENT

Mr. UNENBAT - *Governor, The Bank of Mongolia*
Ms. Enkhjargal, - *Director, Supervision Department Bank of Mongolia*
Mr. Erdenebayar, - *Director of Legal Department and Member of the Policy Board, Bank of Mongolia*
Mr. Ichdorj, *Governor of Sainshand aimag (province)*
Ms. Ts.Badia, *Chairman of the Aimag's Citizens Representative Meeting*

ANNEX II: XAC BOARD OF DIRECTOR

	Name	Job Position	Institutional Affiliation
1	Tsend Enkhtuya (Chair)	Member of the Board of Directors	Liberal Women's Brain Pool
2	Nansaljav Gerelsuren	President	Mongolian Women's Federation
3	Ch. Doljinjav	Executive Director	Local Governance Development Fund
4	D. Khurelbaatar	Director of Client Services Department, Trade and Development Bank	Local Governance Development Fund
5	Natsagdorj Nadmid	President	National Association of Mongolian Agricultural Cooperatives
6	Ravdan Samdandovj	General Secretary of Mongolian Redcross Society	National Association of Mongolian Agricultural Cooperatives
7	R. Burmaa	Member of the Board of Directors	Mongolian Open Society Foundation - SOROS Foundation
8	Dugersuren Sukhjargalmaa	Assistant Resident Representative	UNDP – Mongolia

ANNEX III: CODE OF CONDUCT FOR XAC EMPLOYEES

Extract of XAC's employees code of conduct

1. Respect the interests of the clients; provide fast, good quality services not discriminating them according to their appearances and relations.
2. Maintain the reputation of the institution free from politics, religion and other factors.
3. Do not use the advantages and opportunities the position gives for personal purpose. Do not receive gifts and incentives, which will place you in position of being obligated before others. Do not use bureaucratic approach.
4. To manage the job for which one is responsible fairly and truly, maintain friendly relations with the team and clients.
5. Strictly comply the activities with the laws and regulations of Mongolia, internal policies and procedures of the institution.
6. Protect the confidentiality of information related with the clients and institution, and not to distribute the information on internal affairs of the institution to the public.
7. Take initiative on the job for which one is responsible, be attentive to constantly developing yourself, and conduct the duties and responsibilities in highly professional manner.
8. Strictly comply with the financial discipline.
9. To maintain the team spirit and respect the interest of the team.

ANNEX IV: LIST OF MATERIALS DEVELOPED BY XAC.

XAC has developed an impressive list of policy documents, manual of procedures, handbooks, and training materials.

1- Institutional, Financial, Credit Policies and Procedures

1. Articles of Association
2. Credo
3. Code of Conduct
4. Staff Policy
5. Volunteer Policy
6. Accounting Policies and Procedures
7. Financial Reporting Forms
8. Credit Recording and Reporting System
9. Policy on Loan Classification and Loan Loss Provisioning
10. Working Capital Loan Policy
11. Investment Loan Policy
12. Employee Loan Policy
13. Loan Approval Committee Policy
14. Loan Delinquency Policy

2- Handbooks

1. Growth Management (in English and Mongolian)
2. Microfinance Governance Manual
3. Microfinance Handbook (translation into Mongolian)
4. English-Mongolian Microfinance Dictionary

3- Workshops, Seminar and Meeting Materials

1. MSM Advisory Committee Meetings
 - A. MAC Terms of Reference
 - B. Year Business Plan 1999-2000
2. SEMINARS AND WORKSHOPS
 - A. National Seminar on Institutional Options and Legal Framework For Microfinance. Held on 16th November.
 - Legal Framework for MFIs in Other Countries
 - Speech of Mr. Robert Carter (MSM Program Manager)
 - Mongol Bank Policy on Non-Bank Financial Institutions in Mongolia
 - Speech of Mr. Ts. Ganhuyang (Member of Parliament)
 - History of the Development of Non-Bank Financial Institutions
 - Speech of Mr. S. Ganbold (Consultant of Consulting Unit)
 - Press Materials
 - B. Business Plan Workshop
 - C. 5 Year Business Plan 2000-2004

4-Training Materials

1. International microfinance training materials
 - Principles of Successful Microfinance Institutions
 - Experience of other Microfinance Institutions
 - World Bank: Determination of Interest Rates for Sustainable Microfinance Institutions
 - Guiding principles for Selecting and Supporting Intermediaries
 - Microcredit discipline
 - Internal Control
2. MicroStart / XAC / Internal Credit Training Materials
 - Review of Market Survey
 - Designing a Loan Methodology
 - Preventing from a Loan Delinquency
 - Credit Policies and Methodologies Manual
Clients: Individual and Group Loans
 - Loan conditions (credit size, credit term, repayment, duration)
 - Incentive system
 - Penalty system
 - Clients Training Program and Materials
3. MicroStart / XAC / Social Training Materials
 - Participation, Participatory Methods
 - Gender Issues
 - Customer Service Manual
 - Ethics
 - Work Plan
 - Business Plan

5- Trip Reports

1. Bosnia trip report
2. Bangladesh trip report

6- Surveys

Client Satisfaction Survey

- Questionnaire
- Results
- Analysis