

Expanding frontier in rural finance

Mongolia

In the middle of vast Gobi desert, a plume of dust rises behind a Russian jeep rushing to get to Mandalgovi, a rural *aymag* (province) center, before the sunset. The bumpy ride does not distract Nergui Sandag as she looks out into the endless plains seeking answers for her puzzle. She is the Operations Manager of XacBank in Mongolia. Her task is to assess several factors and make recommendations for XacBank on practical approaches to expand its financial services in rural areas, especially to small farmers and herder families, while maintaining the overall financial sustainability of the bank. She is traveling with Jonathan Schuddeboom, a technical advisor to XacBank. Jonathan has been hired to help XacBank expand and compete while also reaching into rural to address the banking needs of farmers and herders. The investors are concerned about risk and profitability but committed to providing services in rural areas. As Nergui and Jonathan seek potential approaches to address these concerns, they have decided to visit one of the XacBank branches located in Mandalgovi, the center of Umnugovi *aymag*, and meet with the field staff to solicit their input.

History of XacBank

XacBank is a rapidly growing microfinance institution operating in a highly competitive market in Mongolia. Key factors for its rapid growth include its dynamic leadership and constant innovations to expand the frontier. The management has focused on improving the efficiency and customer service to enhance its competitiveness, while implementing aggressive expansion into new markets with new products.

XacBank had its beginnings in the MicroStart Mongolia project (MSM) funded by United Nations Development program (UNDP). The project started in 1997 but did not actually begin operating until 1998. Despite the slow start, XAC, the finance company which grew out of the project, became a very dynamic and entrepreneurial MFI using a unique individual loan methodology.¹ The UNDP advisor worked with local NGOs and field staff to design and test a loan methodology based on international best practices, but adapted to Mongolia.² In just 2 ½ years of operations, XAC demonstrated impressive performance. The institution established a network of 13 branches, managing a loan portfolio of US\$854,000 and serving over 3,600 clients. Furthermore, XAC maintained excellent portfolio quality (Portfolio at Risk of 1 day or more late is 0.3% as of April 2001) and reached operational self-sufficiency after 8 months of operation.

In October 1999, XAC registered as the nation's first non-bank financial institution (NBFI). In the last quarter of 2001, XAC merged with Goviin Ehlel (Gobi Start)³ and as a result, XacBank was created. The banking license was obtained in January 2002. Now, XacBank, the banking subsidiary of XAC-GE group, is incorporated as a limited liability commercial bank with a license to conduct banking activities. Headquartered in the country's capital Ulaanbaatar, XacBank operates branches in all of the provinces (*aymags*) of Mongolia.

¹ "Golden Fund for Development" (pronounced HAS as in HAT)

² Initially, MSM tried a group lending methodology but received only two applications. Having realized the group lending was not well accepted in Mongolia, MSM decided to offer individual loans.

³ Goviin Ehlel, then the second largest non-bank financial institution, was established by Mercy Corps in December 1999 with funding from USAID and received its license in March 2000.

With the increasing competition in the financial sector and rapid growth of microfinance institutions (MFIs) in urban areas, XacBank is feeling the pressure to expand its outreach into rural areas, especially to small farmers and herder families beyond *aymag* centers. Having attracted significant social investment, XacBank wants to demonstrate its commitment to serving communities with little or no access to financial services. Jonathan has been hired as the technical advisor to help XacBank with these tasks. As the Operations Director, Nergui's task on this trip is to organize participatory discussions with the branch level staff and work out innovative solutions that will satisfy both of the two seemingly competing goals: to reach small farmers and herders in remote areas and to maintain the profitability of the bank.

Placing XacBank in context

Mongolia is a landlocked country roughly the size of Western Europe located in Central Asia, bordering Russia to the north and China to the south. The territory of Mongolia is divided administratively into 21 *aymags* (provinces) and its capital city Ulaanbaatar, where over 40 percent of Mongolia's 2.7 million residents live (see Appendix A). Mongolia's Human Development Index is ahead of 58 countries, placing it 117th among the 175 countries ranked globally. Mongolia's economy has traditionally been based on agriculture and breeding of livestock, but it also has extensive mineral deposits.

Mongolia has experienced drastic changes in the economy and society, including a rise in poverty following the introduction of market economy in the early 1990s. Privatization of the production and marketing system did not lead to a flourishing economy straightaway due to constraints surrounding the country such as external economic environment, geographical disadvantages, and a severe natural environment. During the socialist period, production levels and living standards were raised through large-scale financial and technical inputs from the former Soviet Union. With the collapse of the COMECON system in the late 1980s, Mongolia lost the source of production inputs as well as the market for its products. Factories reduced their production and large numbers of employees were fired. The unemployment rate in 1998 was 30 %, and poverty became widespread.

Livestock, the country's prime industry, was also transformed from a centrally planned collective production system to privately owned husbandry. The number of herders significantly increased in most *aymag* in the first half of the 1990s since many of former *negdel* (state cooperative) staff became herders after *negdels* were disbanded in the early 1990s. They had no other job opportunities in rural areas but to become herders. Under the collective production system, the *Negdel* did the marketing, provided livestock related services and paid workers' salaries. However, today's small-scale herders are vulnerable to natural disasters and other shocks and are weak in bargaining with private traders. The severe *dzud* (winter disaster) in 1999 to 2001 impoverished many herders. The differences in the quality of life of people in rural and urban areas are stark, and the extent of rural poverty in Mongolia is striking.

Government policy on rural development

Despite the bumpy road, Nergui manages to give Jonathan an overview of the Mongolian government's policy on rural development. He explains that rural development has become a center point in government's Strategic Development objectives. The rural development strategy (RDS)

was drafted by the Center for Policy Research in October 2002. Its goals are:

- a) ensuring sustained income growth for poor rural people;
- b) ensuring the delivery of quality social services to rural people
- c) promoting the sustainable use of natural resources and the environment.

To achieve the goals, seven inter-linked and mutually reinforcing objectives were set:

- a) improving management capability for rural development
- b) livestock sector development
- c) crop sector development
- d) rural marketing, agribusiness and non-farm sector development
- e) rural social development
- f) environmental protection and sustainable use of natural resources
- g) rural infrastructure development.

The RDS proposes changes in the restocking program, which was implemented in 1995. Though it created important safety nets for short time, is the restocking program was not sustainable because of insecure risk mitigating management, negative influences on rural financial activities, and fears of creating a welfare dependant mentality. “negative influences” can mean anything from organized crime to bad weather. Can you be more specific?

Nergui explains to Jonathan that the government had also approved the “National Program on Reduction of Unemployment’ in 1995. This program was to be implemented in two phases, the first from 1996 to 2000 and the second from 2001 to 2010. The objective of the first stage of implementation was to reduce the number of unemployed by creating an environment conducive to economic growth, leading to the creation of new jobs, enhancing workers’ skills, promoting SME and cooperatives, especially in rural areas, organizing public works, and strengthening employment services. The Primary Rural Development Policy Direction was adopted in 1996, aiming at improving living conditions in rural communities by strengthening the extensive livestock sector.

“It is clear that there is a strong support from the Government to develop rural areas and bring services closer to the herder families, including access to financial services. Are there financial institutions that serve the rural communities?” asks Jonathan. In response, Nergui looks at him and says: “Ah that is the catch.”

The financial sector landscape

Five years ago, the banking sector served only 1% of the population due to the commercial banks’ conservative lending approach toward small and micro entrepreneurs. Today the financial sector is emerging slowly in Mongolia, with an estimated increase of 15% in 2002.⁴ In the last two to three years, commercial banks have also become involved in the microfinance market through their existing branch networks. The Bank of Mongolia reported that the total of loans by banks and non-bank financial institutions to the private sector reached USD 97.8 thousand⁵ in 2002, rising to USD 179.2 thousand in 2003. In 2003 Non-Bank Financial Institutions (NBFIs) as well as Savings and Loan Cooperatives (SLCs) expanded their activities due to a favorable legal and economic environment. As a result, the number of NBFIs and SCLs grew to over 380 by the end of 2003.

⁴ Sub-Sector Review of Microfinance in Mongolia, 2002, UNDP

⁵ MNT1,176=USD1 as of end of 2003.

In the mid-1990s microfinance was introduced to Mongolia as a poverty reduction tool, and the market has been developing rapidly. The microfinance sector has substantially increased access to financial services over the last few years. In addition, NBFIs and SCUs have mushroomed, resulting in a rapid increase in the number of MFIs, as shown in Table 1, Appendix B. This increasing competition has become of a concern for XacBank, said Nergui. However, the services of MFIs are still concentrated in urban areas and the trading sector, and many poor households still depend on various sources of informal finance such as friends, relatives and traders.

“If there is so much support from the Government, yet few financial service providers exist in rural areas, why can’t XacBank launch into rural areas?”, asks Jonathan. “Well, it is not easy, and there are many challenges we have to address. But the good news is that there is a big gap of unmet demand for us to fill,” Nergui responded.

Responding to the challenges in rural finance

A. Widespread market and high transaction cost

One of the biggest challenges for financial development in Mongolia is the low population density. Mongolia has a population density of only 1.6 people per square kilometer, which is one of the lowest densities in the world.⁶ It is much lower in rural areas. 65% of the total population lives in urban areas⁷, while the total area for rural market is 86 times larger than the urban market. Due to the low density and poor infrastructure, rural people have difficulties accessing social services, including financial services.

Mongolia has 22 *aymag*, the second largest administrative division in the country, and the 22 *aymag* are sub-divided into 321 *soums*. Financial services are most limited at the *soum* level. Only Agricultural Bank has branches in almost all *soums* (310 *soums*).⁸ Other commercial banks have branches at the *aymag* level, if they have any, and do not reach the farmers and herders in the *soum* level. While many Savings and Credit Unions (SCUs) have been established at the *soum* level, their outreach is limited, with an average of approximately 23 members outside of Ulaanbaatar.⁹ In a survey commissioned by Japanese Bank for International Cooperation (JBIC), only 8% of 218 herders and 14% of 150 micro entrepreneurs interviewed at *soums* were found to have access to SCUs.¹⁰

The market size and density of clients are important factors for successful microfinance. When clients are scattered over a large geographic area, as is the case in Mongolia, transaction costs

⁶ Mongolian Statistical Yearbook 2003, National Statistical Office (NSO) of Mongolia

⁷ Population and development indicators 2002. For example, population density in UB and major cities is 75 times higher than Selenge, the highest density aimag.

⁸ The numbers of outstanding loans and savings in Table 2 and 3, Appendix B show that Ag. Bank has the largest outreach both in loans and savings, which can mainly be attributed to its extensive branch network. It should be also noted that the small size pension loans mainly for consumption share 63% of total loans by Ag Bank and many accounts are considered to be held primarily for pension payment services in rural areas. According to the survey conducted by a local consulting company, 90% of all herder households are accessing bank services primarily for pension payment services, yet only 5% of these same herder households are borrowing from the banking system and 93% would prefer to keep their savings at home.

⁹ Information from NACCUM.

¹⁰The survey was conducted in five *aymags* in 2003.

are obviously very high. Thus, MFIs must find a special delivery mechanism to provide services for people living in rural areas in a sustainable manner.

B. Depth of microfinance services

The lower income communities are especially lacking access to financial services in rural areas. The depth of financial services refers to how MFIs are serving poorer clients and is often measured by the size of loans or savings. In rural areas, Ag Bank had the smallest average size of loans (USD 277.2) followed by Savings Bank and Credit Mongol (USD 278.9 and USD 398). In terms of savings, Ag Bank also has the smallest (USD 64.6 in savings) followed by XAC Bank and Savings Bank (USD 74 and USD 75.7).

On the other hand, Ag Bank and Savings Bank have many clients with small pension loans, using pension as collateral for consumption purposes, as shown in Table 4, Appendix B. At the end of 2002, 75% of the loans of Ag Bank were pension loans, indicating that in terms of number of active clients their loans are concentrated in these small loans for consumption. In contrast, XacBank's loans for working capital and fixed assets serve 7,088 business clients with small loans averaging USD 301.7. The percentage of micro business loans is as high as 64%. For herders, Credit Mongol provides small loans for consumption, livestock and businesses, though the number of clients is not large because it provides these products in only three *soums* on a pilot basis.

However, MFIs still have challenges in supporting those who plan to start businesses because they often require previous business experience -- typically, at least three months. Eligibility requirements exclude start-up businesses for poor entrepreneurs who want to start businesses but cannot access funding.¹¹

C. Sectoral distribution - Target Businesses

MFIs have been mainly serving small traders, not small manufacturers and herders. For example, more than 50% of the total business portfolio of XacBank went to small traders for working capital (Figure 1, Appendix C). In the case of Ag Bank, 58% of loans are directed toward trade, 28% for pension and payroll loans, and less than 1% for agriculture.¹²

The above trend was also reflected in a banking sector survey of the four major banks, conducted by BOM (Who?) in 2002. The reason lending was concentrated in trading is because trade businesses have quick turnover and generate money to repay the loans despite high interest rates, short maturity, and inflexible loan terms. The survey concluded that changes in loan interest rate level and maturity would play an important role in shifting more loans from trade to the industrial sector. The small percentage of loans in agriculture (5.7%) compared with its GDP share might be explained by its long business cycle, vulnerability to weather conditions, and/or by the limited outreach of banking and financial services in rural areas.¹³

As Nergui finishes explaining to Jonathan, the jeep stops in front of a tiny, white, one-floor house reminiscent of Soviet times. The driver says: "This is the hotel. The dinner will be ready in an

¹¹ However, Credit Mongol provides loans to micro businesses and herders to start businesses.

¹² Annual Report 2002 of Ag Bank

¹³ Lenders' Survey by BOM, 2002 (www.mongolbank.mn)

hour.” Jonathan decides to spend the time reviewing his notes on the current operation of XacBank in rural areas.

XacBank in rural finance

As part of its mission, XacBank strives to continue its strategic focus on rural markets. In 2002, the Bank piloted an agricultural lending program in six *aymags* and disbursed loans of USD 42.5 – 12,755 primarily for agriculture. In 2003, it opened five new branch offices, making XacBank the third banking network with nationwide presence. At the end of 2003, 21 branches (65 percent of all branches) were located in rural areas, and rural borrowers comprised 62 percent of total borrowers. (See Appendix D.). In June of 2003, the Bank activated its facility under IFAD’s Rural Poverty Program in collaboration with the Government of Mongolia. This program was targeted toward Arhangay, Bulgan, Huvsgul and Hentiy *aymags*, which are mainly agricultural and livestock breeding regions. 2, 435 loans totaling USD 1615.64 were disbursed in the four *aymags*.

Compared to the banking sector as a whole, XacBank has a larger share of the market in the rural areas (see Figure 2, Appendix C). When reviewed *aymag* by *aymag*, XacBank has gained an increasing share of the lending market (Figure 3, Appendix C).

“This is not bad” says Jonathan to himself. “But the rural clients are currently served by branches located in the *aymag* centers. Yet, the majority of the rural population lives in *soums* outside the *aymag* centers. Only 1.4% of XacBank borrowers are herders, and loans for livestock account for only 0.8% of the total portfolio as of December 2003. (See Figure 4, Appendix C).”

Jonathan is convinced that both to survive the competition and to demonstrate its performance in balancing developmental objectives with commercial return, XacBank has increase its market share in the rural areas. However, he recognizes that there are two key challenges:

- High transaction cost of delivering financial services in rural areas due to long distance, poor infrastructure and low density;
- Lack of traditional collateral asset among the rural herders and small farmers.

As they sit around the table and wait for the dinner, the three of them prepare a list of questions to facilitate the planned discussion with the field staff to brainstorm and identify innovative solutions.

Questions for the participants to assess the context in Mongolia and identify possible solutions for the Xac Bak to expand its services to rural areas

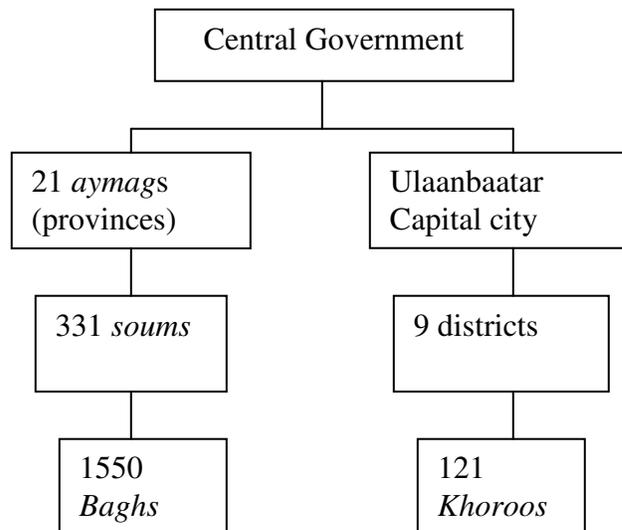
You are the branch staff of XacBank in Mandalgovi, the center of Umnugovi *aymag* (means, south Gobi). Nergui, the Operations Manager of XacBank, has invited you to a participatory discussion to give your recommendations on the following.

1. Based upon the information received (in Appendices) please assess the general layout of the institutions and services in rural finance and the current status of XacBank in relation to the competition and to the feasible rural market potential.
2. How should XacBank approach expansion of services to rural communities in a way that expands access, especially to agricultural and herder families, but does so in a manner that does not significantly affect the overall health of the bank? Identify innovative delivery mechanisms and process for XacBank to expand its outreach to small farmers and herders. Please note that not only the potential approach is important, but also the process for delivering the service is critical.
3. What are the reasons for your recommendation? What are the pros and cons of each option?
4. What are the possible implications for risk and profitability?
5. What capacity building would be needed to achieve the approach that you recommend?

Appendix A Map of Mongolia



Administrative structure of Mongolia



Appendix B

Table 1: Number of MF Providers

	2000	2002
Number of Banks involved in MF	2	6
Number of NBFIs	34	68
Number of SCUs	135	260*
Number of Pawnshops	800	1,000

Source: UNDP Sub-sector review 2002, * Information from Netmon.

Table 2: Outreach of Loans by Major MFIs in Mongolia (Currency: USD)

	No. of outstanding loans	Outstanding Portfolio	Average amount of Portfolio	No. of outstanding loans	Outstanding Portfolio	Average amount of Portfolio
XAC Bank	17,035	7,454,474	514	11,625	5,096,713	439
Ag Bank	118,857	35,083,101	347	92,569	25,674,585	277
Post Bank	8,564	20,481,700	2813	N/A	4,270,281	N/A
Zoos Bank	2,609	15,450,392	5922	676	1,280,865	1895
Savings Bank	71,172	11,281,917	158	15,815	4,411,626	279
Inter Bank	126	5,814,598	46148	N/A	N/A	N/A
Credit Mongol	566	1,022,434	1806	362	144,154	398

Source: Information from the above banks/NBFI

Note: The above data is as of Oct. 30, 2003 except Zoos Bank and Inter Bank whose data are as of end of 2002, and include all the kinds of loans not only micro loans

Table 3: Outreach of Savings by Major MFIs in Mongolia (Currency: USD)

	Total			Rural (excluding UB, Erdenet, Darkhan)		
	Total no. of saving accounts	Total balance of savings	Average amount of savings	Total no. of saving accounts	Total balance of savings	Average amount of savings
XAC Bank	46,507	7,186,064	155	25,891	1,912,537	74
Ag Bank*	351,968	56,194,798	160	295,761	19,054,737	65
Post Bank	40,299	30,376,457	753	N/A	N/A	N/A
Zoos Bank	4,461	10,517,397	2358	726	N/A	N/A
Savings Bank	316,558	39,838,266	126	18,330	1,387,512	76
Inter Bank	N/A	8,932,615	N/A	N/A	N/A	N/A

Source: Information from the above banks/NBFI

Note: The above data is as of Oct. 30, 2003 except Zoos Bank and Inter Bank whose data are as of end of 2002, and include all the kinds of deposits not only small size deposits. The number of current account shares 74-76% of total accounts of Ag Bank.

Table 4: Outreach of Small-size Loan Products (Currency: USD)

Purpose	Bank	Target	No of outstanding loans	Average loan Amount	Min. loan size	Interest rate/ month	Process time*
Business (working capital/fixed asset)	XAC Bank	Micro business	7,088	302	170	3.5-4.5%	3-10 days
	Credit Mongol	Micro business/herders	143	645	255	3%	<7 days
Consumption/ livestock/ business	Ag Bank	Herders	5,128	654	85	3-4%	7 days
	Credit Mongol	Herders	66	185	43	4%	<7 days
Consumption	Ag Bank	Pensioner	76,831	54	9	2-3%	20 minutes
	Savings Bank	Pensioner	43,016	34	21	2%	1 day
	Credit Mongol	Herder	200	82	17	4%	<2 days

Source: Information from banks/NBFI The data is as of the end of Dec. 2002 and includes urban services.

* Process time means period from application to loan disbursement

Appendix C

Figure 1

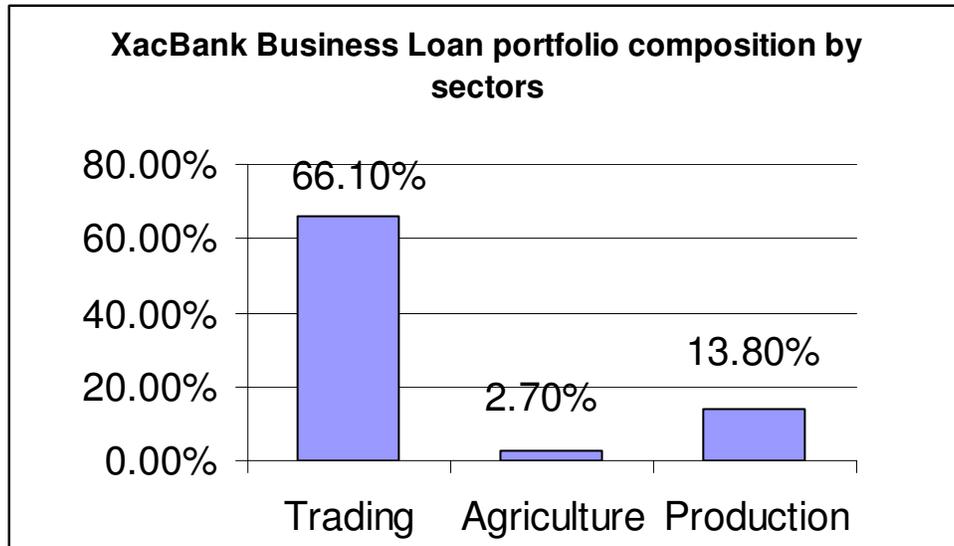


Figure 2

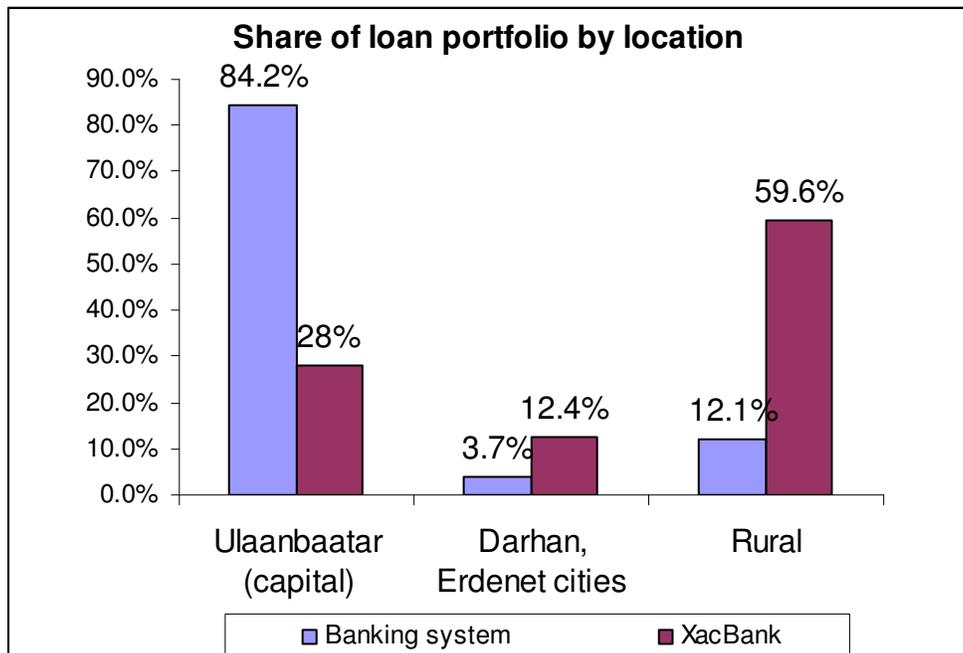


Figure 3

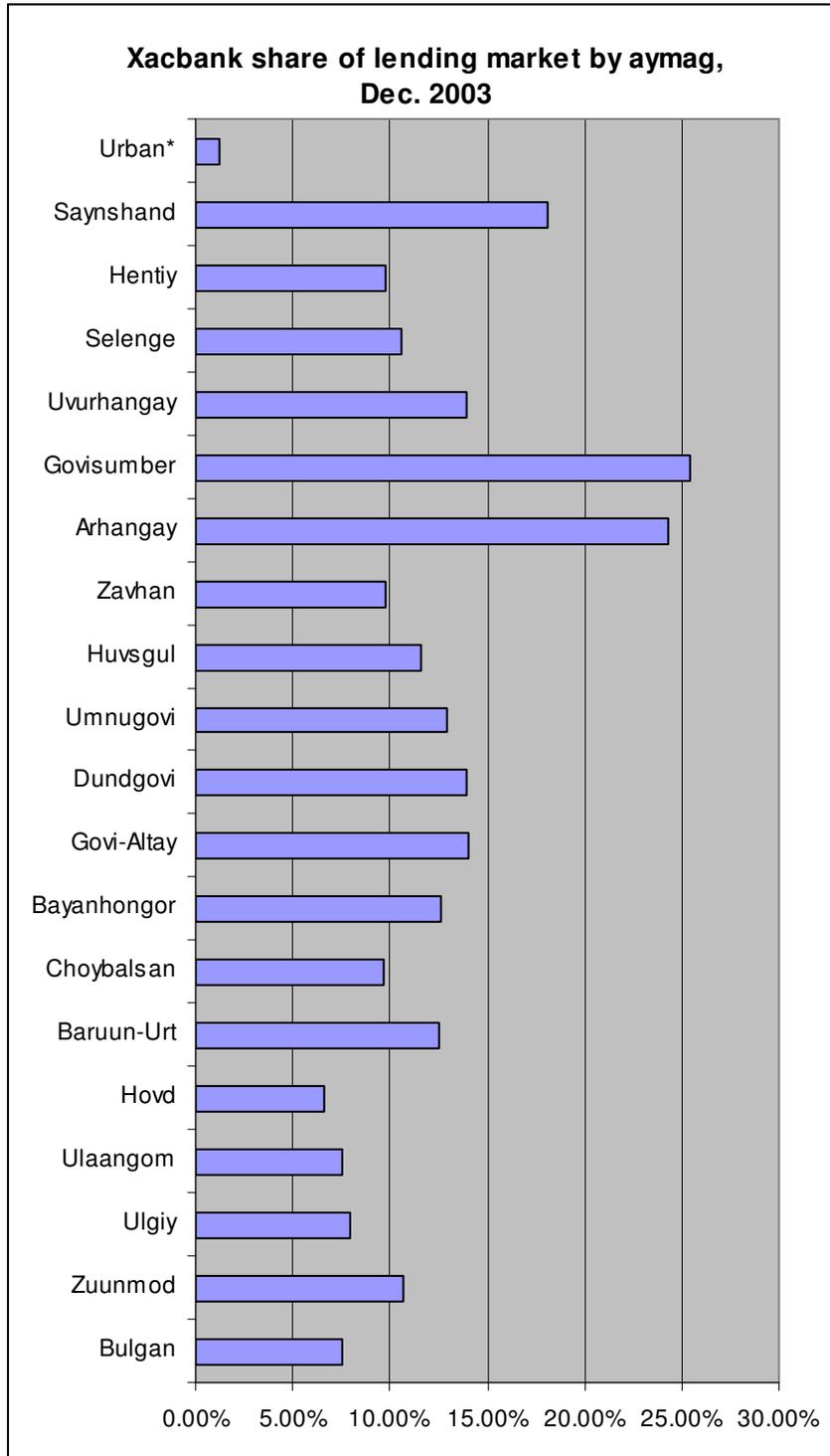
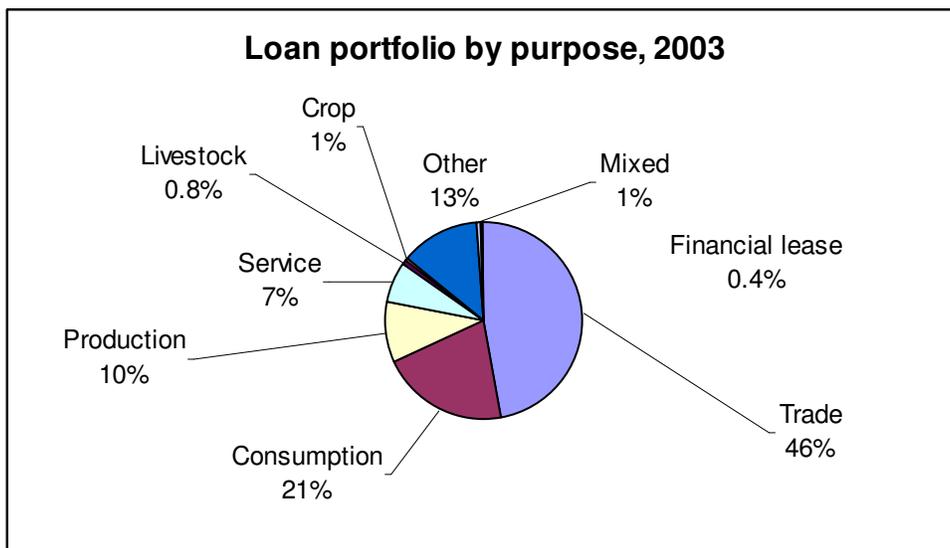
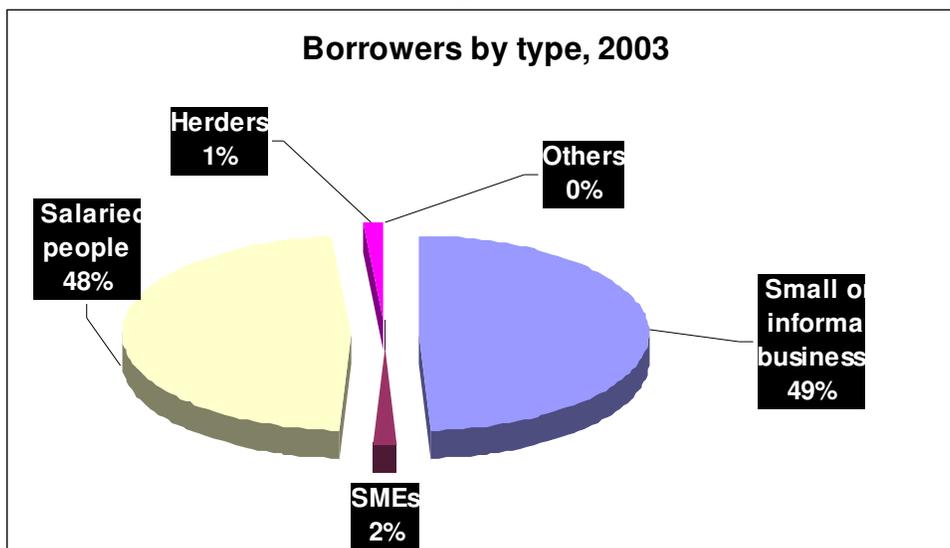
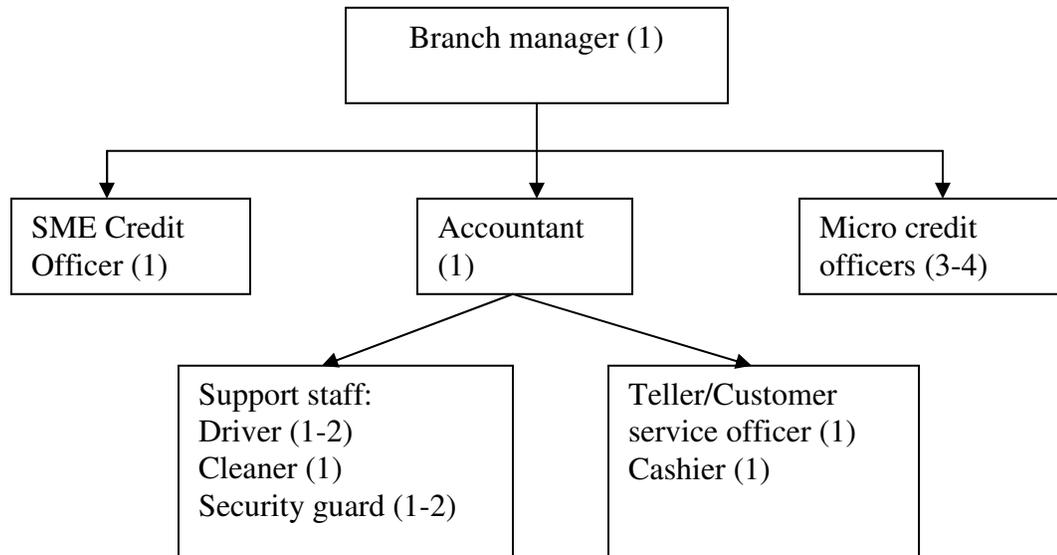


Figure 4



Appendix E

Branch structure of XacBank



Further readings:

Case study of DEMOS-Croatia, by Caroline Tsilikounas

Business transactions for smallholder farmers and entrepreneurs via DRUMNET, by Jonathan Campaigne

Serving small rural depositors: proximity, innovations and trade-offs, by Madeline Hirschland