

**REPORT AND RECOMMENDATION  
OF THE  
PRESIDENT  
TO THE  
BOARD OF DIRECTORS  
ON A  
PROPOSED LOAN  
TO  
MONGOLIA  
FOR THE  
RURAL FINANCE PROJECT**

**September 2001**

## CURRENCY EQUIVALENTS

(as of 31 of July 2001)

Currency Unit	–	Togrog (MNT)
MNT1.00	=	\$0.0009
\$1.00	=	MNT1,090

## ABBREVIATIONS

ADB	–	Asian Development Bank
ABM	–	Agricultural Bank of Mongolia
BOM	–	Bank of Mongolia
CUSO	–	credit union service organization
GDP	–	gross domestic product
GTZ	–	German Agency for Technical Cooperation
IRC	–	information and resource center
MIS	–	management information system
MNFSCU	–	Mongolian National Federation of Savings and Credit Unions
MOFE	–	Ministry of Finance and Economy
NACCUM	–	National Confederation of Credit Unions of Mongolia
NBFI	–	nonbank financial institution
NGO	–	nongovernment organization
NPAP	–	National Poverty Alleviation Program
PCB	–	participating commercial bank
PFI	–	participating financial institution
PIO	–	project implementation office
PMU	–	project management unit
SCU	–	savings and credit union
SDR	–	special drawing right
SDU	–	supervision development unit
SFSPL	–	Second Financial Sector Program loan
TA	–	technical assistance
USAID	–	United States Agency for International Development
XAC	–	Golden Fund for Development

## NOTES

- (i) The fiscal year (FY) of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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## LOAN AND PROJECT SUMMARY

<b>Borrower</b>	Mongolia
<b>Project Description</b>	<p>The Project will support the development of a system of community-based savings and credit unions (SCUs) to (i) increase access of the poor living in rural areas to financial services (savings and credit) and (ii) stimulate the development of the financial sector over the short to medium term. The SCUs will promote savings mobilization and provide small and generally short- to medium-term loans. The Project offers an alternative for access to financial services to the rural population, including the poor, who are unable to receive financial services from other formal financial institutions. The Project encourages the participation of the poor by setting membership fees at an affordable level (\$5) and directing promotional and training efforts to the poor. A credit union service organization (CUSO) will promote SCU development and will provide training and capacity building within newly formed SCUs. A supervision development unit (SDU) will undertake SCU supervision and regulation to create a more secure environment for SCU operation. The CUSO and SDU activities will be coordinated by a project management unit (PMU) to be established under the Project. The need for information in rural areas will be addressed by establishing information resource centers (IRCs) in four pilot aimags (provinces). The Project will have a pilot phase of three years in four aimags (Arhangay, Dundgovi, Dzavhan, and Sukhbaatar) before going nationwide with the second phase.</p>
<b>Classification</b>	Poverty intervention
<b>Environmental Assessment</b>	Category B. The potential negative environmental impacts of subprojects that may be financed under the Project were reviewed and found to be easily mitigated.
<b>Rationale</b>	<p>At present most of the rural population do not have access to formal savings and credit services; only about 3 percent have access to credit services from a bank or Government institutions. The financial sector faces many constraints in terms of liquidity and institutional capability, and delivery mechanisms in rural areas cannot satisfy the demand for financial services, particularly for those without collateral, including the poor and small enterprises. The informal sector also provides credit, but at a high cost. Thus alternative formal financial institutions are needed to offer a range of financial services on a sustainable basis. Such institutions must have a strong community focus to overcome existing negative social attitudes to credit and financial institutions which have developed in recent years due to failures in the banking system. The Government recognizes the need to revive the rural sector and sees microfinance playing a pivotal role. The establishment of a national SCU network is regarded as a viable alternative form of financial intermediation in rural areas.</p>

An unsupervised savings and credit union movement is emerging in Mongolia upon which a more solid, well-planned expansion of the system can be built. For SCUs to achieve significant outreach and long-term sustainability, the provision of financial services should encompass savings mobilization that provides resources at lower costs than borrowing from commercial sources and is more sustainable than externally funded credit lines that may be available only over a limited time frame. The introduction of incentives in the form of secure deposit facilities and interest rates that provide a real return on deposits will enable a significant volume of these savings to enter the financial system through SCUs. Monetizing the economy and providing local financial intermediation are as much a prerequisite to developing the rural economy as is increasing the supply of credit available to farmers and other rural residents. Establishing low minimum share contributions for SCU membership will also facilitate access to financial services for the rural poor who are effectively excluded from access to alternative savings and credit institutions. The development of an SCU supervision and regulation capability under the Project will offer improved protection for members' shares and savings in SCUs.

### **Objectives and Scope**

The long-term objective of the Project is to develop a sustainable rural financial system that will contribute to both economic growth and poverty reduction. The Project has two purposes: (i) to increase the availability of and access to savings and credit services in rural areas and among the poor, and (ii) to provide a focal point for rural communities to access information and resources to support economic activities to be financed by SCUs, and satisfy socially related information and training needs.

The Project has three components: (i) development of rural SCUs; (ii) establishment of information and resource centers (IRCs); and (iii) capacity building in project management. The Project will initially be implemented on a pilot basis over three years in four aimags (Arhangay, Dundgovi, Dzavhan, and Sukhbaatar) and expanded nationwide during the remaining four years of the Project.

### **Cost Estimates**

The total cost of the Project is estimated at \$15.0 million equivalent, of which \$3.2 million (22 percent) equivalent will be in foreign exchange and \$11.8 million (78 percent) equivalent in local currency. The relatively high level of local currency is considered acceptable for financing as Mongolia, due to its low per capita income, is classified as a least-developed country under the United Nations system, and such member countries of the Asian Development Bank (ADB) are given priority in ADB's local currency financing policy.

**Financing Plan**

(\$ '000)

<b>Source</b>	<b>Foreign Exchange</b>	<b>Local Currency</b>	<b>Total</b>	<b>Percent</b>
ADB	3,242	5,444	8,686	58
Government	0	715	715	5
CUSO	0	384	384	3
SCUs	0	4,866	4,866	32
NGOs	0	349	349	2
<b>Total</b>	<b>3,242</b>	<b>11,758</b>	<b>15,000</b>	<b>100</b>

ADB = Asian Development Bank, NGO = nongovernment organization,  
SCU = savings and credit union.

**Loan Amount and Terms**

A loan of SDR6.854 million (\$8.7 million equivalent) is proposed from the Special Funds resources of ADB. The loan will finance \$3.2 million equivalent of the foreign exchange costs and \$5.5 million equivalent, 46 percent of the total local currency costs. The loan will have a maturity of 32 years, including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period and 1.5 percent per annum thereafter.

**Relending and Onlending Terms**

The Ministry of Finance and Economy (MOFE) will relend the proceeds of the project line of credit to participating financial institutions (PFIs) (which will initially be commercial banks) in local currency at a rate of interest that covers cost of funds, administration costs, foreign exchange and interest variation risks, an allowance for inflation, and a charge to be transferred to a fund administered by the PMU for financing SCU promotion and training. Loans to SCUs and subsequently sublending to members will be at rates of interest that cover the cost of funds and include an allowance for administration costs, loan loss provision, credit risk, and commercial margin.

Loans to the PFIs will be for one to five years. The PFIs will onlend to individual SCUs for up to five years, but loans will initially be limited to a maximum period of one year until the SCU has developed a credit history and acceptable repayment performance. Subject to satisfactory performance and agreement between the CUSO, PFIs, and PMU, loan terms may be extended. Indicative interest rates charged by MOFE to the PFIs would be about 12 percent; from PFIs to SCUs, about 24 percent; and from SCUs to members, about 36 percent. Interest rates will fluctuate depending on financial market conditions.

**Period of Utilization**

30 June 2009

**Executing Agency**

Ministry of Finance and Economy

**Implementation Arrangements**

MOFE, as the Executing Agency, will be responsible for overall Project coordination. The CUSO will be responsible for SCU promotion, development, and training. Existing apex organizations in consultation with the PMU and Bank of Mongolia will jointly establish

a unit to undertake SCU supervision. The PFIs with support from the CUSO will be responsible for implementing the project credit line. A project coordinating committee will provide guidance and advice on project implementation .

**Procurement**

All procurement will be carried out in accordance with the provisions of ADB's *Guidelines for Procurement*.

**Consulting Services**

A total of 52 person-months of consulting, comprising 37 person-months of international and 15 person-months of domestic consulting services, will be provided. Consultants will be selected and engaged through a firm in accordance with ADB's *Guidelines on the Use of Consultants* and other procedures acceptable to ADB for the selection and engagement of domestic consultants. Advance action for recruitment of consultants will be taken.

**Estimated Project Completion Date**

31 December 2008

**Project Benefits and Beneficiaries**

The Project will provide improved access for the rural population, including the poor, to savings and credit services through SCUs. Availability and access to financial services have been identified as primary constraints to rural development and poverty reduction. The total membership of SCUs established under the Project is expected to be 22,100, of which 12,000 will be in 60 aimag center SCUs, and 10,100 will be in 270 soum (district) level SCUs.

Provision of saving facilities will support capital accumulation by the poor, enhancing their ability to manage risks and to take advantage of economic opportunities. The Project has established the minimum SCU membership fee at \$5 equivalent, a level affordable by the poor. More than 36 percent of the members are expected to be poor.

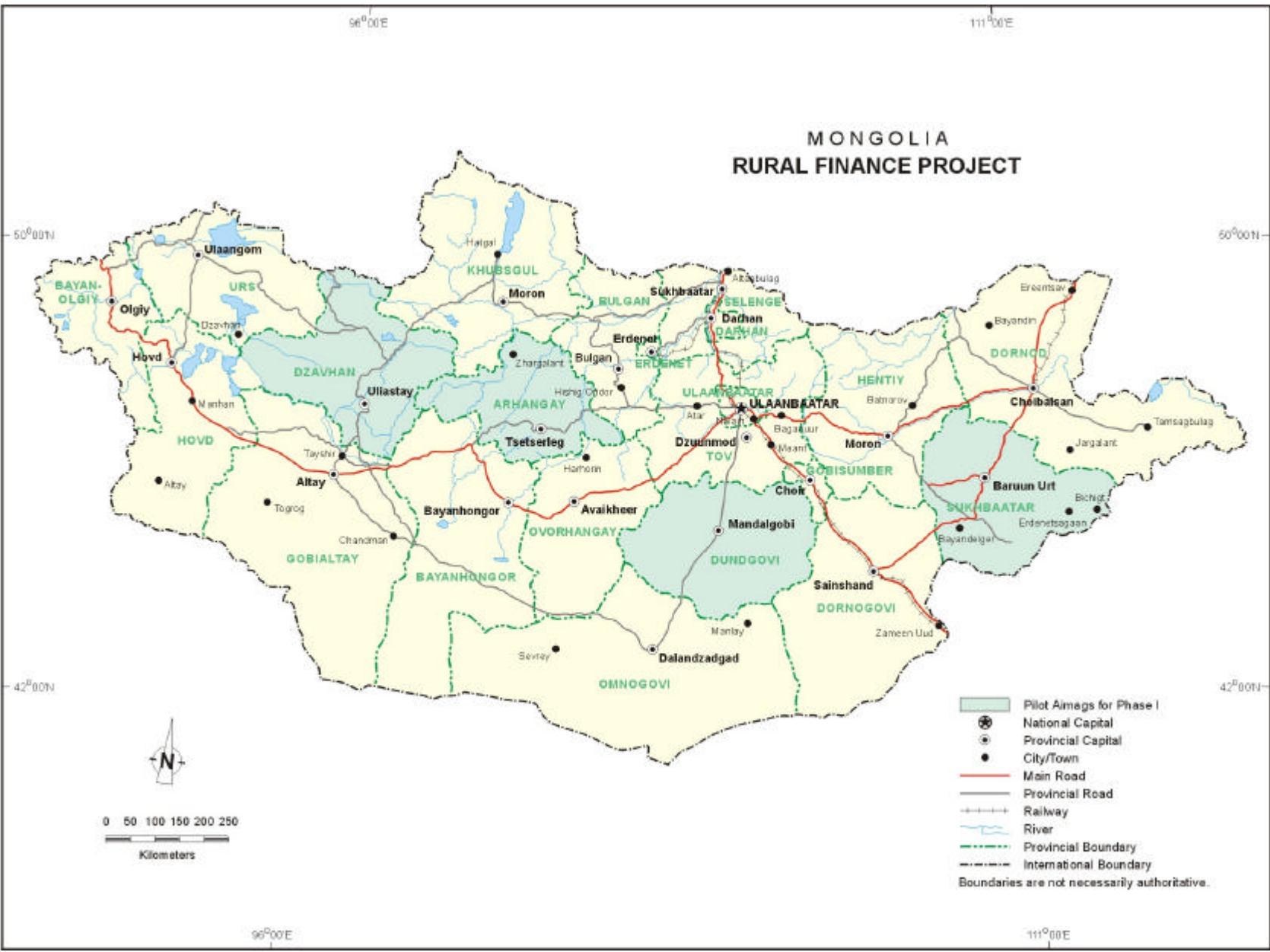
The Project will create new employment opportunities as credit provided to SCU members is used to develop and expand small businesses. Employment opportunities will be created for about 16,500 people assuming that most enterprises will be owner operated.

Through the IRCs to be established in pilot aimags, a wide range of business and skills training and information services will be provided to approximately 29,000 people through training courses and/or workshops.

Financial analyses of the CUSO and illustrative SCUs found that all such institutions would be viable within three to four years and may become sustainable in the long term.

Analyses of representative rural economic enterprises (agricultural trading, retail kiosks, roadside food stalls, ice cream production, flour milling, and tailoring) that could be SCU financed were carried out and found to be viable.

# MONGOLIA RURAL FINANCE PROJECT



## I. PROPOSAL

1. I submit for your approval the following Report and Recommendation on a proposed loan to Mongolia for the Rural Finance Project.

## II. INTRODUCTION

2. In response to a request from the Government, the Asian Development Bank (ADB) financed a project preparatory technical assistance (TA)<sup>1</sup> to review the status of rural financial services and to design a project to address the lack of availability of and access to financial services for rural communities. The TA determined that the development of a system of community-based savings and credit unions (SCUs) with complementary support for apex organizations, and the establishment of an appropriate legal and regulatory framework offered the greatest potential for delivering financial services in rural areas in the short to medium term. The Fact-Finding Mission was fielded in March 2001 to review the design of the Project and to develop the policy dialogue with the Government. The Appraisal Mission was fielded in June 2001.<sup>2</sup>

3. This report is based upon the results of the TA and ADB field visits and discussions with stakeholders in Government, rural communities, the emerging SCU movement, nongovernment organizations (NGOs), and other interested groups. For the purposes of the Project, rural is understood to mean all areas outside the capital city of Ulaanbaatar and includes aimag (province) centers. The project framework is presented in Appendix 1.

## III. BACKGROUND

### A. Sector Description

#### 1. The Economy

4. Mongolia's economy has made good progress during the past 10 years of its transition from a command economy and a single political party to a democratic and market-based economic system. This adjustment has been difficult with the economy initially contracting sharply due to the loss of assistance from the former Soviet Union—the equivalent of 30 percent of gross domestic product (GDP). By 1993, agricultural production had decreased by half, and both industrial output and per capita GDP had declined by a third. The collapse of the state budget followed and led to significantly reduced spending in the health, education, and social service sectors. Annual inflation reached a high of 325 percent in 1993. Unemployment grew as a consequence of the closure of many state enterprises and redundancies in national and local administrations.

5. The economy started to recover in 1994 mainly due to the proactive role of the private sector in the agriculture, manufacturing, and service sectors. The average real growth rate for 1994-1999 was 3.5 percent. However, in 2000, the agriculture sector, the most important economic sector, contracted by 16.8 percent as a consequence of two successive extremely harsh winters (dzud) during which about 10 percent of livestock was lost, affecting the livelihood of nearly 20 percent of the population. The nonagriculture sectors, on the other hand, registered

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<sup>1</sup> TA 3397-MON: *Rural Finance*, for \$700,000, approved on 22 February 2000. The TA was implemented from September to December 2000.

<sup>2</sup> The Mission comprised J. Tokeshi, Project Economist and Mission Leader; S. Wendt, Social Development Specialist; and staff consultants: L. Ito, Credit Union Specialist, and M. Lloyd, Financial Economist.

a growth rate of 13 percent, mainly due to the favorable international price of copper and the strong performance of service industries such as transport and communication, financial services, and wholesale and retail trade. Due to the strength of the nonagriculture sectors, overall GDP growth in 2000 was positive at a rate of 1.1 percent, compared with 3.5 percent in 1998 and 3.2 percent in 1999.

6. The Government addressed the declining trend in growth by giving priority to restoring macroeconomic stability. As a result of the policies to restructure public expenditures, the budget deficit, which was about 12.2 percent of GDP in 1999, was reduced to 6.9 percent in 2000. The growth of money supply slowed to 18.1 percent, compared with 35 percent in 1999. Inflation, which had been declining from 37 percent in 1997 to 7.6 percent in 1999, rose to 11.6 percent in 2000 due to a sharp increase in international oil prices.

7. The current account deficit increased from \$124 million in 1999 to \$165 million in 2000, in spite of a 17 percent increase in exports caused by a rise in the international price of copper. The deficit originated with a 20 percent increase in imports, which was attributable to the strong growth of the nonagriculture sectors, sharp increase in international oil prices, and large inflow of emergency aid for disaster relief provided by the international community to combat the effects of the dzud. The large inflow of official grants also led to a surplus in the balance of payments and an increase in the gross official foreign exchange reserves, from \$157 million at the end of 1999 to \$191 million (equivalent to about 14 weeks of imports) at the end of 2000. External debt has remained stable at around \$850 million, or 88 percent of GDP.

8. Poverty increased in the early 1990s due to the economic downturn and associated unemployment. At present, the percentage of poverty at the national level remains around 36 percent, equivalent to about 900,000 people.<sup>3</sup> Rural poverty, on the other hand, remains at 33 percent. In geographic terms, the distribution of poverty has shifted to rural aimag centers. By 1998, 45.2 percent of the population in aimag centers were poor compared with 41.9 percent in 1995. Over the same period, the percentage of the population in Ulaanbaatar and in rural areas that were reported to be poor decreased slightly. In addition, 26.8 percent of aimag center populations were estimated to be very poor. A discussion of the characteristics of poverty is presented in Appendix 2.

## **2. The Rural Economy**

9. Agriculture accounts for 37 percent of Mongolia's GDP; and with agroprocessing accounting for a third of foreign exchange earnings. About 65 percent of the population live in rural areas and 33 percent of the rural population are poor. During the early years of transition, agriculture declined sharply, in line with the rest of the economy (para. 5). But by the end of the 1990s, it had recovered to its pre-1990 levels of output in real terms. The structure of output in agriculture has changed significantly with a shift away from crop production to livestock husbandry. The share of the crop subsector in total agricultural output declined from 23 percent in 1989 to 10 percent in 1999 due mainly to the withdrawal of state subsidies and progressive deterioration of the production infrastructure. Crop production is based primarily upon the cultivation of wheat, Mongolia's staple food, in the northern and central regions of the country. Production of vegetables, mainly potatoes, on small-scale family plots, is increasing as a means of subsistence and cash income from local marketing of small surpluses. The crop sector faces

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<sup>3</sup> Based on data from World Bank. 1998. Living Standards and Measurement Survey. Washington, D.C. According to the National Statistical Office, the poverty line for Ulaanbaatar is MNT17,600 per capita per month (equivalent to \$0.53 per day), and MNT13,800 to MNT16,400 in other areas of the country (\$0.42 to \$0.50 per day).

serious constraints, such as lack of access to credit, lack of inputs, inadequate post harvest facilities, and poorly developed markets. Faced with such constraints, many farmers shifted into livestock husbandry as a means of subsistence. Livestock production is now the dominant activity and is concentrated in extensive herding of sheep, goats, cattle, and horses. However, the harsh environmental conditions make the dependency on livestock very risky as shown by the huge losses of livestock during the dzud.

10. Agriculture is the main source of income in rural areas and employment in the sector has risen significantly. Its share in total employment increased from a third in 1990 to about 50 percent in 1999. The increasing level of employment and shift to raising livestock reflects the tendency for the unemployed, mainly from former state enterprises and administration, to resort to small-scale herding as a means of subsistence in the absence of alternative employment opportunities and limited welfare payments from the state.

11. Economic activity in rural areas outside agriculture includes small-scale agroprocessing and microenterprises in areas such as trading, retailing, woodworking, and tailoring. Most microenterprises are small family concerns that operate on a part-time, informal basis as a result of constraints caused by a lack of access to raw materials and credit for both investment and working capital. The other main source of employment in rural areas is the public sector, including local administrations and the education and health sectors. In these sectors too, employees frequently need to supplement their incomes by engaging in some informal economic activity, notably petty trading.

12. In addition to lack of financial services, a crucial constraint faced by rural communities is access to reliable sources of information on alternative credit sources, employment opportunities, and prices and market outlets, particularly for agricultural produce. These limit the economic potential of rural enterprises. The provision of such information is seen as an essential complementary service that must be developed in rural areas.

### **3. Rural Financial Services**

#### **a. Commercial Banks**

13. From the mid-1990s, following a number of high profile bank closures, the public began to lose confidence in the banking system and to withdraw deposits on a large scale. The banking system further deteriorated in 1998 resulting from the financial crises in South and Southeast Asia and the Russian Federation, which adversely affected the profitability and liquidity of major corporate clients. Continuing management and governance problems in key banks, together with inadequate bank supervision and political uncertainty made the situation worse. The banking system continues to be weak and is currently unable to serve the rural sector, particularly with basic financial services. Although a bank reform program has been implemented, the financial sector is in need of diversification into alternative forms of financial intermediation that are closer to and better serve the needs of their clients. Appendix 3 presents a review of the rural finance sector.

14. Lending and savings mobilization by commercial banks in rural areas has been very low over the last four years. The only bank with a significant branch network in rural areas is the Agricultural Bank of Mongolia (ABM) which, following an externally supported program of recapitalization, restructuring, and staff training, recommenced lending operations in late 2000. Between mid-November 2000 and mid-February 2001, ABM disbursed 1,026 loans for a total of \$750,000 equivalent, an average loan size of \$730 equivalent. Average loan size in soum

(district) branches is lower, the lowest being \$275 equivalent. Loan terms are between one and six months for a borrower's first three loans and 12 months for borrowers with a good repayment record. Interest rates are 5 percent per month for the first three loans and 4 percent per month for subsequent loans. Collateral, equal to 150 percent of the loan amount, is required as security. Loans are predominantly for trading purposes and medium-sized agricultural and agroprocessing enterprises.

15. During the TA, a rural financial services demand survey covering 600 households was undertaken in three representative aimags to determine the current status of financial services in rural areas. Only 3 percent of all respondents had received credit from banks or Government institutions, such as the Ministry of Health and Social Welfare, in the previous two years. The total of all loans received by respondents was only \$4,400; 45 percent of which was provided by the Government's Poverty Alleviation Program Office of the National Poverty Alleviation Program (NPAP) (para. 31). The average size of these loans was \$220 with interest of 3 to 4 percent per month. At soum centers surveyed, the lack of credit was more severe: only 2 percent of households had received any form of credit from formal sources.

16. Savings mobilization by the banking system in rural areas is also low, as indicated by the low level of deposits held in commercial banks. Funds mobilized by the banking system from outside Ulaanbaatar accounted for less than 17 percent of all individual deposits at the end of 1999. Only 1 percent of the survey's respondents reported depositing cash with a bank. The main reason for households' unwillingness to keep money in financial institutions is their lack of trust in banks and a preference to keep cash on hand. Many households also prefer to use spare cash to purchase consumer durables, converting any surplus cash into household assets. This is common to all rural areas. However, while a third of households reported that they do not trust banks, 81 percent reported that they would use a bank or financial institution if a reliable, trustworthy institution was available to them.

#### **b. Nonbank Financial Institutions and the Informal Sector**

17. Other than commercial bank services in rural areas, the main formal source of credit has been nonbank financial institutions (NBFIs) and programs financed from the Government budget, such as the NPAP and the Local Development Fund. These generally have limited outreach and insufficient funding to service the total demand for credit in rural areas. The main NBFIs operating in rural areas is the Golden Fund for Development (XAC), which was established under the Micro-Start Program of the United Nations Development Programme. XAC aims to reduce poverty by providing microfinance services. XAC has expanded its rural network rapidly and covers 12 aimags. However, branches are only located in aimag centers (provincial capitals) and the bulk of their lending is to aimag center enterprises. Having also started with relatively small loans of between \$100 and \$300, average loan size has been increasing as borrowers graduate to larger loans and longer terms of more than one year. Nominal interest rates range from 48 to 60 percent per year but additional fees for application, loan processing, and collateral notarization raise the effective rate closer to 100 percent. A second, externally supported NBFIs is the Goviin Ekhel, which provides services, including credit, to microenterprises in the Gobi regions of the country and is funded by the United States Agency for International Development (USAID). Goviin Ekhel also effectively targets the more financially secure with loan sizes ranging from \$900 to \$27,000 and interest rates at 48 percent per year. The outreach of both XAC and Goviin Ekhel is limited both in terms of their geographic coverage and their penetration of the lower end of the market for credit. They are also prohibited by law from taking deposits; this limits their potential to mobilize domestic resources. To overcome this, both XAC and Goviin Ekhel plan to restructure to become commercial banks.

18. In the absence of a significant supply of financial services from formal sources, the major supplier of credit in rural areas is the informal sector, which consists of itinerant traders, kiosk (retail outlet) operators, and in the more densely populated aimag centers, pawnbroker operations. The nature of these operations is such that information on the volume of lending and the impact of the informal sector is scarce. Of the informal suppliers of credit, only pawnbrokers are licensed, by the Ministry of Finance and Economy (MOFE), but they operate with very little supervision. Most are small, family-based operations that typically do not lend more than \$1,000 per client per month. They provide short-term loans at interest rates between 10 and 15 percent per month and require collateral in the form of personal property, such as jewelry, carpets, cars, or apartments, with a value of twice the amount of the loan. Loans are mostly for consumption purposes. The insistence upon collateral means that pawnbroker lending is beyond the means of many potential borrowers who are living close to or below the poverty line.

19. Other informal suppliers of credit are more accessible for poorer households. Traders frequently provide household consumables and durables in return for future output from agricultural producers. This system is prevalent among herders who produce and sell meat, wool, and cashmere under such conditions, frequently under disadvantageous terms. For those with less certain means of income, local kiosks provide small amounts of credit in kind in the form of basic necessities. The amounts involved are very small, as little as \$10 per month, but for those borrowers who have little or no cash resources, including the unemployed and pensioners whose welfare payments are frequently delayed, this is a vital service. Often, a borrower's welfare or pension book will be kept by the kiosk owner as collateral. Interest depends upon a borrower's personal circumstances.

20. Finally, self-financing among extended families is also a significant source of credit. Mongolia has a strong cultural tradition of self-help between family members in times of need. Funds are often provided for indeterminate periods with little or no interest expected. The overall extent and impact of such financing is not quantifiable.

### **c. Savings and Credit Unions**

21. The first Mongolian SCUs were established in late 1996 and early 1997 supported by ADB's Employment Generation Project.<sup>4</sup> Initially five were established, four were sponsored by NGOs participating in the project and one by a consultant with the project management unit. All of the SCUs are in Ulaanbaatar.

22. The first SCUs outside Ulaanbaatar were formed in 1999 following the establishment of the Cooperative Training Center in 1998 by the German Gesellschaft für Technische Zusammenarbeit (GTZ), the Soros Foundation, and the Konrad Adenauer Foundation. The center promotes the concept of multipurpose cooperatives (of which savings and credit services are a part), disseminates international cooperative principles, and provides basic member training to aimag center cooperatives. When ABM lending in rural areas stopped, the demand for alternative sources of savings and credit services increased. Depositors in ABM's rural branches also faced increasing difficulty withdrawing their deposits, increasing their distrust of the banking system. In 1998, the Liberal Women's Brain Pool implemented a program to promote SCU formation,<sup>5</sup> and currently provides training on SCU concepts and procedures, and

<sup>4</sup> Loan 1290-MON: *Employment Generation Project*, for \$3.0 million equivalent, approved 16 December 1993 and closed in 1999.

<sup>5</sup> The Liberal Women's Brain Pool currently has branches in 20 aimags and 200 soum centers.

model bylaws provided by Moncord Savings and Credit Union.<sup>6</sup> As new SCUs are only required to register with the local tax authority, no central registry or central licensing procedures exist. Therefore estimating the number and location of SCUs is difficult. As of March 2001, 86 SCUs had been identified, 37 in rural areas. Details of the credit union movement and its financial status are provided in Appendix 3.

23. To oversee the operations of member SCUs and to lobby Government on behalf of the credit union movement, nine Ulaanbaatar-based SCUs established the first apex organization, the Union of Mongolian Savings and Credit Cooperatives (subsequently renamed the National Confederation of Credit Unions of Mongolia, NACCUM), in 1998. By April 1999 a faction split away to form the Mongolian National Federation of Savings and Credit Unions (MNFSCU). NACCUM was perceived to be an urban organization, while MNFSCU claimed national representation. At present both organizations lack the capacity to provide effective services to members and most rural SCUs remain unaffiliated to either organization. A third organization, NetMon, was created as a credit union service organization by six credit unions, one company, and 13 individuals to deliver training and financial services, including credit, that the existing organizations could not. NetMon was licensed as an NBFi by Bank of Mongolia (BOM) in July 2000. The alternative apex organizations, MNFSCU and NACCUM, are registered only as NGOs. NetMon is the only organization with experience in lending to SCUs, using funds provided both by shareholders and through a loan from BOM (using grant funds provided by the United Nations Development Programme to the Government) agreed in January 2001. It has developed internal monitoring skills and encouraged financial discipline in borrowing SCUs through the application of prudent lending policies. NetMon employs three full-time and one part-time staff. It has been able to support staff costs, training, and lending activities from its revenues. An analysis of NetMon and the SCU apex organizations is presented in Appendix 4.

24. While NACCUM and MNFSCU have been largely unsuccessful in providing services to members, they did successfully join with other organizations representing, for instance, farmers, herders, and consumer cooperatives to lobby Government to repeal the SCU portion of the NBFi Regulation issued by BOM in April 1999. SCUs felt that the regulations with regard to licensing, audit, and reporting requirements would inhibit their growth as they were more relevant to commercial banking. Rather than amend the regulations, the Government discontinued BOM supervision of SCUs, which are now governed by the Cooperative Law of Mongolia. The current Cooperative Law primarily addresses agricultural, manufacturing, consumer, and marketing cooperatives, and is inadequate to deal with SCUs. The SCUs recognize that this regulatory vacuum may undermine the future growth and sustainability of the credit union system and are seeking to reintroduce a regulatory framework. A draft of prudential regulations and SCU by-laws prepared during the TA was presented to the Government to be used as an input in the preparation of SCU regulation and supervision policies. With the support of TA to BOM<sup>7</sup> under ADB's Second Financial Sector Program loan (SFSPL),<sup>8</sup> a draft NBFi law, that is expected to include provisions for SCU regulation, is being prepared and is expected to be approved in 2002.

#### **d. Interest Rates**

25. At present, financial institutions enjoy high interest spreads on loans, reflecting the high level of perceived risk in the enterprise sector and high administration costs (up to 59 percent of

<sup>6</sup> Moncord was established as a SCU in 1996 and is widely regarded as one of the most mature credit unions in Mongolia.

<sup>7</sup> TA 3459-MON: *Strengthening Financial Sector Development*, for \$0.6 million, approved on 22 June 2000.

<sup>8</sup> Loan 1743-MON: *Second Financial Sector Program*, for \$15 million equivalent, approved on 22 June 2000.

interest revenue), rather than the level of annual inflation, which stands at 10 to 11 percent per year. Additionally they reflect the lack of competition and inefficiencies in the banking system. Savings Bank reports time deposit interest rates of 1 percent per month and loan rates of 2 to 3.2 percent per month. Mongol Post Bank has deposit rates of 10 to 12 percent per year compared with lending rates of 26 to 36 percent per year. The SFSP is supporting the Government in developing a sound framework for the banking system including the establishment of enabling monetary policy that should help to reduce interest rate spreads in the banking system. In the NBF sector, annual rates of interest on loans range from 60 to 96 percent, and in the informal sector, from 120 to 180 percent.

#### **e. Demand for Financial Services in Rural Areas**

26. The nature of demand for financial services in rural areas is diverse, particularly among the poor. Savings and credit are primarily needed for emergencies, consumption, investment in business, household expenditure, education, and social and family obligations.

27. In the rural financial services demand survey, 85 percent of respondents indicated a need for credit, of which 75 percent specified a need for productive purposes, either to develop business enterprises (38 percent) or to develop crop and livestock activities (37 percent). With respect to loan size, 61 percent of respondents reported a need for loans under \$1,000 equivalent, with 10 percent specifying loans under \$90 equivalent. A further 29 percent indicated a requirement for loans between \$1,000 to \$5,000 equivalent. Respondents were generally aware of the need to pay interest rates for loans within the range of rates currently available from various sources (SCUs, commercial banks, and NGOs), but below the highest rates in the market such as those of pawnbrokers, which are frequently 10 percent per month in rural areas. Half of all households surveyed said that they need loans with a maturity of 6 to 12 months, and a further 30 percent reported demand for loans with a maturity under 6 months. This reflects the need for short-term working capital loans to rehabilitate businesses starved of cash in recent years.

28. Based on the survey, about 85 percent of all rural households require credit; at the estimated weighted average loan size of \$865, the maximum level of demand equates to \$280 million.<sup>9</sup> This probably overestimates actual demand given that once issues such as interest rates, loan maturities, and collateral are introduced into the borrower's decision-making process, effective demand will be reduced. A more conservative estimate in the context of the Project can be obtained from projected SCU membership numbers. Ten percent of potential membership among rural households are expected to actually join an SCU, equivalent to 22,100 households, each with one household member joining a credit union. Based upon lending experience in existing rural SCUs, loan sizes rarely exceed \$1,000. Using only the percentage of the survey's respondents specifying loan demand below \$1,000, a weighted average loan size of \$350 results. Also according to experience among existing SCUs, all members want to borrow. On this basis, total credit demand for SCU members equates to \$13 million.

29. In addition, evidence from the limited lending by other financial institutions in rural areas indicates a significant high level of demand. Since recommencing lending in November 2000, ABM has disbursed over 1,000 loans for a total of \$750,000 equivalent in only three months operating in aimag centers and 25 percent of soum centers. The terms and conditions of such loans with respect to size, purpose, and collateral requirements (para. 14) suggest that they are

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<sup>9</sup> United Nations Development Programme, 2000. *Human Development Report, Mongolia 2000*, New York, estimates 381,000 households in rural areas.

targeted at small enterprises for investment or working capital needs. They therefore serve a different market segment from the potentially large number of borrowers who are unable to offer collateral, which includes the poor, or those who need to borrow for consumption, education, social, or other needs.

30. While the survey found that 77 percent of all households consider borrowing to be the most important financial service, especially for soum centers and rural households, the demand for effective savings facilities is also significant. Among aimag center households, 27 percent of respondents reported savings to be the most important financial service. The corresponding figures for soum centers and rural households are 18 and 19 percent, respectively.

## **B. Government Policies and Plans**

31. In 1994 with external assistance, the Government established the NPAP to tackle poverty by providing funds, including credit for employment generation, rehabilitation of social infrastructure, support for poor households headed by women, and to strengthen the social safety net. Other central and regional government programs have been established for unemployment reduction, women's welfare, child development, and poverty reduction, the latter including a poverty reduction fund administered through local governor's offices. The success of these programs has been limited. The NPAP, in particular, was not well-perceived by groups attending rural workshops and those surveyed during the TA because of its inequitable distribution of funds and lack of transparency and accountability. During 1994-2000, NPAP was allocated \$15.3 million from a variety of assistance agencies for the Employment Promotion Fund (\$4.4 million), Women's Development Fund (\$1.4 million), Local Development Fund (\$9.1 million), and Social Assistance Fund (\$0.4 million). At the end of 1998, only \$6 million had been disbursed and repayment results have been disappointing.

32. In September 2000, the newly elected Government produced its own action program. Social policy in the action program aims at improving living standards by providing equal access to social services, reducing unemployment, improving income distribution to narrow the income gap between social groups, and reducing the absolute level of poverty. This will be achieved by broadening access to education and health services, and strengthening social insurance. In the area of rural finance and poverty, the Government's social policy measures include (i) promoting microfinance activities to provide incentives for enterprise development, and (ii) generating employment opportunities. This will include improving access to skills training, particularly retraining vulnerable groups to enable them to reenter the labor market. Economic policy measures include (i) revitalizing banking and the financial sector by restructuring and privatizing commercial banks; and (ii) improving the legal environment to support NBFIs activities, and increase the responsibilities of lenders and borrowers. Regional and rural policy focuses on establishing improved living conditions by improving services and infrastructure. This includes enhancing marketing networks and encouraging the establishment of cooperatives.

33. Decentralization and emphasis on community participation in economic development are key elements in the Government's strategy to reduce poverty. This is a feature of the Poverty Partnership Agreement signed by the Government and ADB on 24 March 2000, which recognizes that the poor in the different income groups will require different strategies: (i) for people living above the poverty line but likely to become poor, small enterprise development, microfinance, skills development and labor advisory programs, and livestock and agriculture programs; (ii) for the poor living below but close to the poverty line, microfinance, skills development and labor advisory programs, sustained access to social services, livestock and agriculture programs, and development of social infrastructure; and (iii) for the very poor,

income generation activities, training and labor advisory programs, sustained access to social services, and development of social infrastructure.

### C. External Assistance to the Sector

34. Mongolia has received significant external assistance to develop its financial sector. The focus of this assistance has been on introducing a market orientation and commercializing the banking system, liberalizing banking policies, strengthening regulations, building capacity in banking, and restoring health to viable banks.

35. ADB has played an important role in the reform and development of the financial sector. ADB has provided three loans of \$53 million equivalent for the Financial Sector Program,<sup>10</sup> Second Financial Sector Program (footnote 8), and Employment Generation Project (footnote 4). It also provided a TA loan of \$3 million equivalent for improving banking skills,<sup>11</sup> and 13 TA grants totaling \$5.4 million equivalent for the development of the bank and nonbank financial subsectors.<sup>12</sup> Other external assistance to the financial sector includes (i) International Monetary Fund poverty reduction growth facility for SDR33 million approved in 1999; (ii) World Bank private sector development credit for \$12 million equivalent channeled through commercial banks and, together with ADB's SFSP under the Financial Sector Reform Program, the Financial Sector Adjustment Credit for \$32 million equivalent; (iii) USAID TA for bank restructuring, financial audits, and privatization, and support for the pension system; (iv) GTZ TA support for restructuring of ABM alongside USAID; (v) Japan International Cooperation Agency TA support for strengthening commercial banks, the payments system, and rural credit; and (vi) Technical Assistance for Commonwealth of Independent States support for the development of Credit Mongol, an NBFi.

36. In 1999, to ensure effective aid coordination in the financial sector, the Government proposed to the funding bodies that they form a thematic group and prepare a financial sector strategy with World Bank support. The financial sector strategy laid down the long-term vision and medium-term strategy for financial sector development based on improving financial intermediation processes, strengthening prudential regulations and supervisory framework for the NBFi subsector, developing capital market infrastructure, developing the pension system, and strengthening the legal and regulatory reforms of the insurance system. Based on this strategy, the Government has worked closely with ADB and the World Bank to formulate the Financial Sector Reform Program, which covers the various subsectors of the financial sector for potential parallel financing of the associated costs of structural adjustment.

<sup>10</sup> Loan 1509-MON: *Financial Sector Program*, for \$35 million equivalent, approved on 19 December 1996.

<sup>11</sup> TA Loan 1510-MON: *Upgrading Skills and Systems of Commercial Banks*, for \$3.0 million equivalent, approved on 19 December 1996.

<sup>12</sup> TA 2720-MON: *Strengthening the Supervisory and Restructuring Capacity of the Bank of Mongolia*, for \$1.0 million, approved on 19 December 1996; TA 2219-MON: *Strengthening of the Commercial Banking System*, for \$0.6 million, approved on 05 December 1994; TA 1643-MON: *Institutional Support to the Mongol Bank*, for \$0.1 million, approved on 2 January 1992; TA 2605-MON: *Development of Bank Restructuring Strategies*, for \$0.1 million, approved on 9 July 1996; TA 2697-MON: *Implementation of Bank Restructuring Strategies*, for \$0.1 million, approved on 3 December 1996; TA 2105-MON: *Institutional Strengthening of Agricultural Banking Services*, for \$0.3 million, approved on 20 June 1994; TA 3459-MON: *Strengthening Financial Sector Development*, for \$0.6 million, approved on 22 June 2000; TA 1855-MON: *Institution Strengthening of the Financial Sector*, for \$0.6 million, approved on 17 March 1993; TA 3406-MON: *Housing Sector Finance*, for \$0.6 million, approved on 2 March 2000; TA 3397-MON: *Rural Finance*, for \$0.7 million, approved on 2 February 2000; TA 2797-MON: *Development of a Regulatory Framework for Nonbank Financial Institutions*, for \$0.1 million, approved on 20 May 1997; TA 1538-MON: *Adviser to Mongolian Stock Exchange*, for \$0.5 million, approved on 22 November 1993; and TA 1840-MON: *Employment Generation*, for \$0.1 million, approved on 8 January 1993.

37. ADB's support for other sectors also includes indirect support for rural finance. The Agriculture Sector Development Program<sup>13</sup> investment loan includes a line of credit of \$5.5 million equivalent, through participating financial institutions, for rural agricultural enterprises. ADB's Housing Finance (Sector) Project, scheduled for approval in 2001, will provide long-term credit for housing and related infrastructure development by subborrowers. ADB's Social Security Sector Development Program<sup>14</sup> includes support for the development of a social safety net, including unemployment insurance. Support from other external agencies in the rural finance sector includes the NPAP supported by the World Bank, GTZ's support for the development of multipurpose cooperatives, and USAID's Strengthening Participation and Institutional Capacities in Enterprise and Market Development in Rural Areas, and the Gobi Regional Economic Growth Initiative.

#### **D. Lessons Learned**

38. An ADB impact evaluation study<sup>15</sup> reported four important lessons learned from the implementation of rural credit projects. These are that rural credit projects should (i) give due emphasis to promoting a sound and sustainable rural finance system that considers both savings and credit services; (ii) facilitate the mobilization of savings; (iii) encourage the use of market interest rates; and (iv) provide adequate capacity building support that is provided in a sustained manner over a period of time rather than in isolated inputs in order to maximize its impact.

39. In Mongolia, the Employment Generation Project (para. 21) established SCUs and demonstrated that the high demand for efficient microfinance services is not met by the formal financial sector. So far, however, SCUs have developed without adequate access to training on SCU principles and operational policies and procedures. As such, many lack the effective management required to expand and achieve long-term sustainability. To be able to provide effective financial services, they must receive continued assistance in the form of institutional training and capacity building. No effective regulatory and supervisory framework is currently available to oversee their operations.

40. The Kyrgyz Republic Rural Financial Institutions Project,<sup>16</sup> which also focused on the credit union movement, provides additional lessons. Unlike Mongolia, no credit union movement was emerging in the Kyrgyz Republic when the project was designed and implementation started. As of March 2001, 206 licensed credit unions with 12,544 members (an average membership of 60 per credit union) were operating. Average loan size was \$230. The Kyrgyz experience demonstrates that distrust among potential credit members and, as in Mongolia, low population density and wide geographic dispersion does not inhibit the development of the credit union movement.

41. ADB has considerable experience with the development of microfinance as a means to reduce poverty.<sup>17</sup> This indicates that a financial systems development approach is key to maximizing development impact and achieving sustainable results. This approach focuses on

<sup>13</sup> Loan No. 1822-MON: *Agriculture Sector Development Program*, for \$10 million equivalent, approved on 21 December 2000.

<sup>14</sup> Loan 1836/1837: *Social Security Sector Development Program*, for \$12.0 million equivalent, approved on 28 August 2001.

<sup>15</sup> IES: REG 2001-04: *Impact Evaluation Study of ADB's Rural Credit Assistance in Bangladesh, People's Republic of China, Indonesia, Nepal, Philippines, Sri Lanka, and Thailand*, Asian Development Bank, January 2001.

<sup>16</sup> Loan 1529-KGZ: *Rural Financial Institutions Project*, for \$12.5 million equivalent, approved on 21 August 1997.

<sup>17</sup> Meyer, Richard, and Geetha Nagarajan. 2000. *Rural Financial Markets: Policies, Paradigms, and Performance*. Hongkong: Oxford University Press.

establishing an enabling policy environment; appropriate financial infrastructure; and viable, sustainable financial intermediaries committed to providing a range of services. In this context, experience indicates that clients are concerned more about having ready access to a variety of quality services rather than the cost of those services. To have a lasting impact upon poverty reduction, institutions must be committed to expanding outreach and sustainability to ensure permanent access to financial services for the rural population. Services must also be provided on a fully commercial basis. Significant capacity building has been found to be necessary for institutions that target clients in resource-poor areas as is the case for large areas of rural Mongolia. In addition to capacity building in financial institutions, social intermediation to introduce the poor to financial services, and in the case of Mongolia, the market economic system, is essential to facilitate their access to services.

42. The Project is consistent with ADB's microfinance development strategy<sup>18</sup> as it focuses on creating a policy environment conducive to developing financial infrastructure, building viable institutions, supporting pro-poor innovations, and supporting social preparation.

43. Microfinance experience also indicates that the demand for savings services among poor households and microenterprises is as great, if not greater, than the demand for credit. Most cash in rural areas is kept outside financial institutions, and safe, reliable savings opportunities are needed. The provision of secure savings facilities contributes to poverty reduction not only through interest on deposits, but also by facilitating the development of smoother consumption patterns and reducing the impact of economic shocks. Expansion of savings services also offers real potential for the attainment of institutional sustainability. A sound legal and regulatory environment and prudential standards must be established early in the development of financial systems to protect savings.

44. Experience from countries such as Bangladesh,<sup>19</sup> Indonesia,<sup>20</sup> Kyrgyz (footnote 15), Nepal,<sup>21</sup> and Philippines,<sup>22</sup> also suggests that apex organizations can provide an effective mechanism for onlending external funds to rural financial institutions and subborrowers.

## **E. ADB's Sector Strategy**

### **1. Country Operational Strategy**

45. In conjunction with the Government, ADB has developed a poverty reduction strategy for 2000-2005 that forms the focus of ADB's country operational strategy. The key features of the strategy are to (i) generate widespread employment within the short to medium term, (ii) focus employment generation on aimag centers where the poor are concentrated; (iii) promote employment generation through the private sector, (iv) provide a strong social safety net for the very poor who may be beyond the reach of self-help opportunities, and (v) safeguard delivery of social services to prevent the development of non-income-based forms of poverty. The strategy identifies five core sectors of which the financial and agricultural sectors are fundamental to the reduction of income-based poverty.

<sup>18</sup> ADB. 2000. *Finance for the Poor: Microfinance Development Strategy*. Manila.

<sup>19</sup> Loan 1213-BAN: *Rural Poor Cooperative Project*, for \$30.0 million equivalent, approved on 17 December 1992

<sup>20</sup> Loan 1327-INO: *Microcredit Project*, for \$25.7 million equivalent, approved on 25 October 1994.

<sup>21</sup> Loan 1237-NEP: *Microcredit for Women Project*, for \$5.0 million equivalent, approved on 24 June 1993; Loan 1650-NEP: *Rural Microfinance Project*, for \$20.0 million equivalent, approved on 8 December 1998.

<sup>22</sup> Loan 1216-PHI: *Small Farmers Credit Project*, for \$75.0 million, approved on 10 December 1992; Loan No. 1435-PHI: *Rural Microenterprise Finance*, for \$20.0 million equivalent, approved on 23 April 1996.

46. Development of the financial sector will address the constraints posed by the weak banking system, which is virtually nonexistent in rural areas; private sector investment and savings must be mobilized and alternative sources of finance developed, in particular microfinance initiatives. The cost of funds must not be subsidized, rather market interest rates should be applied to support long-term sustainability of microfinance institutions. The agriculture sector, as traditionally the most important in terms of GDP and employment, offers the potential for income and employment generation through the establishment or rehabilitation of production and processing enterprises. The importance of sectoral linkages in revitalizing the economy is emphasized in the country operational strategy. The linkage between the development of rural financial services and agricultural growth is particularly strong. In particular, finance will be required to realize the potential for developing agroprocessing enterprises that offer significant prospects for growth, particularly in view of the large livestock subsector. Agroprocessing too has significant potential for employment creation and providing a year-round source of income with positive implications for poverty reduction.

47. The strategy aims to shift the focus of economic growth from capital intensive, noninclusive public investments to more labor-intensive, inclusive private sector-led employment generation aimed at reducing poverty. The complementary development of human resources appropriate to market economic conditions will require training for professional cadres, as well as skills and business training to ensure a supply of appropriate skills to support growth. For this purpose, both public and private training institutions will need to be strengthened.

## **F. Policy Dialogue**

48. Since Mongolia became a member of ADB in 1991, ADB has maintained a continuous dialogue with the Government on its general reform program for transition, focusing on the agricultural and financial sectors.

49. ADB has strongly influenced the policy of the Government to consider mechanisms for moving away from traditional approaches to rural finance. The traditional approach relied mainly on supply-led, state-owned, agricultural credit institutions delivering directed subsidized credit. The new more systematic and institutional approach promotes private institutions providing both savings and lending services to the broader rural community, not just to agriculture. The Government is pursuing a longer-term strategy to develop self-sustaining rural financial institutions. The steady growth and development of the SCU movement in Mongolia supports the appropriateness of this approach.

50. The Government recognizes that the legal and regulatory framework for SCUs needs to be strengthened, either by amending the existing Cooperative Law or by passing the NBF law. The major issue concerning SCUs is their regulation and supervision to ensure healthy and sustainable SCU development under the overall supervision of BOM. While the final institutional structure of regulation and supervision of SCUs remains an issue of parliamentary debate, the Government has agreed that, as an interim measure, the SCUs under the Project will be supervised by a supervision development unit (SDU) to be within the project management unit (PMU) under the Project. The supervisory capacity developed during the Project will be incorporated into the institutional framework to be established through the envisaged legislation.

51. ADB provided the Government with a draft of legislation and prudential regulations for SCUs prepared during the project preparatory TA. The Government continues to develop the legislation and prudential regulations with the support of ADB technical support under the SFSPL.

52. The interest structure will be formulated in line with competitive market principles to ensure that the interest of different stakeholders including SCU members and participating commercial banks (PCBs), and will enable SCUs to develop on a sustainable basis. No subsidy should be provided through an administrated rate of interest for SCUs.

#### **IV. THE PROPOSED PROJECT**

##### **A. Rationale**

53. A sustainable rural financial system is a critical element of successful rural economies, and accessibility to rural financial services is a crucial factor among the poor, near poor, and vulnerable groups in improving their quality of life. The lack of access to either formal banking or NBFIs has been identified as a major impediment to improving their conditions and livelihood. The survey conducted during the TA found that only about 3 percent of the respondents had access to credit and 1 percent to deposit services. The constraints facing banking suggest that it will not be in a position to satisfy demand for financial services in rural areas, particularly for poor or near poor individuals or small enterprises, in the foreseeable future. Despite ongoing external assistance to the rural banking system, two major problems remain. First, distrust among the rural population of the security of bank deposits is significant. Second, as the rural banking system develops it will initially focus on larger loans requiring collateral. The transaction costs involved in meeting the demand of poor borrowers or small entrepreneurs without collateral and the specialized expertise needed to assess such loans preclude any early significant movement of the rural banks to meet this demand of the rural population, particularly the poor, near-poor, and vulnerable groups. Given this failure by existing banking institutions to reach the rural population and the limited availability and high cost of credit through the informal sector, sustainable institutions need to be established to offer a range of financial services.

54. The TA found that establishing a national network of SCUs and an appropriate legal and regulatory framework is a viable, sustainable alternative to the formal banking system in rural areas. Seventy-five percent of the respondents of the TA survey said they would like to join an SCU. SCUs generally have a strong local focus and have a positive effect upon community development and the growth of social capital. They offer a number of advantages: (i) SCUs are owned by the members, and the policymaking leadership is drawn from the members themselves; (ii) local ownership reduces credit risk and provides peer pressure incentives to repay loans; (iii) SCUs improve access to financial services for local people and can meet short-term or emergency needs of the poor for health and education expenses; (iv) their proximity to potential clients can facilitate mobilization of small deposits; (v) SCUs can offer services with low transaction costs, because of their proximity to, and familiarity with members, thus reducing the debt burden on the poor who now use money lenders at exorbitant rates; (vi) their small size permits the adoption of simple procedures; and (vii) the link between savings and the ability to access credit is much stronger than in commercial banks, particularly where lending is character or cash-flow based rather than collateralized, a feature of SCU lending that makes them particularly attractive to asset-poor households. By providing security for member shares, and savings and interest rates that provide a real return on deposits, SCUs can mobilize savings that are currently converted into nonmonetary assets. The development of SCUs within the Project must be complemented by the support of apex organizations that will help to facilitate an organized delivery of financial services through legally licensed and regulated institutions in the rural areas and stimulate development of the financial sector in the short and medium term.

55. Establishing an SCU system accessible by the poor is not sufficient to ensure the poor will gain access, or that the poor will have the necessary skills to use the credit effectively. In

this regard, poor, vulnerable groups, and small entrepreneurs lack commercially focused business management skills and information regarding business opportunities, alternative credit sources, employment opportunities, prices, and market outlets. They need market-related training including basic business identification, development, operation, and management. The provision of such information is seen as an essential complementary service that must be developed as part of the social preparation in rural areas. Skills training is also needed to enable the unemployed who do not possess entrepreneurial skills to acquire new skills that will be required by a functioning private sector. Social constraints include lack of access to information and training on a range of sociocultural issues including community awareness, health education (disease prevention, alcohol abuse, etc.), environmental protection, self-help schemes, NGO activities, and entertainment. The provision of such services will also lessen the risk that the social dimension of poverty becomes more significant.

## **B. Objectives and Scope**

56. The long-term objective of the Project is to develop a sustainable rural financial system that will contribute to both economic growth and poverty reduction. The Project has two purposes: (i) to increase the availability of and access to savings and credit services in rural areas and among the poor; and (ii) to provide a focal point for rural communities to access information and resources to support economic activities to be financed by SCUs, and satisfy socially related information and training needs. The Project has three components: (i) development of rural SCUs; (ii) establishment of information and resource centers (IRCs); and (iii) capacity building in project management. The Project will initially be implemented on a pilot basis over three years in four aimags (Arhangay, Dundgovi, Dzavhan, and Sukhbaatar) and expanded nationwide during the remaining four years of the Project.

### **1. Development of Rural Savings and Credit Unions**

57. An SCU system, comprising a credit union service organization (CUSO), a network of about 330 individual member-owned SCUs, and an SDU, will be developed to mobilize savings and provide lending services to members at aimag and soum levels.

58. The Project will support the development of an appropriate CUSO to (i) promote SCU establishment, (ii) develop and implement an effective program of training and technical skills for SCU staff, (iii) select local training institutes and NGOs to deliver training to SCU board members and staff, (iv) monitor training effectiveness, and (v) facilitate the delivery of a project credit line to SCUs. Based on an assessment of the three existing credit union apex organizations (Appendix 4), NetMon was selected to perform the functions of the CUSO. NetMon was established with initial paid-in capital of MNT13.5 million (\$13,500 equivalent) and licensed as an NBF1 by BOM in July 2000. It services 20 SCUs, and has successfully provided small loans and enforced prudential standards on borrowing SCUs.

59. During the pilot phase, CUSO activities under the Project will be strictly limited to the four pilot aimags. To ensure the CUSO does not overextend its services, project support will not be available to nonpilot SCUs. However, it will continue to provide services to its existing network of SCUs, but this will not be expanded during the pilot phase. The performance of NetMon as the CUSO will be monitored regularly during implementation; if its performance is not satisfactory, an alternative CUSO will be selected/established.

60. The CUSO will service the SCUs through its head office and using a project implementation office (PIO) as a venue in each aimag to carry out its functions. The Project will

provide computers with appropriate software, office equipment, and furniture for the head office and each PIO to facilitate the effective delivery of the CUSO's functions. A four-wheel drive vehicle will be provided to each PIO to undertake the promotional, training, and monitoring activities at the soum level, but no vehicle will be provided to the head office.

61. The Project will strengthen the CUSO capabilities for management support, staff training and technical skills transfer, design and implementation of financial systems including an appropriate management information system (MIS), and development of SCU lending and savings policies and procedures. In addition, training materials and technical tools will be developed, and training delivery skills of all personnel from the CUSO and other training institutes involved in the training of SCU staff will be developed. The curriculum will be complemented by the training material developed, tested, and delivered under TA 2105, Institutional Strengthening of Agricultural Banking Services (footnote 12).

62. A network of about 330 SCUs, comprising an estimated membership of 22,100 people, will be developed. About 60 SCUs (12,000 members) will be established at the aimag level and 270 SCUs (10,100 members) at the soum level. Each SCU will include a board of directors, credit committee, and audit committee, and will provide savings and loan products to meet the demand and needs of their members.

63. The SCUs will be financed by a combination of member share contributions, and member savings and borrowing. To make membership as open and attractive as possible and to encourage participation by the poor, the minimum full member share contribution will be set at MNT5,000, equivalent to about \$5.<sup>23</sup> Members may be allowed to pay the minimum share contribution in installments. The Project will provide a revolving line of credit totaling \$4.9 million to match members' contributions to supplement the available resources for lending to members. The types of lending activities will not be restricted.

64. Appropriate regulations and effective supervision will be essential for the success of the SCU system. BOM is using the draft legal and regulatory framework prepared by the TA to finalize a framework for the SCUs. The development of adequate supervision capability is important for the financial viability and long-term sustainability of the credit union movement. The Project will support the establishment of a professionally staffed SDU within the PMU. At the end of phase I, a decision will be made by the Government, BOM, and ADB on developing the SDU to meet the significant, expanded capacity required to meet the nationwide expansion of SCUs in phase II. This will include a decision on realigning the SDU as an independent agency or placing it under the authority of another agency. Establishment of an SCU legal and regulatory framework acceptable to ADB is a condition for moving from phase I to phase II of the Project.

65. The SDU will (i) establish a system for regulation and supervision of the SCUs created under the Project, (ii) conduct regular monitoring and on-site supervision and auditing of SCUs to assess compliance with prudential regulations, and (iii) propose corrective measures for adequate compliance with regulations. The Project will provide office equipment, including computers, and consulting services and training for establishing appropriate systems and procedures for the effective supervision and regulation of the SCU system.

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<sup>23</sup> This minimum share contribution is considered feasible on the basis of the size of contributions that soum households indicated in the survey they would be able to make to join an SCU.

## **2. Establishment of Information and Resource Centers**

66. The Project will establish four IRCs, one in each of the pilot aimags. The survey conducted during the TA indicated a significant demand for training, particularly among poor households. In certain areas, NGOs, already providing training to the poor, confirm the need for additional training. A training and information needs assessment will be conducted in each aimag to identify the specific needs at the community level and to review ongoing programs, training facilities, and delivery mechanisms. Based on the findings of this assessment, training programs, information campaigns, and support services will be developed for each IRC (see Appendix 5). Local NGOs will have an important role to play in establishing and operating the IRCs. NGOs will be engaged to facilitate and/or deliver the various services. The Project will finance the necessary refurbishment of existing facilities and provide equipment and training funds in each pilot aimag that has the capacity to accommodate an administration office and training facility.

67. The IRCs will play a key role in the social preparation and promotion of the SCU concept. They will mobilize groups to establish SCUs, help with registration and licensing, and facilitate the training of SCU staff. Particular attention in the promotional campaign and social mobilization process will be given to the poor. These groups will be given special attention to increase their awareness of the savings and credit benefits to be provided by the SCUs, identify specific products the SCUs can develop to meet their needs, and develop appropriate membership arrangements (e.g., payment of membership fee by installment). The CUSO will coordinate all activities with NGOs focusing primarily on the social mobilization process.

68. The IRCs will provide an important mechanism for increasing SCU outreach in remote areas. By providing information, training, and effective targeting, the IRCs will facilitate recruitment of SCU members among the poor. The IRC office will be provided with computer equipment, office furniture and equipment, and training equipment. The Project will also finance the initial purchase of books and publications. A four-wheel drive vehicle will be provided to each IRC to enable it to travel to soums to deliver training courses and workshops and disseminate information.

## **3. Capacity Building in Project Management**

69. The Project will establish a PMU under MOFE that will (i) oversee the CUSO operation; (ii) establish and manage a training fund to finance SCU training; (iii) authorize disbursement of funds under the Project and authorize withdrawal applications; (iv) in conjunction with existing credit union apex organizations and BOM, establish and monitor SDU operation; (v) establish the IRCs and supervise their operation; (vi) develop training delivery capability among training staff in project-related institutions; and (vii) conduct project monitoring and evaluation.

70. The Project will finance the refurbishment of office space for the establishment of a PMU office in Ulaanbaatar and one PIO in each of the pilot aimag centers. Offices will be provided with computers, equipment, and furniture. PIOs will be established only as a venue for the CUSO and SDU to carry out their functions at the aimag level. The PMU will be staffed by a national project director appointed and funded by the Government, and an accountant and an administrative assistant appointed by MOFE. The appointment of the project director, accountant, and administrative assistant will be subject to ADB agreement.

71. On successful completion of the pilot phase, the PMU in conjunction with the CUSO will undertake a series of two-day workshops in all of Mongolia's nonpilot aimag centers. At these

workshops the lessons learned from the pilot phase on SCU promotion and establishment, staff training, membership development, financial services, operating procedures, and SCU regulation and supervision will be presented. This will set the stage for phase II, the nationwide expansion of the SCU system.

### C. Cost Estimates

72. The total cost of the Project is estimated at \$15 million equivalent, including taxes and duties, physical and price contingencies, and interest during implementation. Of this, \$3.2 million (22 percent) equivalent will be in foreign exchange, and \$11.8 million equivalent (78 percent) in local currency. A summary of cost estimates is presented in Table 1 and detailed cost estimates are shown in Appendix 6.

**Table 1: Project Cost Estimates**  
(\$ '000)

Item	Foreign Exchange	Local Currency	Total Cost
<b>A. Base Costs</b>			
1. Establishment of Rural SCUs			
a. SCU Promotion and Training	847	898	1,745
b. SCU Supervision	90	123	213
c. Financing of Rural SCUs	1,460	8,271	9,731
2. Information and Resource Centers	278	880	1,158
3. Capacity Building in Project Management	150	743	893
<b>Subtotal (A)</b>	<b>2,825</b>	<b>10,915</b>	<b>13,740</b>
<b>B. Contingencies</b>			
1. Physical Contingencies <sup>a</sup>	68	112	180
2. Price Contingencies <sup>b</sup>	66	731	797
<b>Subtotal (B)</b>	<b>134</b>	<b>843</b>	<b>977</b>
<b>C. Interest Charge</b>			
<b>Total</b>	<b>283</b>	<b>0</b>	<b>283</b>
<b>Total</b>	<b>3,242</b>	<b>11,758</b>	<b>15,000</b>

SCU = savings and credit union.

<sup>a</sup> Applied at the rate of 5 percent on all costs with the exception of training and information dissemination costs for which a rate of 10 percent has been applied and the line of credit.

<sup>b</sup> Applied at the rate of 10 percent for 2001, 6 percent for 2002, 5 percent 2003, and 4 percent thereafter on all local costs, except SCU member contributions and the line of credit. Price contingencies on foreign exchange costs have been applied at the rate of 2.4 percent per year.

Source: Staff estimates.

### D. Financing Plan

73. It is proposed that ADB provide a loan of SDR6.854 million (\$8.7 million equivalent) to finance 58 percent of the total cost, of which \$3.2 million equivalent will finance all of the foreign exchange costs and \$5.5 million equivalent, 46 percent of the total local currency costs. The Borrower will be Mongolia. The financing will be from ADB's Special Funds resources. The loan will be for a period of 32 years, including a grace period of eight years. Interest will be charged at 1 percent per annum during the grace period and 1.5 percent per annum thereafter. This level of local currency financing is considered acceptable under ADB's local currency financing

policy.<sup>24</sup> Because of its low per capita income, Mongolia is classified as a least-developed country under the United Nations system, and such ADB member countries are given priority in ADB's local currency financing policy. The Government will finance \$0.7 million equivalent (5 percent). The other major financier, the SCUs themselves, will contribute \$4.9 million equivalent (32 percent) in the form of members' financial contributions to their SCUs. The CUSO will finance 3 percent of the total cost and the NGOs 2 percent.

**Table 2: Financing Plan**  
(\$ '000)

<b>Source</b>	<b>Foreign Exchange</b>	<b>Local Currency</b>	<b>Total</b>	<b>Percent</b>
ADB	3,242	5,444	8,686	58
Government	0	715	715	5
CUSO	0	384	384	3
SCUs	0	4,866	4,866	32
NGOs	0	349	349	2
<b>Total</b>	<b>3,242</b>	<b>11,758</b>	<b>15,000</b>	<b>100</b>

ADB = Asian Development Bank, CUSO = credit union service organization, NGO = nongovernment organization, SCU = savings and credit union.

Source: Staff estimates.

74. Additional cost estimates are presented in Appendix 6.

## **E. Implementation Arrangements**

### **1. Project Organization**

#### **a. Executing Agency and Project Management**

75. MOFE will be the Executing Agency for the Project. A PMU will be established within MOFE for overall project implementation. It will be headed by a project director, who together with relevant staff have been appointed by MOFE to ADB's satisfaction. MOFE, through the PMU, will be responsible for administration and disbursement of the loan proceeds, recruitment of consultants, procurement of equipment, maintenance of accounts, and preparation of progress and completion reports. A project coordination committee will be established before loan effectiveness comprising representatives of MOFE, BOM, Ministry of Food and Agriculture, ADB Resident Mission, the international adviser to the CUSO, CUSO, existing credit union apex organizations, and on a rotating basis, two representatives from rural SCUs, to provide overall policy guidance related to the Project. It will meet at least every six months and be chaired by the deputy director of MOFE. The PMU national director will act as committee secretary. Appendix 7 presents a project organization chart.

<sup>24</sup> R1-95: *Review of Lending Foreign Exchange for Local Currency Expenditures on Projects*, 3 January 1995.

**b. Credit Union Service Organization**

76. After phase I, from the fourth year of the Project, the CUSO will expand project operations to the whole of Mongolia, at which time all SCUs will be eligible to access its services, in particular the project line of credit.

77. All staff with a training function must be conversant with appropriate training and workshop delivery techniques in the context of SCU operations. The CUSO training will be comprehensive and include training modules, technical skills transfer, technical tools, MIS, and reporting capability in all key stages and areas of rural SCU development and strengthening.

78. The CUSO's SCU marketing and training staff at the head office, with the help of consulting services, will develop a program of workshops to be run at aimag and soum centers by aimag PIO office staff. Workshops will promote the credit union concept and the benefits of SCU formation among aimag center and soum populations. Aimag office customer services and training officers at the PIO will follow-up the workshops with direct support to groups wishing to form SCUs. Support will include measures to expand membership to reach the minimum size (25 members) required for participation in the Project. The CUSO's aimag office staff at the PIO will also provide support for SCU registration, advice on procedures for election of officers and staff, and support for SCU formation by introducing bylaws, systems, and procedures. Aimag staff will subsequently develop a program of training for board members and all staff of newly formed SCUs within their aimag. Using the curriculum developed at head office, training will be delivered at aimag IRCs. All SCU officers are expected to work on a voluntary basis until the SCU can afford to pay staff.

79. Fees for training provided by both the CUSO and accredited training personnel will be financed from a training fund that will be established and managed by the PMU. The training fund will be financed from the proceeds of the ADB loan and will be used to cover training delivery fees and the travel, accommodation, and subsistence costs of SCU trainees, and the reproduction of training materials. Payments from the fund will be authorized by the PMU. Once MOFE begins to relend the project credit line to PFIs, part of the interest charged to PFIs will be used to replenish the training fund and repay the initial disbursements made by MOFE. The charge to be levied for promotion and training and the training fund disbursement terms and conditions will be negotiated and agreed between MOFE, the PMU, the CUSO, and the PFIs. All training provided to nonpilot aimag SCUs from year 4 under the Project will be based upon 50 percent cost recovery from the SCU. Repeat training for pilot aimags will be charged at the full cost of training delivery. Training costs not covered in this way will be financed from the training fund.

80. The CUSO aimag offices at the PIOs will coordinate with the IRCs on training for pilot aimag SCU members in core subjects, such as business planning and management that will be delivered through the IRCs. Using local expertise from within the business, agriculture, and health sectors or NGOs, the CUSO, and IRCs will also arrange skills training that will be available to SCU members as well as the general public. All such training will carry a nominal charge from the outset as a means of encouraging the principle of cost recovery for the IRCs.

81. The CUSO will also facilitate the delivery of the project credit line, which will be implemented by eligible PFIs. Initially, its role in the credit line will be to develop and review SCU loan applications. The CUSO's aimag offices at the PIOs will review and approve loan applications in accordance with guidelines that will be established by its head office, and will forward all applications to head office for final review. Successful applications will then be

recommended for financing to the PFIs, which will have final responsibility for lending decisions as they will take the credit risk. Guidelines for the allocation of SCU loan applications to the PFIs and onlending terms and conditions will be agreed to by the PFIs, the CUSO, the PMU, and ADB. Allocation of SCU loan applications to PFIs will be based upon an SCU's preference, subject to the PFIs' loan portfolio quality, with particular reference to collection performance on previous loans to the SCUs from the project credit line. All loan information (applications, disbursements, repayments, balances outstanding) and details of loan purposes reported by individual SCU member borrowers will be recorded by the CUSO aimag offices at the PIOs within the MIS, and reported monthly to the PMU.

82. The CUSO will receive fees for SCU eligibility analysis and loan origination and appraisal performed on behalf of the PFIs from the spread that the PFIs earn from onlending the project credit line. In the initial years of the Project while the PFIs' loan portfolio with SCUs and, therefore, interest earned will remain small, and will be insufficient to cover the CUSO operating costs. The balance will be financed by a loan from project funds to the CUSO until fees from credit analysis plus those from the provision of services to the SCUs are sufficient to cover operating costs.

83. The credit analysis role of NetMon (as the CUSO) and the lending role of the PFIs are expected to converge. If NetMon meets the eligibility requirements for a PFI, it may be accepted as a PFI. However, if it is accepted as a PFI, it will stop its function as a credit analyst. A new institution will be selected to play this role. Similarly, should the PFIs develop SCU credit analysis proficiency, they may carry out their own credit analysis on SCU loan applications they receive. Such a convergence under the Project will result in positive externalities of competition within, and deepen the capacity of the financial sector.

### **c. Participating Financial Institutions**

84. During the initial stage of the Project, eligible PFIs are expected to comprise only PCBs. The involvement of PCBs at the outset will encourage financial discipline and ensure the long-term sustainability of the Project. To date, PCBs are the only financial institutions that have significant experience with loan origination, processing, and recovery; however, this does not include lending to credit unions. Appendix 8 presents the proposed eligibility criteria for PFIs. The criteria includes prudential norms issued by BOM (e.g., capital adequacy, liquidity, provision for nonperforming loans, and lending concentration). No ADB loan proceeds will be disbursed to a PFI until an independent auditor's opinion acceptable to ADB has been issued certifying that the PFI is in compliance with these prudential norms.

85. The CUSO will advise the PCBs on SCU eligibility for borrowing and will make recommendations on individual loan applications received from the SCUs. The PCBs will take the credit risk and will therefore have the final lending authority. The level of such borrowing will be determined through negotiation between PCBs, SCUs, and the CUSO on the basis of transaction costs to lenders and the prudential financial structure of the SCUs. The desirability of accelerating start-up operations must be balanced against considerations of SCU safety and soundness. At the start-up of an SCU, the loan size will be limited to a maximum equal to the SCUs' share capital. Subsequently, loan sizes will be limited to 10 percent of an SCU's assets subject to a maximum equal to the SCU's institutional capital (the undivided and

nondistributable reserves of the SCU). Those SCUs with a verified delinquency rate of less than 5 percent will be eligible to apply for funds under the project credit line.<sup>25</sup>

86. On approval of an SCU loan application by a PCB, the PCB will apply to the PMU for authorization for the disbursement of funds from MOFE. MOFE will enter into a subsidiary loan agreement with each PFI for the purpose of disbursement and recovery of SCU loans and for repayment of credit line funds. Loans to individual SCUs will be for up to five years, but initially limited to one year, on terms and conditions to be agreed between the PFI and the SCU with guidance and approval from the CUSO and PMU. The SCUs will be free to determine subblending rates to members according to normal financial criteria.

87. The SCUs will be required to maintain a bank account with the PFI from which it will borrow. The SCUs may also establish accounts in their nearest bank for operational purposes. Credit line funds will be disbursed from the PFIs to individual SCUs into local bank accounts through established transfer systems. In accordance with loan schedules, the PFI will withdraw funds from the SCU account and transfer from this amount the repayment due to MOFE, which MOFE will maintain in a separate account. MOFE will use these funds for amortization of the loan to ADB. When sufficient funds exist, subsequent loan disbursements from MOFE to the PFIs will be made from this account. Incremental SCU funding requirements will be met from further disbursements from the credit line.

#### **d. Savings and Credit Unions**

88. Individual SCUs will be established using model SCU bylaws and policies, standard SCU chart of accounts, and standard SCU financial statements, with guidance from the CUSO and PMU. The standard chart of accounts and financial statements will be consistent with generally accepted credit union accounting standards and practices. Each SCU will set up a board of directors, credit and audit committees, and administrative staff, all initially on a voluntary basis from among its membership. All such SCU officers will be trained by the CUSO's aimag office staff at the PIO or accredited staff from local institutions. SCU officers will implement systems and procedures with the CUSO support and will operate within internationally accepted prudential regulations, which will initially be agreed to by the CUSO, the PMU, BOM, and credit union apex organizations. These regulations will be consistent with the provisions of the legislation currently being prepared under ADB's SFSPL or other relevant legislation.

89. The SCUs will provide a range of savings and credit services to members. They will develop lending and savings mobilization policies and products with the CUSO support, in accordance with ADB relending policies. Initially, loans to members will be for a maximum of three times an individual member's share contribution and for a maximum period of six months. As the SCUs develop their credit analysis skills and as members demonstrate a good credit history, loans may be granted on the basis of members' household cash flow, members' demonstrated capacity to repay, and risk assessment.

90. The SCUs will bear the credit risk of lending to members. They will undertake all credit analysis concerning individual member loans and will have the final authority for loan approval. The SCUs will provide loans for both consumption and production purposes. They will also be

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<sup>25</sup> Delinquency is defined as the total outstanding balance of loans for which at least one payment is 30 days past due.

free to undertake character and cash flow-based lending to reduce transaction costs, but will be encouraged to seek collateral when indicated by prudential norms.

#### **e. Information and Resource Centers**

91. An IRC will be established in each pilot aimag center. Prior to establishment, a training and information needs analysis will be undertaken in each aimag to determine the specific needs of local communities. This will be undertaken by four teams of domestic consultants over a two month period to cover all soums in each aimag. The results of this analysis will guide the design of training and information campaigns that will be run by each IRC.

92. Each IRC will be managed by a director, supported by an accountant and driver. Working with local NGOs, the director will review the needs analysis, and develop and implement the recommended programs. These will consist of a series of training courses and workshops to be run at aimag and soum centers for rural communities covering a range of topical issues. Subject matter specialists for each course and workshop will be drawn from local communities (NGOs, local administrations, agriculture, health, education, finance, and industry sectors, etc.) as required. Alternatively, required expertise will be drawn from neighboring aimags or Ulaanbaatar. During the first three years of operation, the Project will cover all training costs. Thereafter, NGOs, Government, and local institutions will assume increasing responsibility for the IRCs and will introduce a program of cost recovery. As the IRCs will make information available on employment opportunities, a close relationship with the Ministry of Labor will be established.

93. Responsibility for and ownership of the IRCs will remain with the PMU until year 5. Thereafter, the Government will be the owner of the IRCs. The IRCs will charge fees for services such as business planning and training, and the provision of professional advice using subcontracted local expertise. They will also be free to subcontract to local administrations for the provision of public sector functions such as health and social education, training, and workshops.

94. At the end of phase I, the experiences will be consolidated into a practical set of guidelines on mobilizing the poor to participate in the SCUs and developing skills of the poor and small entrepreneurs. During phase II, the lessons from the pilot test will be disseminated to NGOs, the other SCU apex organizations, and externally assisted programs in the expansion aimags, utilizing, as opposed to duplicating, ongoing initiatives to complement SCU development.

## **2. Project Implementation Schedule**

95. The Project will be implemented over seven years. The first three years will comprise a pilot phase for the establishment, training, and operation of SCUs in four aimags. Years 4 to 7 will be used to consolidate and expand the network nationwide.

96. The performance during the pilot phase will be closely monitored, focusing on the establishment of the SCUs, training implementation, membership growth, member share contributions and savings mobilization, lending policies and procedures, loan portfolio growth, and impact upon poverty through outreach of membership and services to the poor. A comprehensive midterm review will be undertaken at the end of the pilot phase. Lessons learned from the pilot phase and annual review missions will be used to develop a program of

expansion to promote and establish SCUs nationwide during the remaining four years of the Project. A detailed implementation schedule is presented in Appendix 9.

### **3. Relending, Onlending, and Sublending Terms and Conditions**

97. MOFE will relend the proceeds of the project line of credit to the PFIs in local currency at a rate of interest that covers the cost of funds, administration costs, foreign exchange and interest variation risks, an allowance for inflation, and a charge to finance a fund that will be established and managed by the PMU for SCU training. The level of the charge to be reserved for the training fund will be agreed to by MOFE, the PMU, and the CUSO. Loans to the PFIs will be for up to five years. The PFIs will onlend to individual SCUs for up to five years, but the initial loans will be limited to a maximum period of one year until the SCU has developed a credit history and acceptable repayment performance. Subject to satisfactory performance and agreement between the CUSO, PFIs, and PMU, loan maturity may be extended to meet demand. Loans to SCUs will be at rates of interest that include an allowance for the cost of funds, administration costs, loan loss provision, credit risk, and commercial margin. The flow of funds is presented in Appendix 10.

98. Part of the margin received by the PFIs will be paid to the CUSO to cover its costs of SCU loan origination and appraisal on behalf of the PFIs and, indirectly, the cost of SCU promotion, training, and service provision. The share to be paid to the CUSO will be determined through negotiation with each PFI. If NetMon is eligible (according to criteria acceptable to the PMU and BOM) to participate in onlending credit line funds to the SCUs on its own account, then it would no longer receive a margin from other PFIs for loan origination and approval. The other PFIs will have to develop their own loan origination and appraisal capability.

99. The SCUs will sublend to members initially for a maximum period of six months at a rate that includes an allowance for administration costs, loan loss provision, credit risk, and commercial margin. This rate will be determined by individual SCU credit committees at a level that provides each SCU with a sufficient margin to cover operating costs and to develop its institutional capital. It will also help to instill financial discipline in the SCUs and borrowing members.

100. Based on discussions with MOFE, administration costs would be about 1 percent and inflation allowance about 6-8 percent. Assuming an allowance of 2 percent for a training fund, an indicative relending rate from MOFE to the PFIs as of July 2001 would be 10 to 12 percent. Discussions with the PFIs, NBFIs, and SCUs suggest onlending from the PFIs to the SCUs at about 24 percent and sublending by the SCUs to members at about 36 percent.

101. The CUSO (NetMon) will also borrow from project funds to cover its operating costs for the first four years under a subsidiary loan agreement with MOFE. The interest rate will be 10 percent, for 8 years, with a grace period of 5 years for payment of the principal. Thereafter, the CUSO will take full responsibility for financing its operating costs from fees for the provision of services and, in the longer term, subject to its eligibility as a participating financial institution (PFI) from onlending the project credit line to the SCUs. Costs for SCU supervision and regulation will be borne by the Project. By the end of the Project, depending on the size of the SCU network, the Government will need to determine the need for and funding of supervision and regulation, which may be a combination of state budget and SCU contributions. The Project will fully finance the operation of the IRCs for the first three years, but project financing will be gradually phased out, reducing to 75 percent in year 4, 50 percent in year 5, and 25 percent in year 6.

#### **4. Disbursement**

102. The Project will establish two imprest accounts at BOM in foreign currency. The first will be used for the disbursement of loan funds for project implementation. The second account will be established and used for the operation of the project credit line. Upon the request of the Government, ADB will deposit an initial amount of \$0.5 million to the first imprest account. The second imprest account for the credit line will have an initial deposit of \$0.25 million. Both accounts will be set up and operated in accordance with ADB's *Loan Disbursement Handbook* and specific agreements reached between the Government and ADB for project implementation.

103. Eligible operating expenditures under the Project will be reimbursed or drawn from the imprest account against satisfactory statements of expenditure subject to a maximum for any single payment of \$100,000. The withdrawal of funds from the credit line account will be in accordance with procedures to be agreed between ADB, MOFE, the PMU, the CUSO, and the PFIs. Requests for withdrawal of funds will be submitted jointly by the CUSO and a PFI to the PMU. The PMU will then authorize the request and submit an application to MOFE for the transfer of funds from the imprest account to a project account to be established and maintained in the PFI. MOFE will establish and maintain a special account (revolving fund) to allow proceeds from PFI repayments to be used to support additional lending activities similar to those under the Project. Operation of the special account will continue after project completion.

#### **5. Procurement**

104. All procurement under the Project will be carried out by the PMU in accordance with ADB's *Guidelines for Procurement*. Each supply contract for vehicles and equipment (other than minor equipment or materials) estimated to cost the equivalent of \$500,000 or less will be awarded through international shopping. Contracts for minor equipment or materials estimated to cost \$100,000 equivalent or less may be procured through direct purchase procedures. Appendix 11 shows the indicative contract packages for goods and services. With respect to the procurement of goods and services financed by subloans, requirements will include that the procurement procedures are appropriate under the circumstances and that goods and services financed by the subloans are from ADB member countries and are purchased at reasonable price.

#### **6. Consulting Services**

105. The recruitment of consultants will be undertaken by the PMU in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements acceptable to ADB for the selection and engagement of domestic consultants. A total of 37 person-months of international and 15 person-months of domestic consulting services will be provided under the Project. At the CUSO, 20 person-months of international consulting services will be provided for head office support and 12 person-months for support in the CUSO's aimag offices at the PIOs. One international and three domestic person-months of consulting services will be provided for the development of the CUSO's MIS. Training services will be provided by the CUSO staff or will be subcontracted to local training institutes, NGOs, or consultants as required. Three international person-months will support the development of the SDU. For the IRCs, eight domestic person-months (two per pilot aimag) will be used to undertake a training and information needs analysis, and one international person-month to deliver a training skills delivery training course for all training staff within project institutions. Four months of domestic consulting services will be provided to the PMU to develop the environmental awareness training module to be included

in the CUSO and SCU training curriculum, and to conduct monitoring of potentially environmentally sensitive subprojects throughout the life of the Project.

106. Consultants, to be provided through a firm, will be selected and engaged by MOFE in consultation with the PMU in accordance with ADB's *Guidelines on the Use of Consultants*. Consultants will be recruited under one package. Terms of reference for consultants are presented in Appendix 12. Advance action for the selection of consultants will be taken in accordance with ADB procedures.

## **7. Accounts, Audit, and Reports**

107. MOFE will maintain records and accounts in accordance with sound accounting principles with sufficient detail to identify all goods and services financed by the Project and to indicate the use to which they were put under the Project. These principles are specified in the Project Accounting Manual prepared for this purpose for all ADB projects in Mongolia.<sup>26</sup> Separate records will be maintained for each imprest account. The accounts (including financial statements, statements of expenditure, and imprest accounts records) will be audited annually according to sound auditing principles by independent external auditors acceptable to ADB. Separate records will be maintained for each imprest account. Costs for annual audits throughout Project implementation have been included within the project costs. MOFE will submit certified copies of the audited accounts and the auditor's report to ADB within nine months of the completion of each fiscal year.

108. Under subsidiary loan agreements between MOFE and the CUSO, and MOFE and the PFIs, the CUSO and each PFI will be required to make audited financial statements available and to maintain all records relating to loans to individual SCUs for a period of five years from the date the loan is agreed. The PMU and ADB may review these loan agreements and records on a random basis. In addition, the CUSO will be required to make available to ADB a statement showing the sources and uses of funds related specifically to project implementation and separate from any other operations it may perform.

109. MOFE through the PMU will be responsible for providing all reports agreed necessary for ADB to ensure compliance with the terms of project implementation. MOFE will provide quarterly reports on project implementation and management, and issues arising that may influence future implementation. At the end of the pilot phase, MOFE will submit a midterm report to be submitted no later than 30 days from the end of the quarter to which they relate. Within three months of project completion, MOFE will submit a project completion report to ADB. All reports will be in a format to be agreed with ADB and be presented in English. MOFE will also provide ADB with any reasonable additional information concerning project implementation that ADB may request from time to time.

## **8. Project Performance Monitoring**

110. A project monitoring and evaluation system acceptable to ADB will be established by MOFE that will allow comprehensive reporting of project input and output data. In addition to financial data, these will include data on physical inputs related to equipment, consulting services, and promotional and training activities undertaken by the Project. Output data will include number of credit unions established, number of members differentiated by socioeconomic group, share contributions and savings generated, loans disbursed, SCU

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<sup>26</sup> TA 2993-MON: *Capacity Building in Project Accounting in Mongolia*, for \$150,000, approved on 10 March 1998.

training course participants, IRC promotional and information campaigns mounted and beneficiaries reached, IRC training workshop participants, and other relevant data that will facilitate monitoring and evaluation of the direct socioeconomic impact of the Project. In the context of the services provided by the SCUs to members, project monitoring and evaluation will include an assessment of the impact of access to savings and credit upon the livelihoods of beneficiaries, specifically the degree to which the poor in rural areas benefit. This will include an analysis of savings and credit growth, terms and conditions, the purposes to which they have been put, and their impact on household incomes.

111. At the start of the Project, necessary baseline data and a set of indicators will be established by the PMU in collaboration with MOFE, the CUSO, the PFIs, the IRCs, and relevant NGOs. Indicators such as percentage of short-, medium-, and long-term loans and respective sizes will be included in the monitoring. A sample of households in the aimag center and selected soums within each pilot aimag will be established to serve as case studies to monitor the socioeconomic impact of SCU membership over the Project's life. Annual monitoring and evaluation reports will be provided by the CUSO and IRCs to the PMU, which will consolidate reports before presentation to ADB in a single annual report.

112. ADB will undertake annual reviews of project implementation, and in cooperation with the Government, will recommend remedial measures where appropriate. ADB will conduct a midterm review at the end of the pilot phase to monitor the performance of the pilot phase in the establishment of SCUs, training implementation, membership growth, member share contributions and savings mobilization, lending policies and procedures, loan portfolio growth, and impact upon poverty. Lessons learned from the pilot phase and the midterm review will be incorporated into an expansion program to promote and establish SCUs nationwide during the remaining four years of the Project.

## **9. Anticorruption**

113. During project processing, ADB's anticorruption policy was explained to Government officials. Attention was drawn to the section on fraud and corruption in accordance with ADB's *Guidelines for Procurement*, particularly the need for bidders, suppliers, and contractors to observe high standards of ethics in procuring and executing ADB-financed contracts, and the sanctions if fraud and corruption are discovered. Similarly, the anticorruption provisions added to ADB's *Guidelines on the Use of Consultants* were discussed.

## **F. Environmental and Social Analysis**

### **1. Environmental Analysis**

114. The Project is classified as environment category B. Beside loans for nonproduction purposes, the SCUs will likely finance small-scale subprojects such as flour mills, bakeries, catering outlets, food shops, kiosks, woodworking, sewing and tailoring, crop and vegetable production, and livestock husbandry. Most subloans are expected to range from \$50 to \$1,000 equivalent for working capital to expand and/or revitalize existing cash-starved small-scale rural enterprises. In view of this, the Project is not expected to cause any significant environmental concerns.

115. Due consideration of environmental issues will be given in the process of selecting and implementing subprojects. Any microenterprise with potential adverse environmental impact, will be required to obtain a clearance from a competent environment agency. An initial

environmental examination for such a subproject will be carried out as part of the appraisal process and an appropriate report submitted to ADB for review. MOFE has given assurance that the PFIs, the CUSO, and all participating SCUs and their subborrowers will comply with the environmental laws and regulations of Mongolia, particularly the Mongolian Law on Environmental Protection (1995), as well as ADB's environmental guidelines.

116. To minimize the risk of any adverse environmental impacts that may result from subprojects and to promote the importance of environmental issues in small-scale businesses, a training module on environmental awareness and requirements will be prepared and used to train staff involved in subloan evaluation and subborrowers involved in implementation of subprojects. The module will be developed by local experts or a reputable local environmental consulting firm and will form part of the overall SCU training program.

117. One month of domestic consulting services will be used to establish the training module on environmental awareness. In addition, two weeks of domestic consulting services per year has been allocated for the PMU to undertake environmental monitoring of SCU member subprojects on a random sampling basis and lessons learned will be fed back into the training process.

## 2. Social Analysis

118. Growth in income-based poverty since 1990 reflects an increase in inequality in income distribution and a decline in key social indicators. Between 1990 and 1995, income and school enrollment declined steeply; life expectancy also decreased. After 1996, a series of Government policy interventions resulted in some recovery. Key health concerns include continuing high mortality, high incidence of diseases such as tuberculosis, hepatitis, sexually transmitted diseases, along with declines in nutritional status. The national incidence of poverty is estimated at 36 percent; rural poverty about 33 percent.<sup>27</sup> In the pilot aimags, according to the official poverty line,<sup>28</sup> 40 percent of the population in Arhangay, 43 percent in Dundgovi, 23 percent in Sukhbaatar,<sup>29</sup> and 43 percent in Dzavhan live below the poverty line.

119. Unemployment rates remain very high. The official rate of unemployment is 6.5 percent<sup>30</sup> equivalent to 39,000 people, but actual levels are undeniably higher. Actual unemployment (after adjusting for persons employed outside the formal sector) is estimated to range from 17 to 23 percent of the working age population.

120. Available data on existing SCUs indicate that while most members (about 75 percent) are middle-income earners, about a quarter of the members are poor. The latter are as keen as middle-income earners to avail of financial services and their membership is expected to increase significantly if two constraints are addressed—affordable membership fees, and SCU competitiveness in meeting the credit needs of the poor. The Project addresses these two factors by setting the membership fee low (\$5) and by targeting the poor in its outreach and training activities. The latter will include developing client-specific financial services to tailor the

<sup>27</sup> Based on the findings of the Living Standards Measurement Survey carried out by the World Bank in 1998.

<sup>28</sup> See footnote 3.

<sup>29</sup> Data for 1998. However, Sukhbaatar has been severely affected by the dzuds of 2000 and 2001, and as a consequence, the percentage of the poor is estimated to have greatly increased to above 40 percent.

<sup>30</sup> The official definition considers the unemployed to be the number of persons who have registered with the Ministry of Labor as unemployed. This excludes first time labor market entrants ineligible for labor registry services and those who see no value in registering. Hidden unemployment is estimated at 12 percent (ADB. 2000. *Mongolia, A Poverty Reduction Strategy for ADB Operations in Mongolia*. Manila).

features of the SCUs in poor communities to the needs of their members. This is done through (i) an affordable membership fee and possibly payment of this fee in installments, (ii) the IRCs' training activities specifically targeting 50 percent of the poor to nurture their participation in the SCUs, and (iii) the SCUs developing financial products tailored to the needs of the poor. In that regard, given the incidence of poverty in the four pilot aimags is at or below the national poverty incidence of 36 percent, the membership of SCUs to be formed in these aimags will likewise be about or above that percentage.

121. About 54 percent of the unemployed are women. Women tend to have less job security than men, less access to information, and less access to credit from the formal banking system. The SCUs will provide women with access to savings and credit services, and their response to the availability of services is likely to be positive. About 73 percent of the existing SCUs have been organized by women and their participation in the total membership is 60 to 70 percent. About 60 percent of managerial positions are occupied by women. Similar strong participation of women in SCUs can be found in the Kyrgyz Republic. In June 2000, participation of women in total membership was about 52 percent, and women occupied 40 percent of all managerial positions.<sup>31</sup>

122. The performance and the repayment rates of SCUs are impressive. Existing SCUs have a repayment rate of nearly 100 percent. The reason for the high repayment rate is the close monitoring of SCU activities by membership, as the work of SCUs is based on transparent and democratic principles, including active involvement of members.

## **V. PROJECT JUSTIFICATION**

### **A. Financial Analysis**

#### **1. Financial Viability of the CUSO**

123. For the financial analysis, the CUSO is assumed to only earn income from providing credit advisory services to the PFIs. The onlending margin that PFIs will earn is assumed to be 14 percent from lending to the SCUs at 24 percent with a cost of funds of 10 to 12 percent. The analysis was performed for a five-year period.

124. The CUSO's income would be small during the first three years of the Project when the volume of onlending is low due to the small number of credit unions in pilot aimags that would be eligible to access the credit line during the pilot phase. Using a rate of 7 percent for the CUSO's fee income and an estimated average portfolio outstanding of \$533,000, the CUSO's revenues reach \$37,300 by year 3. As the Project expands to the whole country, and all financially sound SCUs are eligible to borrow under the credit line, the volume of lending increases significantly. In year 4, the average portfolio outstanding is estimated at \$1.54 million and the CUSO revenue reaches \$108,000. Annual costs in year 4 are \$177,000 resulting from steadily increasing costs of financing the borrowing from MOFE. In year 5, the CUSO is estimated to return a profit of \$18,000 based upon a revenue of \$196,000 earned on the average portfolio outstanding of \$2.8 million. As the size of the portfolio increases, the CUSO's financial viability is improved. By the end of the Project, revenues are estimated to reach \$289,000 on an average portfolio of \$4.4 million.

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<sup>31</sup> ADB. 2000. *Women's Participation in Credit Unions in the Kyrgyz Republic*. Report prepared for ADB's Rural Financial Institution Project. Manila.

125. However, as implementation proceeds, the CUSO will earn an increasing share of the onlending margin that will increase profitability, enabling it to breakeven and start to repay MOFE loans for operational expenses earlier. Projected financial statements for the CUSO's operations under the Project are presented in Appendix 13.

## 2. Financial Viability of Individual SCUs

126. Financial analysis has been undertaken on illustrative examples of SCUs that would benefit from participation in the Project. These are pilot aimag and soum SCUs, and nonpilot aimag and soum SCUs. The assumptions underlying the analysis and financial statements for the four examples are presented in Appendix 13.

127. Growth rates are similar for both pilot and non-pilot aimag center SCUs. In value terms, pilot aimag center SCUs achieve more than three times the assets of nonpilot aimag center SCUs. At the end of five years, nonpilot aimag center SCUs have assets of \$69,000 and earnings of \$3,600 compared with assets of \$212,000 and earnings of \$10,000 for pilot aimag center SCUs. The disparity in asset growth and income between soum level pilot and nonpilot SCUs is similar to that between aimag center pilot and nonpilot SCUs in the first three years. The disparity levels out in years 4 and 5 because the pilot SCUs reach close to maximum penetration of potential membership in the first three years and have nominal membership growth thereafter.

## 3. Financial Analysis of Illustrative Subprojects

128. In the subproject analyses, loan sizes range from the equivalent of about \$40 for a small roadside guanz (cafeteria) to \$1,000 for an investment loan to establish an ice cream production unit. Loan terms range from 3 to 10 months at an assumed interest rate of 2.75 percent per month. In addition to providing employment to the borrower, who will generally be the owner and operator of the enterprise, a number of the enterprises reviewed also will create employment for both skilled and unskilled labor from within their community.

129. Using the data provided on subproject inputs, outputs, and prices, each has been analyzed and found to be financially viable and result in increases in monthly household incomes, and generate sufficient cash flow to cover debt service. The subprojects have been subjected to sensitivity analysis and generally found to be robust with regard to increases in costs and reductions in revenue. Summary results are presented in Table 3.<sup>32</sup>

**Table 3: Summary Financial Indicators for Illustrative Subprojects**

<b>Subproject</b>	<b>Loan Amount (\$)</b>	<b>Annual Net Profit after Debt Service (\$)</b>	<b>Person-Days of Labor per Year<sup>a</sup></b>	<b>FIRR (%)<sup>b</sup></b>
Agricultural Trading	1,125	582	90	—
Roadside Guanz	40	158	150	—
Ice Cream Production	920	2,245	1,500	20
Flour Milling	965	129	180	>100
Tailoring	490	1,570	1,080	—

— = indicates that an FIRR for a subproject cannot be calculated, FIRR = financial internal rate of return.

a Indicates the number of days of labor created by the subproject both within and outside the household operating the subproject.

b Financial internal rate of return over the first 12 months of operation, excluding subloan financing flows.

<sup>32</sup> Detailed analysis and supporting projected financial statements of the five subprojects are available in Supplementary Appendix E.

130. Loans for education, medical expenses, weddings, etc. will also form part of an SCU's portfolio, but no attempt has been made to assess the debt service capacity of SCU members borrowing for such purposes or the "viability" of such borrowing.

## **B. Social Dimensions**

### **1. Growth of SCUs and Membership**

131. By the end of the pilot phase, 16 aimag center SCUs and 79 soum level SCUs are expected to be established. By the end of the Project, total membership is estimated to reach 22,100, of which 12,000 will be in 60 aimag center SCUs (with an average membership of 200), and 10,100 will be in 270 soum level SCUs (with an average membership of 37). The total membership represents 6 percent of all rural households assuming one member per household. On the basis of an average household size of 4.5 persons, the total number of individuals benefiting from SCU membership is estimated to be about 100,000.

132. Through the provision of business and skills training to SCU members, and through the IRCs, the provision of a wide range of training and information services to the general public, the Project will contribute to the revitalization of rural areas, and therefore an improvement of rural livelihoods. The development of SCUs with low minimum share criteria for membership (\$5) will facilitate access to financial services to the rural community irrespective of income or degree of poverty. Similarly, through the IRCs, the provision of training and information related to employment opportunities, health, social, and cultural issues will benefit rural communities and facilitate opportunities for the rural population to improve their livelihood. An estimated 29,000 people will have attended training courses and/or one-day workshops. Through the training of members of the board credit committee, audit committee, and administrative staff, the Project will enhance the financial and managerial skills in rural areas within the SCU movement. In addition, employment creation will be significant both within SCUs themselves when they reach a stage of development that requires full time staff, and within new and/or expanded enterprises that result from members' borrowing from the SCUs.

### **2. Impact on Poverty**

133. Provision of savings facilities will support capital accumulation by the poor, enhancing their ability to manage risks and to take advantage of economic opportunities. The Project provides enhanced access to savings and credit services, which has been identified as a primary constraint to rural development and poverty reduction. The provision of such services through locally organized and managed SCUs offers considerable benefits compared with formal financial institutions such as commercial banks, which are currently unable to provide these services to rural communities. The significantly lower administrative and transactions costs of SCUs coupled with a lower level of risk due to peer pressure among members enables SCUs to offer more competitive and reasonable interest rates on borrowing than their competitors. In terms of economic impact, this ability to offer lower interest rates on loans will have the greatest impact at the local level. Lower costs also translate into the ability of SCUs to offer attractive real rates of return on savings deposits. At present, the SCUs offer interest on deposits in the range of 2 to 3 percent per month compared with informal sources. Initially, this will be the most important benefit that will accrue to the poor who participate in the SCUs and access savings facilities for which demand is strong but which are currently lacking in rural areas. The proposed system of associate SCU membership in which members can contribute to share capital in installments in order to build up to the minimum level of contribution of \$5 equivalent will also facilitate access to membership for the poor.

134. Because of the distribution of population in rural areas, SCUs with the largest memberships will be established at aimag centers. The provision of financial services at aimag centers accords with the strategy of the Poverty Partnership Agreement for Mongolia, which identifies aimag centers as the areas where income and employment generation activities need to focus, since the poor are concentrated in aimag centers. In addition to the impact that the development of SCUs will have on the provision of financial services, the IRCs will perform an important complementary social function providing opportunities for training and information dissemination.

### **3. Impact on Employment**

135. The survey indicated that 75 percent of potential SCU members would probably borrow for productive purposes, 38 percent for business enterprises, and 37 percent for agricultural production. The nature of business enterprises currently being financed by SCUs, XAC, Goviin Ekhel, and ABM in rural areas include trading, retailing, agroprocessing, woodworking, catering, and tailoring. By the end of the Project, SCU membership is expected to reach around 22,100. SCU experience indicates that all members will borrow at some time. Assuming that 75 percent of members will borrow to establish or rehabilitate enterprises, it is estimated that employment will be created for some 16,500 people assuming that most enterprises will be owner operated. Some of this employment will be part-time, or in the case of agriculture, seasonal. Equally, more successful enterprises will generate additional employment opportunities both within a borrower's household and outside in the community at large.

#### **C. Risks**

136. The principal risks associated with the Project relate to the maintenance of a stable macroeconomic environment on the part of the Government and the implementation of its declared policy on the development of rural areas, nonbank financial institutions, and poverty reduction during and beyond project implementation.

137. Within the financial sector, rural financial markets must remain competitive and free from nonmarket interference, and the newly established SCUs must be free under Mongolian law to offer a range of financial services, including deposit mobilization. In this respect, to protect the public interest and to avoid the negative perception with which the public views the formal financial sector, legislation governing the supervision and regulation of SCUs must be effectively implemented. Failure to effectively control the current rapid and unsupervised growth of SCUs may undermine the systematic promotion and development of SCUs under the Project. ADB is assisting the Government to address this concern through the SFSPL, and the Project will support this effort by providing SCU supervision and regulation capability in the SDU.

138. While the rural population, especially the poor, can be expected to realize substantial benefits from the Project, they may adopt a "wait-and-see" attitude to participating in the SCUs, as these institutions are relatively new for them. The risk will be addressed through extensive promotion and training efforts within these groups. Application of prudential regulations and strict supervision will hopefully decrease the rural populations perceived risk of the SCUs.

139. The Project places great importance on the need to (i) properly promote the SCU concept throughout Mongolia through nationwide workshops, and (ii) implement effective SCUs at the aimag and soum levels. Considerable capacity building through consulting services will be directed toward the CUSO and SCU development in the pilot aimags of the Project. The success of the training effort will depend both upon the degree to which training is effective and

upon persons trained remaining in their jobs to perform the functions for which they have been trained. This applies to all the institutions established or supported under the Project, CUSO, SDU, SCU management, and SCU members themselves.

140. Financial risks to the SCUs and their members may arise if membership is concentrated in groups who derive their income from a single economic sector. Economic shocks or collapse within that sector could have adverse impacts upon the viability of individual members and the SCU as a whole. Effective promotion and training will emphasize awareness of the risks of such membership concentration and the benefits of diversity of members' sources of income.

141. On the economic front, the success of the Project will depend upon a strong demand within the rural population for SCU services, in particular that credit demand is sufficient for the SCUs to draw down the project line of credit. All the evidence indicates that this will not be a major risk.

142. The success of the IRC component will depend upon a strong demand within the rural population of the pilot aimags for training and information provided by the IRCs. The complete lack of such facilities since the collapse of the Soviet system together with the demand expressed during rapid rural appraisals suggest that adequate demand will continue. However, the ability of rural communities to pay for such services as project financing is phased out will to some degree depend upon the success of the Project in revitalizing the rural economy by providing SCU financial services and the ability of the IRCs to provide services of a variety and quality that people will be prepared to pay for.

143. While the Project will address the constraints posed by the present lack of financial services and the need for training and information services in rural areas and by so doing help to reduce poverty levels, the Project will not be able to assist certain sections of the rural population through the provision of commercially viable and sustainable financial intermediation.

144. Finally, the success of the Project will also, to a large degree, depend upon effective implementation by the PMU and monitoring by ADB to identify potential problems and initiate remedial measures at an early stage. For this purpose, an effective national project director will be essential as well as non-interference in the appointment of PMU staff.

## **VI. ASSURANCES**

### **A. Specific Assurances**

145. The Government has given the following assurances, in addition to the standard assurances, which have been incorporated in the legal documents:

- (i) To be eligible to receive subloans under the credit line, each SCU will have to satisfy specific criteria, including the following: each SCU will have been established in accordance with the model SCU bylaws, policies, standard SCU chart of accounts, and standard SCU financial statements developed under the Project; all SCU officers will have been trained by the CUSO aimag office staff at the PIO or accredited staff from local institutions; and SCU officers will implement systems and procedures with support from the CUSO, and will operate in accordance with internationally accepted prudential regulations, to be agreed to by the CUSO, the PMU, BOM, and the credit union apex organizations.

- (ii) Under the Project's credit line, the SCUs will borrow funds in accordance with the requirements agreed to by the Government and ADB, including membership share contribution and compliance with relevant environmental laws and regulations and ADB's environmental guidelines.
- (iii) NetMon will be designated as the CUSO with overall responsibility for the SCU promotion and training.
- (iv) The PFIs will be in compliance with the initial and ongoing eligibility criteria agreed to by the Government and ADB, including the prudential norms issued by BOM (e.g., capital adequacy, liquidity, provisioning for nonperforming loans, and lending concentration). No ADB loan proceeds will be relent to a PFI under the Project's credit line until an independent auditor's opinion acceptable to ADB has been issued, certifying that the PFI is in compliance with these prudential norms.
- (v) Based on the training assessment, training programs and information campaigns will be developed at each IRC. At least 50 percent of the persons receiving training will be poor. The programs will concentrate on a broad spectrum of training and information related to improving livelihood strategies of poor households, including skills training, health and nutrition, social services, market opportunities, and agricultural issues.
- (vi) The PMU will establish the SCU training fund which will be funded under the Project and replenished with a portion of the interest payments received from the PFIs and from training fees collected during phase II of the Project.
- (vii) The Government will take necessary actions to encourage the participation of women in SCU development, including SCU establishment and management.
- (viii) MOFE will ensure that real positive interest rates are charged by the PFIs and SCUs with sufficient margin to cover the cost of funds, credit risk, and administration costs, including appropriate provision for loan losses.

## **B. Condition for Loan Effectiveness**

146. In addition to the standard conditions, the PCC will have been established in a manner acceptable to ADB.

## **C. Conditions for Disbursement**

147. No funds from the project credit line will be disbursed until all necessary start-up training has been completed, and a sufficient number of SCUs satisfying the requirements agreed to by the Government and ADB have been legally registered. Prior to disbursement of any funds under the credit line through a PFI, a subsidiary loan agreement, acceptable to ADB, between MOFE and the PFI will have been executed. Prior to the commencement of phase II of the Project, the Government will have established a legal and regulatory framework acceptable to ADB with respect to the regulation and supervision of SCUs, including determination of the Government agency responsible for such regulation and supervision.

**VII. RECOMMENDATION**

148. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve the loan in various currencies equivalent to Special Drawing Rights 6,854,000 to Mongolia for the Rural Finance Project, with a term of 32 years, including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

TADAO CHINO  
President

25 September 2001

**APPENDIXES**

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**SUPPLEMENTARY APPENDIXES**

(available on request)

- A Proposed Savings and Credit Union Bylaws
- B Proposed Savings and Credit Union Financial Discipline and Ratios
- C Analysis of Identified Participating Commercial Banks
- D Projected Financial Analysis of the CUSO and Illustrative Savings and Credit Unions
- E Financial Analysis of Illustrative Subproject
- F Training Schedule and Savings and Credit Union Training Curriculum Outline

## PROJECT FRAMEWORK

<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<p><b>Goal</b></p> <p>To develop a sustainable rural financial system</p>	<p>More than 90 percent of savings and credit unions (SCUs) continue to operate, and are operationally and financially viable at the end of the Project</p> <p>SCUs contribute significantly to the provision of rural financial services</p>	<p>Project completion report</p>	<p>Government of Mongolia policy on the development of rural areas, nonbank financial institutions, and poverty reduction remains in force during and beyond the project period</p> <p>A stable macroeconomic environment exists</p>
<p><b>Purpose</b></p> <p>To increase the availability of and access to savings and credit services in rural areas</p> <p>To provide a focal point for rural communities to access information and resources to support economic activities to be financed by SCUs, and satisfy socially related information and training needs</p>	<p>22,100 SCU members share contributions and savings in \$4.9 million equivalent</p> <p>4,000 persons in rural communities of four pilot aimags will have attended training courses and 25,000 persons will have participated in workshops at pilot aimag information and resource centers (IRCs)</p>	<p>Quarterly and annual reports of the project management unit (PMU)</p> <p>Project management reports</p> <p>Quarterly and annual reports submitted by project IRCs</p> <p>Asian Development Bank (ADB) midterm and annual review missions</p>	<p>Rural financial markets remain competitive and free from nonmarket interference</p> <p>SCUs are free under Mongolian law to offer a range of financial services, including deposit mobilization</p> <p>Legislation governing SCU supervision and regulation of is enacted and effectively implemented</p> <p>Taxation legislation does not inhibit SCU growth</p> <p>The project-supported credit union service organization (CUSO) effectively performs its role as a provider of services to the SCU movement</p>
<p><b>Outputs</b></p> <p><b>1. Rural Development of Rural SCUs</b></p> <p>1.1 Strengthened existing the CUSO</p>	<p>The CUSO staffs four aimag branches</p>	<p>Project management reports</p>	<p>Government is willing to allow the CUSO and</p>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
1.2 A national network of financially viable SCUs with significant membership	330 rural SCUs with 22,100 members by the end of the Project  The SCUs achieve financial viability by the end of the Project	Quarterly and annual reports of the CUSO, BOM, and project management reports  Annual external audit	SCUs commercial freedom in charging for all services to members  SCUs are prepared to pay for services provided by the CUSO
1.3 SCUs' management trained in SCU financial management and administration	1,000 SCU officers trained during the pilot phase of the Project  Both the CUSO and individual SCUs have fully functioning procedures and controls with accounting to international accounting standards		Strong demand exists within the rural population for services provided by SCUs  Training is effective and persons trained remain in post to manage SCUs
1.4 Staff trained in the SCU supervision development unit	The PMU, apex organizations, and BOM establish a supervision development unit that develops procedures, recruits and trains staff, and supervises SCUS		Enactment of nonbank financial institution legislation covering SCUs within the 3 years of the pilot phase  Training is effective and persons trained remain with their employer to implement supervision
1.5 SCUs financed through loan funds	Loan funds of \$4.9 million (equivalent) are drawn from the credit line over the project life		Sufficient credit demand exists for the SCUs to absorb matching loan funds
<b>2. Establishment of IRCs in Four Project Aimags</b>	Four IRCs established and fully operational including full cost recovery by the end of the Project	Reports of IRCs and project management reports	Demand exists within the rural population for IRC services
<b>3. Project Management</b>			
3.1 Establishment of effective project management system	Systems for project implementation including disbursement of funds, management information and monitoring and evaluation fully operational	Project management reports  ADB review missions	Project management is effective
3.2 Establishment of project implementation offices (PIOs) in pilot aimags	Four PIOs established	Project management reports  ADB midterm and annual review missions	PIOs are freely available for use by the CUSO and supervision development unit staff

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p><b>Activities</b></p> <p><b>1. Develop Rural SCUs</b></p> <p>1.1 Strengthen the CUSO head office</p> <p>1.2 Provide management advice and training to the CUSO staff</p> <p>1.3 Establish the CUSO management information system</p> <p>1.4 Establish supervision and regulation capacity</p> <p>1.5 Develop rural SCUs</p> <p>1.6 Establish SCUs and train officers</p> <p>1.7 Encourage and facilitate SCU members to contribute to SCU capital</p> <p>1.8 Provide loan financing to support SCU demand for borrowing</p> <p><b>2. Establish Information and Resource Centers</b></p> <p>2.1 Undertake a needs analysis to determine actual information and training needs</p> <p>2.2 Establish IRCs in 4 pilot aimags and provide office and training equipment, publications, and other resources</p>	<p>\$36,400 of equipment and vehicles for the CUSO Ulaanbaatar and pilot aimag offices</p> <p>33 person-months (\$841,200) of international consulting services over 4 years</p> <p>1 person-month of international consulting services and 2 person-months of domestic consulting services (\$33,600)</p> <p>3 person-months of international consulting services (\$79,400)</p> <p>Equipment for head and aimag offices \$31,100</p> <p>\$257,000 over 3 years of the pilot phase by the CUSO staff and local training institutes</p> <p>\$4.9 million (equivalent) of members' paid-in share capital over 7 years</p> <p>\$4.9 million project line of credit over 7 years</p> <p>8 person-months of domestic consulting services (\$5,600)</p> <p>\$433,700 in 4 IRCs</p>	<p>Project management reports</p> <p>ADB midterm and annual review missions</p>	<p>Government implements legislation to regulate SCUs</p> <p>The CUSO continues to operate as an independent, financially viable institution and can effectively promote, establish, train, and supervise projected numbers of SCUs</p> <p>SCUs operate as independent, financially viable institutions and can achieve projected outreach in terms of members and projected paid-in capital</p> <p>SCUs have sufficient credit demand to access the project line of credit</p> <p>Sufficient demand exists in rural communities for information, training, and entertainment to justify the IRCs and to enable them to recover costs from commercial activities by the end of the Project</p>

<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<p>2.3 Run training courses and workshops in 4 pilot aimags</p> <p><b>3. Project Management</b></p> <p>3.1. Establish a PMU in Ulaanbaatar and one PIO in each pilot aimag with necessary equipment</p> <p>3.2 Establish PMU operating and reporting procedures</p> <p>3.3 Conduct training delivery skills training course for all project staff with a training function</p> <p>3.4 Prepare environmental awareness training module for inclusion in SCU curriculum</p> <p>3.5 Undertake ad hoc subproject environmental monitoring</p> <p>3.6 Conduct SCU promotional workshops in Ulaanbaatar and 17 nonpilot aimag centers</p>	<p>18 5-day courses at aimag centers for 270 participants per year</p> <p>60 1-day workshops at aimag centers for 1,800 participants per year</p> <p>24 3-day courses at selected soums for 360 participants per year</p> <p>108 1-day workshops (2 per soum – 18 soums per aimag) for 3,240 participants per year</p> <p>\$1,116,000 over 7 years</p> <p>Equipment (\$240,600)</p> <p>1 person-month of international consulting services (\$29,400)</p> <p>1 person-month domestic consulting services (\$1,400)</p> <p>3 person-months domestic consulting services over years 2 to 7 (\$4,700)</p> <p>18 2-day workshops in year 4 (\$28,500)</p>		<p>Local staff and consultants recruited as required and perform satisfactorily</p>

## SOCIAL DIMENSIONS AND POVERTY ASSESSMENT

### A. Introduction

1. According to the Living Standards Measurement Survey (LSMS) conducted in 1998 by the National Statistical Office supported by the World Bank, the incidence of poverty in Mongolia is very high. Around 36 percent of the population lives below the poverty line, equivalent to 900,000 people, and about 20 percent live in extreme poverty.<sup>1</sup> The most recent official estimates show that poverty is predominantly urban with 57.2 percent of the poor residing in urban areas and 42.8 percent in rural areas. However, following consecutive dzuds (severe winter weather) in 1999-2000 and 2000-2001, and a widespread outbreak of foot and mouth disease, the incidence of poverty in rural areas has increased. Social indicators of poverty have also deteriorated during the transition to a market economy. Problems of malnutrition among children under five and the prevalence of low birth rates have raised concerns about food security. Previous achievements in education have been eroded; access by the poor is reduced, and literacy and preschool attendance have fallen dramatically.<sup>2</sup> Enrollment in grades 1 to 8 declined from 99 percent in 1990 to 82 percent in 1997. While concerted efforts by the Government have reversed the trend and increased enrollment rates to 90 percent, the previous decline has resulted in many children whose capacities in the long term have been impaired by their years of lost education.

2. Unemployment is officially 6.5 percent<sup>3</sup> covering 39,000 people, but actual levels are undeniably higher. Real unemployment (after adjusting for persons employed outside the formal sector) ranges from about 17 to 23 percent of the population. Aimag centers in particular have suffered from massive redundancies in private firms and public services. Many displaced households have been absorbed into the informal sector and own or tend small livestock herds to provide basic subsistence needs and security. Loss of employment is the most prevalent cause of impoverishment in Mongolia.<sup>4</sup> Nearly 58 percent of all unemployed are poor.

3. Agriculture is the main source of income in rural areas and employment in the sector has risen significantly. Its share in total employment increased from a third in 1990 to 50 percent in 2000. The increasing level of employment and a shift to livestock husbandry reflects the tendency for the unemployed to resort to small-scale herding as a means of subsistence in the absence of alternative employment opportunities and limited welfare payment from the state. The majority of rural households (66.8 percent) have less than 100 animals,<sup>5</sup> which make them extremely vulnerable to risks associated with natural disasters and price fluctuations. Economic activities outside agriculture include small-scale agroprocessing and microenterprises in areas such as trading, retailing, woodworking, and tailoring. Most microenterprises are small family concerns that operate on a part-time basis, mainly as a result of lack of credit and working capital. Public sector institutions are the other main source of employment in rural areas, such as local administrations, education and health sectors, etc. In these sectors too, employees

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<sup>1</sup> National Statistical Office. 1998. Living Standard and Measurement Survey. Government of Mongolia, Ulaanbaatar. The survey is based on an expenditure-based poverty line for a daily intake of 2,100 Kcal, which is comparable with the norm in other developing countries.

<sup>2</sup> United Nations Development Programme. 2000. *Overcoming Human Poverty*. New York.

<sup>3</sup> The official definition considers the unemployed to be the number of persons who have registered with the labor registry as unemployed. This excludes first time labor market entrants ineligible for labor registry services and those who perceive no value in registering. Hidden unemployment is estimated at 12 percent (Asian Development Bank. 2000. *A Poverty Reduction Strategy for ADB Operations in Mongolia*. Manila).

<sup>4</sup> World Bank. 2000. Participatory Living Standards Assessment, Draft. Washington, D.C.

<sup>5</sup> A herd of fewer than 100 animals is considered to not be viable in economic terms.

frequently need to supplement their incomes by engaging in some informal economic activity, notably petty trading.

## **B. Poverty Indicators for the Pilot Aimags<sup>6</sup>**

4. The Project will operate in its pilot phase in four aimags: Arhangay, Dundgovi, Dzavhan, and Sukhbaatar. Estimates of the level of poverty in the four aimags vary according to their source, namely the rural financial services demand survey conducted during the project preparatory Technical Assistance (TA), aimag statistics from the respective aimag administrations, and national statistics from the National Statistical Office. The poverty level in the four aimags is estimated at 40 percent in Arhangay, 43 percent in Dundgovi, 43 percent in Dzavhan, and 23 percent in Sukhbaatar. Estimates for Dundgovi and Sukhbaatar are derived from Government statistics and are considered to underestimate the actual level of poverty at the aimag and national levels. The LSMS by comparison indicates a national average of 36 percent in 1998. Table A2.1 presents poverty and social indicators for the four aimags.

5. The level of poverty, particularly in rural areas, is likely to have increased over the last two years as a result of consecutive dzuds. Although livestock losses occur every year during winter, in 1999/2000 certain parts of Mongolia experienced their worst winter for 30 years. A serious loss of livestock, accounting for over 2 million animals by April 2000, was suffered by 13 aimags. This directly affected 500,000 people equal to 20 percent of the population. All four pilot aimags were affected; in Dundgovi for instance about 30 percent of all livestock were lost, leaving 160 households without any animals at all.

6. Poverty is directly linked to unemployment. Three of the pilot aimags have unemployment rates higher than the national average. Additionally, all four aimags have a high proportion of households headed by women and households with many members, indicating a high prevalence of vulnerable households. The education dropout rate of herders' children is very high, reflecting both the increasing use of children in labor intensive livestock herding, and the remoteness, poor conditions and increased costs of schooling. In terms of health, infant mortality rates in Arhangay, Dundgovi, and Sukhbaatar are higher than the national average.

## **C. Access to Rural Financial Services for Poor Groups**

7. Availability of and access to financial services in rural areas is limited. It is particularly severe for poor groups who are unable to satisfy the eligibility criteria of formal financial institutions. Government credit programs such as the National Poverty Alleviation Program and Local Development Funds have also failed to reach the poor because of poor operational performance or lack of adequate funding. In the absence of adequate formal financial services, the major source of credit in rural areas is the informal sector, which consists of itinerant traders, kiosk (retail) operators, and in the more densely populated aimag centers, pawnbroker operations. For the most part, even these informal sources are beyond the reach of many poor households given their requirement for collateral to support borrowing. For those with very low levels of income, local kiosks provide small amounts of credit in-kind in the form of basic necessities.

8. Various forms of interhousehold transfer have evolved as another coping strategy of both poor and nonpoor households. In the pilot aimags the main source of money in cases of

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<sup>6</sup> The four pilot aimags are quite different in terms of geographic and climatic conditions, representing different zones of Mongolia. The pilot aimags selected are considered to be representative in terms of their population, livestock, industry, and state budget allocation.

emergency is borrowing from friends and relatives. Such borrowing occurs on a regular basis, and is often without interest and for an indefinite period. The TA survey indicated that in soum centers and rural areas, around 75 percent of households rely on relatives for emergency cash. Among herders, as many as 88 percent of households rely on this form of informal borrowing.

9. According to the participatory living standards assessment (footnote 4), the most common reasons for needing credit in rural areas are to meet food and other basic consumption needs and to cover emergencies. At the aimag and soum centers, demand is more likely to be for credit to expand an existing source of income or to start a new business. Other common reasons for taking loans are to cover school and college fees, to repay earlier debt, and to provide for basic needs.

10. Formal savings mobilization in rural areas is low. According to the TA survey, few households have savings to draw on in case of urgent need; only 4 percent of respondents would use savings in these circumstances. The importance of access to saving facilities for poor people has often been ignored and underestimated in microfinance programs. Poor people are assumed to need credit to generate income with little or no attention paid to accumulation of wealth in the form of savings. Experience with credit unions, however, is that poor people have a much higher demand for savings facilities than for credit.<sup>7</sup> According to the survey, 26 percent of rural household reported that they had surplus cash, but in the absence of savings opportunities (based on a general distrust of existing financial institutions) such cash is often spent on additional consumption or converted into consumer durables.

#### D. Membership of Savings and Credit Unions

11. Little analysis has been undertaken of the socioeconomic characteristics of members of existing savings and credit unions (SCUs) in Mongolia. Results of a study undertaken by the United Nations Development Programme's Microstart program in June 1999 are shown in Table A2.1.

**Table A2.1: Poverty Classification of SCU Members**

<b>Category</b>	<b>Active clients (percent)</b>
Vulnerable nonpoor	30
Moderate poor	59
Poor	10
Extremely poor	1

12. The definition of the various poverty categories used in the study does not correspond with the widely accepted official definition of poverty in Mongolia. Moderate poor is defined, among other things, as individuals belonging to a household with a monthly income less than \$100 per month (approximately MNT100,000) which is above the official poverty line. The official poverty line is MNT13,800 to MNT16,400 per capita per month in rural areas; or a monthly income of MNT62,100 to MNT73,800 per household based on an average household size of 4.5 persons. Based on these findings and on discussions with SCUs during project preparation, the perception is that the majority of clients may not be poor, but low-income groups who have a business already and need working capital.

<sup>7</sup> In addition to the obvious benefits of savings accumulation for the poor, two significant benefits for the institution are (i) total economic independence from external financing at more favorable rates, and (ii) abundant liquidity for onlending. Richardson, D.C. 2000. *Unorthodox Microfinance: The Seven Doctrines of Success*. Chile: Microbanking Bulletin.

## **E. Gender Issues**

13. During the period of transition in Mongolia, the economic and social independence of women has been severely undermined. As state enterprises closed or reduced their work forces, women lost more jobs relative to men and were the first to be laid off. After disintegration of state farms and privatization of their livestock and machinery, more than 20,000 trained women lost their jobs.<sup>8</sup> Women account for 54 percent of the unemployed. In addition, Mongolian women lost the strong social support that had previously freed them from their traditional responsibility for family care. Reduction in health and/or social services resulted in women having to spend more time caring for the young, sick, and/or elderly. In practice women tend to have less job security than men, less access to information, and less access to credit from the formal banking system.<sup>9</sup>

14. SCUs are potentially very important for women. First, women have difficulty accessing financial services and SCUs offer a real alternative. Second, credit unions are able to offer loans for household emergencies, education, health, etc., which are generally not available from formal financial institutions, and all of which involve women in the household decision-making process.

15. Existing SCUs in Mongolia are dominated by women. Many have developed from women's nongovernment organizations (NGOs), including one of the biggest, Moncord, which was founded in 1997 on the initiative of 15 members of the NGO, the Liberal Women's Brain Pool (LEOS). As of June 2001, in those SCUs for which data are available, approximately 60-70 percent of all members are women.

## **F. Expected Poverty and Social Impact of the Project**

16. The Project will provide enhanced access to credit and savings services, the lack of which has been identified as a primary constraint to rural development and poverty reduction. The Project will increase the outreach of financial services to rural and poor areas through the establishment of SCUs. Well-functioning SCUs will enhance public confidence in financial systems, and in turn increase savings mobilization. A sound and efficient financial system will facilitate efficient resource allocation, which is a prerequisite for private sector development.

17. The provision of a wide range of financial services to improve housing, health, education, etc., and to meet emergency needs has a positive impact on the quality of life. SCUs also strengthen social capital within local communities, and members' ability to participate in democratic processes. Greater social cohesion that will result from SCU development will have a positive social impact by reducing population migration from soum centers and rural areas to aimag centers, thereby reducing pressure on social services in those areas.

18. On the basis of one SCU member per household and 4.5 persons per household, some 22,100 people can be expected to benefit from SCU membership: 12,000 members will be in 60 aimag center SCUs and 10,100 will be in 270 soum-level SCUs. At the household level, the total number of beneficiaries is expected to reach almost 100,000. Although the proportion of poor in existing SCU membership is lower than the average proportion of the poor in rural populations, existing SCUs are largely centered in Ulaanbaatar where the incidence of poverty is lower than in rural areas. Also, given that SCUs established under the Project and the majority of members

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<sup>8</sup> United Nations Development Fund for Women. 2000. Situational Analysis of Women in Mongolia, Draft. Ulaanbaatar.

<sup>9</sup> The National Committee on the Elimination of Discrimination Against Women Watch Network Center, 2001.

will be from aimag and soum centers where poverty levels are higher than in rural areas outside these centers, more than 36 percent of SCU members are likely to be living below the poverty line, that is more than 7,950 members. In addition, SCU membership will benefit those groups living just above the poverty line who may be vulnerable in terms of lack of assets, including savings to manage crisis situations.

19. The promotion of participation of the poor in the SCUs is supported by the setting of the membership fee at a level affordable by the poor (\$5) and the promotion and training activities specially focused on the poor. This amount is considered feasible on the basis of (i) the size of contributions that would be possible according to households covered by the survey; and (ii) the minimum share level of existing SCUs, which include poor members.

20. Over time, access to credit through rural SCUs will address the issue of employment generation. The Project will create new employment opportunities as credit provided to SCU members is used to develop and expand small businesses. The survey indicated that 75 percent of potential SCU members will borrow for establishing or rehabilitating enterprises. Assuming that all such enterprises are owner-operated, employment will be created for some 16,500 people. Some of this employment will be part time or, in the case of agriculture, seasonal. Successful enterprises that expand may also increase the number of employment opportunities.

21. The Project will address the need for training and information services in rural areas, by establishing information and resource centers (IRCs) in the four pilot aimags. The IRCs will provide training courses and workshops covering a range of livelihood issues, including principles of microfinance, community participation, specific women's issues, health and nutrition, etc. Training courses and workshops are expected to reach a total of 29,000 participants, 4,000 in training courses and 25,000 in workshops. As training and information will be targeted to the needs of the poor, at least during the pilot phase of the Project, 50 percent of all the total number of training activities will be reserved for poor and vulnerable groups. The number of poor benefiting from training is estimated at 15,000. Information campaigns are expected to reach many more.

22. Training and workshops will provide participants with tools necessary to improve their living standards. The IRC facilities will be open for a variety of groups wishing to organize training. For example, line ministries that want to organize skills training at local level, NGOs, local organizations, etc. The IRCs will also act as an important resource for raising awareness among rural populations about SCUs and other socioeconomic issues.

23. The Project will monitor the poverty impact of the Project. Additionally, an impact assessment study will explore in-depth the processes of change and the impact of SCU membership on the livelihood of poor groups. One significant output from the study will be poverty sensitive measures to be included in the project design after the pilot phase.

**Table A2.2: Poverty Profile of Pilot Aimags<sup>a</sup>**

<b>Item</b>	<b>Arkhangai</b>	<b>Dundgovi</b>	<b>Sukhbaatar</b>	<b>Dzavhan</b>	<b>Mongolia</b>
Population ('000)	104.3	54.8	59.7	104.0	2,446.4
Population ('000) 2000	97.0	51.5	56.2	89.9	
Households ('000)	24.7	12.3	12.8	21.6	542.3
Households ('000) 2000	24.4	12.2	12.7	21.6	
Percentage of households engaged in agriculture (2000)	83.6	78.6	74.4	74.5	
Percentage of households headed by women (2000)	10.1	8.7	7.3	12.7	10.2
Percentage of households headed by women (1998)	8.3	9.5	9.1	11.7	n/a
Percentage of households with over four children	10.8	9.4	4.5	12.4	14.0
Unemployed	1,950	n/a	1,100	3,200	39,767
Official unemployment rate (percent)	16.0	3.7	14.8	28.1	4.6
Percentage of women unemployed	56.0	60.0	48.0	56.0	54.0
Percentage of unemployed seeking work <sup>b</sup>	44.6	45.5	55.6	46.7	n/a
Percentage of households below the poverty line <sup>c</sup>	40.0	43.0	23.0 <sup>d</sup>	43.0	36.0
Percentage of herder households	73.5	66.1	56.1	61.6	35.0

<sup>a</sup> Data for 1999 except where noted.

<sup>b</sup> National Statistics Office. 2000. Population and Housing Census of Mongolia, Preliminary Results. Ulaanbaatar.

<sup>c</sup> World Bank. 1998. Living Standards Measurement Survey. Washington, D.C.

<sup>d</sup> This data is for 1998; however, this percentage is expected to have drastically increased due to the loss of a large number of livestock due to severe winter conditions during 2000 and 2001.

Source: Staff estimates.

## THE MONGOLIAN FINANCIAL SECTOR AND RURAL FINANCIAL SYSTEM

### A. Background

1. The formal financial sector does not adequately serve the rural population of Mongolia, which accounts for 66 percent of the total population. As a result of a series of banking crises during the 1990s, which saw a number of bank closures, consolidation, or restructuring, the banking system suffers from widespread public distrust. In rural areas, this is exacerbated by a lack of adequate financial services in savings, credit, and money transfers. Only three banks have a network of branches in rural areas. The Agricultural Bank of Mongolia recommenced lending operations in November 2000 following an aid-supported restructuring program though it is not yet providing credit through all its rural branches. The Mongol Post Bank is currently offering short-term credit, on a very limited basis, to larger agricultural enterprises. The Savings Bank obtained a lending license in April 2001 and is currently developing its lending policies and strategy.

2. Few alternative financial institutions provide essential services to the rural areas. Nonbank financial institutions, notably the Golden Fund for Development and Goviin Ekhel (both externally supported initiatives) have limited presence in aimag centers but only provide credit to small- and medium-size enterprises and do not have savings or transfer services. Savings and credit cooperatives exist in small numbers (approximately 100 as of June 2001), but are at an early stage of development and so far have little representation outside of Ulaanbaatar. The informal sector provides credit through pawnbrokers and through retail kiosks. In many soum centers, kiosks are the only source of credit. The extended family system offers the most important financial safety net for most people in rural areas who find themselves in urgent need of funds.

3. Where credit is available, interest rates are extremely high, particularly in the informal sector where interest rates of 10 to 15 percent per month are common. Even among commercial banks, large spreads exist between deposit and lending rates: as of June 2001, the Savings Bank reported a rate of 1 percent per month on time deposits and 2 to 3.2 percent per month for loans; the Mongol Post Bank indicated deposit rates of 8 to 10 percent and loan rates of 26 to 36 percent per year. With inflation estimated between 6 and 8 percent, these interest spreads represent significant margins for administration costs and credit risk, reflecting the high level of loan transaction costs and the perceived economic risks faced by many enterprises. At present, virtually all credit provided is short term, an estimated 95 percent of outstanding loans have a maturity of less than one year. Table A3.1 provides a summary of current levels of interest rates in the formal and informal sectors and in ongoing and proposed ADB projects that include a line of credit.

**Table A3.1: Interest Rate Structure Selected Financial Institutions and ADB Projects**  
(Annual Rate)

Percentage Rates	ADB Rural Finance Project	ADB Housing Finance Project	ADB Agriculture Sector Development Project	Commercial Banks/NBFIs <sup>a</sup>	Informal Sector
External source of funds through Government	10-12	14.4	10-12	—	n/a
Rates paid on deposits	24-36 (SCU savings)	—	—	8.0 - 10.0	—
Onlending rate from PFI to final borrower	24 (SCU)	20	20	36	120-180
SCU member borrower <sup>b</sup>	30-36 (SCU member)	—	—	—	—

— = not applicable, ADB = Asian Development Bank, NBFIs = nonbank financial institution, PFI = participating financial institution, SCU = savings and credit union.

<sup>a</sup> Mongol Post Bank rates are used to illustrate both commercial banks' and NBFIs' rates which are comparable in rural areas based upon data from XAC. Rural Lombards' rates are used for the informal sector.

<sup>b</sup> This is the sublending rate charged by the SCU to its members.

## B. Savings and Credit Cooperatives and Unions

4. Key aggregate data for urban and rural savings and credit unions (SCUs) as of March 2001 are shown in Table A3.2. Average membership was 11 per rural SCU and 37 per urban SCU. Combined member shares and savings deposits averaged \$200 per member in rural SCUs and \$720 per member in urban SCUs. Total loans outstanding was \$77,000 for rural SCUs, an average of \$2,100 per SCU. For urban SCUs, total loans outstanding stood at \$1.2 million, an average of \$26,000 per SCU. Data on the number of members borrowing, and therefore average loan sizes are not available.

**Table A3.2: Savings and Credit Unions in Mongolia**  
(as of March 2001)

	SCUs	Members	Shares	Average Shares/Member	Savings (MNT '000)	Average Savings/Member	Loans
Rural	37	417	64,100	154	26,600	64	84,600
Urban	49	1,699	917,800	540	421,100	248	1,316,100
<b>Total</b>	<b>86</b>	<b>2,116</b>	<b>1,024,700</b>	<b>475</b>	<b>453,000</b>	<b>210</b>	<b>1,442,700</b>

SCU = savings and credit union.

Source: SCU Apex Organizations. Financial data unaudited.

5. Recent financial data on individual credit unions, particularly rural ones, is scarce as many are relatively new and have yet to develop effective accounting systems. One of the more mature SCUs, Moncord, provided financial statements for 2000 indicating a loan portfolio at the end of the year of \$86,600, representing 96 percent of total assets (\$90,500). The cumulative loan loss provision stood at 2.6 percent of total loans outstanding. Total equity was \$37,000, of which \$25,300 (68 percent) was in the form of shareholders contributions. Moncord's net

operating profit for the year was \$12,000; from total interest income of \$30,000 (equivalent to 35 percent of loans outstanding) and operating expenses \$19,200. After allowing for loan loss provision and taxes, Moncord returned a net profit of \$9,600. Data for 1999 for the five credit cooperatives (including Moncord) established under the Employment Generation Project show an average membership of 70, of which women comprise an average of 69 percent. Average capital amounted to \$22,000 and loans outstanding at 31 October 1999 averaged \$27,000. Average loan sizes ranged from \$250 to \$15,000 with monthly interest rates from 5 to 8 percent. The recovery rate on loans from commercial banks to the credit cooperatives under the Employment Generation Project averaged 93 percent, having risen from 37 percent in 1995 to 95 percent in 1998. By the end of 1999, loan collection rates were above 98 percent with the exception of one cooperative for which it was 90 percent.<sup>1</sup> These credit unions have demonstrated their viability and sustainability over the four years since they were established in spite of economic difficulties faced by Mongolia during 1998. In the case of Moncord for which 2000 data exists, impressive growth has also been demonstrated. Since October 1999, savings deposits, capital, and loans outstanding have demonstrated well-balanced growth, all increasing four fold.

### **C. Commercial Banks Identified for Participation in the Rural Finance Project**

6. Three commercial banks (Mongol Post Bank, Golomt Bank, and Savings Bank) have been identified as potential participating financial institutions (PFIs) and have agreed in principle to participate in the Rural Finance Project. Mongol Post Bank and Golomt Bank meet the PFI eligibility criteria (Appendix 8) at this time. A more detailed analysis of these banks is available in Supplementary Appendix C. Savings Bank has only recently been given a lending license by the Bank of Mongolia (BOM) and does not meet the criterion that a PFI should have been licensed for at least one year. Two other banks, Anod and Zoos, have expressed interest in acting as PFIs. Since the operation of the credit line will not commence until the third quarter of year 1 of the Project (2002), the eligibility of all banks will be reviewed at that time.

#### **1. Mongol Post Bank**

7. Mongol Post Bank (MPB) was created in 1993 and is 4.9 percent owned by the state through shareholdings from Mongol Telecom and Mongol Post Company, and 95.1 percent by the private sector (with an approximately equal split between private enterprises and private individuals). MPB commenced operations with five branches in Ulaanbaatar and is currently represented in every aimag with a total of 27 branches; it also has 22 subbranches located in soum centers, mainly in Hovd and Selenge aimags. Approximately 180 persons are employed by MPB, 67 at the head office and the remainder in the branches and subbranches.

8. The main income generating activities of MPB are (i) disbursement of pension payments, local government salaries, and other benefits for a fee; (ii) distribution of central Government subsidies to local authorities; (iii) remittance of taxes and social insurance contributions to central Government offices; and (iv) cash disbursement services for local petrol stations owned by Neft Import Concern.

9. Lending activities are relatively restricted and confined primarily to Ulaanbaatar-based enterprises. The bank's primary borrowers are Mongol Telecom, Neft Import Concern, and the state electricity authorities. Deposit-taking is carried out on a very small scale. This lack of traditional banking activity is reflected in the bank's low loan to total asset ratio of 52 percent,

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<sup>1</sup> PCR: 26450-MON: *Employment Generation Project*, June 2000.

low ratio of interest income to total income at 46 percent, and a relatively low loan to deposit ratio of 65 percent.

10. MPB has announced an expansion of its financial activities in its current business plan, including (i) an increase in small lending activities through its aimag branches; (ii) expansion of lending activities into trading (60 percent), gold mining (30 percent), and meat and cashmere processing (10 percent); and (iii) increasing the terms of loans for working capital to a maximum of 1 year. However, no plan seems to be in place to actively mobilize individual or corporate savings.

11. MPB has been selected by ADB as a PFI in Hovd aimag to disburse part of a \$5 million line of credit under the Agriculture Sector Development Program.

## **2. Golomt Bank**

12. Golomt Bank, formed in 1995, currently has eight branches in Ulaanbaatar, and one each in Darhan and Erdenet aimags, and employs a total staff of 150. It has no immediate plans to open branches in rural areas due to perceived cost constraints and low potential for profitability. It is wholly owned by a private sector enterprise, Bodi Financial Services Company. This company also owns a general insurance company, a leasing company specializing in gold mining equipment and motor vehicles, and a property development company.

13. The bank has adopted an aggressive but prudent lending policy as part of its strategic business plan. The main customer base consists of small- and medium-size enterprises to which the bank provides loans up to a maximum of MNT3 million and for a maximum term of six months. They have a development loan program for loans up to a maximum value of MNT500 million, with a maximum term of one year. Internal loan management policy prohibits lending more than 20 percent of its total outstanding portfolio to any one economic sector. The bank has been actively involved with the assistance community, been identified as a participating commercial bank in the Asian Development Bank's proposed housing finance loan, and participated in two World Bank project loans, one for food processing and one for a printing operation.

## **3. Savings Bank**

14. The Savings Bank was created as a state bank during the 1996 sector restructuring program as a safe haven to absorb and protect individuals' deposits. It has a branch network of nine aimag branches and 27 soum subbranches, and accounts for one third of all deposits in the banking system, with over 200,000 individual deposit accounts. Until recently, the Government's failure to service the bank restructuring bonds that make up over 75 percent of its assets resulted in negative cash flows and operating losses. BOM has, therefore, given the bonds a 100 percent risk weight, resulting in an inadequate risk-weighted capital adequacy ratio of 7.1 percent. This situation has been improving steadily and in April 2001, BOM issued Savings Bank a full banking license enabling it to commence lending operations. The bank is adopting a cautious lending policy that has been approved by BOM, and is limiting loan size to \$40,000 and loan terms to one year. It also has a ceiling on its total loan portfolio. Interest rates range from 2 to 3 percent per month compared with interest paid on time deposit accounts of 1 percent per month. The bank is keen to participate in the Rural Finance Project as a means of enhancing its services in rural areas. Its ability to meet the Project's PFI eligibility criteria will be monitored during implementation and reviewed prior to the commencement of the operation of the credit line.

## **ANALYSIS OF CREDIT UNION APEX AND SERVICE ORGANIZATIONS**

### **A. Mongolian National Federation of Savings and Credit Unions**

1. The Mongolian National Federation of Savings and Credit Unions (MNFSCU) was established in June 1998 by nine Ulaanbaatar based savings and credit unions (SCUs). MNFSCU enjoyed steady growth until April 1999 when a faction split to form what is now the National Confederation of Credit Unions of Mongolia (NACCUM). Membership then remained steady at 12 until the last quarter of 2000. MNFSCU undertook a major reorganization in November 2000, which culminated in a membership drive and a change in leadership. The previous president was replaced by an individual with 25 years experience with Mongolian banking and a higher educational degree in banking. Five of the nine member board have financial backgrounds. The membership drive attracted 25 new member SCUs, of which 15 are rural. Since November 2000, MNFSCU has taken on two part-time staff, an executive director, and an accountant. The executive director has a master's degree in banking and 10 years experience with banking in Mongolia, and is a certified teacher with the Mongolian Banking Training Center. The executive director is also a board member of MNFSCU. The accountant is an accountant by profession and has two years financial management experience with Moncord SCU.

2. Members of MNFSCU's board have attended and helped to organize a variety of training seminars sponsored by foreign agencies on SCU development and promotion, management, and accounting procedures. MNFSCU has in turn carried out training and information seminars. Where financial support was required, it was supplied by the Liberal Women's Brain Pool (LEOS). MNFSCU is actively engaged in discussions with the Government on financial sector reform and has members serving on the Policy Group on the Banking and Nonbanking Sector, the Working Group on SCU Development of the Ministry of Social Welfare and Labor, and the Parliamentary Subcommittee on Legislation for Nonbanking Institutions.

3. MNFSCU has capital of MNT1.2 million and made a net loss of MNT46,600 on income of MNT211,300 in 2000. MNFSCU was unable to provide financial statements for previous years.

### **B. National Confederation of Credit Unions in Mongolia**

4. NACCUM was formed from a splinter group of MNFSCU in April 1999. As of September 2000, NACCUM has 30 member SCUs of which six are rural. NACCUM changed leadership on 1 March 2001. The new president is a former member of parliament and a teacher by profession, and has experience with herder cooperatives but not with SCUs. Resumes of other directors were not available. NACCUM employs one full-time executive director and recruits other staff on a part-time basis as required. The resume of the executive director was not available.

5. NACCUM has been active in developing model bylaws for SCUs and a standard chart of accounts. The standard chart of accounts was prepared in conjunction with NetMon with support from Gesellschaft fur Technische Zusammenarbeit (GTZ) and has been provided to the tax authorities for approval. NACCUM intends to produce a variety of standard forms and manuals for SCU use.

6. NACCUM's operating plan for 2001 focuses on promotion of SCUs through public media and by developing four regional model SCUs. The model SCUs are to be established in the aimag centers of Bayanhongor, Bayan-Olgii, Darhan-Uul, and Dornod.

7. NACCUM was unable to provide any financial statements. Its operating plan appears to be heavily reliant on financial support from GTZ and other, as yet unidentified, international organizations.

### **C. NetMon**

8. NetMon was licensed as a nonbank financial institution (NBFI) by the Bank of Mongolia (BOM) in July 2000. Its initial shareholders were four (now six) SCUs, 13 private investors, and one consulting company. The president of NetMon has a master's in business administration from the University of Rochester; the other directors all have degrees in finance or economics, and experience in the financial sector including SCUs, microfinance, and banking. NetMon employs three full-time staff and a part-time executive director.

9. NetMon enforces financial discipline with its borrowers by applying prudent lending policies. Since inception NetMon has made 14 loans to SCUs. It has also worked with other apex organizations to establish a standard chart of accounts for SCUs and has provided training to potential borrowers to strengthen their operating procedures. NetMon was capitalized by share subscriptions of MNT13.5 million by founding members at the outset, and was therefore able to begin lending activities and earn revenues immediately. NetMon was also able to attract private sector loans for onlending purposes.

10. In January 2001, NetMon received a \$13,000 capital grant and a \$137,000 loan from the United Nations Development Programme (for 5 years at 10 percent per year) to onlend to SCUs. Prior to receiving the loan, NetMon's capital adequacy was 38 percent. After receipt of the loan and capital grant, NetMon's capital represented 14.7 percent of total assets, which meets the BOM requirement of 10 percent. NetMon was required to draw the entire loan in a lump sum and incurred a significant loss on interest prior to full disbursement as it employs a sound lending policy that requires a detailed assessment of potential borrower SCUs, based not only on financial prudence but also the requirement that SCUs operate according to cooperative principles. As of May 2001, NetMon had disbursed all of the loan funds. Loans to SCUs are either progress loans (three months minimum and interest at 3 percent per month) for first time borrowers, or partnership loans (10 months minimum and interest at 2 percent per month). Progress loans have a minimum value of \$500, and partnership loans a minimum of \$1,500 with both being subject to a maximum equal to 80 percent of the SCU's capital. Loans from SCUs to members range from \$100 to \$500.

11. As part of the loan agreement, NetMon is required to provide quarterly financial statements of its borrowers to BOM, and so is developing its reporting and monitoring systems. NetMon also received the support of a part-time technical advisor from the United Nations Development Programme for six months, which ended in June 2001.

## TRAINING PROGRAM SUMMARY

### A. Training for Savings and Credit Unions

1. Training of savings and credit union (SCU) directors and staff is essential to ensure sound growth of the SCU movement in Mongolia. The international adviser assigned to the credit union service organization (CUSO) will be responsible for developing a stand-alone modular curriculum for SCU training that can be delivered by the CUSO staff or other accredited trainers. The international adviser will also be responsible for devising an accreditation system for external local trainers. The use of local trainers will be encouraged. A summary training schedule is presented in Supplementary Appendix F, Table F.1, and a curriculum outline in Table F.2.

2. Although it is assumed that the CUSO will recruit staff with financial backgrounds and accounting skills, all existing and future CUSO staff will be required to complete the entire training program before they can begin training SCU directors and staff. All the CUSO staff involved in training will also participate in a training of trainers course to be conducted at the start of the Project by the project management unit (PMU).

3. To determine the training needs of newly formed SCUs in the pilot aimags, each SCU is assumed to have a board consisting of five members, a credit committee (three members), an audit committee (three members), and a staff of two. Training will be undertaken in a series of one week courses at the aimag center. Board members and audit committee members will receive two training courses; others one course. These assumptions have been used to determine the total training requirement during the pilot phase of the Project, which equates to a total of 80 weeks of training in year 1 (for SCUs existing at the end of 2001 and those created in year 1), 40 weeks in year 2 and 12 weeks in year 3. Although 80 weeks of training are required in year 1, this level of training is thought to be unsustainable and 48 weeks of training per year is a more reasonable level. Hence in year 3, 36 weeks of excess capacity will be utilized in nonpilot aimags. Nonpilot aimag SCUs will be responsible for 50 percent of training costs. Therefore the number of participants per SCU will be reduced; and individual training sessions will reach a greater number of SCUs.

4. The costs of providing this training are included in the operating costs of the CUSO. In addition, costs will be associated with travel, accommodation, and subsistence of SCU officers coming from soums to aimag centers for training. Travel is based on an average of 100 kilometers between each soum and the aimag center at a cost of \$20. Participant costs for accommodation and subsistence are estimated at \$5 and \$4 respectively. Finally, \$30 is allowed for preparation of all materials (handouts) for participants. This results in a total cost for participants of \$60,500 over the three years of the Project's pilot phase. The cost for trainers is estimated to be \$20 per day inclusive of remuneration, travel costs, and subsistence. Each training session includes five days of training plus two travel days. For pilot SCUs these costs will be fully covered. Nonpilot SCUs will be required to cover 50 percent of trainers' costs and 100 percent of participants' costs. Thus 12 weeks of training in year 3 are estimated at \$20 per day and 36 weeks at \$10 per day. This brings the total cost of trainers during the pilot phase to \$21,000. A one-time cost for curriculum preparation is included for 2 weeks of preparation for each week of delivery. Six course weeks require 12 weeks of preparation at a cost of \$150 per week for a total of \$1,800. The total cost of training during the Project's pilot phase is estimated at \$83,300.

## **B. Training through Information Resource Centers**

5. The establishment of information resource centers (IRCs) will be based on a training needs assessment to be conducted in the four pilot aimags within the first six months of project implementation. The assessment will include (i) identification of potential training facilities in the aimag centers, (ii) assessment of existing training activities carried out in the aimags, (iii) review of previous training activities and identification of lessons learned, and (iv) identification of training and information needs in the aimag. Terms of reference for the training needs assessment will be prepared by the PMU, and the PMU will be responsible for recruiting four domestic consultants to carry out the training need assessment. On completion, the PMU will review the assessment in each aimag and, as appropriate, establish each IRC at the aimag center and recruit necessary staff. In consultation with the PMU and local aimag organizations, and based upon the findings of the training needs assessments, each IRC director will develop and implement aimag-specific training programs.

6. Training will be undertaken in 6 five-day training courses per year per aimag at the aimag center, 20 one-day workshops per year per aimag at the aimag center, 8 three-day training courses per year per aimag at one soum center to cover 4-5 surrounding soums, and 2 one-days workshops per year at each soum center.

7. The objective of the IRCs is to provide training and information to communities in the four pilot aimags, with specific focus on poor groups. The training and information activities will focus on a wide spectrum of training activities, from skills training to social and community issues. Subject matter specialists for each course and workshop will be drawn from local communities; nongovernment organizations; local administration; and agriculture, health, education, finance, and industry sectors, etc.

8. Training and information activities may include the following:

- (i) skills training to SCU members and the general public, notably the unemployed and poor;
- (ii) information campaigns to identify employment opportunities;
- (iii) basic business management and financial training to existing and local potential entrepreneurs;
- (iv) specialized training and information campaigns by Government ministries, for instance, extension training by the Ministry of Agriculture; and
- (v) specialized training and information campaigns by nongovernment organizations and other institutions, based on adequate expertise in social, health, and community issues.

9. While training and information will be available to all sections of local communities, it will aim to facilitate the expansion of SCU membership and access for the poor and vulnerable groups. As such, 50 percent of all training places will be reserved for the poor and vulnerable.

10. Supplementary Appendix F, Table F.3 provides illustrative training needs identified during project preparation.

## COST ESTIMATES AND FINANCING PLAN

1. The following tables present summary and detailed project costs by component, expenditure account, and financiers.<sup>1</sup>

2. All unit costs are based upon domestic prices estimated in Togrog (MNT) at the time of data collection (June 2001). Foreign exchange costs have been converted at a rate of exchange of US\$1 = MNT1,090, the rate of exchange prevailing at the end of November 2000 when data collection was undertaken. No significant movement has taken place in either prices of project inputs or outputs or the exchange rate in the period between data collection and loan appraisal.<sup>2</sup> For the purpose of preparing cost tables, these unit costs have been used to derive project base costs and been entered into COSTAB in US dollar terms.

3. It has been assumed that the Project will be implemented from the beginning of 2002. Price contingencies have been applied at the rate of 10 percent for 2001, 6 percent for 2002, 5 percent 2003, and 4 percent thereafter on all local costs. Price contingencies on foreign costs have been applied at the rate of 2.4 percent per year between the time of data collection to project startup and throughout project implementation. Price contingencies are based upon domestic and foreign (US dollar) inflation rates derived from discussions with staff of the Bank of Mongolia and Asian Development Bank (ADB) missions. No price contingency has been applied to the Project's line of credit to savings and credit unions (SCUs), or the contributions made to SCU's capital by their members.

4. Physical contingencies have been applied at the rate of 5 percent on all costs with the exception of training and information dissemination costs for which a rate of 10 percent has been applied.

5. All vehicles and equipment investments have been assumed to attract value-added tax at the standard rate of 13 percent. Where appropriate, foreign exchange costs have been estimated as a percentage of the unit cost of each item. Where no direct estimate of cost, insurance, and freight (cif) price was available, the foreign exchange percentage was estimated after subtracting local duties and taxes and dealer's margin, which is assumed to cover local transportation and distribution costs, etc. All staff costs have been assumed to include social and health tax contributions of 19 percent of basic wage costs. In the absence of information on exactly how members will use funds borrowed from SCUs, it has been assumed that on average 15 percent of all products and services purchased will represent either a direct or indirect foreign exchange cost. This foreign exchange percentage has been applied both to the line of credit and members' contributions to SCU capital and savings.

6. The credit union service organization (CUSO) will receive project support for the purchase of fixed assets and recurrent costs. These costs have been included in the cost tables. The SCUs will operate initially with volunteer board members and staff until they reach a membership of 50 when they will employ their own staff. The SCUs will finance recurrent costs from revenues generated from operations and no costs have been included for the operation of the SCUs themselves.

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<sup>1</sup> Cost tables have been derived using COSTAB software based upon cost estimates for individual project components.

<sup>2</sup> As of June 2001, the exchange rate was \$1 = MNT1,090.

**Table A6.1: Components Project Cost Summary**  
(\$ '000)

	Local Currency	Foreign Currency	Total Cost	% Foreign Exchange	% Total Base Costs
<b>A. Establishment of Rural SCUs</b>					
1. SCU Promotion and Training	898.6	846.7	1,745.3	49	13
2. SCU Supervision	123.3	89.7	213.0	42	2
3. Financing of Rural SCUs	8,271.2	1,459.6	9,730.8	15	71
<b>Subtotal (A)</b>	<b>9,293.1</b>	<b>2,396.0</b>	<b>11,689.1</b>	<b>20</b>	<b>85</b>
B. Information and Resource Centers	879.7	277.6	1,157.2	26	8
C. Capacity Building in Project Management	742.9	150.3	893.1	17	7
<b>Total Baseline Costs</b>	<b>10,915.7</b>	<b>2,823.9</b>	<b>13,739.5</b>	<b>21</b>	<b>100</b>
Physical Contingencies	112.3	68.2	180.5	38	1
Price Contingencies	730.6	66.4	796.9	11	6
<b>Total Project Costs</b>	<b>11,758.5</b>	<b>2,958.4</b>	<b>14,716.9</b>	<b>20</b>	<b>107</b>
Interest during Implementation	0.0	283.1	283.1	100	2
<b>Total Costs to be Financed</b>	<b>11,758.5</b>	<b>3,241.5</b>	<b>15,000.0</b>	<b>22</b>	<b>109</b>

SCU = savings and credit union.

Note: Figures may not add up due to rounding.

Source: Staff estimates.

**Table A6.2: Expenditure Accounts by Components**  
(\$ '000)

Item	Establishment of Rural SCUs			Information and Resource Centers	Project Management	Total
	SCU Promotion and Training	SCU Supervision	Financing of Rural SCUs			
<b>I. Investment Costs</b>						
A. SCU Member Contributions	0.0	0.0	4,865.4	0.0	0.0	4,865.4
B. SCU Line of Credit	0.0	0.0	4,865.4	0.0	0.0	4,865.4
C. Vehicles & Equipment						
1. Vehicles	0.0	0.0	0.0	82.5	82.5	165.0
2. Computer Equipment	23.5	23.2	0.0	62.7	76.5	185.9
3. Office Equipment & Furniture	13.3	8.4	0.0	166.5	82.9	271.0
4. Miscellaneous Equipment	0.0	0.0	0.0	113.5	0.0	113.5
5. Office Refurbishment	1.2	0.0	0.0	4.6	1.2	6.9
<b>Subtotal Vehicles &amp; Equipment</b>	<b>38.0</b>	<b>31.5</b>	<b>0.0</b>	<b>429.8</b>	<b>240.6</b>	<b>742.4</b>
D. Training and Information						
1. Training and Workshops (Local)	268.1	0.0	0.0	0.0	30.1	298.2
3. Publications	0.0	0.0	0.0	3.0	0.0	3.0
<b>Subtotal Training and Information</b>	<b>268.1</b>	<b>0.0</b>	<b>0.0</b>	<b>3.0</b>	<b>30.1</b>	<b>301.1</b>
E. Consulting Services						
1. International	870.6	79.4	0.0	0.0	29.4	979.4
2. Domestic	4.3	0.0	0.0	5.7	6.3	16.3
<b>Subtotal Consulting Services</b>	<b>874.8</b>	<b>79.4</b>	<b>0.0</b>	<b>5.7</b>	<b>35.7</b>	<b>995.7</b>
F. Project Management	0.0	0.0	0.0	0.0	433.8	433.8
G. Project BME and Audit	0.0	0.0	0.0	0.0	375.6	375.6
<b>Total Investment Costs</b>	<b>1,180.9</b>	<b>111.0</b>	<b>9,730.8</b>	<b>438.5</b>	<b>1,118.2</b>	<b>12,579.4</b>
<b>II. Recurrent Costs</b>						
A. SCU Promotion & Training Salaries	762.4	0.0	0.0	0.0	0.0	762.4
B. SCU Promotion & Training Office Administration	185.1	0.0	0.0	0.0	0.0	185.1
C. SCU Supervision Salaries	0.0	152.0	0.0	0.0	0.0	152.0
D. IRC Salaries	0.0	0.0	0.0	304.1	0.0	304.1
E. IRC Office Administration	0.0	0.0	0.0	57.0	0.0	57.0
F. IRC Training and Information	0.0	0.0	0.0	564.1	0.0	564.1
G. IRC Vehicle O&M	0.0	0.0	0.0	112.9	0.0	112.9
<b>Total Recurrent Costs</b>	<b>947.5</b>	<b>152.0</b>	<b>0.0</b>	<b>1,038.0</b>	<b>0.0</b>	<b>2,137.6</b>
<b>Interest during Implementation</b>						283.1
<b>Total Project Costs</b>	<b>2,128.4</b>	<b>255.4</b>	<b>9,730.8</b>	<b>1,476.5</b>	<b>1,118.2</b>	<b>15,000.0</b>
Taxes	170.7	29.0	-	228.1	45.2	473.0
Foreign Exchange	923.7	97.3	1,459.6	312.0	165.8	2,958.4

BME = benefit monitoring and evaluation, IRC = information and resource center, O&M = operation and maintenance, SCU = savings and credit union.

Note: Figures may not add up due to rounding. Includes physical and price contingencies.

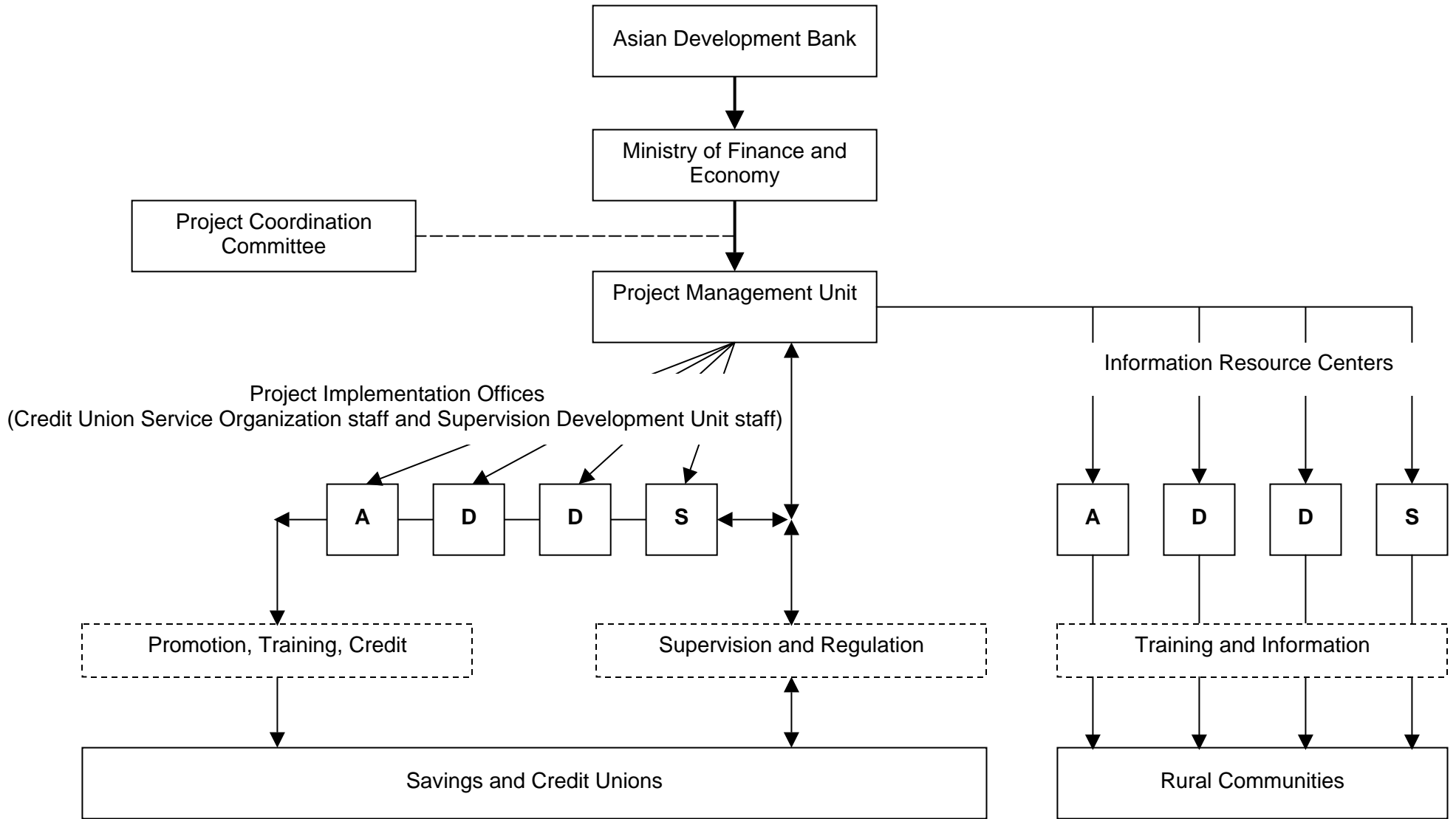
**Table A6.3: Expenditure Accounts by Financiers**  
(\$ '000)

	ADB		Government of Mongolia		CUSO		SCUs		NGOs		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
<b>I. Investment Costs</b>												
A. SCU Member Contributions	0.0	0.0	0.0	0.0	0.0	0.0	4,865.4	100.0	0.0	0.0	4,865.4	33.1
B. SCU Line of Credit	4,865.4	100.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	4,865.4	33.1
C. Vehicles & Equipment												
1. Vehicles	134.3	81.4	30.7	18.6	0.0	0.0	0.0	0.0	0.0	0.0	165.0	1.1
2. Computer Equipment	157.9	84.9	28.0	15.1	0.0	0.0	0.0	0.0	0.0	0.0	185.9	1.3
3. Office Equipment & Furniture	230.2	84.9	40.8	15.1	0.0	0.0	0.0	0.0	0.0	0.0	271.0	1.8
4. Miscellaneous Equipment	96.4	84.9	17.1	15.1	0.0	0.0	0.0	0.0	0.0	0.0	113.5	0.8
5. Office Refurbishment	5.8	83.3	1.2	16.7	0.0	0.0	0.0	0.0	0.0	0.0	6.9	0.0
<b>Subtotal Vehicles &amp; Equipment</b>	<b>624.7</b>	<b>84.1</b>	<b>117.8</b>	<b>15.9</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>742.4</b>	<b>5.0</b>
D. Training and Information												
1. Training and Workshops (Local)	250.6	84.0	47.6	16.0	0.0	0.0	0.0	0.0	0.0	0.0	298.2	2.0
3. Publications	2.5	84.0	0.5	16.0	0.0	0.0	0.0	0.0	0.0	0.0	3.0	0.0
<b>Subtotal Training and Information</b>	<b>253.0</b>	<b>84.0</b>	<b>48.1</b>	<b>16.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>301.1</b>	<b>2.0</b>
E. Consulting Services												
1. International	979.4	100.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	979.4	6.7
2. Domestic	16.3	100.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	16.3	0.1
<b>Subtotal Consulting Services</b>	<b>995.7</b>	<b>100.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>995.7</b>	<b>6.8</b>
F. Project Management	321.1	74.0	112.7	26.0	0.0	0.0	0.0	0.0	0.0	0.0	433.8	2.9
G. Project BME and Audit	375.6	100.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	375.6	2.6
<b>Total Investment Costs</b>	<b>7,435.5</b>	<b>100.0</b>	<b>278.5</b>	<b>2.2</b>	<b>0.0</b>	<b>0.0</b>	<b>4,865.4</b>	<b>38.7</b>	<b>0.0</b>	<b>0.0</b>	<b>12,579.4</b>	<b>85.5</b>
<b>II. Recurrent Costs</b>												
A. SCU Promotion & Training Salaries	341.5	44.8	121.7	16.0	299.2	39.2	0.0	0.0	0.0	0.0	762.4	5.2
B. SCU Promotion & Training Office Administration	99.9	54.0	0.0	0.0	85.3	46.0	0.0	0.0	0.0	0.0	185.1	1.3
C. SCU Supervision Salaries	0.0	0.0	152.0	100.0	0.0	0.0	0.0	0.0	0.0	0.0	152.0	1.0
D. IRC Salaries	144.5	47.5	48.6	16.0	0.0	0.0	0.0	0.0	111.0	36.5	304.1	2.1
E. IRC Office Administration	34.9	61.3	0.0	0.0	0.0	0.0	0.0	0.0	22.0	38.7	57.0	0.4
F. IRC Training and Information	289.5	51.3	90.1	16.0	0.0	0.0	0.0	0.0	184.5	32.7	564.1	3.8
G. IRC Vehicle O&M	57.0	50.5	21.1	18.7	0.0	0.0	0.0	0.0	34.8	30.8	112.9	0.8
<b>Total Recurrent Costs</b>	<b>967.3</b>	<b>45.3</b>	<b>433.5</b>	<b>20.3</b>	<b>384.4</b>	<b>18.0</b>	<b>0.0</b>	<b>0.0</b>	<b>352.4</b>	<b>16.5</b>	<b>2,137.6</b>	<b>14.5</b>
Interest during Implementation	283.1										283.1	
<b>Total Project Costs</b>	<b>8,685.9</b>	<b>57.1</b>	<b>712.0</b>	<b>4.8</b>	<b>384.4</b>	<b>2.5</b>	<b>4,865.4</b>	<b>33.1</b>	<b>352.4</b>	<b>2.6</b>	<b>15,000.0</b>	<b>100.0</b>

BME = benefit monitoring and evaluation, IRC = information and resource center, O&M = operation and maintenance, SCU = savings and credit union.  
Note: Figures may not add up due to rounding. Includes physical and price contingencies.

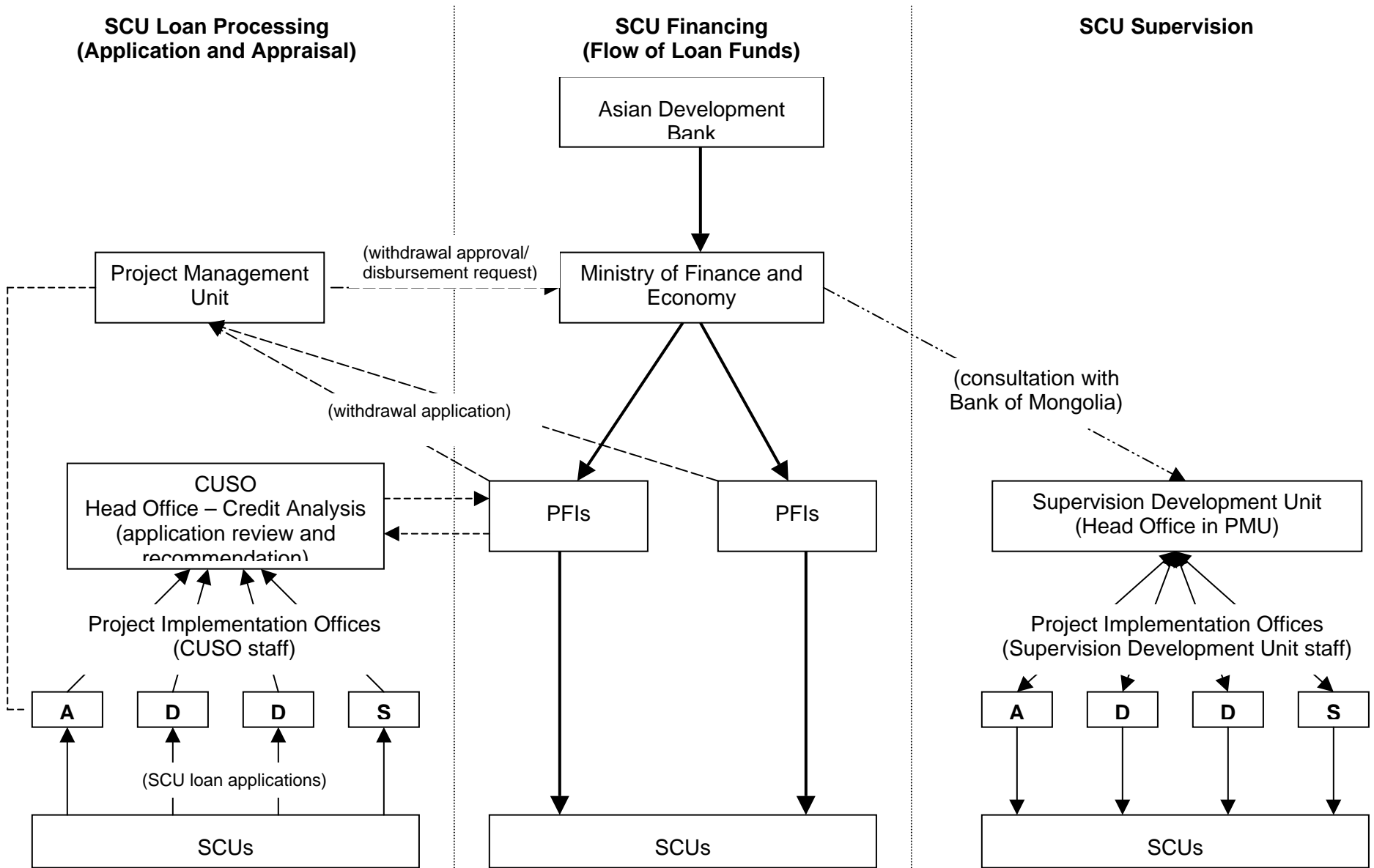
# ORGANIZATION CHARTS

**Figure A7.1: Project Organization Chart**



Note: Pilot aimags: A – Arhangay; D – Dundgovi; D – Dzavhan; S – Sukhbaatar

Figure A7.2: Savings and Credit Union Financing and Supervision Organization Chart



CUSO = credit union service organization, PFI = participating financial institution, SCU = savings and credit union.  
 Note: Pilot aimags: A – Arhangay; D – Dundgovi; D – Dzavhan; S – Sukhbaatar

## PROPOSED ELIGIBILITY CRITERIA FOR PARTICIPATING FINANCIAL INSTITUTIONS

1. The project credit line will be available for all participating financial institutions (PFIs), both commercial banks and nonbank financial institutions (NBFIs), that meet agreed eligibility criteria. NBFIs currently operating in Mongolia have yet to demonstrate sufficient experience with credit operations for them to be eligible in the initial phase of the Project. Once such NBFIs, including the initial credit union service organization, NetMon, are able to meet the following eligibility criteria, they will, subject to approval by the Ministry of Finance and Economy, Bank of Mongolia (BOM), and Asian Development Bank (ADB), be entitled to access project funds for onlending to savings and credit unions.

### A. Criteria for Initial Participation

2. The PFIs will be thoroughly examined to ensure that they are in compliance with the eligibility criteria at the time of assessment of eligibility. Throughout the project period, the project management unit (PMU), in cooperation with BOM, will identify potential PFIs, undertake an initial assessment, and make a decision on the eligibility of a PFI. The eligibility criteria for PFIs are shown in Table A5.

**Table A5: Eligibility Criteria for PFIs to Participate in the Credit Line**

<b>1. Legal Compliance</b>	
Licensed as bank or nonbank financial institution (NBF)	A financial institution must have been registered and licensed under the Banking Law or under the relevant regulation for NBFIs for at least one year before acceptance as a participating financial institution (PFI)
<b>2. Prudential Regulations and Criteria</b>	
Capital adequacy	Capital to be at least 10 percent of risk weighted assets
Liquidity	Liquid assets to be at least 18 percent of total deposits and borrowed funds
Single borrower lending	Not to exceed 20 percent of capital
Loans to shareholders or bodies corporate controlled by it	Loan to any one insider not to exceed 5 percent of capital and loans to all insiders not to exceed 20 percent of capital
Loan-loss reserve	Loan-loss provisions to be 100 percent for 1 year past due loans and 35 percent for loans 1-12 months past due
Intermediation cost	Noninterest expenses to total income ratio must not exceed 30 percent.
Return on assets	Return on assets should not be less than 2 percent.
Foreign exchange exposure	Exposure not to exceed 20 percent of total capital

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**3. General Structures and Procedures**


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Financial performance	PFI to have satisfactory financial performance, as confirmed by external audit of financial statements by independent auditors acceptable to the Bank of Mongolia (BOM) and Asian Development Bank (ADB), in accordance with international accounting standards, for the previous fiscal year
Asset-liability management	PFI to demonstrate acceptable policies and operational guidelines for interest rate and maturity gap management, limits, and other related issues
Corporate governance	PFI to possess an active, independent, and experienced board of directors
Internal audit <sup>a</sup>	PFI to have an accounting system with adequate internal controls, an internal audit function, and an audit committee to which the PFI's internal audit function reports directly
Management information system (MIS)	PFI to have an MIS that permits monitoring to acceptable standards of the quality of the loan portfolio on a regular basis and provides a financial projection system (cash flow forecasting)

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**4. Structures and Procedures for Lending Operations under the Credit Line**


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Lending experience	PFI to have an acceptable record of lending to small-scale enterprises and individuals
Staffing	PFI to have adequate staff (sufficient number and quality) for the prudent management of project funds
Lending policies and guidelines	PFI to possess or to be prepared to develop, under the Project, lending policies and guidelines (such as loan appraisal and approval authorities, classification procedures, monitoring requirements, collection procedures, terms, and conditions) that are approved by BOM and regularly supervised. Policies should reflect the onlending terms and conditions agreed to in the subsidiary loan agreement between the PFI and Ministry of Finance and Economy, as well as the terms and conditions for borrowing savings and credit unions,

<sup>a</sup> The internal audit can be carried out based on domestic accounting standards.

## **B. Ongoing Eligibility Criteria for Participating Financial Institutions**

3. Throughout the Project, the PMU and BOM will monitor the PFIs on a quarterly basis to determine their continuing eligibility to participate in the project credit line. Throughout the project period, PFIs will make audit reports and other financial records openly available to the PMU and ADB so that ongoing eligibility can be verified.

4. In addition, for continued eligibility, each PFI will be expected to (i) have given at least five subloans to savings and credit unions (SCUs) in the first year after signing the subsidiary loan agreement and 10 subloans per year in subsequent years (subject to review by the Ministry of Finance and Economy, PMU, BOM, and ADB); and (ii) have no more than 10 percent of the its SCU portfolio under the credit line in nonperforming loans. Nonperforming loans are defined as those loans that are delinquent (i.e., having at least one payment past due for 30 days or

more). Delinquency calculations include the entire outstanding balance of a nonperforming loan not only late payments.

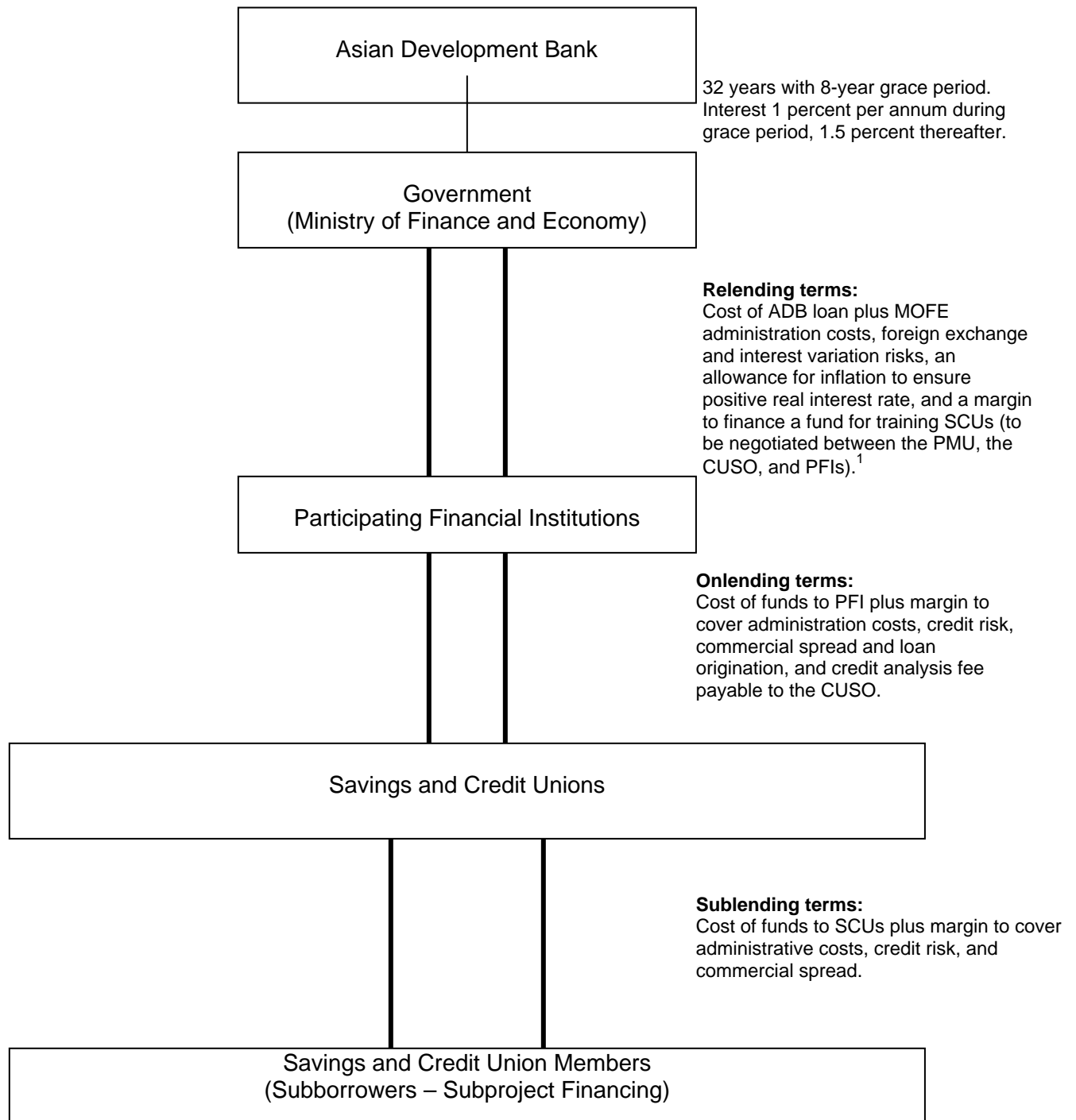
5. If a PFI is found not to be in compliance with the initial and ongoing eligibility criteria, the PMU and BOM, with the prior approval of ADB, will determine whether the PFI concerned will (i) prepare and implement a plan of action with the objective of reaching compliance, or (ii) will be excluded from the project credit line. Any PFI that is not in compliance for more than one quarter will be automatically excluded from the Project. If a PFI is excluded from the Project, it will pay back to the Project all funds made available through the Project.

## PROJECT IMPLEMENTATION SCHEDULE

Project Year	1				2				3				4				5				6				7			
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28
<b>SCU Promotion and Training</b>																												
Set up the CUSO head office	■																											
Establish the CUSO aimag offices	■	■																										
Hire and train personnel	■	■	■																									
Develop/review strategic plan and annual budgets		■	■	■																								
Develop/review SCU promotion campaign		■	■																									
Develop/install/train MIS		■	■																									
Develop SCU training programs		■	■																									
Promote SCUs and train members																												
<b>SCU Supervision</b>																												
Establish the CUSO supervision department		■	■																									
Hire and train personnel		■	■																									
Supervise SCUs																												
<b>SCU Development and Financing</b>																												
Create rural SCUs																												
Train SCU officers																												
Mobilize member share contributions																												
Install SCU bylaws and operating procedures																												
Assist SCUs to develop savings and credit products																												
Mobilize member savings deposits																												
Disburse credit line to SCUs through PCBs																												
Supervise and recover loans from credit line																												
<b>Information and Resource Centers (IRCs)</b>																												
Conduct information and training needs analysis	■																											
Establish IRCs in pilot aimags		■	■																									
Select and train staff		■	■																									
Prepare information and training programs			■	■																								
Conduct SCU staff and general training																												
<b>Project Management Unit (PMU)</b>																												
Establish PMU in coordination with BOM	■																											
Hire and train PMU staff	■	■																										
Install procedures and prepare budget	■	■																										
Conduct training of trainers course		■	■																									
Establish monitoring and evaluation system		■	■																									
Monitor project implementation																												
Conduct SCU promotion in nonpilot aimags																												
<b>Consulting Services</b>																												
International adviser in the CUSO head office	■	■	■			■			■			■																
International advisers in the CUSO aimag offices	■	■	■																									
International MIS specialist in the CUSO		■	■																									
International SCU supervision specialist in the CUSO		■	■																									
Local training specialists																												
Local short term inputs (MIS, environment, IRC needs analysis)	■	■					■			■			■			■			■			■			■			■
<b>Reporting</b>																												
Quarterly reports																												
Annual implementation review																												
Annual audited accounts																												
Midterm review																												

BOM = Bank of Mongolia, CUSO = credit union service organization, IRC = information and resource center, MIS = management information system, PCB = participating commercial bank, PMU = project management unit, SCU = savings and credit union.

## FLOW OF FUNDS AND INTEREST RATES



ADB = Asian Development Bank, CUSO = credit union service organization, MOFE = Ministry of Finance and Economy, PFI = participating financial institution, PMU = project management unit, SCU = savings and credit union.

<sup>1</sup> Administration costs (1 percent) and inflation allowance (6 – 8 percent) are based on discussions with MOFE. Assuming an allowance of 2 percent for a training fund results in an indicative relending rate from MOFE to PFIs as of June 2001 of 10 to 12 percent. Discussions with PFIs, nonbank financial institutions, and SCUs suggest onlending from PFIs to SCUs at 24 percent and sublending by SCUs to members at 30 to 36 percent.

**INDICATIVE CONTRACT PACKAGES**

<b>Contract and Description</b>	<b>Number of Contracts</b>	<b>Estimated Total Contract Value (\$ '000)</b>	<b>Procurement Method</b>
<b>A. Vehicles</b>	1	120	LCB
<b>B. Equipment</b>			
1. Computers	4	131	IS
2. Office Equipment	4	196	IS
3. Training/Media Equipment	1	86	IS
<b>Total</b>	<b>9</b>	<b>413</b>	
<b>C. Consulting Services</b>	1	895	ICR

ICR = international competitive recruitment, IS = international shopping, LCB = local competitive bidding.  
Source: Staff estimates.

## **OUTLINE TERMS OF REFERENCE FOR CONSULTING SERVICES**

1. Consulting services are required to (i) assist the credit union service organization (CUSO) to implement a comprehensive promotion and training program for rural savings and credit unions (SCUs); (ii) train participating financial institutions (PFIs) in prudential financial structure of SCUs and in specialized credit analysis requirements for onlending to SCUs; (iii) provide the CUSO and the project management unit (PMU) with policy, management, and operational advice to establish an SCU and project management information system (MIS); (iv) establish a supervision development unit with the Ministry of Finance and Economy (MOFE) and Bank of Mongolia (BOM) in consultation with existing SCU apex organizations; and (v) conduct a training delivery skills course in order to develop the essential training skills of personnel within the CUSO, and potential trainers from related institutions, SCUs, and information and resource centers (IRCs).

### **A. Consulting Services for SCU Promotion and Training, MIS Development, and the Supervision Development Unit**

#### **1. Policy, Management, and Operational Support to the CUSO Head Office**

2. The adviser to the CUSO will provide services from the start of the Project for a total of 20 person-months. The adviser will:

- (i) help the CUSO expand its head office facilities and staffing, and establish operations in the PMU's project implementation offices in the four pilot aimags in accordance with the needs of the Project;
- (ii) develop and implement a program of workshops for the promotion of SCUs within pilot aimags to be conducted in IRCs;
- (iii) develop a curriculum and training materials for the training of the CUSO staff, SCU apex organization leaders and staff, and SCU boards of directors, committees, and staff;
- (iv) develop an accreditation program to certify local trainers and institutions to deliver the curriculum;
- (v) deliver ongoing training to the CUSO staff based on the curriculum and evolving needs of SCUs over the pilot phase;
- (vi) monitor effectiveness of training and take necessary corrective actions;
- (vii) provide ongoing support to the directors and management of the CUSO to develop and implement policies and procedures resulting in sound business practices;
- (viii) liaise regularly with the PMU, BOM, MOFE, SCU apex organizations, and other relevant authorities and institutions; and
- (ix) prepare terms of reference for domestic consultants who will provide assistance with the CUSO and SCU training curriculum, MIS development, and IRC training and information needs analysis.

## **2. Policy, Management and Operational Support to the CUSO at the Aimag Level**

3. Two advisers for six person-months each will be assigned to support the CUSO's operations at the aimag level. Each adviser will cover two pilot aimags during the six months. The advisers will

- (i) help the CUSO develop its promotion and training capacity, and to expand its operations in pilot aimags; and work with the PMU and the CUSO to select facilities and staff, and establish offices in the four pilot aimags in accordance with the needs of the Project;
- (ii) develop and implement a program of workshops to promote SCUs within pilot aimags to be conducted in IRCs;
- (iii) support development of a curriculum and training materials for the training of the CUSO staff, and SCU boards of directors, committees, and SCU staff; and prepare training materials, taking account of materials that could be used as reference;
- (iv) support development of an accreditation program to certify local trainers and institutions to deliver the curriculum;
- (v) deliver training to the CUSO staff based on the curriculum and evolving needs of SCUs;
- (vi) monitor effectiveness of training and take any necessary corrective measures;
- (vii) in consultation with BOM, support development and implementation of a program of supervision of SCUs at the aimag level;
- (viii) work with the MIS consultant to support development of monitoring tools and procedures relevant to Mongolia's regulatory and operating environment at the aimag level;
- (ix) train and support the CUSO staff to use the SCU MIS system and other tools;
- (x) provide ongoing support to the directors and management of the CUSO to develop and implement policies and procedures resulting in sound business practices; and
- (xi) support preparation of terms of reference for domestic consultants who will provide assistance in the CUSO and SCU training curriculum development, MIS development, and IRC training and information needs analysis.

## **3. Management Information System**

4. An MIS consultant will be required for one person-month to assist the CUSO to design and implement an MIS that will provide necessary financial and operational information on a regular, standardized basis. In the context of Mongolia's SCU operating environment, the MIS consultant will

- (i) review the current accounting systems of the SCUs and the CUSO and determine institutional capacity for providing operational and financial information on an accurate and timely basis;
- (ii) collaborate with the CUSO and the PMU to determine the reporting requirements of Asian Development Bank (ADB) procedures for the Project;
- (iii) develop an MIS appropriate to the needs of the SCUs and the CUSO for existing and future, project-related business;
- (iv) develop report formats and information dissemination methods to provide participant SCUs, the CUSO management, the PMU, and the project coordination committee (PCC) with operational and financial information including loan and savings portfolio analyses and regular financial statements;
- (v) develop report formats showing comparative analysis of SCUs with similar assets and/or membership with respect to delinquency, financial structure, operating costs, return on assets, capital adequacy, staffing levels, and SCU compliance with regulations; and
- (vi) advise the PMU and the CUSO upon appropriate hardware and software required to meet the requirements of the MIS.

#### **4. SCU Supervision and Regulation**

5. The international adviser, with the input of the SCU apex organizations, will assist the PMU and BOM to

- (i) develop prudential rules and regulations, and rules for SCU action;
- (ii) in consultation with BOM, develop and implement a program of SCU supervision;
- (iii) help establish a supervision development unit (SDU); train and support SDU staff to carry out supervision
- (iv) work with the MIS consultant to develop monitoring tools and procedures relevant to Mongolia's regulatory and operating environment; and
- (v) help draft and adopt appropriate supervisory procedures for off-site and on-site surveillance of the SCU system; these procedures will be reflected in the design and implementation of the MIS.

#### **5. Environmental Awareness Training and Monitoring**

6. A domestic consultant will be required to develop an environmental awareness training module and conduct monitoring of potentially environmentally sensitive subprojects throughout the life of the Project. The consultant will

- (i) prepare the module to be applied by the CUSO in its environmental awareness activities with the SCUs;

- (ii) help the CUSO design and implement the environmental awareness activities;
- (iii) periodically monitor potentially environmentally sensitive subprojects with the support of the CUSO, SCUs, and Government.

**B. Consulting Services for Overall Project Needs**

7. International consulting services will be required to develop the training skills of training personnel. Up to one person-month will be need upon completion of the training on NetMon and SCU curriculum to

- (i) review the curriculum developed by the CUSO and its international advisers, and advise upon its presentation to ensure it is user-friendly for a wide variety of education levels and adult learning styles;
- (ii) review the proposed trainer accreditation program prepared by the CUSO and its international advisers; and
- (iii) deliver a training course to develop the training delivery skills of the CUSO staff, potential SCU trainers and directors, and where available, training staff working in the IRCs.

## **FINANCIAL ANALYSIS OF THE CREDIT UNION SERVICE ORGANIZATION AND SAVINGS AND CREDIT UNIONS**

### **A. Introduction**

1. Financial analysis has been performed for the credit union service organization (CUSO) on the basis of its operations as a provider of services to promote and train savings and credit unions (SCUs) to support participating financial institutions (PFIs) in the delivery of credit to SCUs. Financial analysis has also been undertaken for illustrative aimag and soum SCUs based upon five-year projections of savings and credit activities. A summary of the analyses is presented below. Detailed analysis and supporting financial statements and ratios are presented in Supplementary Appendix D.

### **B. Analysis of the CUSO**

2. The CUSO is assumed to undertake SCU promotion and training and the provision of credit analysis services to the PFIs that onlend the Project's credit line to the SCUs. The cost of promotion and training will be paid from the training fund that the Ministry of Finance and Economy (MOFE) will establish with funds from the charge that will be included in the interest that it earns from relending the project credit line to the PFIs. Costs and revenue from promotion and training have not been built into the analysis. Credit analysis services will be paid out of the interest spread earned by the PFIs from onlending the project credit line to the SCUs. Indicative interest rates used are 10 to 12 percent relending rate from MOFE to the PFIs and 24 percent onlending rate to the SCUs. For the purpose of the analysis, based on joint discussions with the CUSO and PFIs during project appraisal, the CUSO is assumed to earn the equivalent of 5 percent of the interest spread that the PFIs will earn. The CUSO is expected to qualify in its own right to operate as a PFI, in which case it will earn the full spread from onlending the credit line. For the analysis, the CUSO is assumed to commence lending in year 2 and will onlend 10 percent of the portfolio in that year, 20 percent in year 3 and 50 percent from year 4 onward. The CUSO is assumed to borrow credit-line funds at 12 percent interest and onlend to the SCUs at 24 percent per year.

3. The CUSO's costs comprise initial investment in fixed assets in head office of \$12,000. At the aimag level it will operate out of offices to be established by the PMU, and the CUSO will not need to invest in fixed assets for those offices. A rental charge has however been included in its operating expenses. Annual operating costs are estimated at \$64,000 at the aimag level and \$28,000 at head office. Of total operating costs, salaries amount to \$54,000 (58 percent). The financing of fixed assets and operating costs has been assumed to be in the form of a loan from MOFE to the CUSO on terms and conditions that reflect the CUSO's financial status and ability to meet interest and principal repayments. For the analysis, an interest rate of 10 percent is assumed. The total financing requirement in year 1 amounts to \$103,000 (including fixed assets of \$12,000) and in years 2 and 3, \$88,000 and \$77,000 respectively. By the end of year 3, borrowing from MOFE amounts to \$256,000. From year 4 onward, the CUSO is able to cover operating costs from revenues and to reduce its borrowing from MOFE. By the end of year 5, the debt to MOFE has been reduced to \$113,000.

4. The CUSO's income from providing credit analysis services to the PFIs would be small during the first three years of the Project when the volume of onlending is low due to the small number of credit unions in pilot aimags that would be eligible to access the credit line during the pilot phase. As more of the credit line is disbursed, particularly from year 4 when all credit unions in Mongolia are able to access its funds, the CUSO's revenue increases significantly.

The CUSO will make a loss in the first three years of operation but as it engages in onlending the credit line, its profitability increase. It achieves both operational and financial sustainability from year 4 and has a positive net income in year 4 of \$68,000, rising to \$233,200 in year 5. At the end of year 5, total assets reach \$1.8 million, of which the net SCU loan portfolio accounts for \$1.7 million after allowance for a loan loss provision of 3.5 percent. Equity at the end of year 5 stands at \$43,000. Summary financial statements are presented in Table A13.

5. The CUSO's future growth and its ability to provide services to the SCUs is dependent upon its ability to onlend funds from the project line of credit. It is however able to withstand a significant fall in the spread that it earns on onlending the credit line. Onlending at 20 percent with the cost of funds remaining at 12 percent reduces revenue but it still shows a positive net income from year 4 onward. If the CUSO does not become involved in onlending project funds, its activities will be limited to SCU promotion and training. While it will be reimbursed for providing these services to pilot aimag SCUs from the training fund to be established by MOFE or will charge a fee to nonpilot SCUs, these services and the credit analysis service provided to other PFIs will be insufficient to allow the CUSO to grow significantly.

**Table A13: Summary Financial Statements for the  
Credit Union Service Organization, 2002-2006**  
(\$'000)

<b>Item</b>	<b>Year 1 2002</b>	<b>Year 2 2003</b>	<b>Year 3 2004</b>	<b>Year 4 2005</b>	<b>Year 5 2006</b>
<b>Balance Sheet</b>					
<b>Assets</b>					
Cash in bank and near cash	412	467	563	1,352	1,213
Net portfolio outstanding	0	35,263	189,536	1,877,026	1,662,278
Short-term investments/other current assets	990	990	990	990	113,891
Net fixed assets	8,808	6,606	4,404	2,202	0
Long-term investments/other long-term assets	0	0	0	0	0
<b>Total Assets</b>	<b>10,210</b>	<b>43,325</b>	<b>195,493</b>	<b>1,881,570</b>	<b>1,777,382</b>
<b>Liabilities</b>					
Savings deposits	0	0	0	0	0
Project credit line loans	103,066	226,304	454,030	2,072,208	1,734,826
Other liabilities	0	0	0	0	0
<b>Total Liabilities</b>	<b>103,066</b>	<b>226,304</b>	<b>454,030</b>	<b>2,072,208</b>	<b>1,734,826</b>
<b>Equity</b>					
Shareholder equity (less dividend payment)	0	0	0	0	0
Accumulated net surplus	(92,855)	(182,979)	(258,538)	(190,638)	42,556
<b>Total Equity</b>	<b>(92,855)</b>	<b>(182,979)</b>	<b>(258,538)</b>	<b>(190,638)</b>	<b>42,556</b>
<b>Total Liabilities and Equity</b>	<b>10,210</b>	<b>43,325</b>	<b>195,493</b>	<b>1,881,570</b>	<b>1,777,382</b>
<b>Income Statement</b>					
Total financial income	4,114	19,975	58,631	396,351	522,029
Total financial costs	4,216	16,154	36,407	181,211	196,028
Gross financial margin	(102)	3,821	22,224	215,141	326,001
Provision for loan losses	0	1,138	4,977	54,435	0
Net financial margin	(102)	2,683	17,247	160,706	326,001
Aimag level operating expenses	64,320	64,320	64,320	64,320	64,320
Head office operating expenses	28,434	28,486	28,486	28,486	28,486
Tax paid	0	0	0	0	0
<b>Net Income From Operations (after tax)</b>	<b>(92,855)</b>	<b>(90,123)</b>	<b>(75,559)</b>	<b>67,899</b>	<b>233,194</b>
<b>Cash Flow</b>					
Cash flow from operations	(90,653)	(86,784)	(68,381)	124,537	235,396
Total other sources	103,066	123,238	264,127	1,813,828	2,187,564
Total other uses	12,000	36,400	195,650	1,937,575	2,423,100
Net change in equity	0	0	0	0	0
Plus grant income	0	0	0	0	0
Ending balance	412	467	563	1,352	1,213

Source: Staff estimates.

### C. Analysis of Savings and Credit Unions

6. Financial projections have been prepared for illustrative pilot aimag center and soum SCUs. Projected financial statements are available in Supplementary Appendix D. Arhangay is considered to be representative of the four pilot aimags and is used for the illustrative aimag center SCU. The analysis is based on the assumption that in aimag center SCUs, members will make an average contribution of \$50 per year and in soum level SCUs they will contribute \$25 per year. By the end of year 3, an aimag center SCU member will have an average total contribution of \$150, and a soum level SCU member \$75. In year 1 all existing members (those in SCUs created by the end of 2001) and new members are assumed to make these contributions. This means that members of existing SCUs will increase their contributions to these average levels. A minimum membership of 25 and a minimum share contribution of \$5 have also been assumed in accordance with the levels set for participation in and support from the Project. SCU borrowing from the project line of credit will be limited to a ratio of 1:1 against aggregate member shares. Loans to members are assumed to be three months in accordance with current practice. Interest rates are assumed to decline over the period of the projections. No attempt has been made to optimize asset management in the analyses.

7. Savings growth is modeled on the experience of Moncord Savings and Credit Union. Moncord is the only SCU with sufficient history to provide a trend, and although it is an urban SCU, their experience is reasonable given the financial history of Mongolia. In the first three years of operation, savings growth was very slow due to distrust of the newly formed institution and lack of excess cash on the part of members. As member trust in Moncord grew and members began to improve their earnings through businesses started with loans from Moncord, they began to make deposits with the SCU. In Moncord's third year of operation, savings surpassed shares with total deposit balances climbing to 1.5 times that of total shares, and in the fourth year to two times total shares. CYDAN, another urban SCU, also experienced slow growth of savings at the beginning but now those members who do save, save at a rate of 30 times their share contribution. Approximately 33 percent of CYDAN's members are savers. For the purposes of the illustrative analyses, savings have been held at 1.5 times shares in the fifth year on the basis that incomes in rural areas are lower and the consumption need is greater, so savings will take longer to build.

8. One of the strengths of the existing SCU movement in Mongolia is the trend to hire staff as soon as possible. In keeping with this trend the analyses assume that part-time staff will be hired when the SCU reaches 25 members and there will be one full time staff per 50 members. This staff ratio further decreases when membership reaches 75 at which time the SCU is assumed to purchase its first computer, thereby increasing operational efficiency. This staff ratio is supported by the experience at both Moncord and CYDAN. Staff salaries are based on average public service salaries, that is MNT45,000 plus benefits at the aimag level and MNT30,000 plus benefits at the soum level. Based on these assumptions, the pilot aimag is able to hire staff and rent premises in the first year of the Project. The pilot aimag SCU also purchases a computer in the first year. None of the soum level SCUs purchase a computer during the first five years of the Project but generate sufficient resources to do so by year 6.

9. Covering all training costs for pilot SCUs is a major benefit as this is a significant cost. Pilot SCUs will only need to provide upgrading or training for new staff and board and committee members after the pilot phase so this analysis assumes that soum SCUs will only train one new person per year and aimag SCUs will train two people each year.

10. Other cash expenses are board and committee expenses, communications, affiliation fees payable to the apex, and stationery and supplies. Communications at the aimag center SCU are set at \$25 per month and at the soum level at \$25 per year. Infrastructure to support electronic communication is limited at the soum level, so communication costs include only postage. Stationery and supplies are calculated at \$1 per year per member. Fees payable to the apex begin in year 3 at a rate of \$0.20 per member. Board expenses are a nominal \$5 to \$10 per month based the on the SCU's ability to pay board expenses. No remuneration for board or committee members is included at this stage, although the unallocated earnings allow scope to cover greater expenses and still build reserves.

11. Noncash expenses include depreciation and loan loss allowances. The loan loss allowance is set at 5 percent of loans disbursed. Actual experience in Mongolia is less than 1 percent, but SCUs have maintained very close memberships with very careful prescreening for membership and loan applications. The workshops on establishing SCUs will encourage much more open membership and more risk-taking on loans so losses will inevitably be greater than experienced to date.

12. Mongolia is currently experiencing downward pressure on lending rates. The ability to offer reasonable loan rates, while at the same time being competitive on deposits and paying a reasonable dividend, is critical in that investors are very sensitive to receiving a return on their investment. Members in existing rural SCUs have demonstrated a willingness to pay interest rates of up to 10 percent per month on loans provided that they receive comparable dividends. The dividends are often paid out in cash but members are increasingly willing to receive them as shares to build the SCUs equity base.

13. The pilot aimag center SCU is able to offer loans at 33 percent per annum at the outset, compared with current rates of 48 to 60 percent for the Golden Fund for Development and up to 180 percent for pawnbrokers. By year 3 the pilot aimag center SCU rates are assumed to fall to 21 percent. The pilot soum SCU starts with a rate of 60 percent before the Project, but this falls to 48 percent in year 1 and reduces steadily to 27 percent by year 5.

14. Similar analysis of illustrative SCUs in nonpilot aimags show the same trend of reducing interest rates but at a slower rate, particularly at the soum level, than those SCUs that participate in the pilot phase of the Project.