

**APPRAISAL DOCUMENT FOR
MICROSTART MONGOLIA**

Special Unit for Microfinance - UNDP

July 1999

INTRODUCTION

This institutional appraisal was conducted in June 1999 by Heather Clark, Director of the MicroStart Programme and Principal Technical Advisor of UNDP's Special Unit for Microfinance, and Maria Paula Carvajal, Programme Officer for Asia and Latin America. The purpose of the appraisal was to review the operations of MicroStart Mongolia approximately a year after inception in order to establish an objective written record of performance as the organization makes the transition to a formally licensed microfinance institution from an NGO structure. The review focused on analyzing performance and areas that would promote or hinder charting a smooth course for the future. The appraisal was carried out using the CGAP Appraisal format that is becoming the standard in the field. Additional components were added to this review that focus on legal, regulatory, ownership and governance issues, as well as programme support issues that are germane to UNDP supported efforts and the MicroStart model. For a comparative analysis of performance of X.A.C with other institutions, the reader can refer to data presented in the MicroBanking Bulletin.

The intended audience for this document is primarily the people involved in the XAC operations including the staff, Board of Directors and UNDP Mongolia who started and supported this initiative. The appraisal will also be presented to potential investors. The document is important to SUM's learning agenda, particularly, how to best support start-ups. As the report is intended for slightly different audiences, there is information that will extraneous to one audience and essential to the other.

ACKNOWLEDGEMENTS

We would like to express our deep appreciation to the MicroStart Mongolia and X.A.C. staff, board members and the UNDP Country Office staff and leadership for their assistance during our mission. X.A.C. staff maintained an open and helpful attitude during our stay, answering our many questions with the same openness, sincerity and patience that we found in their current operations, their analysis of the past and their plans for the future.

Our special acknowledgement goes to Robert Cater, the resident technical service provider, whose insights and analysis enriched our work. Robert was instrumental in helping develop the institution as we know it, and as we have documented it today. His dedication to staff development and ability to recruit a capable and qualified staff who embody the spirit of a "business with a social mission" will continue to contribute to the institution's growth and development.

Special thanks go to the UNDP Country Office Resident Representative, Douglas Gardner, who is tireless in his support for MicroStart Mongolia and unmatched in his ability to create the space for this unique institution to blossom and growth. We also wish to thank D. Sukhjargalmaa, who nurtured this fledgling institution. We will miss her as she goes on to other important duties. We also thank Bruno Pouezat for his insightful analysis about future plans and promise, and Batkhuyag who is currently entrusted with the support and growth of this new institution. Special recognition goes to the members of the MAC who set ambitious goals and have (almost) completed a job well done.

We would also like to thank the Board of X.A.C. There are many challenges ahead of you and we are confident that these tasks will call for the creativity, the skills and the insights you expressed in our meetings as you uncover the demands setting historical precedent has placed on you. We encourage you in this endeavor.

We are certain that in another year we will see the growth of X.A.C. into the first non-bank financial intermediary in Mongolia. Questions have surfaced about whether the people associated with X.A.C. have contributed all they have to give and whether their duties have been completed. Our short answer is: “you have only just begun”.

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Special Unit for Microfinance
UNDP

ACCRONYMS

UNDP	United Nations Development Programme
LEOS	Liberal Women's Brain Pool
MWF	Mongolian Women's Federation
X.A.C.	Golden Fund for Development
NGO	Non Governmental Organization
MHSW	Ministry of health and Social Welfare
MIS	Management Information System
NBFI	Non Bank Financial Institutions
MFI	Microfinance Institution
MSM	MicroStart Mongolia
BOD	Board of Directors
ITSP	International Technical Service Provider
LTSP	Local Technical Service Provider
ADB	Asian Development Bank
LAC	Loan Approval Committee
IFC	International Finance Corporation
ACDI/VOCA	Agricultural Cooperative Development International/ Volunteers in Technical Assistance

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EXECUTIVE SUMMARY

A. Key Data

Table # 1: Summary of Key Data

	ITEM	ACTUAL		PROJECTED	
		Jan-99	May-99	Dec-99	Dec-00
1.	Number of currently active loan clients	398	1,146	1,550	3,600
2.	Total outstanding loan balance (US\$)	41,710	134,571	294,638	724,985
3.	<u>Average loan balance per client</u>	105	117	190	201
4.	Number of voluntary savings clients	-	-	-	-
5.	Total balance of voluntary savings accounts (US\$)	-	-	-	-
6.	<u>Loan loss rate</u>	0.0%	0.6%	3.3%	5.5%
7.	<u>Delinquency rate (portfolio at risk basis > 1 day late)</u>	0.0%	0.2%	7.4%	12.7%
8.	<u>Administrative efficiency</u>	127.4%	65.3%	48.8%	47.1%
9.	<u>Portfolio yield</u>	57.6%	72.1%	85.3%	72.2%
10.	<u>Operational self-sufficiency</u>	28.5%	48.9%	74.0%	127.0%
11.	<u>Return on average assets</u>	-29.5%	-18.1%		
12.	Adjusted return on average assets	-42.9%	-30.1%		
13.	Year-end free market exchange rate	910.00	1,000.00	1,000.00	1,000.00
14.	<u>Per capita gross domestic product (US\$)</u>	433	433	433	433

B. Summary of Major Conclusions and Recommendations

1. Background:

On June 26, 1997 the MicroStart Project Document was signed by the Government of Mongolia making Mongolia the second country to begin operations as part of the UNDP Global MicroStart Pilot Programme. At the beginning of 1998, ACVDI/VOCA was selected as the International Technical Service Provider (TSP). By August 1998, ACDI/VOCA had fielded an international technical advisor for a period of 18 months to guide the programme's activities.

Two local NGOs were initially selected to participate in the MicroStart Programme, Mongolian Women's Federation (MWF) and the Liberal Women's Brain Pool (LEOS). X.A.C. (which in Mongolian means "Golden Fund for Development") was created as a local organization which would serve as the central credit office for the NGO lending activities. Under MicroStart Mongolia, X.A.C. and the NGO programmes consolidated into one operation which now has 5 branches, two in the capital, Ulaanbaatar and three more in rural areas. On September 28, 1998 the first loans were disbursed. In May 1999, the institution applied for a license to operate as a formal financial institution.

2. General Assessment

The MicroStart programme is attempting to create a new structure and a new way to do business in Mongolia. There is a clear demand for microfinance services in Mongolia and X.A.C is currently the only institutional approach serving this market. The operation is young, but in its initial stages it has developed a client responsive, transparent and relatively efficient operation while maintaining high portfolio quality and targeting profitability.

Local Financial Sector

X.A.C. has the potential to become something significant in the local financial sector. Not only is X.A.C. an important source of credit for a population who does not have access, but it is a new type of institution within

the formal financial sector that is an innovative business operation with a social objective. It is further distinguished from other formal financial institutions in the country because it maintains high portfolio quality, transparent operations and embodies a staffing structure that is based on merit, performance and a high set of standards.

Staff Capacity

In a short period of time, through the ITSP representative Robert Cater and core staff, X.A.C. has assembled a team that is dedicated, qualified and capable. Staff is responsive to clients and a market driven approach is evident in all X.A.C. operations. It is striking how staff assembles information and analyzes experience, applying lessons to improve operations. The organization is a dynamic learning organization with demonstrated problem solving skills. These are particularly important skills for any organization and they will serve X.A.C. well as it matures and confronts the challenges of growth, such as competition in the marketplace, developing more complex systems, and expanding and diversifying products and services.

Market and Poverty

- Market Penetration: X.A.C. estimates a potential market for microfinance services in Mongolia of approximately 77,000. Using this rough calculation, X.A.C. is serving about 1% of the potential market.
- Market Strategy: In the Mongolian context with small populations grouped in areas with great distances among them, X.A.C. needs to develop a vertical market penetration. This means that in order to be sustainable, X.A.C. will have to target more than one segment of the population in which it works, rather than a mono-product horizontal market penetration practiced by MFIs in other parts of the world with large population concentrations.

Product

X.A.C. began offering both group and individual loans, but is in the process of phasing out the group loans. It will introduce a new loan product in July of 1999 and will begin developing consumer and cooperative loan products during the third quarter of 1999. X.A.C. appears to proceed carefully piloting activities before making them fully operational. The review team encourages X.A.C. to take this same approach to product diversification, paying particular attention to additional administrative costs required to manage four loan products effectively.

Methodology

X.A.C.'s methodology seems to be appropriate for the country and context in which it works. Potential clients undergo an application process that includes visits to their homes and businesses and attendance at compulsory training. This ensures the appropriate background check that has enabled the institution to maintain excellent levels of repayment. The complete process takes an average of 14 days to complete for first cycle loans.

The review notes two aspects of the methodology that X.A.C. should re-examine. First, the time it takes for a client to access repeat loans appears excessive. The process could be expedited to increase client satisfaction and improve portfolio turn. Secondly, compulsory training includes business planning. Although the topic appears to be of interest to many clients, it is a complex one, which makes it difficult to offer it in one session. Therefore, X.A.C. should consider offering this more specialized training outside the compulsory credit training to improve quality, depth and client satisfaction. The review team encourages X.A.C. to further explore its pilot efforts in arranging for business development services to be provided independently by local entrepreneurs.

Delinquency

X.A.C. has maintained on time repayment rates well above 95% in most branches. Portfolio at risk greater than one day late measured on an outstanding balance basis is 2% of the outstanding portfolio on May 31, 1999. To date, X.A.C. has written off \$495 as bad debt, which translates to a loan loss rate as of May 31, 1999 of .6%. The consolidated non-performing loan portfolio of the commercial banking sector in Mongolia was 38% at the end of April 1999 (Source: Central Bank of Mongolia).

Financial Viability

X.A.C. has made significant strides in improving financial performance during the past five months. This growth has enabled it to move from 30% Operational Self-Sufficiency to 53% in the five month period from January to May 1999. These figures do not include the cost of ACDI/VOCA technical assistance, which gradually phases out over the next two years. The growth rate is impressive.

X.A.C. plans to expand operations by adding four additional branches (2 in August 1999 and 2 in April 2000) and develop new lending products. This will mean higher costs and lower rates of productivity during the short term, before the investment in expanded capacity and diversified products pays off. After 9 months of operation, four out of five branches are covering all cash operational expenses. Income and expenses for May 1999 were approximately \$900 from break-even for the entire operation, including Central Office expenses. Since September 1998, the operation has accrued an operations deficit of \$37,387, which is covered by grant funding and owner equity. The deficit is likely to be recovered from operations by the end of the year, assuming X.A.C. maintains current growth rates. However, plans do call for expansion. Additional financing, preferably through a mix of grants, equity contributions and soft loans, will be required.

3. Challenges and Recommendations:

The major challenges for X.A.C are the natural challenges faced by an institution as it transforms from an NGO structure into a formal financial institution; namely issues of governance and ownership.

Ownership and Governance

X.A.C. Board members are institutional seats rather than individuals. Board members have been representing their respective NGOs, and have built an expectation of NGO affiliated branch performance and remittance of dividends rather than the performance of the entire operation and the amount of re-investment that will be required for the health and sustained growth of the company. In addition, a poor precedent was set during the pilot phase when all interest earnings were returned to the “NGO owned branches”. This action allowed the board to expect dividends at a stage when none were due, heightened the prospect that dividends would be that large that quickly, and re-inforced the mentality that each NGO owned a branch, while no one owned the company.

The Board needs to develop a vision for the health of the company as a whole rather than focusing on the performance of individual branches. A focus on the earnings of the individual branches at the expense of the company as a whole, or viewing the company as a “cash cow” to finance NGO efforts will inevitably weaken the company, its potential earnings over the long-term and its contribution to Mongolia’s financial sector.

Board Training and Board Committees

Over the next few months X.A.C. will have to dedicate time and energy to Board orientation and training. The Board recognizes that their responsibilities in running a finance company are new to them. This report stresses the importance that is placed on the Board’s own suggestion that a great deal of attention be paid to Board training. Board training needs to focus on:

- Clarifying Board vision for the company
- Understanding the financial aspects of the company and clarifying financial expectations
- Obtaining an understanding of the fiscal prudence and responsibilities required for the effective functioning of a private sector entity.
- Defining roles and responsibilities of the Board and management, including developing a clear division between the two roles and functions and establishing structural autonomy.
- Gaining a commitment of loyalty to the company and the commitment of Board members to subordinate their institutional interests to the interest of the financial and institutional health of the company.

- Establishing a partnership and common vision between Board and staff.

A search of a socially responsible private investor

The search for a socially responsible private investor or investors group should begin in earnest. A local investor group or an international equity fund set up specifically for this purpose should be considered to provide a balance for the company as well as a healthy array of investors that spread the risk. Emphasis must be on recruiting investors with strategic long-term objectives. A board committee with management input should be organized to expand private, socially responsible ownership.

Politics, Politics

X.A.C. should develop a “code of conduct” at the institutional level for staff, loan approval committees and board members during the 1999/2000 campaigning and election period. It is essential that the organization remain above politics. The penalty for political activity that compromises the neutrality of the institution should be severe.

Operational Policy

X.A.C. has developed a thorough set of systems, standard procedures and operational and administrative policies. The systems, reporting and type of information generated is excellent and used by management to make decisions. The review comments on the following areas:

- Cash control needs to be improved. Cash counts are performed once a week, but should be performed daily.
- Security needs to be improved. Larger more secure safes should be installed, branches should keep excess cash in safety deposits where possible, or safes should be set permanently into the floors. Additional efforts should be made to keep cash secure and out of sight of branch visitors.
- Clear policies need to be developed on: loan write-offs, re-scheduling, collateral seizure, and certain aspects of collateral, such as limits on collateral, particularly for 1st time loans, and appropriate valuation of collateral.
- The value of co-signer guarantees and prohibitions on credit officer guarantees are elements of operational policy that need to be reviewed.
- X.A.C. information collection allows the organization to review trends and identify problems, such as the source of delinquency by loan type, branch or credit officer. Information on income, yield gaps and trends in portfolio size and income and branch costs will enable X.A.C. to monitor branch performance and identify where problems may exist by comparing monthly branch reports with previous trends in performance and inter-branch performance.

4. Lessons for the MicroStart Programme

MicroStart Model

As a learning programme, MicroStart endeavors to keep abreast of experiences in the field and revise policies and procedures as appropriate.

ITSP

Robert Cater has been able to deliver what many MicroStart programmes long for. He is aware that X.A.C. is building a lasting institution, and has given attention to staff development at all levels of the organization. It is important for MicroStart to note that resident advisors are essential in countries where microfinance is young and institutions are new.

MicroStart Advisory Committee

The MAC has completed its purpose as stated in the original mission of the MAC, which is to ensure the viability of the institution beyond the duration of the programme. It is simply ahead of schedule. The last act of

the MAC should be the approval of MicroStart-X.A.C. as a financial institution. MAC members agreed that the MAC should hold its final meeting when the company is licensed by the Central Bank, and the X.A.C. Board of Directors (currently an Ad Hoc Board) is installed.

- There should be an official transfer of responsibility to the X.A.C. Board of Directors and minutes that record the dissolution of the MAC and the creation of an alternative oversight function.
- A new body will be created that will be responsible for the oversight of project activities, such as funding authorizations, disbursements and monitoring. The body will include one representative and/or designate from the MHSW and the UNDP.
- In its donor oversight role, UNDP will appoint a staff member or an outside representative designate as an “Advisor” to the Board until the end of the agreement or until such time that the deferred liabilities are transferred as equity to the institution. This position will have a voice but no vote. The purpose of this position is to ensure the X.A.C. board is aware of UNDP procedures, guidelines, and conditionalities. It is the opinion of this review that the appointee advisor be fully knowledgeable of the administrative procedures and contractual obligations of the agreement in addition to understanding the delicate balance between influence and control.

MicroStart restrictions

In a context with limited monetary and personnel resources, an approach of working with 5 – 7 organizations with a maximum of \$150,000 per organization may entail a delusion of resources that can limit the growth of the organizations. In the context of Mongolia, the grant ceiling of \$150,000 to one institution is a factor limiting the options for growth. Under these arrangements X.A.C. is forced to consider partners and paths that are not optimal, such as continuing to seek additional NGO investors when a larger grant to X.A.C. to cover operational expenses and portfolio growth would be more appropriate and institutionally more desirable. MicroStart Mongolia is an example of what could be accomplished if resources were concentrated and expansion achieved within the same institution.

5. Future Funding

Proposal to the Government of Finland

X.A.C. is at a critical stage in its development as it transitions to a non-bank financial institution. Additional funding of \$650,000 is required for portfolio growth, international technical assistance for an additional 18 months, and institutional development.

- Efforts will be directed to expanding new branches, and piloting new products to reach a more diverse market. US\$ 330,000 is sought to expand operations.
- A continuation of the current technical assistance contract for an 18 month period and short-term specialized international technical assistance will be sought to assist staff to develop savings products, and staff equity options plans. US\$ 180,000 is sought for resident technical assistance (US\$150,000) and short-term specialized technical assistance (US\$30,000).
- Over the next 18 months, board training will be intensified, a staff development program with the local university will be launched, an integrated computerized MIS will be installed that links branches to the center, and additional work will be required on the legal and regulatory framework. These institutional development efforts are estimated at US\$ 100,000.
- Funding in the amount of US\$40,000 is included to cover monitoring, evaluation and UNDP overhead.

I. INSTITUTIONAL FACTORS

C. Legal Structure

MicroStart Mongolia (MSM) - X.A.C. currently operates under the legal auspices of the NGO Sant Maral. In May, 1999, X.A.C., the Golden Fund for Development, applied for a license to become a Non-Bank Financial Institution (NBFI) under new legislation pending in Parliament. X.A.C will register as a non-bank shareholders finance company, in accordance with the Partnership and Company Law and the Banking Law of Mongolia. An agreement was signed on May 18, 1999 by the Liberal Women's Brain Pool (LEOS) and the Mongolian Women's Federation (MWF) to establish a private finance company. LEOS and MWF are the two NGOs which have received Micro Capital Grants as part of the MicroStart Programme. By-laws for the finance company have been approved by both founding members. Once licensed and registered the new company will be able to provide credit anywhere in the country. The NBFI regulation allows savings mobilization and other financial transactions but these are limited through institutional definition and licensing procedures – only for savings and loan cooperatives.

D. History

1. Start-up

The MicroStart initiative launched by UNDP is an international pilot programme intended to contribute to poverty alleviation efforts through the development of the microfinance sector. A project document was signed on June 26 1997 between the UNDP Country Office in Mongolia and the Ministry of Health and Social Welfare (MHSW) which approved the MicroStart project to provide technical and financial support to start-up local microfinance operations.

MicroStart Mongolia (MSM) became operational in July, 1998 with the arrival of the ACIDI/VOCA technical advisor, Robert Cater. Sant Maral, a locally registered NGO, provided the legal umbrella for the operation. In August 1998, three local institutions received microcapital grants, Sant Maral, LEOS and MWF. Sant Maral acted as the MicroStart X.A.C. legal umbrella and provided central office and staff support, but did not establish branches. There are currently five branches: Sainshand and Ayrags opened under MWF auspices in September 1998 and October 1998, respectively, Henti and Ulaanbaatar (Chingeltei) opened under LEOS auspices in October 1998 and November 1998 respectively and the latest branch, Ulaanbaatar (Bayanzurh) opened directly by X.A.C. in February, 1999.

To date, UNDP Mongolia is the only donor providing funds for the technical support and operating expenses of X.A.C. The Soros Foundation has provided funding for three MSM staff to participate in international training activities during 1999. A new budget has been presented to UNDP and the Ministry of Health and Social Welfare as of May 1st 1999. Given the consolidation of the different branches under X.A.C., the budget is for US\$134,481 for a 4-month period that will be disbursed directly to X.A.C.. The grant amounts and approval dates for the participating NGOs are presented below.

Table # 2: Total Amount of Funds provided to X.A.C.

#	Organization Name	Approved Date	Received Date	Funding in US	Funding in Tug	Exchange Rate
1	X.A.C.-Santmaral	8/17/98	8/27/98	45,660.00		
		1/20/99	2/8/99	43,763.28	40,262,219.00	920.00
	Total			89,423.28	40,262,219.00	
2	MWF	8/17/98	9/8/98	18,016.00		
		8/17/98	10/29/98	18,016.00		
		1/20/99	2/8/99	35,433.81	32,599,104.00	920.00
	Total			71,465.81	32,599,104.00	
3	LEOS	8/17/98	9/24/98	25,867.50		
		8/17/98	12/16/98	25,867.50		
		1/20/99	2/8/99	48,025.02	44,183,018.00	920.00
	Total			99,760.02	44,183,018.00	
	Total Amount Received in USD			133,427.00		
	Total Amount Received in Local Currency			127,222.11	117,044,341.00	920.00
	Total Amount in USD			260,649.11		
4.	X.A.C.	Pending		134,481		
	Total funding including pending approval (US\$)			395,130.11		979.00

2. Transition to a Finance Company

In April 1999, MicroStart Mongolia - X.A.C. began a concerted effort to consolidate the NGO projects financed under MicroStart Mongolia to operate more efficiently and build a base for the future. If the X.A.C. application for an NBFI license is successful, it will become the first finance company licensed under this new regulation. The Standing Committee on Economic Policy has already approved the statute. The Central Bank is supportive of this new legal and regulatory regime, and is currently working on a framework that will support the growth of NBFI's, and strictly monitor their performance. The Central Bank is also supportive of the X.A.C. license.

Due to its short history and rapid development, X.A.C. is in the process of transition from an NGO to a finance company and also from a "project and its NGO sub-projects" to a formal financial institution. It is relatively uncommon for these two major transitions to be taking place simultaneously.

One of the key issues in this review is this transition. X.A.C. recognizes the attention that must be devoted to these transitional processes. The two-year business plan designates as the main priority "the consolidation of our transition from that of being three separate projects to becoming a fully functional Private Finance Company." Areas that have been highlighted as priorities are the organizational structure, ownership and governance. These are discussed in the next section.

3. X.A.C Performance

In nine months since start-up, X.A.C. has shown steady financial performance and market responsiveness.

Table # 3: Summary of Key Data for the Nine-Month Period (September 1998 – May 1999)

	December 31, 1998	May 31, 1999
Number of active clients	398	1,146
Total Outstanding Loan Balance (US\$)	41,710	134,571
Average Loan Balance per client	105	117
Loan Loss Rate	0	.6%
Delinquency Rate (portfolio @ risk > 30 days	0	.2%
Administrative efficiency	127%	65%
Portfolio Yield	57.6%	72.1%
Operational self-sufficiency	28.5%	48.9%
% female clients	82%	77%
Per capita cash GDP	433	433

The main characteristics of X.A.C. institutional performance to date are: attention to standardized systems, high quality of staff recruited and detailed attention to training, building a system of checks and balances within the operations of the organization, and transparent systems that are intrinsic to the operation. A few indicators of this transparency are:

- Installment repayment reports are posted on branch walls,
- The names of clients for whom loans are approved are posted in the branch,
- Branches are run as profit centers,
- Branches receive monthly overall performance records of every other branch and the consolidated report for the organization,
- Staff is tested for internal job vacancies, and is required to submit an application from for new positions that are developed as the organization grows.

E. Ownership/Board of Directors

During its transition, X.A.C. is governed by an Ad Hoc Board of Directors who will assume full ownership and governance responsibilities once the finance company is licensed and registered. The Ad Hoc Board is made up of five members, two members from each of the founding NGOs (MWF and LEOS) and one from the National Association of Mongolian Agricultural Cooperatives.

The Board is meeting at the request of the staff during this transition, which means approximately every two weeks but often times even more frequently. The Office Manager of X.A.C. keeps formal minutes of these meetings. It is still unclear how succession and new membership of the Board will be handled in practice, although the by-laws provide for an open membership policy and a term limit for Board of Directors.

The relationship between Board and management is cordial and has been forged over the past eight months during the pilot phase. Branch staff, affiliated with the NGO owners and, in several instances, hired by them, has developed a sense of loyalty to X.A.C.. The X.A.C. Executive Director is new, but thoroughly familiar with the operation of the organization having served previously as the Finance Manager of the same organization.

The main challenges of X.A.C. during this transition period are related to ownership, corporate structure and governance. In this transition, period the main challenge for all parties involved will be to sort out the lessons

from the short history of MicroStart/X.A.C. as a project and build a structure that will be responsive to the important role that it can play in the Mongolian financial sector as a socially responsible financial company.

The ownership, governance and transitional issues are complex. This review discusses the major elements as follows: transition from a group of projects to an institution, UNDP and government supervision, company ownership, board structure and governance issues.

1. Transition from a group of projects to an institution

Because it is in a transitional period there are quite naturally elements of a project operation that underlie some of the institutional choices and operations. Several elements of the project approach that cause degrees of complexity, particularly in the ownership, management and supervision are as follows:

- MicroStart microcapital grants of up to \$150,000. Because of this limitation, X.A.C. is seeking other NGOs that will receive a grant from the UNDP MS Programme to invest in the institution as an equity share. Under previous project operations, each institution developed an expectation that it will take responsibility for newly opened branches and earn a percentage of the revenues of those branches. This issue is explored in more detail below in section 3.
- There are positive aspects to the project and NGO sub-project approach that have been working so far. For example, there is a strong sense of local and NGO ownership and involvement in the operation of the branches. Because of local NGO member's position in the community local government and authorities have been supportive of the effort and their cooperation is essential for legal permits and assistance with defaulting or delinquent borrowers.
- One rationale for continuing to expand the current structure of NGO ownership through microcapital grants is to maintain a strong social mission through active NGO participation. In addition, experience in Mongolia recently with bank failures due to excessive politically and personally motivated large loans that have defaulted argues for maintaining a separation from both local government and local financial institutions.
- Another rationale for continuing the NGO responsibility/ownership of the branch is to seek a balance in the ownership of the institution and a balance on the board of directors. As explained by the Chair of the X.A.C. Board a plurality of NGO owners is thought to contribute to a balance, while too many NGO owners would contribute to a weakness of the ownership structure.
- In addition, staff and board members assert that it will be difficult to find socially motivated private individuals, investor groups or institutions who would invest in the company. Because of the small size of the investment that would be required, international equity funds, such as those available through FMO, KFW, IFC, may not be interested. Preliminary discussions held with potential social investors indicate that diversified sources of equity investment may be available in the short-term. However, further research is required to investigate all avenues of equity, as the organization is likely to require them in the long run and the type of owners sought will likely influence the character of the organization.

2. UNDP and government supervision

As part of the MicroStart Programme, UNDP and the government executing agency organized an Advisory Committee that has the general oversight of the MSM project. The purpose and role of the MAC include: review and approval of workplans, approval of the participation of MFIs as recipient organizations, monitoring of achievements, ensuring that annual audits are conducted, ensuring the institutionalization of the programme within three years, and, advocating before the Government of Mongolia for a supervisory and regulatory environment that encourages and promotes microfinance activities throughout the country.

Composition

The MAC is made up of 7 members from the government, private sector and NGO community, and is co-chaired by the Minister of Health and Social Welfare and the Resident Representative of UNDP. There is a healthy mix of members on the MAC that represent different sectors of Mongolia society, including the Central

Bank, the Ministry of Finance, Parliament, the NGO community and the private sector. For a list of the MAC members refer to annex 1.

The Role of MAC: Past and Future

The MAC played a crucial role in the establishment of MS-X.A.C. and in creating the framework and the space for its financial services to develop. The MAC has performed its job well by enabling a new institutional form to develop in Mongolia. As X.A.C. finalizes its transformation from a project to a finance company, with its own Board of Directors decision-making body, and comes under the direct supervision of the Central Bank, many roles for the MAC are assumed by other entities. In addition several MAC members noted that:

- The MAC is too big to supervise one organization and not big enough for a larger policy role;
- The supervisory function of the MAC has become increasingly technical which requires increasing time and expertise on the part of members for substantial participation;
- The finance company will require more specialized support in the financial and legal areas and will need to raise private capital; and,
- The operation of a finance company requires quick decision making in the early stages of start-up and current stage of consolidation, requiring a rapid response time that the MAC, due to members' schedules, cannot often provide.

There are important functions that will not be assumed by other entities, such as oversight of the UNDP/MHSW project agreement. The key functions are:

- Donor Oversight on the general use of funds
- Authorization and Disbursements of MSM Funds
- Monitoring impact of MSM Funds
- MicroStart Mongolia Public Relations
- Approval and oversight of new activities under MicroStart Mongolia, but independent from X.A.C.

As the Deputy Governor of the Central Bank noted, the final goal of the MAC should be the approval of X.A.C as a financial institution. This is in keeping with the original purpose of the MAC with respect to the institutionalization of the project within a three year time frame. In this case, achievement of targets are simply ahead of schedule.

In addition, there is a role which is not currently filled to work within the broader policy environment and donor networking. Members of the MAC can play a valuable role in the sector by establishing a working group on rural and microfinance as part of the Resolution of the Speaker of Parliament, March 5, 1999, No. 26 on banking sector reform.

MAC Meeting

During this review, the MAC structure and role was analyzed with UNDP, individual members and, during the MAC meeting, with 3 of the 7 members present. Two other members of the MAC were canvassed for their opinions on the future of the MAC before the meeting.

MAC members agreed that the MAC should hold its final meeting when the company is licensed and the X.A.C. Board of Directors, which is now an Ad Hoc Board, is installed. There should be an official transfer of responsibility to the X.A.C. Board of Directors and minutes that record the dissolution of the MAC and the creation of an alternative oversight function.

In consultation with the UNDP Country Office, MAC members, the technical service provider, X.A.C. staff and the Ministry in charge of national execution the future project structure was re-designed as follows:

- A new body will be created that will be responsible for the oversight of project activities, such as funding authorizations, disbursements and monitoring. The body will include representatives and/or designates of the MHSW and the UNDP.
- In its donor oversight role, UNDP will appoint a staff member or an outside representative as an “Advisor” to the Board until the agreement is terminated. This position will have a voice but no vote. The purpose of this position is to ensure the Board of Directors is aware of UNDP procedures, guidelines, conditionalities and agreements to protect donated funds from misuse or misappropriation until such time that the deferred liabilities are transferred as equity to the institution at the end of the project agreement. It is the opinion of this review that the appointee advisor be fully knowledgeable of the administrative procedures and contractual obligations of the agreement in addition to understanding the delicate balance between influence and control.
- MAC members will be invited to participate in the project oversight body that will be formed by the UNDP and the MHSW. Further investigation should be undertaken to assess whether any of the MAC members fit criteria for strategic investors in the company.

3. Company ownership, board structure and governance.

With the transition to a formal financial institution, X.A.C. is re-examining its ownership structure. There are several issues that have been identified with the current ownership and governance structure that need to be explored with the Board as part of a comprehensive orientation and training programme. In addition, prior to further transfers of equity to the company, or further grants made to new NGOs for equity purchases, these issues should be resolved and a memorandum of understanding should be negotiated and signed between UNDP Mongolia and the Board of Directors. The Memorandum should clearly describe the roles and responsibilities of each party with respect to each issue identified below.

NGO Ownership

Currently, NGO institutional ownership does not appear to create any problems with either board oversight or undue bias in the influence of day to day operations. In fact, the role of the NGO at the local level, including their presence on the loan approval committee, contributes to strong local involvement and participation. However, this element of the organizational structure will require careful review at company inception and monitoring as the company grows.

The structure has evolved so that each branch operation is owned by an NGO. The key issue is whether the NGO owners and their institutional representative on the Board of Directors will be able to subordinate the financial interests of the NGO to protecting the financial and institutional interests of the company. Elements of this potential conflict may develop in the following ways:

- Motivation and Expectation. The motivation of the NGOs to form a finance company is both a social motivation as well as distribution of dividends to finance their own multi-sectoral operations. On the one hand, the NGOs will look to the company as a profitable venture. On the other hand, there is the potential institutional conflict of interest that the NGO owners will view the profit making operation as a source of funding for their other operations which may jeopardize the financial health of the institution. The risk is that NGO owners will prematurely require dividends and neglect the considerable re-investment the company will require for maintenance, stability and growth. It is not clear that Board expectations for distribution of company dividends are in line with the investment requirements of the company. Key elements are the time required for the institution to generate a profit, the amount of the dividends the institution will be able to afford to pay while requiring retained earnings for growth and the capital the investors will need to contribute for the growth of the company. It is also not clear that the investors understand that the owners of the company are expected to raise additional capital for the company to grow, or, for example, in the case of financial need.

Recommendation: The Board of Directors should adopt a clear resolution stating that the owners will not distribute dividends from the company until such a time as it has sustained adjusted rates of return on assets, adequate reserves and growth levels that will ensure the profitability and stability of the company.

- Branch Responsibility vs. Institutional Responsibility. Institutional Board members may feel responsible only for the performance of the branch they own rather than the performance of the entire operation. In addition, there may be a tendency to neglect poor performance of the particular NGO branches on the part of affiliated Board members. For the overall health of the company the entire Board should feel equally responsible for the performance of all branches.

Recommendation: The Board of Directors state in writing that Board members will not influence or attempt to control/own specific branch offices but instead will make their decisions based on the overall institutional interests and financial health of the company.

- Branch Staff. Although staff are paid by X.A.C., the level of loyalty branch staff feel to the NGO owners or the X.A.C. central staff who supervise branch staff may become an issue for management. This arrangement opens the organization to potential conflicts that may undermine the role of management's ability to effectively supervise staff.

Recommendation: Upon licensing of the company, all staff must reapply for their positions. Only the position of Executive Director and Internal Auditor(s) must be ratified by the Board (this hiring procedure is in line with current staff policy)

- Loan Approval Committees. The loan approval committees in each branch include, and are often chaired by, the local representative of the NGO owner. This system appears to be working effectively. However, it opens the organization to a potential conflict of interest where NGO owners are also involved in direct operational activities, and communication goes directly from the branch to the Board without communicating with management.

Recommendation: That the executive management of XAC revise the policy of the Loan Approval Committee to specifically state that members of the LAC will be appointed by the Executive Director in consultation with branch offices. These appointments should be made in an open manner and LAC members should be appointed based on qualifications and not on their institutional affiliations.

- Perceptions. It is clear that the leadership of the founder NGOs, do not have the same perceptions as the staff about what it will mean to own and operate a private finance company. X.A.C. staff seems to have a consolidated vision of their growth and their future. Perceptions of the Board and the local NGO leadership that are active in the operations of the branch do not necessarily share this vision, and some have very distinctly different visions particularly with respect to branch ownership.

Recommendation: That the ITSP present a plan of orientation and training to the Board and this plan be reviewed, revised and adopted by the Board of Directors.

Developing a Board – Management Partnership

Over the next few months X.A.C. will have to dedicate time and energy to Board orientation and training. The Board recognizes that their responsibilities in running a finance company are new to them as the structure is also new in Mongolia. Board training needs to focus on:

- Clarifying Board vision for the company
- Understanding the financial aspects of the company and clarifying financial expectations
- Obtaining an understanding of the fiscal prudence and responsibilities required for effective functioning of a private sector entity.
- Defining roles and responsibilities of the Board and management, including developing a clear division between the two roles and functions and establishing structural autonomy.

- Gaining a commitment of loyalty to the company and the commitment of Board members to subordinate their institutional interests to the interest of the financial and institutional health of the company.
- Establishing a partnership and common vision between Board and staff.

Attracting Additional Investors

The search for a socially responsible private investor or investors group should begin in earnest. The addition of private, socially responsible investors will provide a balance for the company as well as a healthy array of investors that spread the risk. As the Deputy Governor of the Central Bank notes, the success of X.A.C. is its orientation as a socially responsible profit making company, and employment of professional staff and management with a financial orientation. These elements make X.A.C. substantially different from other poverty alleviation credit programs sponsored by the World Bank, ADB and other bilateral donors. Recruiting new strategic investors who bring a commercial orientation and long-term objectives to the Board will balance the current social orientation and concentration of ownership. In addition, international investors with experience in microfinance institutions will bring know-how and skills to this new institution.

While private local participation or participation of an international equity fund set up for the purpose of investing in MFIs will not guarantee success, it will provide an active technical role in MFI governance and provide long term capital the institution will required for growth. A board committee, with management input, should be organized to expand private, socially responsible ownership.

Political Influence

Discussions of the banking sector inevitably lead to a discussion of politics and the vulnerability of banking institutions to political influence on the part of Boards, management, staff and local and national government officials. Concerns are heightened due to the current banking “meltdown” and the June 2000 National elections for which campaigning has already begun in earnest. According to discussions, it is rare for anyone in Mongolia to not have a strong political party affiliation and to actively exercise these rights.

X.A.C. is potentially vulnerable on a number of fronts:

The nature of the business ---small cash loans to many people, support and involvement at the local level on the loan approval committees who are both respected members of the community but who may also be politically affiliated, activities of Board members with political aspirations, staff who may have political involvement. While the institution does not have any overt political affiliation, like many other “firsts” in its short history, the coming election in June 2000 will be the first election X.A.C. has ever experienced. Political influence can be as subtle as allowing candidates to hang posters outside branch offices, or staff and loan approval committee members joining X.A.C. “marketing campaigns” where local candidates are present. Political influence can be as overt as Board members directing staff to give loans to politically affiliated borrowers or declaring repayment suspensions or interest rate reductions in branch offices. Staff can also act in their own politically motivated ways. Obviously, it is difficult to anticipate all the ways politics can disrupt a microfinance operation. These are examples from other international experience.

X.A.C. should develop a “code of conduct” at the institutional level for staff, loan approval committees and board members during this campaigning and election period. It is essential that the organization remain above politics. The penalty for political activity should be severe, such as losing employment or position for involving X.A.C. in any political activity. Staff, LAC and Board members should sign a “code of conduct” ensuring they understand what is acceptable personal political activity and what is unacceptable because it jeopardizes the institution. X.A.C. should review the timing of loan approvals and disbursements to ensure these do not fall on days dedicated as major political events, and prohibit involvement of political candidates in decision making or turning these every day activities into public events that may benefit particular candidates. To date, the institution has maintained a high degree of professionalism. Analysis has been applied to developing many of the systems, products and procedures and staff training programmes. The same degree of in-depth analysis and participation is required to develop and implement a code of conduct for the institution throughout the upcoming election period.

F. Alliances

X.A.C.'s main alliances at present are with:

- Participating NGOs, which both have a strong tradition and presence in Mongolia.
- UNDP, the donor responsible for initiating the programme and providing all financial support to date; and,
- Central Government agencies, including the MHSW, the Central Bank and Standing Committees in Parliament. Government representatives were named to the MAC, and has assisted the Central Bank to develop a regulatory framework for NBFIs.
- Perhaps the strongest alliance is with the Central Bank of Mongolia, where a reciprocal relationship of collaboration has been established. For example: The CB has assisted XAC in many aspects related to the development of an appropriate institutional framework for operation and XAC has assisted the Central Bank in the development of the NBFi regulation and a manual on NBFi accounting standards.
- International programmes (such as the UNESCO Distance Learning Programme and the USAID funded Gobi Regional Economic Growth Initiative and Mongolian private sector affiliations for the linking of microenterprise development services with XAC-MicroStart clients.

At the local level, each branch has developed strategic alliances with the local government through its activities and the participation of local government in the Loan Approval Committees. In some places these government and NGO representatives are very active in promoting the activities of the branches and even offering support in the loan recoveries when problems arise.

Currently there are few alliances with international organizations, namely the link with the International Technical Service Provider and recent efforts to present the institution to foreign donors for potential funding such as the Government of Finland. During the next phase, X.A.C. will need to develop new alliances with potential private investors in order to raise the amount of capital that will be needed for the growth of the organization. It will also need to explore relationships with commercial banks that may be able to offer a line of credit in the future.

G. Human Resource Management

Table # 4 : Personnel Statistical Summary

	December 1998	May 1999
Number of total staff , end of period	15	21
Number of staff hired during period	15	6
Number of staff who left during period	0	0
Turnover rate (staff who left over avg. staff)	0	0
Number of loan officers , end of period	4	10
Percent loan officers of total staff	26.66%	47.6%

1. Structure, Profile and Recruitment:

Each branch consists of a lead credit officer, a credit officer and an accountant. One branch has hired an additional credit officer due to its rapid expansion. All lead credit officers are women from the communities in which they work, giving them a better knowledge of the clients and respectability within the community. The lead credit officer in these branches is normally more experienced than the other staff in the branches. In the

branches set up by the NGOs, the lead credit officer was a member of the respective NGO and was initially selected and hired by the NGO itself. Generally their background is not in accounting or finance but they have previous experience working with either government agencies or the NGOs.

The other credit officers are generally younger, some of them hired immediately after finishing university but normally with a more technical background, in either accounting or in finance and banking. There is an accountant in each branch office who is generally hired straight out of university.

2. Salaries and Incentives

The credit officer's salary is divided between a basic salary and a bonus. The bonus is determined by the number of active clients as long as the repayment rate is above 95%. Since the accountant does not have clients, the calculations for her bonus is the average number of clients the credit officers have between them in a particular branch. There is a slight difference between the capital city and the rural areas because of the difference in the cost of living.

The target set for the credit officers to be able to access the full incentive package is 125 clients per credit officer. It takes approximately 4 to 5 months for the credit officers to reach this target, having an average of 25 to 30 new clients each month. The central office is aware that credit officers are reaching their target rapidly and therefore the incentive system will need to be revised.

Given the lack of other examples of microfinance institutions in the country, it is not possible to compare salaries within the same industry. However, nominally the credit officers and accountants have relatively high salaries when compared with similar positions in the government or in the private sector. In general, nominal salaries in equivalent positions in Mongolia are very low. However they have a number of benefits that the staff at X.A.C does not yet have, such as training opportunities or housing benefits. A study published by the World Bank on the informal sector during the transition,¹ described how the income of a person who owns a kiosk (small store on the street that sells food and basic supplies) is the same as a barber or a member of parliament or cabinet minister. It is roughly US\$ 100 per month.

3. Recruitment and Training:

X.A.C hired a Personnel Officer in May who is responsible for enforcing and overseeing personnel policies. Clear and thorough staff policies that are in accordance with the Mongolian Laws have been developed. The staff policy includes policies related to recruitment and selection, benefits, salaries, evaluations, termination of contract and volunteer conditions. Previously, staff were hired by the participating NGOs.

All new credit officers receive training from the Central Office. Training is also given when a new branch is started. The Central Office gave a 14 day training in loan methodology, loan recovery and all policies developed by X.A.C. Currently the staff believe that a 3 day training will be sufficient for new branches as policies and procedures are standard. As new credit officers join, they go through training provided by the Central Office but most of the training at that stage comes directly from the lead credit officer on site.

Most of the staff working at the central office were hired shortly after the institution began its operations, and their positions have been shifted during this period in an effort to find the best combination of skills and job descriptions. During the recent changes new positions have been advertised internally to give the staff an opportunity to apply. Tests have been developed to determine the skills of each applicant. Most positions have been filled internally except the Field Co-ordinator. There is a 3-month probation period for all positions that

¹ | The World Bank Publications. "The size, Origins and Character of Mongolia's Informal Sector During the Transition" The Development Research Group and the East Asia and Pacific South East Asia and Mongolia Country Unit. James H. Anderson. May 1988.

gives the organization the opportunity to evaluate the staff member's performance and appropriateness for each job.

4. Financial Manager

Until recently, the international expert was acting as the Executive Manager of X.A.C. At the end of May, as the institution presented its request for a license to operate as a financial institution and in an effort to prepare for that transition, the staff was rearranged and some were promoted. As a result, the person who had been until then the Finance Manager was promoted to Executive Director and a test was given to staff internally to select the financial manager. The new financial Manager is very capable and detail oriented and knows the systems well. She has previous experience in the stock market in Mongolia and will be able to grow with the organization.

5. Leadership

As part of the transition that X.A.C. is going through and because it is such a new institution, it still depends largely on the international expert. However there are a number of efforts in place to train the staff and for the international expert to phase out in time. The staff will be able to develop the networks and expertise necessary to run the organization by themselves with the support of the Board. The staff is completely open about the way the organization is managed, they are open to advice and look for external support in areas where they do not have the expertise. They have developed a structure that can replace people if necessary, given that they have systematically developed guidelines, policies and trainings for all their activities. There is also a priority given to employees when new positions are instituted, which gives the employees ample opportunity to advance within the organization depending on their capacities.

6. Atmosphere

Overall, the staff is very dynamic and committed to their work. Microfinance is a very new industry in Mongolia. Most of the staff are very young and enthusiastic about this new possibility of offering financial services to low income clients on a professional and sustainable basis. Given the recent transition into a market economy and the interest of the staff of providing a high quality service, there is an incredible openness to learn about new ways of delivering services, a focus on the client and on delivering good quality service.

Emphasis is placed on learning about other experiences abroad and undertaking pilot efforts before starting something new. Once a new service is designed, effort is placed on ensuring that appropriate systems are in place to ensure accountability and transparency. The staff seem to be motivated by the desire to create a different type of institution in Mongolia that brings together the social focus that was present before the market transition but delivered in a competitive and efficient way under the new market conditions. For staff, X.A.C seems to be a possibility of doing business in a new way while still adding value to the society.

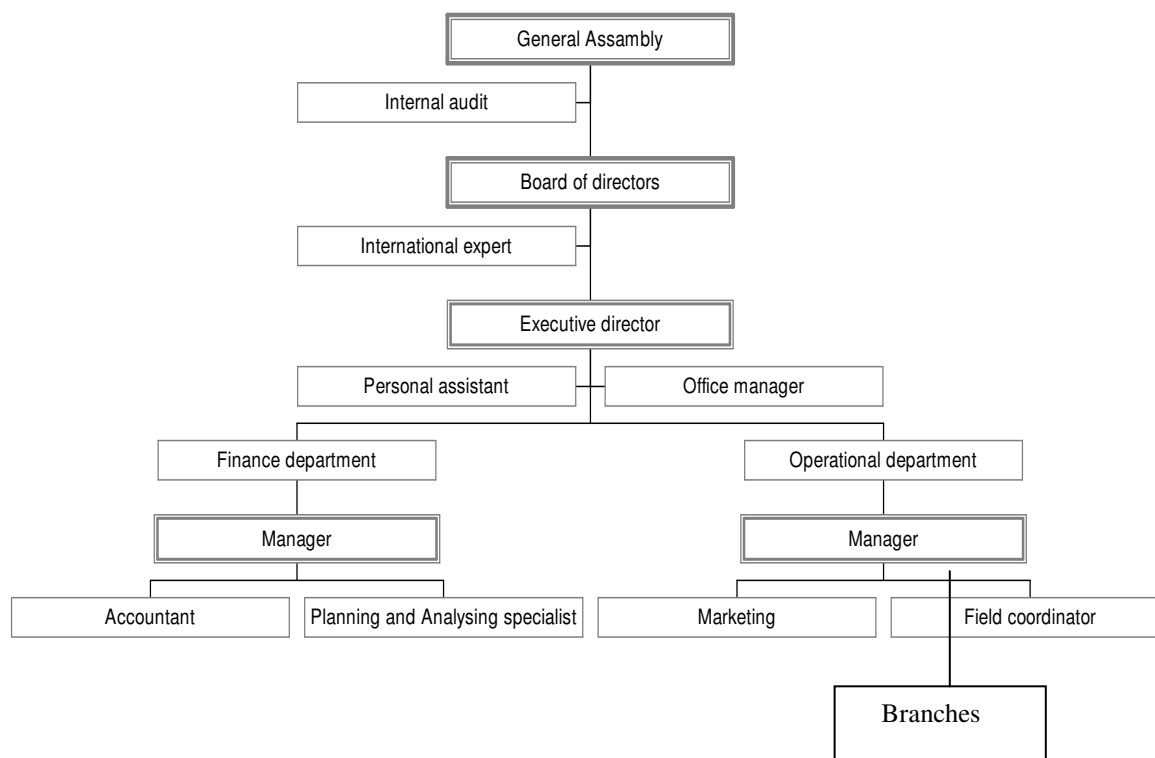
The biggest difficulty currently faced by the staff is the transition through which the organization is going through from an NGO into a formal financial institution and the uncertainty this creates. Given that the license has not yet been granted to the institution, X.A.C has not been able to offer definitive contracts to those employees who were originally representing the member NGOs and are now part of the staff of the Central Office. X.A.C. is extending previous contracts staff had under the NGO structure. Some staff have short-term contracts even though they hold critical positions within the organization.

Overall, the staff's perception of the organization is a positive one. They see it as an organization with great potential and with a good reputation despite its short existence. The main strengths they identified are the commitment, capacity and interest of the staff, the support from all sectors of society, the support and identification with honorable people and the transparency and accountability that has been developed within the organization. The quality of the technical assistance received and the client focus of the institution were also mentioned as strengths. The major weaknesses identified are the lack of previous experience in this field, the current lack of legal status as a financial institution, the need to improve the training and communication, MIS and incentive systems as well as fraud identification and control systems within the organization. The lack of

competition was identified as both a positive and a negative factor among the staff and was one of the most repeated strengths and weaknesses.

H. Organizational structure

The latest organizational structure as of the end of May of 1999 is presented below. Until recently, the position of Executive Director was held by the International expert representing ACDI/VOCA. In May the functions changed in an effort to further build the capacity of the local staff and consolidate operations. The ITSP has been gradually handing over major responsibilities while keeping an oversight role. There is a clear plan for phasing out outside technical assistance within a two-year period.



X.A.C. operates a central office and 5 branches. Two additional branches will open before the end of 1999. Visits were conducted in three of the five branches, two branches set up by LEOS and one set up directly by X.A.C. Due to location and time availability, the team was unable to visit branches set up by MWF. The observations below are mainly from the three branches visited.

Table # 5: Summary of X.A.C Activities – May 30, 1999

Name of Branch	Months of Activity	Active clients	Number of credit officers	Portfolio Outstanding	Portfolio income to date
Khentii	7.5	187	2	26,458,000	
Sainshand	8	272	2	30,373,000	
Airag	8	136	2	16,269,870	
Chingeltei	7.5	306	2	37,315,325	
Bayanzurg	3	234	3	24,153,292	
	Avg. 6.8				

Decentralization and Standardization of Procedures:

All branches follow standard operating procedures, reporting requirements and organizational policy. When recommendations for improving operations may affect the methodology or overall policies of the organization they are presented to the central office for analysis, and piloted in both rural and urban branches before organization-wide implementation takes place. For example, experiments with an interest rate rebate incentive for clients with on-time repayment is being carried out by the Hentii branch. In addition branches are experimenting with a lottery for on-time repayment. Each client gets a ticket at the time an on-time repayment is made. The first lottery is scheduled to be held in July in the Ayrag branch. Decisions that do not affect the general guidelines of the organization, such as office layout or schedules for training, are made at the branch level.

Loans are approved at the branch level by a loan approval committee. This committee is normally formed by an average of 5 members. The branch staff in consultation with the central office chooses the members. They are distinguished members of the community that are available and willing to meet twice a month for about three hours and that know the community well.

Each branch is treated as a cost and profit center. 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 of experiences. The central office costs will eventually be charged to the branches. There is still a discussion on whether this will be done on an equal basis or whether factors such as distances, population density and other considerations will be taken into account.

Accountability:

The staff at the branch level are directly accountable for results and since the information is updated weekly, any increase in late payments is carefully monitored by the central office and immediate action taken. The loan officers are assessed by the number of active clients, on time repayment, level of client satisfaction as measured through periodic client satisfaction surveys and through branch and credit officer trend analysis. There is also a value given to the degree to which they can maintain independent but close working relations with individuals at the local level which are critical for the optimum functioning of the branch. This applies mostly to the branches located in the rural areas.

At the central level the staff and management jointly develop a monthly workplan that follows the broader objectives presented in the business plan. Staff are held accountable for accomplishing those short term objectives. The degree to which these objectives were accomplished is reviewed jointly. An incentive system for central staff is based on meeting these short team objectives. If the objectives are not met, a percentage of the salary is deducted from the team responsible for those tasks. This principle and practice is applied to all members of the staff .

I. Management Information System

1. Hardware and Software.

Each branch and the central office are equipped with PCs. All accounts and financial records are maintained on Excel spreadsheets and backed-up both electronically and in hard copy. Only a few of the spreadsheets are linked. In essence, the MIS system is a manual system aided by a spreadsheet. This system requires points of data entry that are too numerous to detail as all branch reports are received in hard copy and re-entered into the central office system. While this provides a cross check of accuracy, efficiency is lost. Growth of the institution has increased workload. Until recently one central office staff person could complete the reports in one day per

branch. Now it takes two staff person days to complete one branch report, requiring the hiring of additional staff.

While this workload remains heavy, X.A.C. has maintained an on-time reporting system. Branches are expected to submit reports within the first 5 days of the month. Reports are submitted by mail, drop-off from the UB branches and with individuals who are known and trusted by X.A.C for the outlying branches with no easy access. The central office reviews the reports, makes corrections and sends copies back to branch offices by the 10th or 12th of each month. Recently in March, branches also receive the financial summary reports (income statements, balance sheets, ratios and portfolio performance) of all branches so each branch can view their performance in relation to others.

After a thorough review of many of the systems available, X.A.C. recently purchased MicroBanker which will address many of the problems now confronted.

2. Reports

At the branch level the following reports are prepared and submitted to the central office:

Balance sheet, Income Statement, Trial Balance, Cash Flow statement, Cash Journal, General Ledger, Credit Journal, Depreciation, Salary Sheet, Office Supplies, and a Cash flow projection for the following month. Portfolio Report includes the amount disbursed, the total outstanding, arrears and portfolio at risk. A loan registry is also produced which includes the client name, code, loan use, repayment schedule, disbursement date, and amortization schedule divided by principal and interest. The loan repayment report adds to the previously mentioned data the amount paid, the date paid, the amount past due and the number of days past due. The client code mentioned above carries numbers that indicate the number of clients, gender, use of loan, branch code, credit officer responsible, the client identification number and the loan cycle. Monthly reports are signed by the accountant and the lead credit officer.

In addition to the monthly reports, a weekly report on repayment and delinquency is filled out by the central office which collects the data by phone for outlying branches and in person from UB. Every quarter a client profile is produced and updated which indicates client name, age, gender, registration number, number in family, monthly family expenditure, business activity (trade, service, production or mixed) address.

Reports are used regularly by central office staff and branch office staff to manage and administer operations, monitor client repayment, make decisions on loan renewal, visit clients who have missed payments, review overall branch performance. Reports are used to determine client incentives for on-time repayment. Branches are concerned with their profitability, delinquency and performance. They view the reports as integral to their operations.

A comprehensive system of trend analysis is already in place and is continually being improved and acted upon.

3. Systems

Branch staff are competent in computer entry skills and interpretation and use of the financial reporting system. Central office staff are competent in the system as the system was developed by both central and branch staff. Careful attention has been given to reviewing systems as they are implemented. All staff will need to be trained in the new MicroBanker system.

4. Security

The current system allows access to all staff at the branch and central office level. The new MicroBanker system has different levels of security access.

5. System Development

The system was developed by the current staff. They are fully knowledgeable of the process and operations and encouraged to offer suggestions for improvement. These suggestions are taken seriously by management and

several changes have been implemented based on branch staff experience. A Financial Policies and Procedures manual has not yet been written as it is still being updated based on staff meetings. It is described by staff as a “dynamic document” hinting at both pride in flexibility, but also a desire for closure. The chart of accounts in use is one that is established by the Central Bank. The Central Bank, in collaboration with MicroStart Mongolia is currently adapting this manual for general usage by non-bank financial institutions.

As X.A.C has noted the current system has a strong MIS that produces accurate and timely information. The manually based computer-aided system is not efficient for future growth. To address this problem, X.A.C has evaluated all of the MIS systems developed for microfinance institutions. They chose the DBS system, which subsequently stopped distribution. In June X.A.C purchased a copy of the MicroBanker system, which they were configuring at the time of the review. X.A.C. anticipates MicroBanker will meet their needs for the future.

J. Internal Control System, Audits and Supervision

1. Internal Control System.

The lead credit officer authorizes, the credit officer performs the cashier function, and the accountant posts entries. Vouchers are prepared, authorizations are made and subsidiary reports track with receipts and summary reports. Checks and balances are integrated into both the loan approval system and the accounting system. Cash control needs to be improved at the branch level. Cash counts are performed once a week, but should be performed daily. Branches in UB have access to bank accounts where cash is deposited. Several rural branches do not and keep large amounts of cash in the branch office. The safes are small and could easily be transported. In addition, excess cash has occasionally been stored in unsecured filing cabinets and often in open view of clients and branch visitors. Cash control and security needs to be improved. If larger more secure safes cannot be purchased, safes should be set permanently into the floors. There have been no incidences of theft and the Mongolian context is not prone to the violence and theft prevalent in other countries. However, a large scale theft has to happen only once for the institution to take a heavy loss in cash and staff morale.

2. External Audit.

In January 1999, an external audit was conducted by a local auditing firm, “Itgelt Audit”, that is licensed by the Central Bank to conduct audits of financial institutions. Three CPAs reviewed financial reports and certified financial statements, internal controls at the central office and the branches. Income statements and balance sheets were produced for the period. The audit was prepared in accordance with International Standards on Auditing and Mongolia Law. According to X.A.C staff the audit team maintained their professional distance and identified issues in a management letter that were germane to the operation. The management letter commented on the segregation of duties at the branch level, board receipts, use of the cash based accounting system and personal income tax withholding obligations.

X.A.C management commented and followed up on the audit recommendations as follows:

- Branch offices at the time of the audit had only one or two staff so that segregation of duties was not feasible. With the current structure of 3 staff per branch and the loan approval committee, duties are separated into authorization, cashier functions, record keeping and cash accounts.
- Official receipts. Receipts are difficult to get in rural areas but are now required.
- Income recognition methods will continue to use a cash basis accounting system until a more sophisticated financial and accounting MIS system is in place. It is important to note that most banks in Mongolia use a cash based system.
- Personal Income tax obligations were not met by MicroStart recipient organizations. Personal Income Tax withholdings among all employees has now been remedied.

X.A.C will continue to work with this auditing firm and plans to use the CGAP manual that has recently been published. The audit firm will be contracted to translate it and will use it when the next audit takes place. In the

context this is an important development, as the Central Bank is looking to establish a body of experience relevant to supervision on NBFIs. (See section 5, below.)

3. Internal Audit function.

An internal audit function is envisaged for the new finance company. The auditors will report directly to the Board of Directors. Until recently a staff member from the central office performed the internal audit function. The following reviews were conducted:

- Completeness and proper authorization of transactions
- Loan interest rate charged, size and term
- Procedures following policy
- Reports substantiated by records, documentation signed, notarized and proper receipt and application number systems applied
- Loan approval system, including the length of time between loan application and loan approval and disbursement
- Credit officer and accountant procedures
- Client visits, including delinquent clients
- Monthly workplan in place
- Filing system properly kept
- Cash counts
- Listening to difficulties or suggestions on revisions of policies and procedures

Internal audits were complemented by surprise visits, a practice that continues.

4. Fraud Control.

There have been no incidences of detected fraud. A staff meeting held to discuss the strengths and weaknesses of X.A.C noted that the institution does not have a specific system in place to identify and prevent fraud and corruption. However, the internal audit function, surprise branch visits and client signatures on receipts, contracts and repayment vouchers are systems that contribute to fraud control. In addition, client surveys by outside sources could be used to determine corruption.

5. Public/Prudential Supervision

Currently there is no supervision from a public agency. When licensed, X.A.C will be supervised by the Central Bank. On the 1st of April 1999, the Central Bank Policy Board adopted a new regulation, which outlines the means by which non-bank financial institutions can operate within the country. All cooperatives, finance companies, leasing companies, money changers, pawnbrokers and insurance companies must register, become licensed and be supervised under this regulation.

After \$100,000 of assets the entity will be supervised by the Central Bank. The Deputy Governor of the Central Bank recognized that the Central Bank does not currently have the capacity to regulate NBFIs. Since they have none of these entities to regulate, the guidance is broad and reliance will be on the ownership to self-regulate until a body of experience can be developed together with the institutions.

The Central Bank is not currently in a position to undertake the supervision of NBFIs as all efforts are concentrated on the supervision and intervention of the formal sector institutions. Commercial banks have been plagued by mismanagement, lack of capital and inefficiencies resulting in several bank failures over the past 4 years. This has resulted in a consolidated commercial bank rate of non-performing loans of 38.7 % as of the end of March 1999². In 1999 the Central Bank intervened in three specialized banks:

² Source: Central Bank of Mongolia.

- The Agricultural Bank which has a presence in every Aimag center and sum in Mongolia. It is expected to be fully privatized during 1999. All rural lending activities have been suspended in the bank since the beginning of 1999 and the bank is currently under Central Bank intervention.
- The Reconstruction Bank which has branches in ten aimags. All rural lending activities have been suspended in the bank since the beginning of 1999 and the bank is currently under Central Bank intervention.
- ITI bank has 32 branches, is a relatively strong bank and provides savings and lending services to approximately 15 thousand corporate and individual clients. This bank was intervened by the Central Bank in March of 1999.

All three of these banks are considered by many outsiders to be both technically and financially insolvent and will require massive recapitalization if they are to survive.

K. Other Donor Experience

No other donor had supported X.A.C. However, it is noteworthy that many donors are looking at the X.A.C experience as an important contribution to financial services in Mongolia. The banking system is in crisis, donor efforts to support specialized financial institutions such as the Agricultural Bank, ITI and Reconstruction Bank are now under Central Bank conservatorship. Donors are looking to support credit and savings cooperatives and NBFIs as answers to providing financial services to people who have no access to the banking system in this period of crisis. During this initial stage of promoting NBFIs it will be increasingly important for donors to coordinate their agendas because an uncoordinated donor can undermine the microfinance environment, for example, by supporting subsidized interest rates. It will also be important for the Central Bank to proceed cautiously on the licensing of many NBFIs initially, lest the experience with specialized banking institutions be repeated in another institutional form.

II. SERVICES / CLIENTELE / MARKET

L. Services

1. Financial Services

The institution currently has two loan products: individual and group loans. X.A.C. is phasing out group loans, given the numerous problems it has encountered with applying the group methodology. Three new loan products will be designed and offered during the next nine months.

The Loan delivery methodology for their existing individual loans:

Promotion

The process begins with the promotion of the services offered by each branch such as presentations in trade fairs, announcements on the radio and fliers. As a result of promotion and word of mouth, the clients arrive at the branch offices to inquire about the services offered by X.A.C. The credit officers provide basic information and then direct the clients to the detailed information that is posted in the walls of the branch office. If the client is interested in applying for a loan, he/she will buy an application, which costs T100 (US\$ 0.10).

Loan conditions:³

The maximum initial loan size is T150, 000 (US\$150). The conditions of the loan are as follows;

- Average loan has a three-month cycle although the client also has the option of a two-month cycle or 45 days.
- The interest rate paid by the client is 7% per month calculated on a declining balance.
- Once the loan is approved the client pays T400 (US\$ 0.40) for the contract filing.
- The client has to provide collateral for 50% more than the value of the loan. This collateral needs to be insured at a cost to the client of 1% or 1.5% of the appraised value of immovable or movable collateral.
- The contract between the client and X.A.C. where the conditions of the loan are stated and the collateral presented is notarized at a cost to the client of 0.5 % of the amount of the contract.
- The loan payments are calculated and agreed to with the clients during group training. Minimum payments are 15% at the end of the first month, 35% at the end of the second month and a final payment of 50% of the loan amount.

First cycle loans

Clients fill out the application form which is stamped so that people cannot freely make photocopies and sell them. The information requested in the application for first cycle loans is:

- Basic personal information including age, gender, identification number, home address, work address, profession and telephone number.
- Information regarding family dependants.
- A description of the current business activities
- Information on past loans, if any.
- Monthly family expenses including rent, utilities, food, transportation, education and support to relatives.
- A list of the assets owned by the applicant.
- A calculation of the profit earned by the business before the loan is received with the same calculation including the loan amount.

³ All figures are calculated at a rate of 1,000 tg: US\$ 1.00

After the application is received, 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 meets twice a month in regular conditions. The applicant will also have to attend two training sessions of three hours each during those fourteen days, after he/she has been informed that their loan application was approved.

Training required

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

1. Loan Terms
2. Interest
3. Collateral
4. Repayment
5. Incentives / penalties
6. Business plan

Normally the training is divided into two sessions, topics 1 through 5 are covered in the first three hour session and the development of the business plan is covered during the second three hour session. The purpose of the training, as stated by X.A.C is to provide the client with information that will enable him/her to better comply with the loan payments. During the final session the clients have to prepare and commit to the payment schedule as described in the policies above.

The training is conducted by the Credit Officers in each branch, although sometimes speakers such as auditors are invited. The clients do not directly pay a fee for this service. X.A.C. budgets T10, 000 a month as cost of training which covers the cost of coffee and supplies. The institution does not separately budget the time of the credit officer as a cost of the training or rent of the premises. The training is normally held in an adjacent room to the branch.

Time and number of visits required to access a first cycle loan

Below is a description of the minimum number of visits the clients needs to make in order to receive a loan and the time each visit takes:

Table # 6: Time required for getting a loan.

Client visits	Time	Institution visits	Time
Client goes to branch to buy application form	20 min.	Credit officer visits the clients' home	1 hour
Client goes to institution to submit application form	10 min	Credit officer visits the clients' business	1 hour
If selected, client attends first training session	3 hours		
Client attends second training session	3 hours		
Total time	6 1/2 hours		2 hours

Second cycle loans

The process to receive a second loan will take the same amount of time, 14 days. The rationale behind it from the institutions' point of view is that this period of time between loans gives the credit officers the opportunity to check whether the loan was used appropriately, whether there was any real profit created by the use of the loan and to determine the appropriate amount of the next loan that the client should receive. After the second loan, however, the client can receive third and fourth loans immediately after repaying the last installment of the outstanding loan.

The application form for the second loan is shorter than the one for the first loan. It consists of general client information, information on the collateral with the same insurance requirements as the first loan, a business plan showing the actual profit and the projected profit with the loan and a section on suggestions and comments for improving the products and services.

The training for the second, third and fourth loans is a half hour meeting where experiences are shared among the clients, any changes in policies are presented by the credit officer and the clients calculate and sign their repayment schedules.

Maximum amounts

The maximum amounts for each cycle loans are as follows:

Table # 7: Loan amounts

Loan cycle	Maximum amount US\$
1 st	150
2 nd	225
3 rd	300
4 th	400
5 th	500
Subsequent Loans	Yet to be determined

There are no policies on the maximum amount a client can borrow. Given the youth of the institution, the oldest clients are only now in their fourth loan.

New Products

Currently there are no other financial services offered. However, there is a plan to provide investment loans as of July 1999. These loans will be exclusively targeted towards what X.A.C calls certified clients, those who have received and paid on time more than three loans from X.A.C. Investment loans will have initially an average size of US\$ 380, a maximum loan size of \$ 1,000 and a maximum length of 9 months. The interest rate for equipment loans is tentatively set at an effective annual rate of 60.4%.

X.A.C. plans to develop two more loan products during the next year. Cooperative and consumer loans. However, this is still very preliminary and no definitive plans or guidelines have been developed to date.

Comments

Overall, the products and methodology seem appropriate for the characteristics of the country, the population and the institution. There are a few elements of the methodology that X.A.C. should review in its characteristic analytical way to determine if improvements can be identified that minimize the risk to the institution and enhance the value of the product to the client.

Time between 1st and 2nd cycle loans

The number of meetings to obtain a loan appears excessive at first glance. However, there are mitigating circumstances in the Mongolian context and within the financial operation that argue for this number of meetings. The first is the absence of clients' exposure to business/enterprise principles, including costing, pricing and cash flow. Secondly, meetings with 2nd and 3rd cycle clients promote client understanding and accountability for the amortization schedule, which is important for most borrowers who have never had institutional loans. Having the client fill out an amortization schedule in a group with staff assistance helps to ensure that the client understands the loan terms, when the payment is due, and the total amount owed. Undertaking this exercise in groups reduces transaction costs for the staff, but increases the time involved for the clients. The time invested in the first cycle loan has helped the organization ensure on time repayment at this early stage. However, the clients generally need to wait the same amount of time in order to receive a second loan despite the number of visits that they have received during the first cycle and maintaining on-time repayment. This time seems long for second cycle loans and clients have asked for it to be reduced. More rapid portfolio turn will also enhance portfolio yield.

Pledging too much collateral

In some instances collateral is pledged at 200%-300% of the value of the loan. The reason given is that clients intend to work their way up to larger loans and have difficulty finding something that is worth the value of the loan (plus interest). Client circumstances change and pledging collateral valued much higher than required can result in clients losing assets that will be sold at a fraction of the price. While this may not always be possible, X.A.C. should make efforts to identify collateral that is closer to the value of the loan plus interest. For example, a 150% collateral pledge would be closer to the mark.

Property: apartments and housing

As loan sizes increase, it may be necessary for X.A.C. to require collateral such as immovable property that is valued at the size of the loan. X.A.C. should make every effort to find collateral that is more appropriate, especially for clients in the initial cycles who have little experience in borrowing. Although this review falls short of recommending an outright prohibition of clients pledging houses and apartments for 1st cycle loans due to limited experience in the Mongolian context, the reviewers have every confidence that X.A.C. staff will examine this issue in depth and find appropriate solutions, including maintaining the current policy.

Paper work and costs associated with registering collateral

Clients want to avoid repeating the paperwork needed for larger loans, knowing they can graduate rapidly into the next cycle. Each time they borrow for such short term loans transaction costs in time, paperwork and cash increase -- insurance in the amount of 1% of the value of immovable collateral and 1.5% of the value of movable collateral. Costs of time and money associated with registering collateral should be examined for their value to the institution for securing collateral, minimizing the risks of the institution and increasing costs to the client.

In some instances collateral is over valued

X.A.C. requires both branch staff and the insurance company to value collateral as the insurance company tends to overvalue collateral in order to sell a higher priced policy. Equipment may have been purchased at a certain price, but due to its specialized purpose or configuration it may not be readily saleable on the local market. X.A.C. should check not only the value, but also the ease of which the item can be sold. As X.A.C. staff become more experienced with this type of transaction their expertise will develop. Including a special section on assessing the value of collateral in the on-going staff training is timely.

Credit officer guarantees

Since all loans are secured by collateral there are a few cases where an otherwise credit worthy client does not have any appropriate collateral. There are a few instances where loan officers have personally guaranteed client loans. This practice although admirable in its intentions, is one that should be curtailed since it puts the institution at risk, creates a conflict of interest where the lender becomes the guarantor and undermines the

business relationship between the client and the credit officer. In case of client default the loan officer would have a financial burden that may be difficult to meet. To prevent a situation where the institution loses a good credit officer because of good intentions, X.A.C. should study the situation and develop a clear policy that deals with credit officers offering their personal guarantee to clients. It is the opinion of the assessment team that X.A.C. should prohibit this practice.

The breakthrough in microfinance was largely predicated on substitutes for traditional collateral, such as something a person values that would not be accepted by a conventional bank, a co-signer, and peer group guarantees. If X.A.C. finds that there is a large market for this type of product, or more and more clients require an exclusive character based guarantee ---- and it may as many microfinance organizations elsewhere operate exclusively on collateral substitutes----- X.A.C. should develop a product that responds to this demand. X.A.C. should also take care not to divert its limited resources on developing a plethora of new products. (See section on new product development.)

Business plan training

Staff feels compulsory client training is critical in ensuring on-time repayment as clients calculate the amortization schedule and clients better understand the costs involved in borrowing. Although clients are interested (and even eager) for training in business plan development, complete with cash flows and financial projections, the topic appears too complex to be covered in a 3 hour training period without more specialized instruction. If business planning training is a service that clients want, then it could be offered to them through other means, such as the marketing sessions that are now being piloted on a cost recovery basis with private consultants. (See non-financial services, below.) Limiting compulsory training to understanding the costs of borrowing, the obligations and the risks is an option X.A.C. should consider.

Client drop out rates

X.A.C. does not calculate client drop out rates. It will become increasingly important for the institution to do so in the context of such low density populations and within its effort to be sustainable given the high cost drop out clients represent to the institution.

2. Non-financial Services

X.A.C is in the process of developing non-financial services for its clients. The approach being piloted consists of responding to clients' requests for additional training by contacting outside consultants who provide training services to small enterprises as a business. X.A.C plays an intermediary role finding the consultant and making initial arrangements. In June 1999 in Ulaanbaatar, X.A.C advertised an informational meeting for marketing training with a consulting company for the first time. 40 clients attended the informational meeting and a total of 20 clients signed up and paid T4, 000 to attend the course on marketing that will be offered by the consulting firm. Additional arrangements have been made with a private sector consulting group supported by the Gobi Regional Economic Growth Initiative and the UNESCO Distance Learning Programme.

M. Outreach

X.A.C currently has 5 branches and intends to open 2 more by the end of 1999 and a total of 4 more in the year 2000. By the end of the year 2000 X.A.C. will be operating 11 branch offices under the support of one central office. Of the 5 current branches, two operate in the capital city, Ulaanbaatar, and the remaining three operate in rural areas. One is located in Ayrang Sum in Dornogovi Province which has a population of 3,100 (775 families). Another one is in Saynshand also in Dornogovi Province with a population of 18,100 (4,525 families). The third one is located in Ondorkhaan, the capital of the Khentii Province. The population of Khentii is 16,500 (4,125 families). Of the two branches located in Ulaanbaatar City one is in the Chingeltey district which has a population of 95,000 (23,900 families) and the newest branch operating since March 1999 is located in the Bayanzurh district with a population of 104,000. 61% of the clients are urban and 39% are rural based.

Table # 8: Outreach indicators

Indicators	December, 1998		May, 1999	
	# of Loan	Total Value	#	Total Value
Loans Disbursed for the Period:	188	24,480,000	445	69,320,000
New Loans:	175	21,680,000	267	32,100,000
- Individual	169	19,650,000	267	32,100,000
- Group	6	2,030,000	-	-
Renewal Loans:	13	2,800,000	178	37,220,000
- Individual	12	2,125,000	178	37,220,000
- Group	1	675,000	-	-
- Number of New Clients	192	21,680,000	267	32,100,000
- Second Cycle Clients	17	2,800,000	127	23,845,000
- Third Cycle Clients	-	-	48	12,075,000
- Fourth Cycle Clients	-	-	2	800,000
- Fifth Cycle Clients	-	-	1	500,000
- Number of Active Clients	398	-	1,146	-
- # Female Clients current period	168	80.4%	355	80.0%
- # of Female Active Clients	326	81.9%	877	76.5%
- Average Number of Loan Officers	4	-	10	-

Loan disbursements for purpose of loan	December 1998	May 1999
	%	%
Trade	59.5	62.9
Production	25.3	22.3
Agriculture	0.2	0
Service	7.4	9.3
Mixed	7.6	5.5

N. Market

Mongolia has a population of 2.3 million who are 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.⁴ 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 sector⁵. 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 clients⁶.

The market strategy practiced by X.A.C is a vertical one that is appropriate to the context of small populations grouped in areas with great distances among them. The vertical approach also practiced by PRODEM (a prestigious micro-lending institution in Bolivia) which works in rural areas, has the potential to reach a greater

⁴ EIU Country Profile Mongolia 1998 -1999

⁵ World Bank. From the X Business Plan

⁶ 33% of an estimated 258,750 families engaged either part or full time in the informal sector. From the X Business Plan.

number of clients with credit. The cost of administering many small loans is higher than relatively larger loans. In addition, the market itself is quite limited at all levels. Developing a range of products that are appropriate to the poor, low-income groups and non-poor vulnerable groups is a viable strategy for client outreach, depth and institutional viability. Because X.A.C mixes its portfolio to reach all client groups, it has a positive outreach to the poor and vulnerable.

The financial sector, like most countries, has both informal and formal components. Within the formal commercial sector, there are 15 legally registered commercial banks, 1 stock exchange and a number of currency exchange houses. Non-bank financial entities such as insurance companies, leasing companies and savings and loan co-operatives while present in Mongolia have not played a significant role in the nation's economy to date. There are 22 registered savings and loan co-operatives in Mongolia yet are entirely concentrated in Ulaanbaatar City, have inadequate institutional capacities and reach a minimum number of members. Relying on statistics of the Central Bank Risk Center, approximately 99 % of all commercial lending activities is reaching less than 1 % of the population with more than 95 % of this activity concentrated in Ulaanbaatar City.⁷

1. External Threats and Opportunities for market penetration.

X.A.C has virtually no competition. As the presence of NBFIs grows institutional competition will increase. A revitalized Agricultural Bank (currently under consideration by the Government of Mongolia and the international donor community) may also pose a significant source of future competition. There is no way to determine at this point in time whether this competition will be fair, or attempt to undercut the relatively lucrative X.A.C market with subsidized interest rates, either to gain market share or on the behest of other donors. (See section I. K, above for recommendations on donor networking.)

The market is highly literate and educated, although they have limited business experience and little experience with institutional borrowing. Perhaps in this context, many clients who are now engaged in trade because the barriers to entry are so low, will begin to diversify their own businesses. This will be a great contribution to the development of the country, but also poses a risk for X.A.C. in the sense that the experiential base of many of the clients (particularly with profitability and cash flow) will be limited in newly established businesses. This risk will become more prominent when “investment, or equipment loans” are added to the product menu.

Market saturation is a potential threat to X.A.C's profitability. In some areas, such as Ayrag, which is a profitable branch because of the low cost structure and high interest rate, the market potential is limited in sheer numbers and may be limited in client growth potential. The characteristics of the market force X.A.C to develop new products to attract a new clientele as well as open new branch offices in areas that have high market potential as well as low cost structures. Low cost structure includes not only the branch itself, but also the costs of central office supervision and requirements on branches to maintain certain standard systems and equipment as the branch network grows.

Reaching dispersed populations that regularly move about the countryside will be a challenge for X.A.C as they attempt to develop an agriculture/livestock product for the herder community.

Market studies and feedback from clients

X.A.C. began its operations in Mongolia through the participating NGOs, LEOS and MWF. Branch location was determined on the basis of where the NGOs had a strong presence and where they felt these services could work. Today this process has changed. There is a cost analysis done before opening a new branch and a strategical analysis that factors in travel time, distance to other branches and local government support. Given the lack of any type of financial services in most areas in Mongolia, there is a general feeling that there is sufficient market in almost any large town to be able to operate a branch on a sustainable basis.

⁷ From the X Business Plan

The MFI generates feedback from its clients both in an informal and a formal way. Most of the feedback, as stated by the credit officers, is provided by the clients during loan application and follow up visits. However, they also provide written comments on their application for second loans where there is a section for suggestions for improving the products and services.

As for the training that is provided as part of the loan delivery methodology, after each training the staff asks the 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.

X.A.C. commissioned a client satisfaction survey which was conducted by outside consultants. A total of 82 clients were interviewed and asked about their level of satisfaction with the services provided by X.A.C. They were selected on a random basis and represent 10% of the total active clients. 28 were male and 59 female. 57.3% of the total respondents were in their first cycle loan, 31.7% in their second cycle and 11.3% were in their third or fourth cycles. The survey contained a total of 32 questions. Separately structured surveys were conducted amongst active clients, dropout clients and clients who had had their applications rejected. The results of the rating the clients gave by branch for as per the quality of services of X.A.C. is presented below. :

Table # 9: Quality of service

	Sainshand	Airag	Khentii	Chingeltie	Total
Excellent	41.2%	46.2%	26.3%	85%	50%
Good	58.8%	50%	73.3%	15%	48.8%
Middle		3.8%			1.2%
Not good					

Clients and poverty targeting

This same survey was used to determine the poverty level of those clients that were surveyed. The strategy was to visually assess the level of poverty of the clients when they were visited, based on the visual observations of the surveyors. While this means of classification is not wholly reliable it provides a context for the assessment of the types and percentages of clients served. There were four basic categories that were used: Vulnerable Non-Poor, Moderate Poor, Poor, Extreme Poor. The descriptions of how each category was determined are provided in 2. Based on the above classification, the following is the distribution of X.A.C’s sample clients:

Table # 10: Poverty targeting

Category	Active clients	Drop-out clients	Applicants rejected for loans
Vulnerable non-poor	30.49%	33.33%	1.89%
Moderate poor	58.54%	60%	58.49%
Poor	9.76%	6.67%	26.42%
Extremely poor	1.22%		12.21%

Based on this survey as well as on few visits to clients and comments by credit officers, the perception is that the majority of clients of the institution are poor and low-income people who have a business already and need working capital. There are a few clients that are very poor, but overall collateral requirements and an active business tend to limit clients in this income group. Some clients are interested in accessing larger loans, but given the lack of available services, they begin with small low loans and pay them rapidly in order to graduate to a higher level.

III. STRATEGIC OBJECTIVES

O. Mission/Objectives

X.A.C's mission 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 final objectives of X.A.C.'s Two-Year Business Plan are to:

- Establish a Sustainable Private Finance Company capable of delivering high-quality, client appropriate financial services.
- Effect a positive social and economic impact⁸ on the clients and the communities where we work.

In order to meet the final objectives of the business plan, the following specific two year objectives are targeted:

- Provide client appropriate sustainable financial services to a minimum of 3,600 low-income families in eleven distinct locations.
- Disburse approximately \$US 3,000,000⁹ in loans while maintaining a portfolio at risk of no more than 15 %.
- Achieve full financial sustainability for the institution by the end of the year 2000.

P. Near to Mid-term Objectives

The following parameters were established based on MSM performance results during the last quarter of 1998 and on all staff retreat held on the during the second week of 1999. The performance results were further updated in May 1999.

- **Number of Active Clients.** The major thrust of the strategy will focus on improving and consolidating the services provided within the five branch offices already established and an additional 6 branch offices to be established. The client base will increase from a current level of 1,146 active loan clients to approximately 3,600 active loan clients at the end of the year 2000.
- **Loan Products:** The group loan methodology will be cancelled, individual loans strengthened and new loan products developed: equipment loans for certified clients, and pilot projects for testing consumer loans and cooperative loans.
- **Loan Portfolio:** The net active loan portfolio outstanding will be increased from the current level of \$ 135,000 to \$ 300,000 at the end of Year 1 and \$ 725,000 at the end of Year 2.
- **Client Retention Rate:** The cumulative annual client retention rate is expected to decrease from the current level of 100 % to a low of 95% per month at the end of Year 1 with a further decrease to 75 % during year 2.
- **Loan Default:** The rate of default on loans has been conservatively estimated at a level of 3.3 % of total loans disbursed during Year 1 and will increase to 5.5 % by the end of year 2.
- **Delinquency:** The rate of delinquency will vary according to the type of loan. Yet will increase from the current rate of 0 % to a 5 % for by the end of year 1 and 8 % by the end of year 2.

⁸ Albeit, perhaps only measurable in qualitative terms.

⁹ Exchange rates in this document have been calculated at 1,000 tg/US\$ 1.00

- Interest Rate: During the pilot programme the interest rate on loans products varied by branch from 72 % to 92 % per year, were calculated on a declining balance with a minimum up-front commission of \$ 0.11 to \$ 0.47. The end of year annual inflation for 1998 was 6 %¹⁰. The nominal monthly interest rates charged during 1999 and 2000 will vary between 5 to 7 % per month with real annual interest rates of between 51 to 75 % per year.¹¹. An up-front commission for offsetting the costs of paper forms of \$ 0.5 is charged on individual, consumer and equipment loans. A \$ 10 up-front commission will be charged on cooperative loans. These fees minimally effect the effective rate of interest charged.
- Credit Officer Productivity: Credit officer productivity will reach a high of 150 clients per credit officer for individual and equipment loans, 125/1 for consumer loans and 45/1 for group loans. This ratio is dependent on the successful introduction of efficient front office/back office MIS system at all branch offices.

Table # 11: Key Scale and Outreach Indicators

Q. Performance Indicator	1999	2000
Portfolio per Credit Officer	\$ 21,000	\$ 31,500
Total Loan Portfolio	\$ 300,000	\$ 725,000
Number of Active Borrowers	1,550	3,600
Portfolio at Risk	7.4 %	12.7 %

¹⁰ Central Bank of Mongolia.

¹¹ The International Monetary Fund projects a rate of inflation of 9% for 1999. The same estimate has been used for the Year 2000.

IV. FINANCIAL PERFORMANCE

A. Income Statement and Balance Sheet.

Income statements and balance sheets are provided for the period September 1 –December 31, 1998, the first four months of operation, and from January 1 – May 31, 1999. As the operation, is a start-up the second group of statements is more indicative of trends in financial performance.

Table # 12 Balance Sheet

BALANCE SHEET
(nominal local currency)

	Jan-99	May-99
ASSETS		
15. Cash and due from banks	37,095,320	30,369,619
16. Reserves in central bank		
17. Short-term investments in market instruments		
18. Total loan portfolio	37,955,700	134,570,743
19. (Loan loss reserve)	(379,557)	(1,442,698)
20. Other short-term assets	1,461,775	2,358,415
21. Long-term investments		
22. Net fixed assets + net NBTA	26,110,925	30,467,333
23. TOTAL ASSETS	102,244,163	196,323,412
LIABILITIES		
24. Savings accounts: forced		
25. Savings accounts: voluntary		
26. Time deposits		
27. Loans: commercial		
28. Loans: Central Bank		
29. Loans: subsidized		
30. Other short-term liabilities	575,575	1,478,811
31. Other long-term liabilities (Def. rev.)	114,941,712	172,136,721
32. TOTAL LIABILITIES	115,517,287	173,615,532
EQUITY		
33. Paid-in equity from shareholders		60,000,000
34. Donated equity -- prior years, cumulative		-
35. Donated equity -- current year	-	
36. Prior years' retained earnings/losses	-	(13,273,126)
37. Current year retained earnings/loss	(13,273,126)	(24,014,074)
38. Other capital accounts		
39. TOTAL EQUITY	(13,273,126)	22,712,800
40. TOTAL LIABILITIES AND EQUITY	102,244,161	196,328,332

Table # 13 Income Statement

INCOME STATEMENT
(nominal local currency)

		Jan-99	May-99
<u>OPERATING INCOME</u>			
1.	Interest and fee income from loans	2,792,769	21,597,007
2.	Income from other finance-related services		
3.	Income from investments	2,607,867	2,218,593
4.	Total Operating Income	5,400,636	23,815,600
<u>OPERATING EXPENSE</u>			
5.	Interest and fee expense+ reval cur. Exps	5,300	710,937
6.	Loan loss provision expense	379,557	1,063,141
7.	Administrative expense -- Personnel	7,206,454	19,734,670
8.	Other administrative expense	11,340,065	27,204,095
	rent & utilities	2,301,434	3,964,300
	office materials and supplies	1,688,466	1,982,853
	transportation and travel & communications	3,336,442	7,176,207
	client training	121,680	144,650
	Affiliation expenses	-	4,234,017
	staff training	20,000	
	LAC honoraria		474,810
	bank charges		
	Depreciation	1,225,147	5,390,069
	Other	2,646,896	3,837,189
9.	Total Operating Expense	18,931,376	48,712,843
10.	NET OPERATING PROFIT (LOSS)	(13,530,740)	(24,897,243)
<u>NON-OPERATIONAL INCOME</u>			
11.	Cash donations for financial services		54,755,185
12.	Other non-operational income	257,614	883,169
13.	Total Non-Operational Income	257,614	55,638,354
14.	Total Non-Operational Expenses		
15.	TOTAL CONSOLIDATED PROFIT/LOSS	(13,273,126)	30,741,111

B. Adjustments for Inflation and Subsidies.

The inflation rate is used for adjustments to financial statements for inflation. When regularly performing adjustments for subsidies, X.A.C. uses a 15% adjustment based on the probability of borrowing US\$ on the international market at this rate. It is a question whether X.A.C. could borrow US\$ at 15%. The inter-bank lending rate is 21%, which is currently very high due to the liquidity crisis in Mongolia. Although theoretically possible, X.A.C. will not be able to borrow on the commercial market due to the lack of liquidity in the system, however, if one were looking for an adequate shadow price for subsidies --that is, at what rate would a

commercial institution have to borrow to undertake the same endeavor, the inter-bank lending rate of 21% on local currency is a more reliable rate than 15% on US\$. This is the rate used in this analysis.

C. Profitability

X.A.C has made significant strides in financial performance during the past five months. This growth has enabled it to move from 28% Operational Self-Sufficiency to 49% in the five month period from January to May 1999. These figures do not include the cost of ACDI/VOCA technical assistance which gradually phases out over the next two years. The growth rate is impressive. If X.A.C. can maintain its current high productivity and its enviable portfolio quality, while keeping portfolio yield high and gradually increasing portfolio size, X.A.C. will become a profitable entity within the next two years.

However, it should be noted that expansion plans to four additional branches and the development of new lending products will mean higher costs and lower rates of productivity during the short term, before the investment in expanded capacity and diversified products pays off. While the part of the operation represented by existing branches are or soon will be fully self-sufficient, new branches will begin at low levels of cost recovery until they build up a fully operational portfolio. In addition, product development requires careful pilot testing before the product is rolled out and finds a wide acceptance in the marketplace and among the staff who manage it.

Table # 14: Profitability

	Jan-99	May-99
Return on Assets	-29.0%	-18.2%
Adjusted Return on Assets	-42.9%	-30.1%
Operational Self-Sufficiency (excluding cost of funds)	30.5%	52.6%
Operational Self-Sufficiency (including cost of funds)	29.9%	50.7%
Financial Self-Sufficiency	16.9%	33.6%

The increase in financial viability is due to an expanding portfolio, rather than increase in loan size. On-time repayments continue to remain high which contributes to a robust portfolio yield. The increase in income from December 1998 to May 1999 of a little over 7 times far outpaced the growth in administrative costs, which increased 2 ½ times. The biggest component of those costs, personnel, increased by almost 3 times. The dramatic increase in administrative costs is expected for an operation that is still spending money on building basic institutional infrastructure, branches, staff and systems development.

Noting the additional costs required to grow and maintain market share over the long run, and the retained deficits on operations during the first four months and the first half of 1999, should make the Board and staff more cautious about suggestions of “dividend distributions”. During the 5 month pilot a poor precedent was set when interest rate earnings (\$4,234) for the four NGO owned branches were distributed to the two NGO owners. This amount currently shows up as a reduction of equity on the balance sheet. In other words, the \$60,000 equity contributed by the NGOs in May was worth \$21,572 as of May 31. (See table # 13). Major adjustments are for inflation and operating grants.

The adjusted return on equity ratio is not relevant in this context, as it is impossible for the institution to borrow funds on the local market. To carry out the analysis, however, a 21% interest rate on local currency was used. This rate was chosen because this is the rate that the Central Bank will lend to commercial banks. Another factor the reader should note is that grant income is recorded as deferred revenue, a contingent liability. Equity contributions from shareholders began only in May 1999. Under these two conditions, adjusted return on equity

reads quite high given the equity contribution is new and the operation is covering most cash costs. The indicator that reveals a true financial picture of the institution is total equity of \$60,000 in May was worth \$22,172 as of May 31st.

D. Efficiency

Table # 15 : Efficiency

		Dec 31-98	May-99
1.	Administrative Efficiency (administrative costs excluding financial costs as % of avg. net portfolio)	127.4%	65.3%
2.	Operational Efficiency (total operational costs as % of avg. net portfolio)	130.1%	67.7%
3	Personnel costs as % of total administrative costs	38%	41%
4.	Number of active loan clients per staff member (end of period)	27	55
5.	Number of active loan clients per loan officer (end of period)	100	115
6.	Outstanding portfolio per loan officer (US\$, end of period)	10,427	13,457
7.	Number of clients per branch office (end of period)	100	229

With an average of 115 clients per credit officer, most credit officers will soon reach what has become the accepted full client load of 125. While credit officers are reaching this client load quite rapidly, the current individual product and methodology can probably not sustain much more than 125 clients per credit officer.

Although X.A.C. is performing well in terms of reaching financial viability, it is still in this initial stage of its development, an expensive operation. Its operating expenses have dropped dramatically from 127% of portfolio to 65%. As a measure of where it needs to aim, top performing microfinance institutions have operating expenses in the range of 10 – 25 percent of portfolio. It is expected that X.A.C. will gain a higher number for operating efficiency as the average net portfolio reaches maturity and is not weighted by the first four months of start-up. In addition, headquarters staff is expected to remain stable as the credit officer staff and portfolio outstanding expands with the additional branches. The installation of the MIS system should further reduce staffing requirements for data input.

With the current cost structure and pricing policy, X.A.C. will become profitable in the short term. X.A.C. is aware that it needs to keep an eye on costs as it expands, and if it wants to remain client responsive, particularly to the pressure to drop interest rates. X.A.C. has planned to carefully select the sites for future branches that not only meet minimum profitability in the short run, but have growth potential. Branches site selection will also be assessed in terms of geographic proximity to each other and ease of service by the central office in order to reduce travel costs, which account for over 15% of total administrative expenses. As a comparison, personnel costs are 42% of total administrative costs.

E. Loan Portfolio Analysis

X.A.C. measures delinquency in it's portfolio by tracking arrears, loan delinquency of over one day late, aging arrears and recording the outstanding balance of loans with any payment late. Portfolio at risk is also categorized by age. Management is committed to tracking delinquency, addressing delinquency problems and recovering collateral on loans that are in default.

Table # 16: Portfolio Data

LOAN PRODUCT #1:		Dec 31 98	May 31 99
a.	Total principal balance outstanding, end of period	34,460,700	129,782,297
b.	Number of active loans at end of period	351	1,084
c.	Average loan balance (a/b)	98,179	119,725
d.	Average principal balance outstanding over the period	16,811,675	75,134,242
e.	Loan losses written off over the period	-	495,000
f.	Increase in loan loss reserve over the period	379,557	1,063,141
g.	Loan loss rate (f) as a % of (d)	0%	1%
h.	% of total outstanding balance associated with loans that are:		
	On time (and never refinanced)	100%	98%
	On time (but have been refinanced)	0%	0%
	Late (at least 1 payment) 1 - 30 days	0%	2%
	Late " 31 - 60 days	0%	0%
	Late " 61 - 90 days	0%	0%
	Late " 91 - 180 days	0%	0%
	Late " 181 - 360 days	0%	0%
	Late " a year or more	0%	0%
i.	Portfolio-at-risk delinquency rate > 30 days late	0%	0%
LOAN PRODUCT #2:			
a.	Total principal balance outstanding, end of period	3,495,000	4,788,446
b.	Number of active loans at end of period	47	62
c.	Average loan balance (a/b)	74,362	77,233
d.	Average principal balance outstanding over the period	1,477,750	4,578,951
h.	% of total outstanding balance associated with loans that are:		
	On time (and never refinanced)	100%	91%
	On time (but have been refinanced)	0%	0%
	Late (at least 1 payment) 1 - 30 days	0%	7%
	Late " 31 - 60 days	0%	2%
	Late " 61 - 90 days	0%	0%
	Late " 91 - 180 days	0%	0%
	Late " 181 - 360 days	0%	0%
	Late " a year or more	0%	0%
i.	Portfolio-at-risk delinquency rate > 30 days late	0%	2%
TOTAL			
a.	Total principal balance outstanding, end of period	37,955,700	134,570,743
b.	Number of active loans at end of period	398	1,146
c.	Average loan balance (a/b)	95,366	117,426
d.	Average principal balance outstanding over the period	14,631,540	72,753,161
e.	Loan losses written off over the period	-	495,000
f.	Increase in loan loss reserve over the period	379,557	1,063,141
g.	Loan loss rate (e) as a % of (d)	-	0.01
h.	% of total outstanding balance associated with loans that are:		
	On time (and never refinanced)	1.00	0.98
	On time (but have been refinanced)	0	-
	Late (at least 1 payment) 1 - 30 days	-	0.02
	Late " 31 - 60 days	-	0.00
	Late " 61 - 90 days	-	-
	Late " 91 - 180 days	-	0.00
	Late " 181 - 360 days	-	-
	Late " a year or more	-	-
i.	Portfolio-at-risk delinquency rate > 30 days late	-	0.00

1. Provisions. X.A.C. currently provisions as follows:

On-time	1% of outstanding balance
1-30 days	1% of outstanding balance
31-60 days	25% of outstanding balance
61-90 days	50% of outstanding balance
> 90 days	100% of outstanding balance

When X.A.C. gets its NBFIL license it will follow Central Bank guidelines on provisioning that are set up to limit abuse by banks in avoiding tax laws. Provisioning under the law is set as follows:

1-90 days	1% of outstanding balance
91-180 days	25% of outstanding balance
181-360	50% of outstanding balance
> 360 days	100% of outstanding balance

The Central Bank regulations on provisions for X.A.C. will not be adequate. X.A.C. requires a stricter provisioning policy due to the higher risk nature of the lending it does, in addition to the much shorter terms of its loans. For example, X.A.C. considers a loan in default after 90 days have passed, and correctly sets aside a 100% provision. The Central Bank regulation provisions only at 25% for the same period of delinquency.

2. Write-off

X.A.C. has written off T495,000 (US\$495) since the beginning of the operation. Collateral has been seized in the same amount.

3. Refinancing

At the moment, the rescheduling policy is more a one-month extension to pay rather than rescheduling. To date, no loans have been re-financed. X.A.C. staff realizes that it is unlikely that a borrower who is not able to repay a \$100 outstanding balance in two months is even less likely to repay it in one month. Re-scheduling is done at the request of the client and only when there is agreement among the client, the loan approval committee and the credit officer that the loan should be re-scheduled and that the client will be able to repay.

Recommendation: Re-scheduling should be done rarely and then only for two reasons: 1) when it will help a client meet his obligations to repay the loan, or, 2) for a client who has regularly met on-time repay obligations, respond to an opportunity. The current X.A.C. rescheduling practice does neither. If the client is unlikely to repay, the loan should not be rescheduled. If the client is likely to repay, a more appropriate schedule should be negotiated. (E.g. a client is not likely to pay in one month, what he was unable to repay in three months.)

4. Collection

X.A.C. is serious about collection and has developed a methodology where clients are regularly visited when paying on time. When a client misses a payment the credit officer visits immediately. Penalties accrue at the rate of .5% of total outstanding balance plus interest per day.

Penalties accrue until either the payment is made, the loan is refinanced or rescheduled or the collateral is seized. There is no specific policy on the seizure of collateral. It is seized after the client does not pay the installment, or the rescheduling period has expired with no payment forthcoming.

Recommendation: X.A.C. should develop a policy on collateral collection and ensure that the seizure and sale of collateral remains transparent and public process. This is an area where the operation is vulnerable to allegations of unfair business practices.

A collateral registry is kept in the branch and the central office. When collateral is seized and sold, debts are cleared in the following order of priority: payment of interest & penalties, costs, principal and what is left is returned to the client. In Hentii branch a radio broadcast announcing the sale of collateral to the public prompted four of eight defaulting borrowers to repay their debts and reclaim their goods. This policy has increased X.A.C.'s credibility in the community as a serious institution.

5. Crisis

The only significant delinquency crisis X.A.C. has experienced to date occurred immediately after the Mongolian New Year in February 1999. Since that time, X.A.C. staff has paid attention to delinquency -- recording, aging, penalties and seizure and sale of collateral. These experiences have also led staff to re-examine their policies, methodologies and client selection criteria. Staff is serious and quick to absorb their experience, extrapolate lessons and apply them to operations.

F. Liquidity Management

To date, liquidity has not been an issue for X.A.C.. The major exception to this occurred in June 1999 with the processing of a grant disbursement that had been in the UNDP for several weeks with no action. As X.A.C. grows, liquidity issues are likely to become more pressing and UNDP will have to be more vigilant about the timeliness of future payments.

G. Interest Rate Analysis

Table # 17: Yield vs. Effective Rate

LOAN PRODUCT #1:		Dec 31 98	May 31 99	Apr-May 99
a.	Theoretical interest yield (APR)	28.67%	35.83%	14.33
b.	Percentage of total outstanding year-end net loan portfolio	90.70%	96.44%	0.96
c.	(a) times (b)	26.00%	34.56%	13.82
LOAN PRODUCT #2:				
a.	Theoretical interest yield (APR)	28.67%	35.83%	14.33
b.	Percentage of total outstanding year-end net loan portfolio	9.20%	3.56%	0.04
c.	(a) times (b)	2.64%	1.28%	0.51
TOTAL				
d.	Weighted theoretical interest yield (APR)	28.64%	35.83%	14.33
e.	Actual yield on net portfolio	19.19%	30.03%	12.2%
f.	(e) as a percentage of (d)	67.00%	83.81%	85.00%

The gap between the theoretical yield and the actual yield on portfolio is due to timing of disbursements and the growing portfolio. Portfolios in all branches and the overall operation are continuing to expand by at least 25% on average every month. With the exception of perhaps, Ayrag, none of the branches have reached mature portfolio size. With the exception of the Chingeltei branch, which appears to have a lower actual yield due to delinquency, the gap between theoretical and actual yield can be explained by high portfolio growth in the last few months and the waiting time between disbursements. For example, the yield on average net portfolio for the past two months would annualize at 73%.

With commissions, documentation fee, notary fee and insurance fees the client pays an effective interest rate of a little over 11% more than the effective rate the institution actually earns. Although the client can choose the percentage of principal to be repaid as an installment payment, the installment payments carry a minimum installment of the percentage of principal as follows: 15%, 35% and 50%. Clients generally find the repayment period, installments and the term of the loan satisfactory. The effective interest rate on a typical 1st cycle loan of T150,000 over a three-month period with the minimum installment payments carries an effective annual interest rate to the client of 99%. The institution effectively earns an annualized interest rate of 86% for the same loan. The approximate 13% difference is due to the notary fee and the insurance of collateral. The requirement of

insurance is there to formalize the act of offering collateral in addition to protecting the collateral of the institution in case of loss.

Recommendation: X.A.C. should examine whether the cost of insurance and the risk to the institution in the case of loss or damage to collateral, is worth the added cost to the client which is considerable especially on short term loans of small amounts.

1. Interest Rates: Setting, Constraints and Comparisons

Rates are set so that the institution will achieve financial viability within a reasonable period of time, and according to what the market will bear. Because X.A.C. is the only operator in the market, it is relatively easy to get this rate for a valued service. Comparing X.A.C. rates to others in the market reveals the following:

“Pawn brokers in rural areas charge between 240 to 360% per year and in Ulaanbaatar City charge between 132 - 180 % per year. Commercial banks are currently charging as high as 240% per year in rural areas and 36 % to 60 % in Ulaanbaatar City¹².”

Table # 18: Interest Rates: APR and Effective Rates the Client Pays

Finance Charges to the Client					
Principal 150,000 \$150			Principal 300,000 \$300		
Average loan term 3 months			average loan term 3 months		
Turrogs			Turrogs		
Application Fee	100		Application Fee	100	
Document fee on Approved Contracts	400		Document fee on Approved Contracts	400	
Notary fee @.5% of contract	750		Notary fee @.5% of contract	1500	
Insurance Fee 1.5% of value movable	2250		Insurance Fee 1.5% of value movable	4500	
Insurance Fee 1% of value immovable			Insurance Fee 1% of value immovable		
Interest 7% monthly declining balance			Interest 7% monthly declining balance		
Installment 1 15%	ob	p	Installment 1 15%	ob	p
Installment 2 35%		I	Installment 2 35%		I
Installment 3 50%		payment	Installment 3 50%		payment
	150000	22500		300000	45000
	127500	52500		255000	105000
	75000	75000		150000	150000
		10500			21000
		8925			17850
		5250			122850
		80250			160500
Institution Earns	Client Pays		Institution Earns	Client Pays	
	100	-100		100	-100
	400	-400		400	-400
	-150000	-750		-300000	-1500
	33000	-2250		66000	-4500
	61425	150000		122850	300000
	80250	-33000		160500	-66000
		-61425			-122850
		-80250			-160500
	7.17%	8.29%		7.09%	8.18%
	86.09% APR	99.52% APR		85.04% APR	98.21% APR
		Difference			Difference
		13.43%			13.17%

¹² This rate of 240% for commercial banks is not an official figure, but is commonly reported in some Aimag Centres. Several Ulaanbaatar City banks are known to require under the table commissions and fees in order to access their commercial loans.

Table # 19: Mongolia's interest rates on loans

MONGOLIA'S HIGH RATES OF INTEREST ON LOANS	
No interest rate paid:	23.41 %
Less than 5 % /month:	8.60 %
5 to 10 % /month:	26.33 %
10 to 15 % /month:	19.66 %
20 % per month:	11.00 %
More than 20 % /month:	11.00 %

Source: MicroStart Mongolia, Market Survey, Sept. 1998.

H. Liabilities, Cost of Funds Analysis and Capital Management

X.A.C. has no commercial liabilities. The source of liabilities, considered deferred income, are all grants from UNDP. Cost of funds is calculated at the cost of inflation.

It is unlikely that X.A.C. will be able to obtain any loan (soft or commercial) on the local market until such a time that liquidity is injected into the banking system. The timing of this investment will most likely be determined by the World Bank or ADB, the two major donors supporting financial sector development in Mongolia. X.A.C. recognizes the importance of managing debt and is seeking a soft loan.

The only source of equity is approximately US\$ 60,000 in the form of NGO shares in the company. The equity was donated by UNDP to each of the NGOs as part of the MicroCapital Grants. The important topics of equity, ownership and capital planning are discussed in the sections above.

ANNEX 1: PEOPLE MET DURING THE VISIT

HENTII PROVINCE

Mr. Enkhee, *Governor of Hentii aimag (province)*
Mr. Khaltar, *Chairman of the Aimag's Citizens Representative Meeting (Local Parliament)*
Mr. Jargalsaikhan, *Deputy Governor of Hentii aimag (province)*
Mr. Tumurbaatar, *Governor of Herlen sum, Hentii aimag (province)*
Mr. Norovtseren, *Governor of Berkh sum, Hentii aimag (province)*
Mr. Davaatseren, *Director of Berkh-Uul State Ownership Mining Enterprise*
Mr. Bayarsaikhan, *Vice-Director of Berkh-Uul State Ownership Mining Enterprise*
Ms. Donoijav, *Chief Accountant of Governor's Office of Berkh sum*
Ms. Dulamjav, *Chair of LEOS Council of Hentii province, Chair of the Loan Approval Committee of Hentii Branch Office*

ULAANBAATAR

XAC

Mr. GANHUYAG Chuluun- *Executive Director*
Ms. DOLJE,MAA Dorjpurev- *Operation's Manager*
Ms. DELGERJARGAL Bayarjargal - *Finance Manager*
Ms. NERGUI Sandagjav - *Marketing Officer*
Ms. BATAA Byambadorj - *Personnel Officer*
Ms. BOLORMAA Gansuh - *Accountant*
Ms. PUREVSUREN Dojpalam - *Planning and Analysis Specialist*
Ms. ZULAA Ganzorig - *Office Manager*

Mr. ROBERT CATER ACDI/VOCA - *ITSP- Programme Director*
Mr. BAT-OCHIR Dugersuren - *Finance Advisor and Internal Auditor*
Mr. BATBOLD Aryasuren - *Translator and Legal Advisor*

All staff in the three branches visited, Hentii, Chingeltei and Bayanzurh

MEMBERS OF MICROSTART ADVISORY COMMITTEE

Mr. DOUGLAS GARDNER - *Resident Representative, UNDP*
Mr. SODOV SONIN, *NID, PILD. Minister of Health and Social Welfare (Unable to meet with mission)*
Mr. MAGVAN BOLD - *Deputy Governor, The Bank of Mongolia*
Mrs. G. OYUNGEREL - *Director of Restructuring Policy Department Ministry of Finance*
Mr. TS.MAIDAR - *Co-ordinator, National Green Revolution Programme Director, Society for Horticulture*
Mrs. KHASHBAT KHULAN - *Member of Parliament (Unable to meet with mission)*
Mr. GANBOLD - *Director and owner of E-mail Daily News of the Ulaanbaatar Rotary Club*

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Mr. Bruno Pouezet – *Deputy Resident Representative UNDP Mongolia*
Ms. D. Sukhjargalmaa – *Assistant Resident Representative UNDP Mongolia*
Mr. Batkhuyag – *Programme Officer UNDP Mongolia*
Mr. Ts. Ganhuyag – *MP Chairman on the Standing Committee on Security and Foreign Policy*
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Ms. Narantuya - *Legal Department Bank of Mongolia*
Mr. Ts. Ochirbat – *Deputy Chairman of Policy Implementation and Coordination Department MHSW*
Ms. Tsetsegbadral – *National Programme Officer Ministry of Health and Social Welfare*
Mr. Edward Birgells – *USAID Resident Representative*

ANNEX 2: POVERTY CLASSIFICATIONS

Vulnerable Non-Poor:

- Own a small business place or rent a comfortable place of business
- They own their apartment or ger
- The lead members of the family each have steady sources of income
- They have had business experience over a longer period of time
- Have TV, carpets, 2-3 room apartment, refrigerator and stove
- Do not have more than 3 family dependants
- The net income of the family is not higher than US\$200 per month

Moderate Poor:

- Own a ger or have a low quality apartment
- Rent a small fixed business place
- Have mixed sources of income
- The net income of the family is not more than US\$100 per month
- Has 3-5 family dependants
- The household assets are not as good as those of the vulnerable non-poor
- Business is usually not more than 1 or 2 years old

Poor:

- Has difficult living conditions
- Living in a public apartment (shared bathroom and other facilities with other dwellers of the same floor) or living in a low quality ger
- Limited household assets. Usually not TV or refrigerator
- Monthly income below US\$50 per month
- Has more than 3-5 family dependants
- High drop out rate from school children
- Nascent business
- No fixed place or assets
- Usually only one source of household income

Extreme Poor:

- Two or three families living in a ger
- Many family dependants
- Income restricted from one source and only allows for day to day planning
- Beginning a business
- Very limited household assets
- Very high drop out from school children
- Often only one head of household, mainly women
- All family members involved in the new business but very low daily income
- Net income is less than US\$30 per month

ANNEX 3: LIST OF REPORTS CONSULTED FOR THE ASSESSMENT

- Partnership and Company Law of Mongolia
- “The size, origins and characteristics of Mongolia’s informal sector during the transition”. The Development Research Group and the East Asia and Pacific South East Asia and Mongolia Country Unit. James H. Anderson. The World Bank Publications.
- Draft legislation for Non Bank Financial Institutions
- EIU Country Profile Mongolia 1998 - 1999
- Survey conducted by X.A.C. among clients on client satisfaction and poverty targeting
- Trend analysis developed by X.A.C. Latest version June 1999
- XAC Business plan
- Personnel policies

ANNEX 4: SUMMARY OF RECOMMENDATIONS

This is a summary of the recommendations that are found throughout the document.

Governance and Legal Structure

- As X.A.C. is transforming into a formal financial institution, there should be an official transfer of responsibility to the X.A.C. Board of Directors and minutes that record the dissolution of the MAC and the creation of an alternative oversight function.
- In its donor oversight role, UNDP will appoint a staff member or an outside representative as an “Advisor” to the Board until the agreement is terminated. This position will have a voice but no vote.
- Prior to further transfers of equity to the company, or further grants made to new NGOs for equity purchases, all issues highlighted and identified during the SUM mission should be resolved and a memorandum of understanding should be negotiated and signed between UNDP/Mongolia and the Board of Directors.
- The Board of Directors should adopt a clear resolution stating that the owners will not distribute dividends from the company until such a time as it has sustained adjusted rates of return on assets, and adequate reserves and growth levels that will ensure the profitability and stability of the company.
- The Board of Directors should state in writing that Board members will not influence or attempt to control/own specific branch offices but instead will make their decisions based on the overall institutional interests and financial health of the company.
- The Board needs to develop a vision for the health of the company as a whole rather than focusing on the performance of individual branches.
- The ITSP should present a plan of orientation and training to the Board and this plan be reviewed, revised and adopted by the Board of Directors.

Human Resource Management

- Upon liscencing of the company, all staff must reapply for their positions. Only the position of Executive Director and Internal Auditor(s) must be ratified by the Board (this hiring procedure is in line with current staff policy).
- The executive management of XAC should revise the policy of the Loan Approval Committee to specifically state that members of the LAC will be appointed by the Executive Director in consultation with branch offices. These appointments should be made in an open manner and LAC members should be appointed based on qualifications and not on their institutional affiliations.
- X.A.C. should develop a “code of conduct” at the institutional level for staff, loan approval committees and board members during this campaigning and election period. The penalty for political activity should be severe, such as losing employment or position for involving X.A.C. in any political activity. Staff, LAC and Board members should sign a “code of conduct” ensuring they understand what is acceptable personal political activity and what is unacceptable because it jeopardizes the institution.

Funding

- The search for a socially responsible private investor or investors group should begin in earnest. The addition of private, socially responsible investors will provide a balance for the company as well as a healthy array of investors that spread the risk.

- X.A.C. should explore relationships with commercial banks that may be able to offer a line of credit in the future.

Internal Control Systems

- Cash control needs to be improved. Cash counts should be performed daily instead of weekly.
- If larger more secure safes cannot be purchased, safes should be set permanently into the floors.

Methodology

- The time required to access repeat loans could be expedited to increase client satisfaction and improve portfolio turn.
- Limiting compulsory training to understanding the costs of borrowing, the obligations and the risks is an option X.A.C. should consider. Compulsory training includes business planning, which is a complex topic that appears to be of interest to many clients. X.A.C. should consider offering this more specialized training outside the compulsory credit training to improve quality, depth and client satisfaction.
- Clear policies need to be developed on: loan write-offs, re-scheduling, collateral seizure, and certain aspects of collateral, such as limits on collateral, particularly for 1st time loans, and appropriate valuation of collateral.
 - Costs of time and money associated with registering collateral should be examined.
 - X.A.C. should check not only the value, but also the ease of which the item can be sold. As X.A.C. staff becomes more experienced with this type of transaction their expertise will develop. Including a special section on assessing the value of collateral in the on-going staff training is timely.
 - X.A.C. should develop a policy on collateral collection and ensure that the seizure and sale of collateral remains transparent and public process.
 - X.A.C. should examine whether the cost of insurance and the risk to the institution in the case of loss or damage to collateral, is worth the added cost to the client which is considerable especially on short-term loans of small amounts.
- Re-scheduling should be done rarely and then only for two reasons: 1) when it will help a client meet his obligations to repay the loan, or, 2) for a client who has regularly met on-time repay obligations, respond to an opportunity. If the client is likely to repay, a more appropriate schedule should be negotiated.

Clients and Outreach

- It will become increasingly important for X.A.C. to calculate client drop out rates in the context of such low density populations and within its effort to be sustainable given the high cost drop out clients represent to the institution.

UNDP

- As X.A.C. grows, liquidity issues are likely to become more pressing and UNDP will have to be more vigilant about the timeliness of future payments.