Mongolia
Ministry of Finance

TWO STEP LOAN PROJECT FOR SMALL AND MEDIUM SCALE ENTERPRISES DEVELOPMENT AND ENVIRONMENTAL PROTECTION (SUPPORT FOR ESTABLISHMENT OF FINANCE SCHEME FOR SMALL AND MEDIUM ENTERPRISES) IN MONGOLIA

FINAL REPORT

April 2018

Japan International Cooperation Agency (JICA)

Koei Research & Consulting Inc.
The Japan Economic Research Institute

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ABBREVIATIONS

ADB	Asian Development Bank
ALM	Asset Liability Management
APCO	Asia Pacific Capital Corporation
BOD	Board of Directors
BOM	Bank of Mongolia
CGC	Credit Guarantee Committee
CGF	Credit Guarantee Fund
CGF/MOF	Credit Guarantee Fund by the Government of Mongolia
CHPs	Combined Heat and Power Plants
CIB	Credit Information Bureau
CIS	Credit Information Service
CMAP	Comprehensive Macro Adjustment Plan
DBM	Development Bank of Mongolia
DFC	Development Finance Company
DML	Debt Management Law
E/A	Executing Agency
EBRD	European Bank for Reconstruction and Development
EFF	Extended Fund Facility
EGSPRS	Economic Growth Support and Poverty Reduction Strategy
EMTN	Euro Medium-term Note
EPL	Environmental Protection Loan
EPRC	Economic policy reform and Competitiveness
EU	European Union
FDI	Foreign Direct Investment
FEBTC	Far East Bank and Trust Company
F/F	Fact Finding
FIRR	Financial Internal Rate of Return
FKI	Federation of Korean Industries
FPS	Food Price Stabilization
FRC	Financial Regulatory Commission
FSL	Fiscal Stability Law
FX	Foreign Exchange
GCF	Green Climate Fund
GHG	Greenhouse Gas
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
GOJ	Government of Japan
GOM	Government of Mongolia
GSF	Government Special Funds
HOB	Heat Only Boiler
IDF	Investment and Development Fund
IFC	International Finance Corporation
IFI	International Financial Institution
IMRI	Integrated Mineral Resources Initiative
IMF	International Monetary Fund
IPO	Initial Public Offering
IWRM	Integrated Water Resources Management
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
KDFC	Korea Development Finance Corporation
KDLC	Korea Development Leasing Corporation
KfW	Kreditanstalt für Wiederaufbau
KIFC	Korea Investment and Finance Corporation

KLB	Korea Long Term Credit Bank
L/A	Loan Agreement
LGF	Loan Guarantee Fund
LLC	Limited Liability Company
LNBFA	Law on Non-Bank Financial Activities
LULUCF	Land Use, Land-Use Change and Forestry
M2	Money Supply
MBA	Mongolian Bankers Association
MEFP	Memorandum of Economic and Financial Policies
MIK	Mongolian Mortgage Corporation
MNCCI	Mongolian National Chamber of Commerce and Industry
MNT	Mongolian Tugrik
MOF	Ministry of Finance
MOFA	Ministry of Food and Agriculture
MOFALI	Ministry of Food, Agriculture and Light Industry
MOJC	Mongolia-Japan Center for Human Resources Development
MOI	Ministry of Industry
MOIT	Ministry of Industry and Trade
MOL	Ministry of Labour
MONE	Ministry of Nature and Environment
MONET	Ministry of Nature, Environment and Tourism
MONEF	Mongolian Employers' Federation
MonSEFF	Mongolian Sustainable Energy Financing Facility
MoU	Memorandum of Understanding
MSE	Mongolian Stock Exchange
NAPCC	National Action Programme on Climate Change
NEDA	National Economic Development Authority
NBFA	Non-Bank Financial Activities
NBFI	Non-Bank Financial Institutions
NDCs	Nationally Determined Contributions
NEDA	National Economic Development Authority
NPL	Non-performing Loan
NPO	Non-profit Organization
NSO	National Statistics Office
ODA	Official Development Assistance
PFI	Participating Financial Institution
PHP	Philippine Peso
PNB	Philippine National Bank
PPP	Public Private Partnership
PS	Preferred Shares
PDCP	Private Development Corporation of the Philippines
PSP	Price Stabilization Program
PSTF	PFI Selection Task Force
REDP	Regional Economic Development Program
RF/A	Revolving Fund Account
RMB	Chinese Yuan
ROA	Return on Assets
ROE	Return on Equity
RSF	Risk Sharing Facility
RV/F	Revolving Fund
S/A	Special Account
SAPI-2	Special Assistance for Project Implementation for Two-Step-Loan Project for Small- and Medium-scaled Enterprises Development and Environmental Protection
SCC	Saving and Credit Cooperative

SDGs	Sustainable Development Goals
SDR	Special Drawing Rights
SEFIL	Strategic Entities Foreign Investment Law
SIFS	Strategic Import Financing Schema
SME DFC	SME Development Finance Corporation
SPE	Special Purpose Entity
TA	Technical Assistance
TARP	Troubled Asset Refinance Program
TDB	Trade and Development Bank
TSL	Two Step Loan
UB	Ulaanbaatar
UNFCCC	United Nations Framework Convention on Climate Change
USAID	United States Agency for International Development
USD	US Dollar
WB	World Bank
WBC	World Bank Group
WHO	World Health Organization

Introduction

0.1 Background of the Technical Assistance (TA)

This technical assistance (TA) is to assist Ministry of Finance (MOF) to prepare the establishment of Special Purpose Entity (SPE) in PPP model which is expected to take over present public owned system to manage “TSL Project for SMEs Development and Environmental Protection (Support for Establishment of Finance Scheme for SMEs) in Mongolia”. The idea of SPE was proposed as an exit policy of TSL Project by the report of Special Assistance for Project Implementation for Two-Step-Loan Project for Small- and Medium-scaled Enterprises Development and Environmental Protection (SAPI-2) which JICA undertook in order to prepare for Phase III when TSL Phase II was terminated in 2015. At that time, SPE is expected to be established after disbursement of Phase III is completed. However, after SAPI-2 study ended, the Mongolian economy was threatened suddenly and government regime was also changed. In this circumstance, provision of Phase III was postponed and its perspective was not relevant anymore. Hence, JICA in consultation with MOF decided to undertake this technical assistance in advance of Phase III. A brief outline of this TA is introduced below.

0.2 Objectives

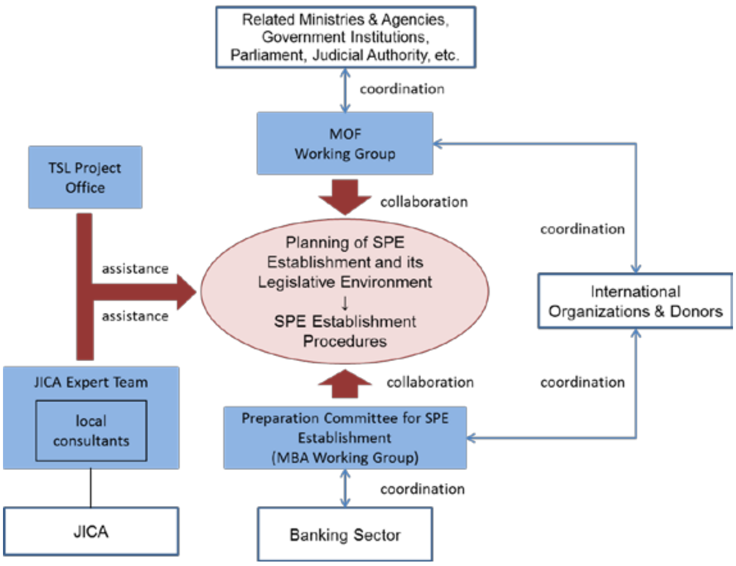
The objectives of TA are to verify the optimal form of a new finance scheme for SMEs which utilizes the revolving fund of TSL Project, and to provide TA for the process of considering and establishing an appropriate SPE.

0.3 TA Area

TA targets all of Mongolia but most of activities will be in Ulaanbaatar City.

0.4 Implementation Structure

Implementation structure of TA is illustrated in Figure 0.4.1. The role and function of the JICA Expert Team, the MOF Working Group, the Preparation Committee for SPE, and the TSL Project Office are briefly explained below.



Source: JICA Expert Team

Figure 0.4.1 Implementation Structure of TA

0.4.1 JICA Expert Team

The JICA Expert Team is formed with international and local experts. The members are shown in the Table below.

Table 0.4.1 Member List of JICA Expert Team

Support Area	Name
INTERNATIONAL EXPERTS	
Team Leader/ Development Financing	Mr. Makoto Sunagawa
SMEs Financing Institutions	Mr. Giovanni Vacchelli
Organization/ Business & Budgetary Planning	Mr. Kazuo Mishima
Organization/ Business & Budgetary Planning (2)	Mr. Takeshi Shibuya
Legislation	Mr. Hironobu Adegawa
Capacity Development/ Training	Mr. Kenji Sato
LOCAL CONSULTANTS	
Establishment of SPE, negotiation with the international financial institutions (IFIs)	Mr. Batbayar Purevjargal
Development of a new accounting system and managing system of service charges along with the transition from TSL to SPE	Mr. Tuguldur Baavai
Drafting related legal documentations including SPE prospectus, company charter, term sheet, shareholder’s agreement, etc.	Mr. Batbayar Ganbayar
Coordination with the banking sector to establish SPE, advisory for the environmental protection loans	Mr. Naidalaa Badrakh
Macro-economic analysis, current situation analysis for the banking sector, and financial demand survey	Mr. Danaasuren Vandangombo
Questionnaire and interview survey for the best practice survey	Mr. A. Munkhjin
Current situation analysis for the environment protection sector and its financial demand	Mr. Ch. Munkhzul

Source: JICA Expert Team

0.4.2 Ministry of Finance (MOF) Working Group

The working group (WG) which would be a counterpart of TA was established in MOF (MOF WG). The MOF WG works jointly with JICA Expert Team on SPE establishment and its necessary decision making. Coordination among related ministries and agencies, parliament, judicial authority, and other stakeholders is also the function of the WG. The following issues are discussed under the coordination by the WG: namely, investment amount, the method of commission to SPE on operating revolving fund, how to ensure the related policies, to what extent and how the government gets involved, etc. The WG will work closely with the preparation committee for SPE establishment as described in the next section.

0.4.3 Preparation Committee for SPE Establishment (Mongolian Bankers Association (MBA) Working Group)

Another working group was formed from the banking sector as the preparation committee for SPE establishment. The committee members mainly consist of the middle-class personnel from the current PFIs. The main functions of the committee are coordination in the private sector and negotiation with the government. Once SPE Prospectus and its business plan are endorsed, the committee would be a founder as well as the MOF WG, and work for the establishment of SPE.

0.4.4 TSL Project Office

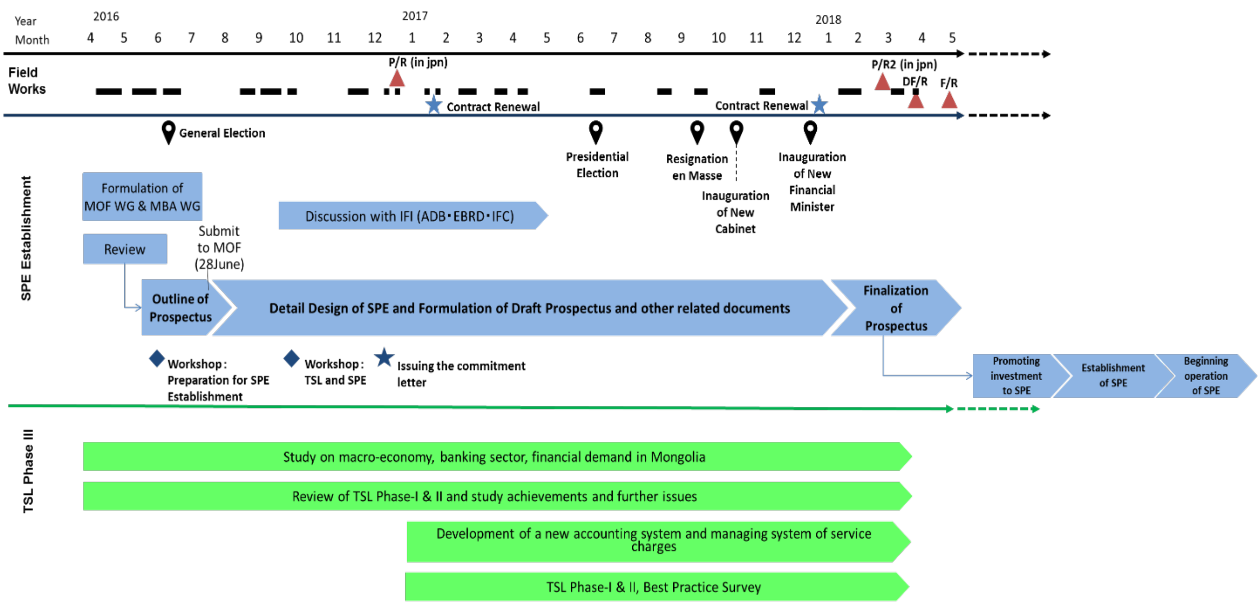
There are six full-time personnel in TSL Project Office since Phase I started under the contract between MOF and KRI (now KRC) to provide the consulting service for the project. They are experts on operating and managing the TSL project by conducting up-to-date review of loans, and building up a direct network with SMEs.

0.5 Implementation Schedule

The TA durations is from April 2016 to May 2018 by renewing the contract twice. Contact periods for each contract are as follows.

- Initial contract: 15 April 2016 - 31 July 2017
- First renewal of the contract: 15 April 2016 - 28 December 2017
- Second renewal of the contract: 15 April 2016 - 30 May 2018

The implementation schedule is shown in the Figure below.



Source: JICA Expert Team

Figure 0.5.1 Implementation Schedule

0.6 Components of the Final Report

This report is composed of Parts 1 to 4.

Part 1 outlines the Mongolian economic situation, the current state of the banking sector, the current state of the SME, the current situation of environmental problems and activities of other donors.

Part 2 summarizes the impact and effect of TSL after reviewing Phase I and II.

Part 3 proposes the establishment plan of SPE and necessary design of corporate governance for it.

Part 4 outlines a projection of TSL Phase III loan.

This report contains relevant attachments including SPE Prospectus, Best Practice Analysis of TSL Phase I & II, and performance reports of EPLs and PFIs for reference.

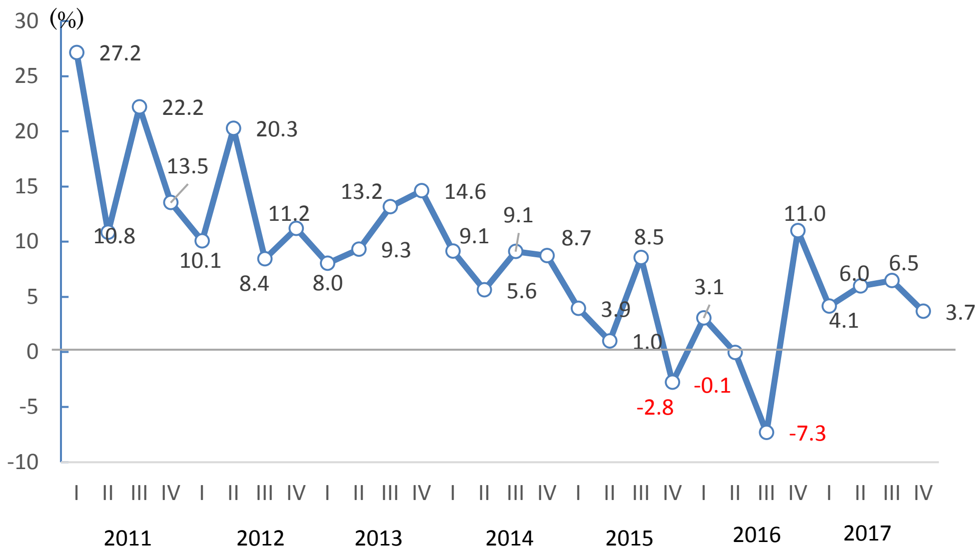
Part 1:

Analysis of Current Situation

Chapter 1 Economic Situation of Mongolia

1.1 General

Mongolia has achieved steady economic growth since 2000, with annual average growth rate of 7.5% between 2001 and 2008 due to the expanded inflow of foreign direct investment (FDI) into the mining sector. The Mongolian economy was hit hard by the global financial crisis triggered by the bankruptcy of the Lehman Brothers in 2008, and it recorded a negative growth of -1.3% in 2009. The economy recovered relatively fast thanks to a sharp rise of copper price from the second half of 2009 and a growth of 17.5% in 2011. The Mongolian economy continued high growth during the period 2012 - 2013 because of production of copper and gold. However, the growth rate dropped to 2.5% in 2015 and to 1.4% in 2016. Real GDP growth rate dropped in the first quarter of 2015. In the third quarter of 2016, GDP recorded a rate of -7.3% on a year on year basis. Mongolia's economy has shown recovery since the fourth quarter of 2016 supported by an increase in gross investment. An annual economic growth rate in 2017 was 5.1%.

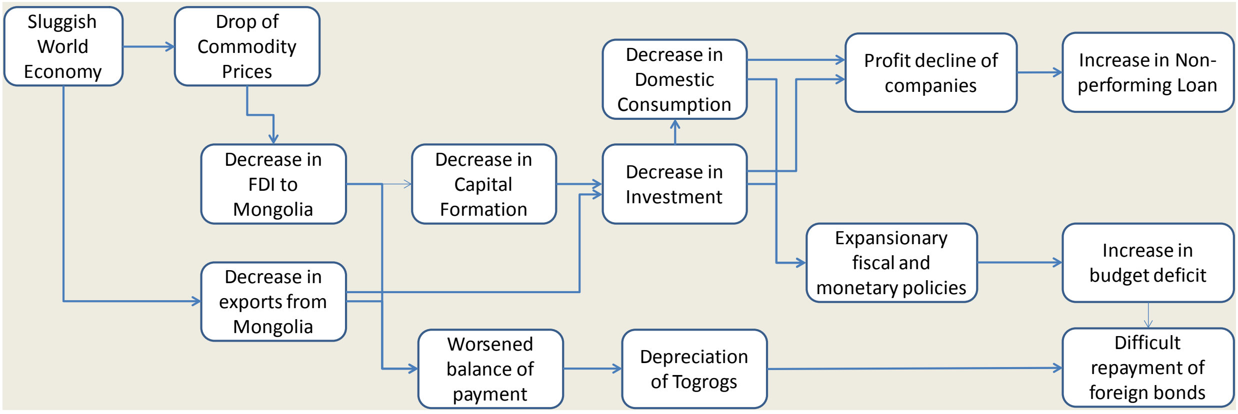


Source: Central Statistical Office of Mongolia

Figure 1.1.1 Real GDP Growth Rate by Quarter

Mongolia has been in a economic crisis in recent years. The following are major issues of the economy.

- weak copper and coal prices and a drop of exports, as a result, a balance-of-payment deficit and disappointing revenue
- expanded budget deficit due to expansionary government programs with foreign-currency borrowing in recent years
- upcoming repayment due of government bonds
- a precipitous drop in the value of tugrik currency
- dropping foreign direct investment (FDI)
- low level of foreign exchange reserves



Source: JICA Expert Team

Figure 1.1.2 Factors Which Affected Recent Economy of Mongolia

After the formation of new government in 2016, the Government of Mongolia (GOM) developed its Action Program for the period 2016-2020 basing on the Sustainable Development Vision 2030. The main objectives of the program were to restore economies health within a short period, promote growth, support social sectors and significantly upgrade the well-being of its citizens. The adopted policy for overcoming economic slowdown included ensuring macroeconomic stability, diversifying the structure of the economy, reducing vulnerability to commodity price fluctuations, easing balance-of-payments pressures, lessening debt burden in the mid-term; and generating economic resilience.

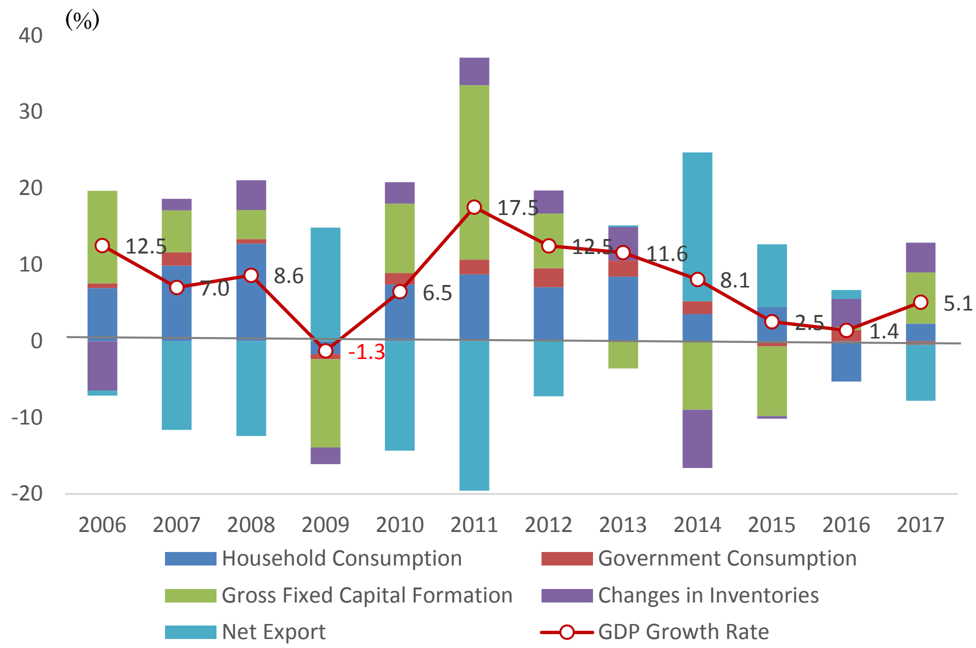
Under further deteriorating economic and financial situation, GOM requested assistance from the International Monetary Fund (IMF) in September 2016 to stave off a financial crisis. In May 2017, IMF approved a three-year extended arrangement under Extended Fund Facility (EFF) for Mongolia for a total amount of SDR 314.5 million (approximately USD 434 million) to support Mongolia's economic reform program. The total financing package of approximately $ 5.5 billion was announced at the same time. The package included support from Asian Development Bank (ADB), World Bank, Japan, South Korea and China.

Prior to the approval of financing package, GOM and IMF has agreed to the Memorandum of Economic and Financial Policies (MEFP). Key points of reforms proposed in MEFP are to: (i) increase discipline in fiscal policy, (ii) improve the central bank's independence, governance, and focus on core responsibilities, (iii) strengthen the financial sector, (iv) foster economic diversification and inclusive growth, and (v) protect the most vulnerable in society[1].

1.2 Factors Contributing to GDP Growth

Economic growth in 2010 and 2012 was achieved by strong gross capital formation (investment). The investment decreased since 2013 due to a drop of FDIs into the mining sector. A drop of investment has been compensated by net export balance in 2014 and 2015 as the result of a drop of imports. Household consumption is a stable contributing factor to the economic growth; however, the contribution has been weak since 2014 reflecting a trend towards recession in the country. The recovery of the economy in 2017 was supported by an increase in gross investment.

[1] IMF Country Report No. 17/40 "Mongolia 2017 Article IV Consultation and Request for an Extended Arrangement under the Extended Fund Facility", May 2017



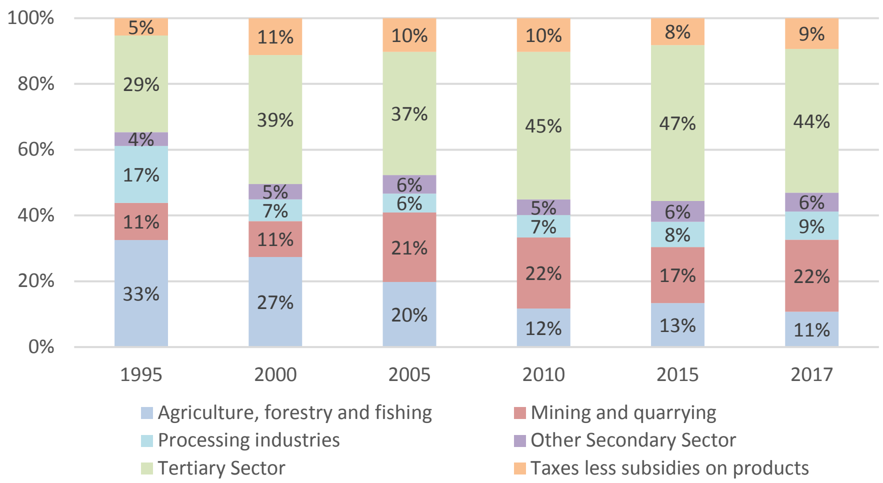
Source: Central Statistical Office of Mongolia

Figure 1.2.1 Real GDP Growth by Expenditure

1.3 Industrial Structure

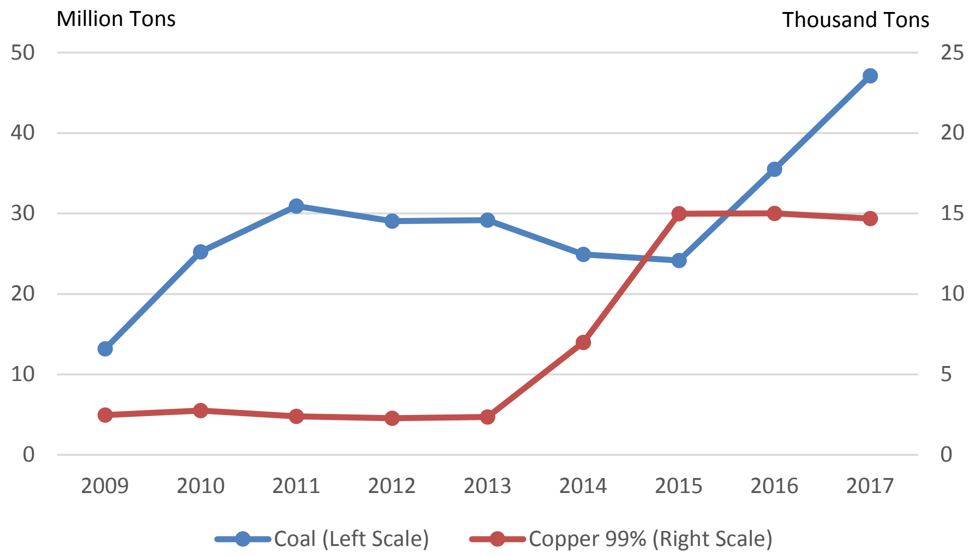
Mongolia's economy is overly dependent on the mining sector, especially coal and copper; therefore the diversification of economic structure is a long-held policy of economic development.

As a long-term trend, the share of the primary industry to total GDP has been continuously decreasing during the last decade; on the contrary the share of the tertiary industry has increased. The share of secondary industry has shown a modest growth. The mining sector expanded rapidly in the middle of 2000s due to massive investments to mines. The production of coal spiked in 2010 and that of copper in 2015. The share of mining reached to 22% of GDP in 2006. However, since then the share has dropped down to 17% in 2015. The manufacturing sector has shown a gradual upward trend.



Source: Central Statistical Office of Mongolia

Figure 1.3.1 GDP by Industry Sector

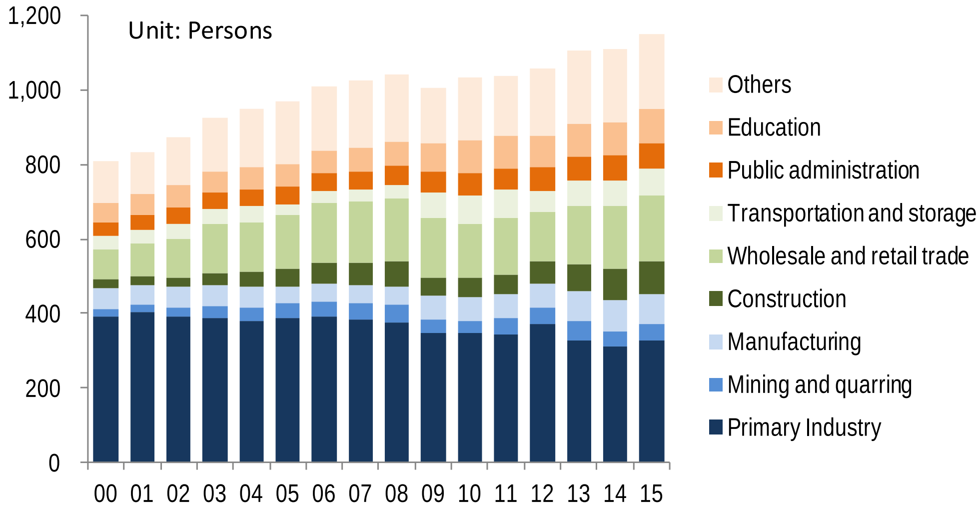


Source: Central Statistical Office of Mongolia

Figure 1.3.2 Production Trend of Coal and Copper

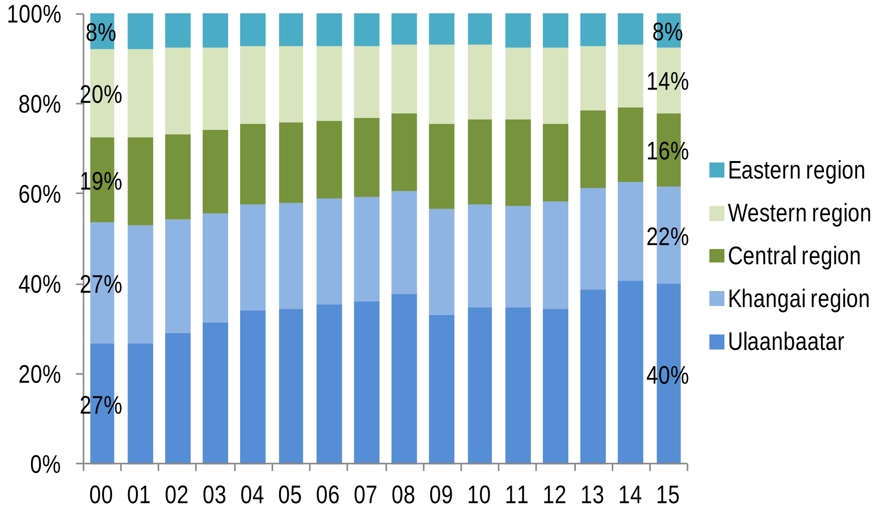
1.4 Employment

The sector which has the largest employment is the primary sector, especially the agriculture sector, followed by the wholesale and retail sector, manufacturing sector and construction sector. During the last five years (2010/2015), the employment of construction sector increased by 80.5%, the manufacturing sector 25.5%, and the mining sector by 24.9% while total employment increased by 11.4%. In Mongolia, migration from rural area towards cities and urban settlements, especially Ulaanbaatar, increased in the middle of 1990s. An increasing number of Mongolian workers are going to foreign countries looking for job opportunities and better wages.



Source: MONSIS

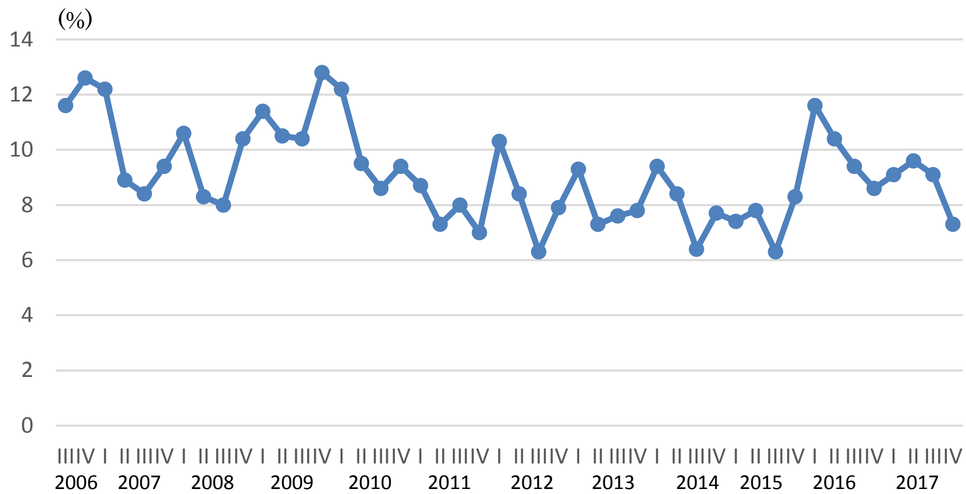
Figure 1.4.1 Employment by Industry



Source: MONSIS

Figure 1.4.2 Employment by Region

The unemployment rate increased in the late 2000s due to the impact of global financial crisis. The rate tended to decrease in the 2010s; however, it remained at a level of over 6%. It jumped to 11.6% in the first quarter of 2016 although the Mongolian economy stagnated. The employment rate decreased since the second quarter of 2016.



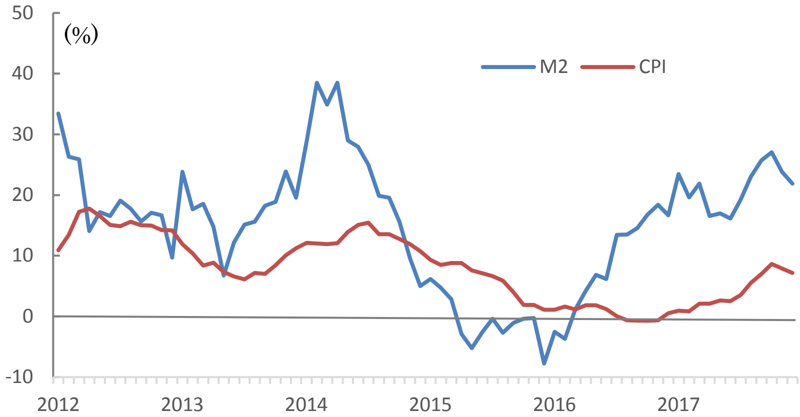
Source: Central Statistical Office of Mongolia

Figure 1.4.3 Employment Rate

1.5 Money Supply and Inflation

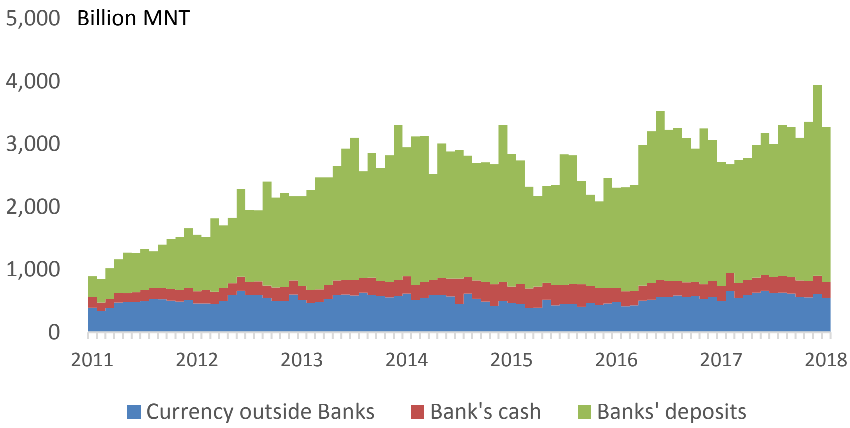
After a sharp increase of 60% in 2010, the growth rate of money supply (M2) dropped. However, the money supply drastically rose in early 2014. This is a result of government expansionary spending and loosened monetary policy in response to the slowdown of economy due to the drop of investment. The growth rate of money supply turned to decrease in the middle of 2014 and was negative in 2015. Since March 2016, the money supply has accelerating growth.

A year-on-year increase rate of consumer price index (CPI) remained at a high level of around 15% until the middle of 2012, then temporarily decreased. It began to rise in the second half of 2013 and peaked at 15.4% in July 2014. It continued to drop and became very slightly negative in the latter half of 2016. The CPI growth rate gradually increased throughout 2017.



Note: Year on year basis. CPI is the data of Ulaanbaatar City.
Source: Bank of Mongolia, Central Statistical Office of Mongolia

Figure 1.5.1 Change of CPI and Money Supply (M2)



Source: Bank of Mongolia

Figure 1.5.2 Outstanding of Monetary Base

1.6 Public Finance

The fiscal balance of Mongolia worsened due to expanded expenditure in 2011 and 2012. The size of fiscal deficit compared to GDP was 5.7% in 2011 and 6.8% in 2012. The financial deficit jumped in 2015. Revenue decreased due to sluggish coal and copper prices in 2015 and 2016.

Under the former government, the parliament approved a "Comprehensive Macro Adjustment Plan" (CMAP) in February 2015, which comprises macro-financial adjustment and structural policies. CMAP retains the target fiscal path in the supplementary budget. It aims to phase out the Price Stabilization Program of the Bank of Mongolia and transfer the remaining program loans to the government. However, the CMAP did not thoroughly transfer all of the BOM's programs loans including the mortgage loans to the budget.

In 2015, the parliament passed the new Debt Management Law with the purpose of improving management of public debt. Parliament also revised the Fiscal Stability Law (FSL) and raised the debt ceiling to 58.3% of GDP from 40.0% for the issuance of foreign-currency sovereign bonds.

The fiscal deficit surged in 2016 to cover former off-budget expenditures and was equal to 15.3% of GDP[2].

[2] According to IMF's data, the budgetary deficit was equal to 17.0% of GDP in 2016.

Table 1.6.1 Government Revenue and Expenditure

Unit: Billion MNT

Item	2011	2012	2013	2014	2015	2016	2017
Revenue	4,241	4,887	5,940	6,277	5,981	5,835	7,239
Expenditure	4,997	6,018	6,165	7,145	7,138	9,495	8,981
Balance	-756	-1,131	-225	-868	-1,157	-3,660	-1,742
Ratio of Balance to GDP	-5.7%	-6.8%	-1.2%	-3.9%	-5.0%	-15.3%	-6.4%

Source: Central Statistical Office of Mongolia

The fiscal imbalance of Mongolia was much higher when off-budget financing. Is considered Most infrastructure development was financed with loans of the Development Bank of Mongolia (DBM). In 2013, the government started the price stabilization program disbursing government subsidized loans through the Bank of Mongolia (BOM) to domestic manufacturers/traders handling construction materials (cement, steel frames, and insulating materials) based on the issuance of the Chinggis Bond. The participation of BOM in the price stabilization measures is beyond a normal role of monetary authorities. The use of sovereign bonds for expenditures is an issue of fiscal discipline and principle of the Financial Stability Law (FSL). In 2015, FSL was amended and a new Debt Management Law (DML) was enacted. DML excluded SOE debt and government's full guarantees from the definition of government debt, raised the debt ceiling and targeted to lower the fiscal deficit down to the previous limits by 2018.

The program of MEFP in 2017 highlights substantial fiscal consolidation including a rationalization of capital expenditure, streamlining of social transfers, reform of public pensions and wage bill and tax revenue increase. GOM aims to continue to reduce the deficit below 2.0% of GDP by 2022 after returning the primary balance to surplus in 2020.

1.7 Balance of Payment

1.7.1 General Trend of the Economy

During the period 2011 - 2013, the current account deficit sharply increased, but it was compensated by a surge of financial accounts surplus, mainly a large inflow of direct investment. The inflow of FDI surged in 2011 but sharply dropped in 2014. In addition, the issuance of Chinggis Bonds contributed to the increase in financial accounts. The current account deficit has decreased since 2015 because of a drop of imports.

Table 1.7.1 Balance of Payments

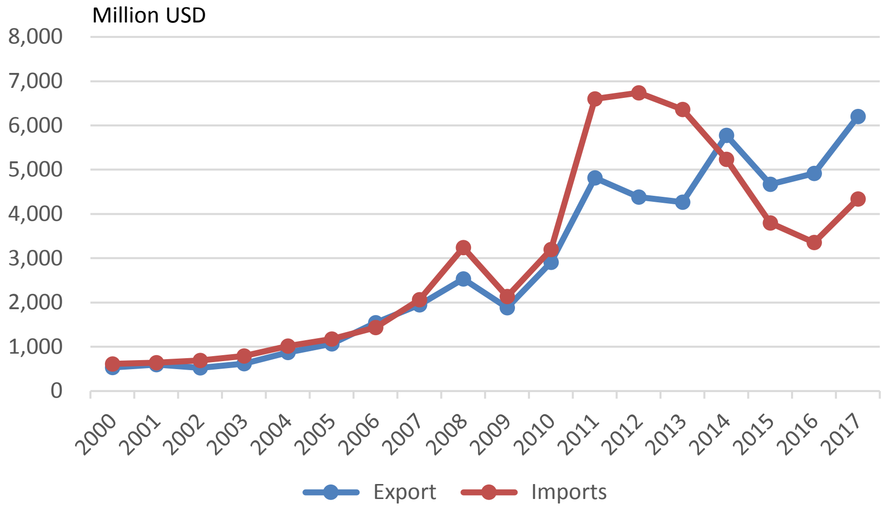
	2010	2011	2012	2013	2014	2015	2016	2017
I. Current account	-212.9	-999.3	-1,755.7	-1,520.1	-948.5	-195.3	-204.4	-156.8
Goods and services	-155.1	-818.1	-1,568.6	-1,241.7	-756.9	85.4	46.9	143.7
1. Goods	-64.9	-578.6	-1,043.5	-703.6	-204.5	421.6	482.6	613.2
1.1 Exports FOB	729.0	1,051.0	1,076.3	1,053.2	1,333.7	1,480.6	1,377.1	1,747.6
1.2 Imports FOB	793.9	1,629.5	2,119.8	1,756.7	1,538.2	1,059.1	894.5	1,134.5
2. Services	-90.2	-239.5	-525.1	-538.1	-552.4	-336.2	-435.7	-469.4
2.1 Transport	-21.9	-81.8	-110.2	-84.2	-67.5	-41.3	-57.2	-121.0
2.2 Tourism	-16.7	-86.8	-122.5	-154.1	-129.5	-111.3	-111.7	-117.6
2.3 Other services	-51.5	-70.9	-292.3	-299.8	-355.4	-183.6	-266.7	-230.8
Primary income	-118.9	-261.8	-288.9	-317.2	-260.7	-306.0	-316.5	-350.0
Secondary income	61.0	80.5	101.8	38.8	69.2	25.4	65.1	49.5
II. Capital Account	37.3	48.0	62.6	39.4	46.1	30.3	22.1	16.9
Balance from current and capital account	-175.6	-951.4	-1,693.1	-1,480.7	-902.4	-165.0	-182.3	-139.9
III. Financial Account	-265.9	-1,122.9	-1,883.9	-907.5	-562.2	2.5	-591.2	-171.5
1. Direct investment	-377.5	-1,343.5	-1,513.9	-991.9	-311.6	123.8	-287.8	-284.8
2. Portfolio investment	76.5	27.8	-575.9	-8.1	-401.0	29.4	-523.7	10.0
3. Financial derivatives	0.0	0.0	0.0	0.0	-0.2	0.4	0.1	12.5
4. Other investment	35.2	192.8	205.9	92.5	150.7	-151.1	220.1	90.7
IV. Net Errors and Omissions	-24.1	-184.1	332.4	-80.6	-79.2	-153.0	-206.6	-127.4
Total of Current, Capital and Financial Accounts	66.2	-12.6	523.2	-653.8	-419.4	-320.5	202.3	-95.8
V. Reserve assets	66.2	-12.6	523.2	-653.8	-419.4	-320.5	202.3	-95.8

Source: Bank of Mongolia

1.7.2 External Trade

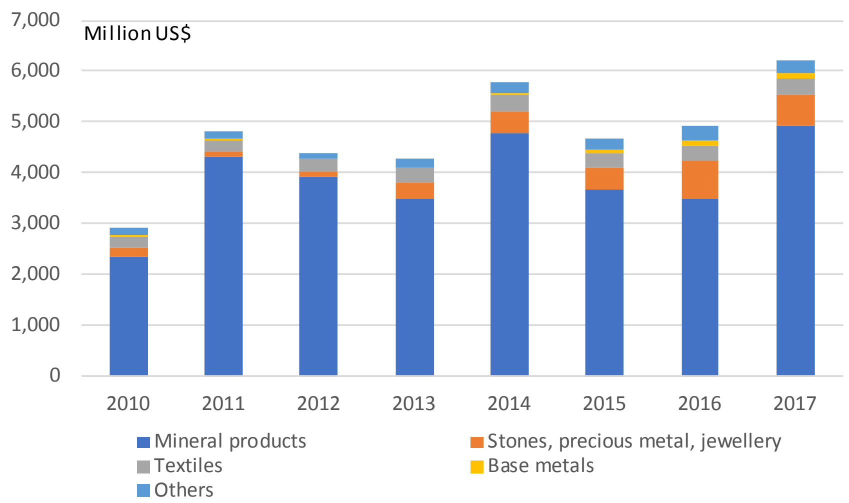
Mineral products, mainly coal and copper, account for 90% of total exports, and 90% of them are bound for China. Therefore, Mongolia's exports are vulnerable to world commodity prices and the economic condition of China. The growth of exports has stagnated since 2011 because of a drop of copper and coal prices and the slowdown of Chinese economy.

A sudden increase of imports in 2011 was mostly caused by an increase of imports of mineral products, machinery, equipment, and vehicles. This was further fueled by the Price Stabilization Program in 2012. However, imports have sharply decreased since 2014 in line with the decline of FDI and economic slowdown.



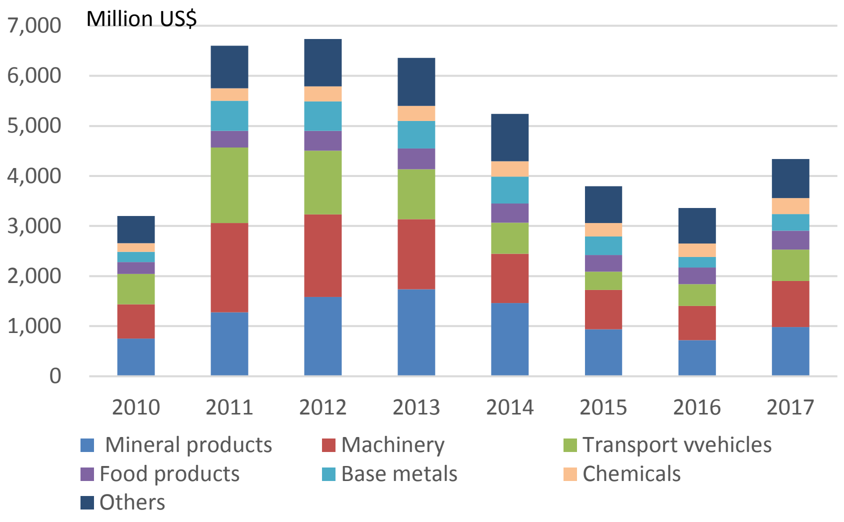
Source: Central Statistical Office of Mongolia

Figure 1.7.1 Trend of External Trade



Source: Central Statistical Office of Mongolia

Figure 1.7.2 Exports by Commodity



Source: Central Statistical Office of Mongolia

Figure 1.7.3 Imports by Commodity

1.7.3 Foreign Direct Investment

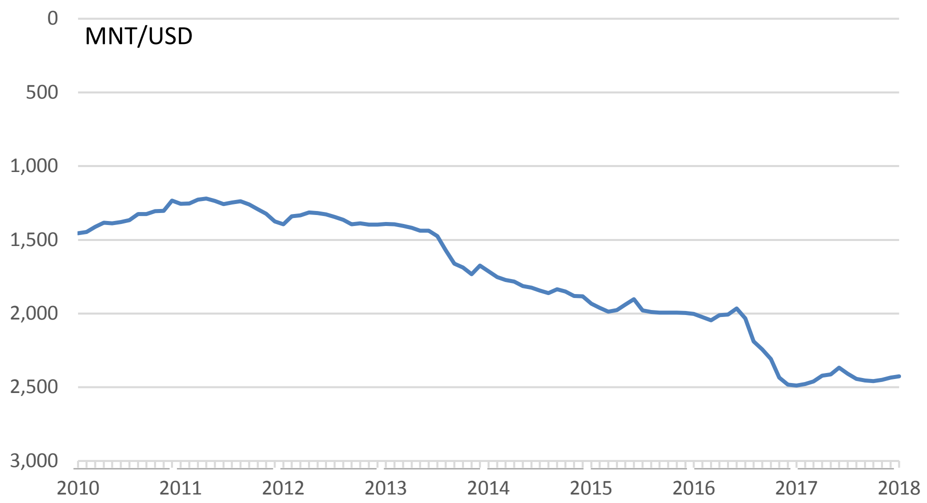
FDI to the private sector makes a significant contribution to the economy. A large portion of FDI goes to the mining sector, resulting in a boom in this sector.

FDI sharply increased in 2011. Approximately 70% of FDIs was directed to the mining sector. However, in 2013, FDI inflow began to slow down suddenly. This reflected the expected unwinding of capital expenditure by the Oyu Tolgoi Project of copper exploration. It was a negative signal.

GOM prioritizes investment promotion in its economic development policies. There has been a growing concern among foreign investors over the investment climate in Mongolia GOM enacted the Law of Mongolia on the Regulation of Foreign Investment in Business Entities Operating in Sectors of Strategic Importance in 2012 and the Law of Mongolia on Investment in 2013.

1.7.4 Exchange Rate

The value of Mongolian currency, MNT (Mongolian Tugrik), has rapidly been weakening against the dollar since 2014 without any effective measure of halting the weakening. MNT started to depreciate drastically in August 2016 reflecting the increased uncertainty of Mongolian economy. MNT has remained at the level of 2,400 MNT per USD.



Source: National Statistical Office of Mongolia

Figure 1.7.4 Foreign Exchange Rate of MNT per USD

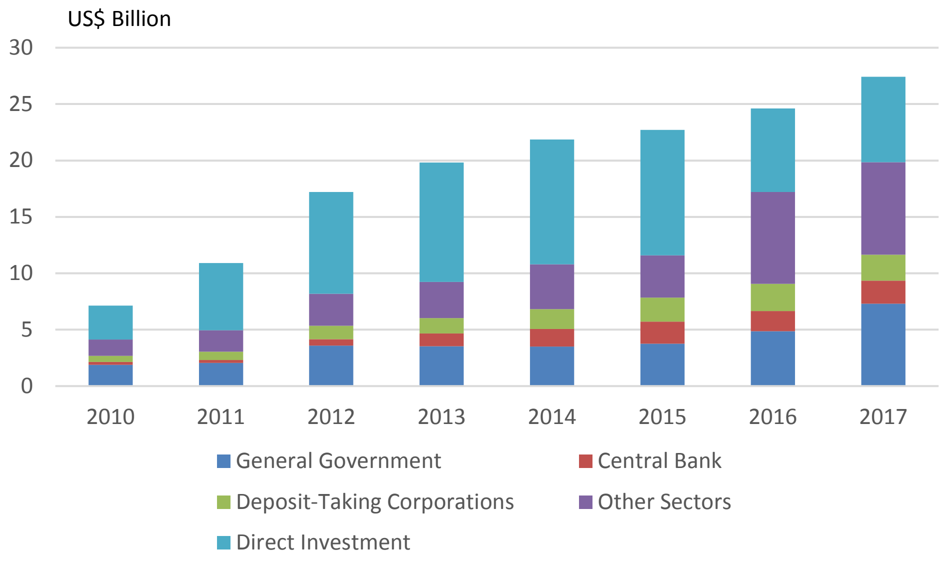
1.7.5 Foreign Debt

As of the end of 2016, total balance of Mongolia's external debt amounted to USD 24.6 billion, increasing by USD 1.9 billion compared to the end of 2015. The external debt consists of general government debts (19.8%), central bank debts (7.3%), banks debts (9.8%), debts of other sectors (33.0%) and foreign investment companies (30.2%). This external debt was equal to 250% of GDP[3].

In addition to the borrowing from donors and international organizations, GOM has begun to raise funds from the international capital market and it provides a guarantee to bonds issued by domestic banks in the 2010s. In November 2012, GOM issued USD 1.5 billion of long-term bonds, known as the Chinggis Bond, in the Singapore international capital market. The repayment due dates of the bond are in 2018 and 2022. In May 2015, the government has guaranteed USD 500 million of senior unsecured notes issued by the Trade and Development Bank of Mongolia under the Global Medium-Term Note Program which mature in 2017 and 2020. The government has guaranteed USD 580 million bonds issued by the Development Bank of Mongolia due in 2017. Further, the government issued a RMB 1 billion dim sum bond at 7.5% in June 2015. The government also has a RMB 15 billion bilateral 3-year swap line with the People's Bank of China due in 2017.

In 2017, GOM has borrowed USD 250 million from the Credit Suisse Bank and issued $500 million government bonds. Furthermore, in May 2017, the GOM agreed to a financing package of USD5.5 billion from donors including IMF's 3-year extended arrangement of approximately USD434 million.

[3] According to IMF's data, external debt at end-2016 was 220% of GDP.



Note: As of the end of year
Source: Bank of Mongolia

Figure 1.7.5 External Debt of Mongolia

Chapter 2 Banking Sector in Mongolia

2.1 Financial Sector in Mongolia

2.1.1 Structure of Financial Sector in Mongolia

(1) Overview

The financial sector in Mongolia consists of commercial banks and non-bank financial institutions (NBFI). As of 2017, there are 14 commercial banks, 17 insurance companies, 290 saving and credit cooperatives (SCCs), 535 finance companies and 52 securities companies.

Table 2.1.1 Mongolian Financial System Structure

Financial institutions	2008			2011			2014			2017 Q3		
	No.	Assets (Billion MNT)	% of total asset	No.	Assets (Billion MNT)	% of total asset	No.	Assets (Billion MNT)	% of total asset	No.	Assets (Billion MNT)	% of total asset
Banks	15	3,630	91	14	9,371.6	95.7	13	22,562.6	96.3	14	27,654.8	95.2
NBFIs	379	179	4.5	472	416.1	4.3	629	866.6	3.7	894	1,390.3	4.8
Insurance companies	15	35	0.9	17	81.2	0.8	17	152.5	0.7	17	251.7	0.9
SCC	192	46	1.2	162	61.9	0.6	159	80.5	0.3	290	142.8	0.5
Finance companies	137	72	1.8	195	205.4	2.1	378	508.0	2.2	535	906.0	3.1
Securities companies	35	26	0.7	98	67.6	0.7	75	125.6	0.5	52	89.8	0.3
Total financial system	421	3,988	100	486	9,787.7	100	642	23,429.2	100	908	29,045.1	100.0

Source: BOM and FRC Statistical Bulletin various editions, BOM, FRC (Dec 2017) “Financial Stability Report”, No.10

(2) Commercial Banks

Established under the Banking Law of Mongolia, a bank can engage in financial intermediary services such as taking deposits, extending loans and settling payments under a license from the Bank of Mongolia. The minimum capital requirement for commercial banks ordered by the Bank of Mongolia is MNT 16.0 billion. The 14 commercial banks that dominate the financial sector in Mongolia have approximately 95% of the total assets of the financial sector.

(3) Non-bank Finance Institutions

NBFIs can engage in various financial services regulated by the Law on Non Bank Financial Activities. Although NBFIs’ lending has the minor share of 3.1% in the financial market, the number of NBFIs has been rapidly increasing. As of 2017, there were 535 NBFIs lending to 1.4 million customers, many of whom are low income and rural households. The outreach of NBFI has rapidly increased owing to various tailored financial products and flexible loan conditions. The largest 21 NBFIs hold 47% of total asset and lending and 54% of the remaining earnings of the NBFI sector.

(4) Saving and Credit Cooperatives

SCCs can accept members’ deposits and provide loans only to their members. Out of 290 licensed SCCs, 67% (or 193) of SCCs are located in Ulaanbaatar, and 33% (or 97) of them are located in rural areas. 49 SCCs have been established as franchisees of Xac Bank.

In terms of lending, SCCs can provide short-term loans, typically up to one year, including loans for small manufacturing, consumption, student tuition, and car purchase. Despite high interest rates, SCCs became attractive loan providers because of their speedy lending process, acceptance of borrowers with no prior credit history, easy access to very small loans, and flexible lending terms, including one-year grace period for good customers. They serve for 53,780 cooperative members as of September 2017. The average size of loans for one of the biggest SCCs, Monkord, is MNT 6 million.

(5) Securities Companies

Securities companies can engage in brokerage, stock and bond dealing, public stock offering, bond issuance, etc. There are 52 securities companies and most of them are brokers and dealers.

(6) Insurance Companies

There were 17 private insurance companies, 2,893 representatives, 40 insurance brokers, 31 insurance loss evaluators and 15 actuaries in 2017. Since the enforcement of the Law on Insurance in 2004, the insurance market in Mongolia has gradually developed. Only one company has provided life insurance since 2008, whereas others operate in the general insurance market. During the last four years, total assets of insurance companies increased twofold; however its share to total financial sector is less than 1%. General insurance companies hold 81% of total assets, whereas reinsurance companies hold 17%, life insurance accounts for 3%. Among others, Mongol Daatgal holds the biggest share (14.5% of total assets).

2.1.2 Regulatory Bodies

(1) Bank of Mongolia (BOM)

The Bank of Mongolia (BOM), as the central bank, assumes the ordinary central bank's roles of stabilization of national currency, implementation of monetary policies and supervision of commercial banks as well as issuance of currencies in circulation, management of official foreign exchange reserves, interbank settlements, and supervision of the banking sector. The independence of BOM is secured by the Law on Central Bank (1996) and BOM reports directly to the Parliament. The Law of Mongolia on Central Bank was amended and became effective in April 2018 with the purpose of strengthening the independence of the Bank of Mongolia. The amendments include a collective decision by the counsels and committee and the limitation of budgetary operation.

(2) Financial Regulatory Commission (FRC)

The Financial Regulatory Commission (FRC) was established in 2006 as the regulatory body to supervise nearly 1,000 NBFIs comprising insurance companies, brokerage companies, non-bank financial companies, and savings and credit cooperatives.

FRC is in charge of improving the legal environment of non-banking financial sector including the capital market and insurance market. FRC also supervises financial institutions such as the credit guarantee fund, non-banking financial institutions, savings and credit cooperatives and currency exchange units.

2.1.3 Financial Markets

(1) Money Market

BOM executes its monetary policies through the interbank market. BOM controls money supply and manage liquidity within the interbank market.

The Bank of Mongolia offers the operation of interbank payment systems for interbank settlement services. The interbank market trades central bank bills, repo financing, overnight loan, and interbank saving. The interbank market is the main component of foreign exchange trade in Mongolia. However, the size of transactions at the interbank market is very limited in Mongolia.

(2) Capital Market

In Mongolia, the capital market (i.e., equity and bond markets) constitute only 4% of total domestic financial market. This rate is much lower than other developed and developing countries where a capital market accounts for approximately 30% of domestic long-term financing[1].

[1] Group of Thirty (2013) "*Long-term Finance and Economic Growth*"

The capital market of Mongolia is immature and has been underperforming. The main reasons are that: the liquidity of equity on the stock exchange is weak; few shareholders hold the majority of shares of most listed companies; there are no institutional investors such as mutual funds, insurance companies and pension funds; the capital market lacks highly-skilled specialists; high interest rate of the banking sector negatively affects equity and bond issuance; and there is a lack of financial knowledge among the public and companies.

Table 2.1.2 Key Indicators of Capital Market in Mongolia

	2000	2005	2010	2015	2016	2017
Listed companies	410	392	336	235	219	218
o/w: actively traded	125	108	69	71	82	95
Market capitalization						
in billion MNT	40.5	55.7	1373.9	1262.5	1474.2	2436.3
in million USD	36.9	45.6	1092.9	632.7	592.2	1003.8
in percent of GDP	3.3	1.8	16.3	5.4	6.2	9.0
Trading value						
in billion MNT	3	2.5	92.9	30.5	49	64.5
in million USD	2.7	2.1	73.9	16.1	19.7	19.7
in percent of GDP	0.2	0.1	1.1	0.1	0.2	0.4
Bond trading value (in billion MNT)						
Government	11.1	6.8	30	33	105.2	13.2
Corporate	0	2.7	0	0	0	0.3
Top 20 index						
High	506.3	1053	14759.8	15737.2	12456.1	24520.3
Low	459.6	955.9	14006	11962.1	10938.3	19870.1
Average	489	995.3	14331.3	12279	11605.7	22108.5
Close	469.9	1019.2	14759.8	12897.6	12456.1	20736.9

Source: Financial Regulatory Commission

MSE was originally established under the government's initiative to facilitate the privatization of state-owned enterprises. Therefore, most of listed companies are former state-owned enterprises. The number of listed companies has been constantly decreasing since 2000. Inadequate policy of the Securities Commission and the tax regime in late 2000s are pointed out as reasons for mass delisting.

Although the trading value has significantly increased during the past 27 years, the traded volume of stocks is rather limited, and the stock price is very vulnerable to speculative trading. Due to a surge in stock price, the market capitalization has dramatically increased from 1.8% of GDP in 2005 to 16.3% of GDP in 2010. However, due to a sharp drop of major commodity prices and economic downturn, the stock price declined until 2017 and the size of market capitalization dropped to 9% of GDP.

Therefore, the role of stock market for raising fund still remains minimal compared with the banking sector.

Source: http://www.tradingeconomics.com

Figure 2.1.1 Stock Price Change (Top 20 Index)

The bond market is dominated by government bonds. There is no high-yield bond issued by other institutions in Mongolia yet. The government bonds are mostly traded by BOM. In October 2012, the Regulation on Issuing and Trading of Government Securities was issued, which stipulated that BOM manages trading of government securities. As a result, the value of government bonds traded at the MSE declined significantly. The regulation was eased in 2014; however the government bonds traded at the MSE just totaled MNT 13 billion in 2017.

Corporate bonds have not been used as a financing instrument by most companies. Until now, there are less than 10 companies that issued their bonds totaling only MNT 17.5 billion to finance their major projects. This is because very few companies have enough financial capability to issue bonds for their funding and most companies do not see benefits from issuance of a bond due to the immature bond market of Mongolia.

2.1.4 Monetary Policy

BOM is responsible for formulating and implementing monetary policies as the central bank of Mongolia. BOM formulates its monetary policy annually and submits it to the Parliament for approval by October 1 of each year.

The most important role of BOM is to control inflation through monetary policy, as the inflation rate is measured in consumer price indexes within the rate stated in the Monetary Policy Guidelines issued each year. To maintain the flexibility exchange rate in line with macroeconomic fundamentals is also an important role.

BOM utilizes monetary policy tools such as: i) setting a policy rate to affect the interbank rate, and subsequently the lending and deposit rates to stabilize the economic situation; ii) reserving requirements to affect broad money supply; iii) opening market operations to absorb excess liquidity; iv) foreign exchange (FX) market intervention to control exchange rate volatility; and v) repo facilities to manage intraday liquidity.

In addition to these monetary policy instruments mentioned above, BOM also conducted currency swap transactions between USD and MNT in order to maintain foreign exchange reserves and to respond to liquidity shortage of commercial banks.

The following table shows monetary policy instruments of BOM.

Table 2.1.3 Monetary Policy Instruments of BOM

Instruments		Frequency of operations	Eligible Securities	Counter-parties	Auction procedures, interest rate basis
1. Reserve Requirements		Once every 2 weeks.	Current accounts at BOM.	Banks	
2. Open Market Operations	**1-week CBB**	Weekly on Wednesdays.		Banks	variable rate (+/-2% units from the policy rate) with pre- announced range volume.
	12-week CBB	Bi-weekly on Mondays.		Banks	Market-based rates.
	28-week CBB	Once every 4 weeks.		Banks	Variable rate tender with preannounced allotment volume.
3. FX market	**Intervention**	Twice a week on Tuesdays and Thursdays.	Current accounts at BOM.	Banks	Variable rate tender with preannounced allotment volume.
	Swap/Forward	Twice a week on Tuesdays and Thursdays.	Current accounts at BOM.	Banks	Market-based rates for MNT, and LIBOR rates for USD .
4. Standing Facilities	**Intra-day loan**	Irregular	Central bank bills (CBBs).	Banks	At the initiative of commercial banks.
	Repo	Daily	CBBs, Government securities & obligations, MMC bonds.	Banks	At the initiative of commercial banks.

5. Non-Standing Facilities	**Over night**	Daily	Current accounts at BOM.	Banks	At the initiative of commercial banks.
	Emergency Lending	Irregular	CBBs, Government securities & obligations, MMC bonds, performing loans.	Banks	At the initiative of commercial banks.
	Repo	Irregular	CBBs, Government securities & obligations.	Banks	Market rates higher than policy rate.

Source: Bank of Mongolia

In addition to conventional monetary policy, BOM also implements subsidized policy loans for stimulating the economy and stabilizing prices.

In 2013, based on a memorandum of understanding on joint implementation of a mid-term program for stabilizing the price with the government, BOM started the following programs:

i) Price Stabilization Program (PSP) to staple food, fuel retail price stability, imported consumption goods, and the construction sector, providing subsidized loans with 0.5%-0.89% interest rate per annum.

ii) Additional support program to construction companies and real estate developers.

iii) Housing Mortgage Lending Program with 4% interest per annum to stimulate housing demand in order to boost economic growth.

As a result, BOM injected massive money to the construction and housing sector in 2013. The outstanding central bank loans to commercial banks jumped to an extraordinary size of MNT 3.4 trillion (equivalent to 20% of GDP). Since 2015, BOM has suspended additional loans under the Price Stabilization Program according to the Parliament decision of November 2014. BOM's new mortgage loan is limited to the total amount of principal and interest payments received on existing mortgage assets.

BOM uses a policy interest rate for its monetary policy. BOM cut the policy rate from 13.3% to 10.5% by stages in 2013 in order to stimulate the economy. BOM raised the rate to 13.0% in January 2015 and reduced to 12.0% in January and to 10.5% in May 2016 under the stagnated economic condition. In August 2016, BOM suddenly raised the rate to 15.0% as an effort to respond to a precipitous drop of MNT. The rate has been gradually decreased step by step since December 2016 and the rate is 10.0% as of March 2018.

Table 2.1.4 Policy Rate of Bank of Mongolia

Date	Policy Rate	Date	Policy Rate	Date	Policy Rate
2007/7/9	6.4%	2009/9/30	10.0%	2013/6/24	10.5%
2007/10/17	7.4%	2010/5/12	11.0%	2014/7/31	12.0%
2007/11/21	8.4%	2011/4/28	11.5%	2015/1/15	13.0%
2008/3/19	9.8%	2011/8/29	11.8%	2016/1/14	12.0%
2008/9/10	10.3%	2011/10/25	12.3%	2016/5/5	10.5%
2008/11/13	10.3%	2012/3/19	12.8%	2016/8/18	15.0%
2008/11/19	9.8%	2012/4/17	13.3%	2016/12/19	14.0%
2009/3/11	14.0%	2013/1/25	12.5%	2017/6/15	12.0%
2009/5/12	12.8%	2013/3/13	12.5%	2017/12/25	11.0%
2009/6/12	11.5%	2013/4/5	11.5%	2018/3/23	10.0%

Source: Bank of Mongolia

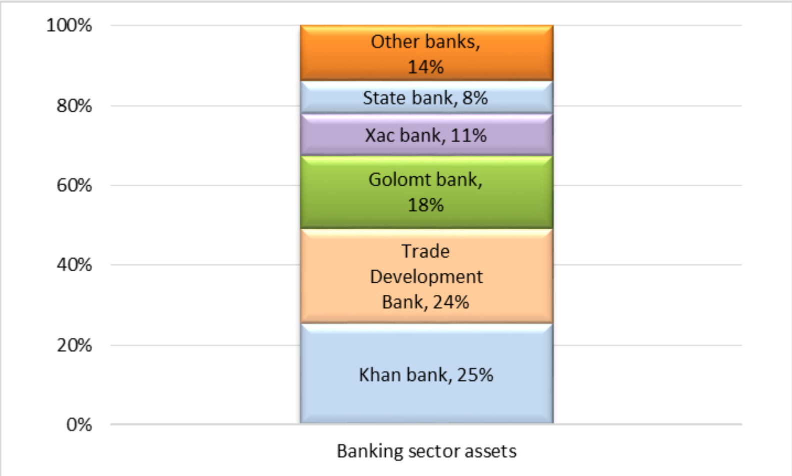
2.2 Overview of Banking Sector

2.2.1 Recent History of the Banking Sector

In the late 1990s, the banking sector suffered from severe liquidity and solvency problems due to the difficult political environment and the financial crisis with a sharp drop in prices of the major commodity exports. The non-performing loan (NPL) ratio was 54% in 1999. In 2000 the government adopted a Long-Term Vision and Medium Term Strategy for Financial Sector Reform and Development in 2000-2010. With the government's efforts for reforms, the banking sector has been transformed into a mostly privatized banking during the 2000s.

In October 2009, Savings Bank took over Mongol Post Bank which they suffered from high levels of non-performing loans. In November 2009, a new state-owned bank, State Bank, was formed by the government to hold Anod Bank and Zoos Bank which fell into difficulty after the global financial crisis. In 2013. the government of Mongolia combined Savings Bank with the State Bank after Savings Bank failed due to poor corporate governance, a large bad loan to its parent company and previous losses from the merger of Mongol Post Bank.

Currently, the banking sector consists of 14 commercial banks regulated by the Bank of Mongolia. The banking sector in Mongolia is characterized by a high concentration of big banks as the three largest banks hold 70% of total banking assets. There are no subsidiaries or branches of foreign banks[2].



Note: As of the end of 2017
Source: Financial statements of banks and Bank of Mongolia (2017) "Banking Sector Financial Statement Overview"

Figure 2.2.1 Share of Commercial Banks

Under an economic slow-down, BOM took measures to support the slowing economy and significant monetary easing of over MNT 3 trillion (equivalent to 20% of GDP) through various policy channels.

The supply of liquidity was conducted through the following policy lending programs:

i) Provision of discounted loans of MNT 718 billion to selected industries under the Price Stabilization Program to address supply side constraints on prices since November 2012.

ii) Liquidity injection of MNT 900 billion to banks in the form of one-year deposits to counter slowing credit growth since March 2013.

iii) A construction and housing development program including MNT 1,200 billion for low-interest rate mortgage lending and MNT 430 billion for construction companies since June 2013.

As the result of these measures, outstanding central bank loan to commercial banks has jumped by MNT 3.4 trillion. Also, the outstanding domestic credit reached 67.8% of GDP in September 2013.

[2] However, Bank of China, Standard Chartered and ING have their representative offices in Ulaanbaatar.

The Government of Mongolia and BOM signed a Memorandum of Understanding on the price stabilization program in October 2012. The price stabilization program (PSP) consists of four sub programs: i) price stability of staple food; ii) fuel retail price stability; iii) reducing the cost of imported consumption goods; and iv) promoting the construction sector and achieving stability of housing prices. The program is expected to cost 720 billion MNT and aims to address supply bottlenecks in the four areas. By February 2013, 229.6 billion MNT of credit lines had been released to local oil, meat and flour industries through participating banks.

International financial organizations such as the IMF and World Bank criticized these quasi-fiscal operations of BOM and urged them to be ended. With the start of IMF Extended Fund Facility program of 2017, the Government of Mongolia and BOM has taken a number of actions to end the quasi-fiscal operations, to strengthen the banking system through special audits and recapitalization of banks, and to upgrade the regulatory and supervisory framework.

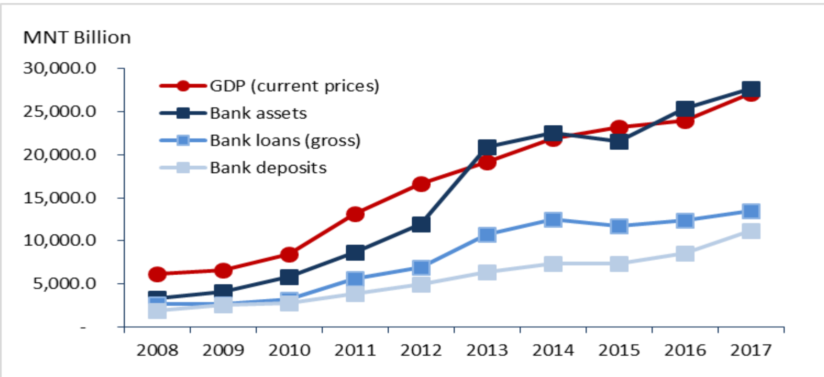
Within the scope of the IMF program, BOM organized international competitive bidding to select a consultant for Asset Quality Review (AQR) on commercial banks in Mongolia. The PwC Česká republika company was selected and conducted the AQR with more than 230 specialists and experts over 6 months. AQR covered banks loans, receivables, guarantees, other credit-equivalent guarantees, letters of credit, other off-balance-sheet assets and third-level assets.

As a result of the review, required capital of the banking system needed to be increased by equivalent to 1.9% of 2017's GDP in order to meet capital adequacy ratio requirement. It is consistent with the BOM's estimates. BOM has given commercial banks a 9 months period to cover the capital shortfall and increase the required capital. That means the banks will be required to complete the requirement within December 2018.

Within the legal reforms of the banking sector to strengthen the financial sector stability, amendments on the Law on Bank of Mongolia, the Banking Law and the Deposit Insurance Law were passed by the State Great Khural, and amendments on the Money Laundering and Terrorist Financing Prevention Law is expected shortly. The adoption of the amendments to the Banking Law will enable a financially stable banking system with improved risk bearing capacity that will lay out the basic conditions for overcoming Mongolia's economic challenges. By successfully implementing legal reforms in banking sector, and with approval of the draft laws, banking supervision methods and requirements will meet international standards, and strengthen the deposit insurance system, as well as ensure the stability of the banking sector.

2.2.2 Size of Banking Sector

During the period of 2008 - 2009, the sizes of loans and deposits significantly decreased due to the Lehman shock. The situation had recovered since then, and the banking sector recorded rapid growth in 2013 as the results of expanded government money injection in the form of subsidized policy loans. The size of total assets of banking sector equals to 102% of nominal GDP in 2017 and 1.4 times of 2012. After two years of decrease in the ratio of total assets to GDP, the ratio has recovered since 2016.



Note: As of the end of year
Source: Bank of Mongolia

Figure 2.2.2 Size of Banking Sector

The banking sector holds the biggest assets in the economy and the ratio of assets to GDP is more than 100%. It also generates deposits more than 1/3 of GDP.

Table 2.2.1 Size of Banking Sector

		2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
GDP (current prices) (in MNT billion)		6,130.3	6,590.6	8,414.5	13,174.0	16,688.0	19,118.0	21,844.0	23,166.8	23,935.8	27,167.0
	Nominal GDP growth (%)	34.5	7.5	27.7	56.6	26.7	14.6	14.3	6.1	3.3	5.1
Bank assets (in MNT billion)		3,356.7	4,089.9	5,873.5	8,652.7	11,992.2	20,883.7	22,562.6	21,521.4	25,323.5	27,654.8
	Growth (%)	17.4	21.8	43.6	47.3	38.6	74.1	8.0	-4.6	17.7	9.2
	Bank assets/GDP (%)	54.8	62.1	69.8	65.7	71.9	109.2	103.3	92.9	105.8	101.8
Bank loans (gross) (in MNT billion)		2,635.6	2,655.0	3,264.8	5,641.2	6,941.1	10,764.2	12,502.5	11,695.8	12,422.2	13,511.9
	Growth (%)	28.2	0.7	23.0	72.8	23.0	55.1	16.1	-6.5	6.2	8.8
	Bank loans/GDP (%)	43.0	40.3	38.8	42.8	41.6	56.3	57.2	50.5	51.9	49.7
Bank deposits (in MNT billion)		1,869.7	2,521.0	2,756.2	3,890.3	4,922.7	6,393.4	7,380.1	7,383.0	8,548.4	11,153.9
	Growth (%)	3.3	34.8	9.3	41.1	26.5	29.9	15.4	0.0	15.8	30.5
	Bank deposits/GDP (%)	30.5	38.3	32.8	29.5	29.5	33.4	33.8	31.9	35.7	41.1

Source: Bank of Mongolia

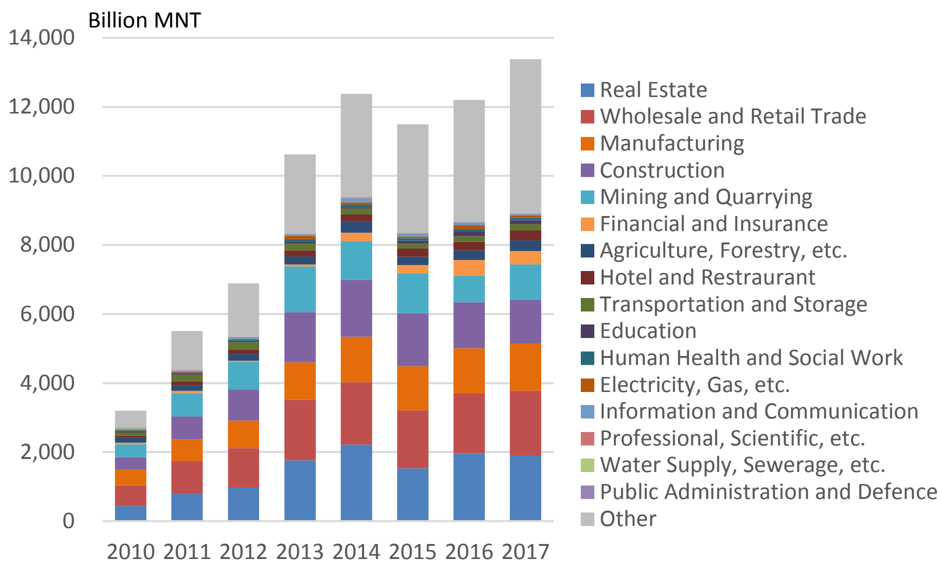
Being the key financer of the private sector and individuals, the outstanding loans accounts for a half of the GDP and the loan to deposit ratio was 121% in 2017. The ratio reached the highest point in 2014 when the ratio skyrocketed to 169%.

2.3 Lending

2.3.1 Loans by Industry Sector

The following Figure shows the breakdown of gross loans outstanding by industry sector. Top 5 industry sectors are real estate, wholesale and retail trade, manufacturing, construction and mining, and they account for 55.0% of total loans outstanding as of 2017 (14.1%, 13.8%, 10.2%, 9.3% and 7.6% respectively).

The growth of three sectors (loans for financial activities, real estate and construction) was remarkable compared with other sectors. This was because BOM and the government initiated low-rate mortgage loans in 2013 and 2014.



Note: As of the end of year
Source: Bank of Mongolia

Figure 2.3.1 Gross Loans Outstanding by Industry Sector

As a trend, the share of the service sector such as real estate, trade and financial activities has tended to increase.

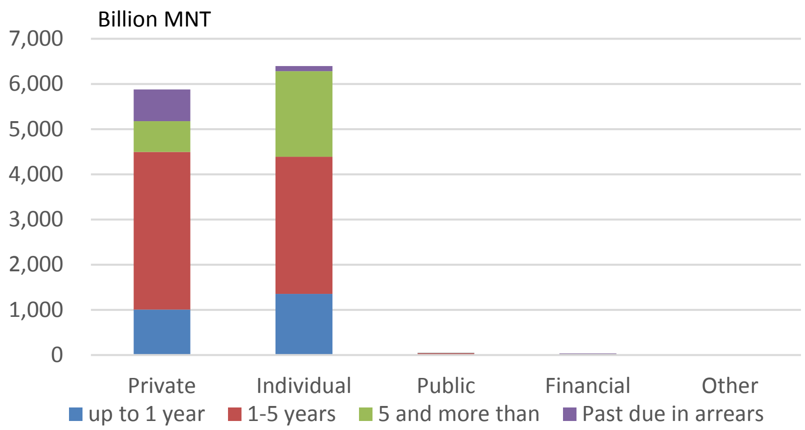
Table 2.3.1 Loans Outstanding by Industrial Sector among Loans

Economic sectors	2010		2017		Change 2010-2017 (%)
	Amount (MNT Billion)	Share (%)	Amount (MNT Billion)	Share (%)	
Agriculture, forestry and fishing, hunting	142	4.4%	311	2.3%	119.0%
Mining and quarrying	387	12.0%	1,034	7.7%	167.2%
Manufacturing	456	14.1%	1,373	10.2%	200.9%
Electricity, gas, steam and air conditioning supply	21	0.6%	60	0.4%	185.6%
Water supply; sewerage, waste management and remediation activities	15	0.5%	9	0.1%	-38.1%
Construction	349	10.8%	1,261	9.3%	261.0%
Wholesale and retail trade; repair of motor vehicles and motorcycles	599	18.6%	1,864	13.8%	211.3%
Transportation and storage	87	2.7%	190	1.4%	118.0%
Accommodation & food services activities	70	2.2%	286	2.1%	308.6%
Information & communication	23	0.7%	44	0.3%	91.3%
Financial & insurance activities	38	1.2%	388	2.9%	920.3%
Real estate activities	438	13.6%	1,905	14.1%	335.2%
Professional, scientific & technincal activities	4	0.1%	19	0.1%	442.9%
Administrative & support service activities	30	0.9%	125	0.9%	319.8%
Public administration & defence: compulsory social security	18	0.5%	2	0.0%	-87.6%
Education	35	1.1%	112	0.8%	222.7%
Human health & social work activities	30	0.9%	73	0.5%	139.3%
Other	486	15.1%	4,456	33.0%	816.1%
Total	3,228	100.0%	13,512	100.0%	318.6%

Source: Bank of Mongolia

2.3.2 Loans by Type of Borrower

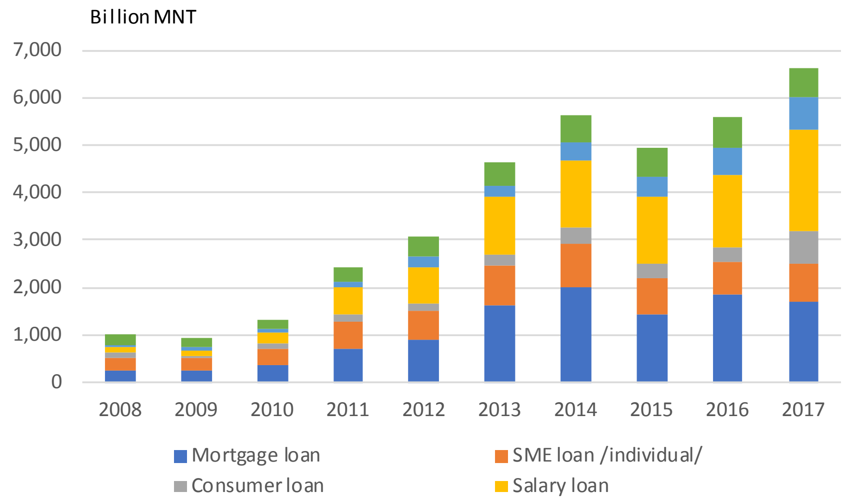
Among the gross loans outstanding of MNT 13,512 billion as of the end of 2017, 50.4% is directed to the private companies, 48.9% to individuals, 0.3% to the financial sector, and 0.3% to the public sector.



Note: As of the end of 2017
Source: Bank of Mongolia

Figure 2.3.2 Breakdown of Loans by Type of Borrower and by Maturity

The breakdown of individual loans is as shown in the Figure below. The mortgage loans and salary loans account for approximately 60% of total. The share of SME loans (individual) have tended to decrease, namely from 28.3% in 2008 to 12.2% in 2017.



Note: As of the end of year
Source: Bank of Mongolia

Figure 2.3.3 Breakdown of Individual Loan

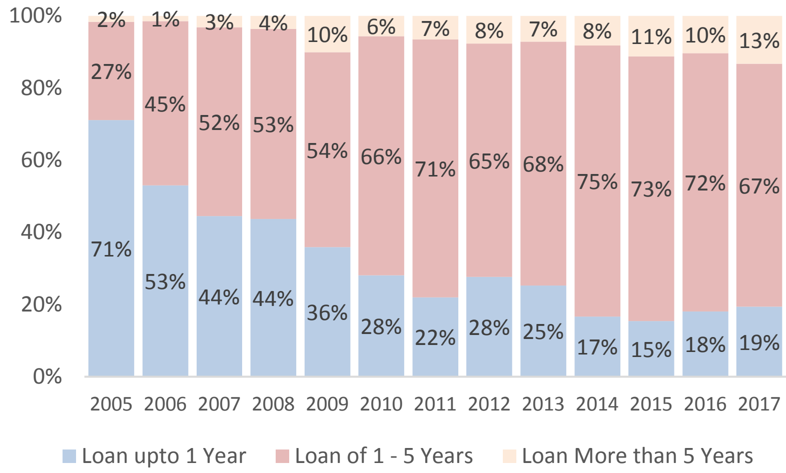
2.3.3 Loans by Maturity

There has been a significant change in banks' loan portfolio in terms of the maturity during the 2010s. The characteristic trends of maturity of bank loans are:

i) The share of loans up to 1 year has sharply dropped for both private and individual loans.

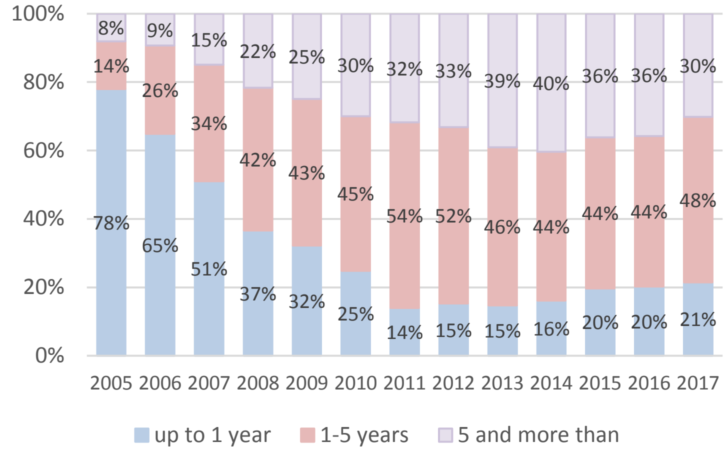
ii) Among individual loans, the share of loans with 5 years and more maturity has significantly increased since the late 2000s due to an increase in mortgage loan.

iii) The share of loans with maturity of 5 years and more in private loans has tended to increase; however, it is still very limited (around 10%).



Note: Standard loan as of the end of year
Source: Bank of Mongolia

Figure 2.3.4 Private Loans by Maturity



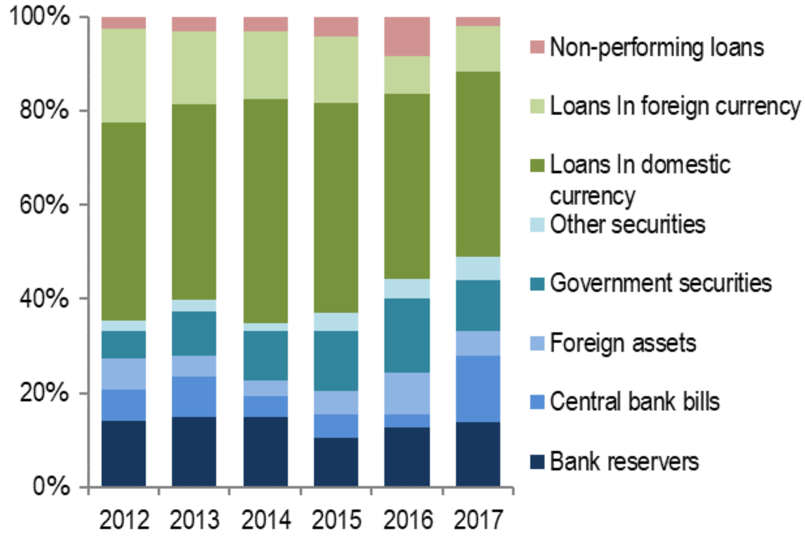
Note: Standard loan as of the end of year
Source: Bank of Mongolia

Figure 2.3.5 Individual Loans by Maturity

The reasons for this change are:

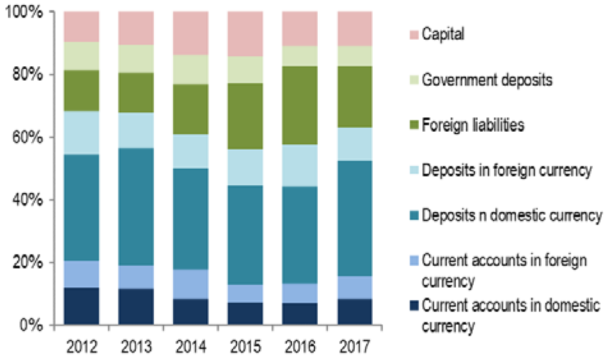
- Increased funding from BOM and the Development Bank of Mongolia (DBM) especially for mortgage loans and infrastructure loans.
- Increased and diversified funding from donors and international financial institutions for program loans.
- Increasing share of time deposits among total deposits.

As for the assets, banks have been increasing investment in government securities and other securities instead of loans in recent years.



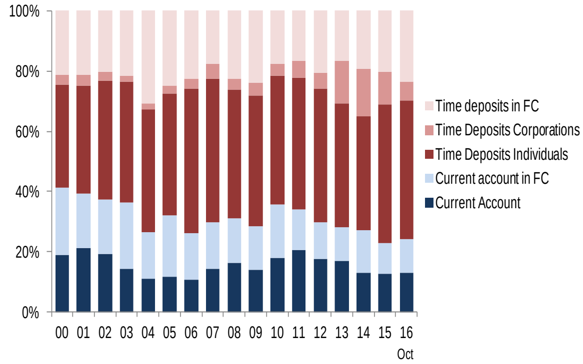
Note: As of the end of year
Source: Bank of Mongolia

Figure 2.3.6 Assets of Banks



Note: As of the end of year
Source: Bank of Mongolia

Figure 2.3.7 Liabilities and Equities of Banks

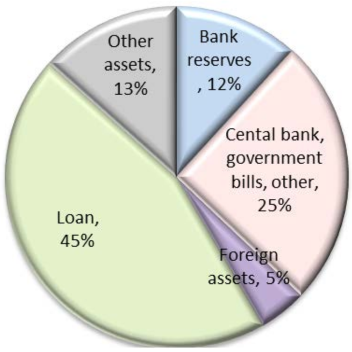


Note: As of the end of year
Source: Bank of Mongolia

Figure 2.3.8 Current Accounts and Time Deposits

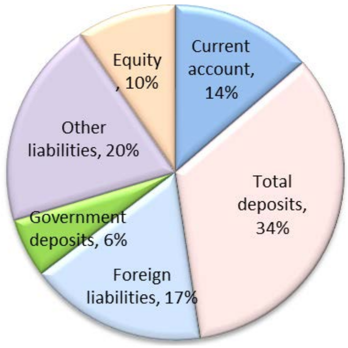
2.4 Funding

The breakdown of assets, liabilities and equity is as shown in the following Figures. Loans are not fully financed by deposits. The borrowing from the government through BOM and foreign lenders are also an important financial resource for providing loans.



Note: As of December 2017
Source: Bank of Mongolia

Figure 2.4.1 Breakdown of Assets of Banks



Note: As of December 2017
Source: Bank of Mongolia

Figure 2.4.2 Breakdown of Liabilities and Equities of Banks

Table 2.4.1 Balance Sheet of Banking Sector

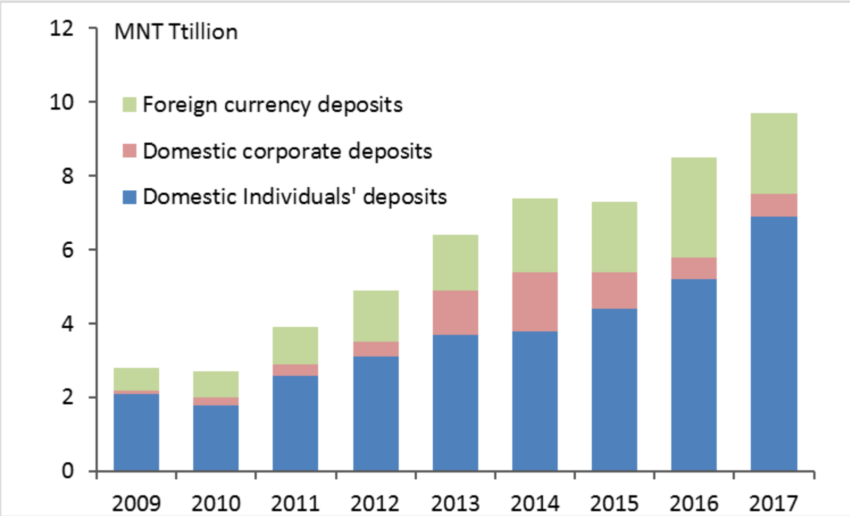
Unit: MNT Billion

Main categories	2010	2011	2012	2013	2014	2015	2016	2017
Bank reserves	771.0	1,145.3	1,564.3	2,769.8	3,012.1	2,064.8	2,924.7	3,385.9
Central bank, government bills, other	1,280.4	1,349.7	1,637.2	3,061.7	3,284.4	4,330.0	5,054.2	7,288.7
Foreign assets	655.9	711.1	758.1	812.6	675.1	978.0	2,067.1	1,301.2
Loan	3,284.1	5,659.5	7,026.3	10,715.6	12,440.9	11,633.6	12,337.5	12,947.9
Other assets	254.2	506.0	1,006.3	3,524.0	3,169.9	2,550.3	2,954.9	3,849.2
Total asset	6,245.6	9,371.6	11,992.2	20,883.7	22,582.4	21,556.7	25,338.4	28,772.9
Current account	1,521.3	1,980.7	2,090.6	2,485.4	2,756.5	2,208.5	2,965.2	3,871.8
Total deposits	2,756.2	3,890.3	4,922.7	6,393.4	7,380.1	7,383.0	8,500.5	9,615.7
Foreign liabilities	424.9	653.5	1,298.6	1,654.6	2,491.3	3,595.5	5,386.9	4,836.9
Government deposits	422.2	931.5	933.5	1,186.2	1,565.0	1,453.9	1,373.9	1,615.3
Other liabilities	738.5	1,238.7	1,761.1	7,782.9	6,255.2	5,024.4	4,175.9	6,124.4
Total liabilities	5,863.1	8,694.7	11,006.5	19,502.5	20,448.1	19,665.3	22,402.4	26,064.1
Equity	382.5	676.9	985.7	1,381.2	2,134.3	2,426.8	2,936.0	2,708.8
Total liabilities & capital	6,245.6	9,371.6	11,992.2	20,883.7	22,582.4	22,092.1	25,338.4	28,772.9

Source: Bank of Mongolia

The share of deposits to total assets decreased from 44% in 2010 to 33% in 2017. The share of liabilities significantly increased from 15% to 38%. This amount was much larger than that of deposits. This was mainly due to the policy lending programs, which deposited MNT 3.4 trillion to commercial banks for the purpose of implementing price stabilization programs, and liquidity injection to banks for dealing with slowed credit growth. Therefore, banks started to rely on governments' programs loans and project loans rather than competing to attract deposits. The share of other liabilities has tended to decrease.

As for deposits, corporate deposits significantly increased in 2013 and 2014. This was due to extra liquidity of companies as the results of expansionary policy lending. In 2017, domestic individuals deposits account for 92% of total deposits in MNT, whereas deposits in foreign currency generate less than ¼ of total deposits.



Source: Bank of Mongolia

Figure 2.4.3 Breakdown of Deposits

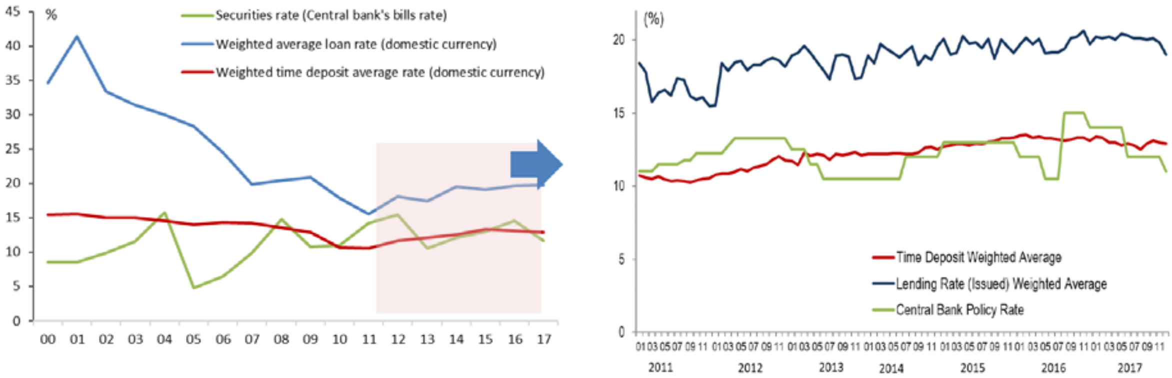
2.5 Interest Rate

Loan rate has stabilized in the 2010s after an extraordinary high rate in the early 2000s. Since 2011, weighted average loan rate and deposit rate have moved rather stably even though they are still at a high level. Commercial banks secure a sufficient level of spread margin of more than 5%.

A weighted average time deposit rate moves at a near range with the central bank's policy rate and the rate of central bank's bill. But the weighted average deposit rate is not sensitive to the change of policy rate.

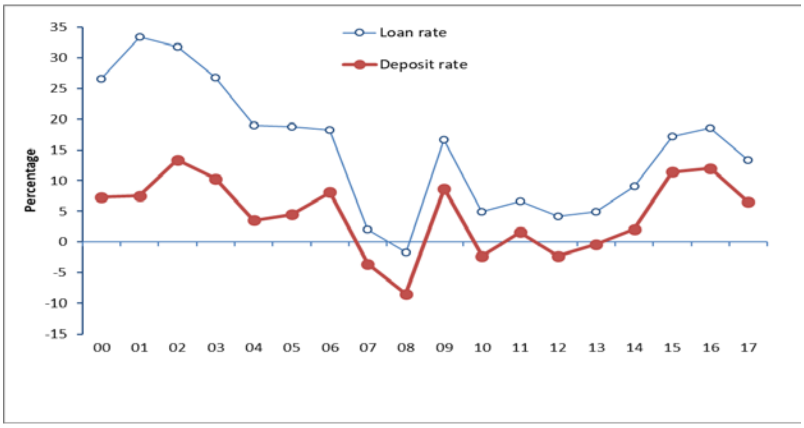
The commercial banks compete for deposits among them and with other saving financial institutions. The lack of money saving practice of Mongolians also leads banks to offer high deposit rates. Moreover, individuals are cautious to deposit their money for the longer term with volatile inflation; thereby most deposits are demand or time deposits of only up to one year.

A high deposit rate results in a high lending rate. With volatile exchange rate changes since 2013, borrowing in foreign currency became risky and costly. Thus, businesses and households have preferred borrowing in the domestic currency despite the lower interest of US dollar.



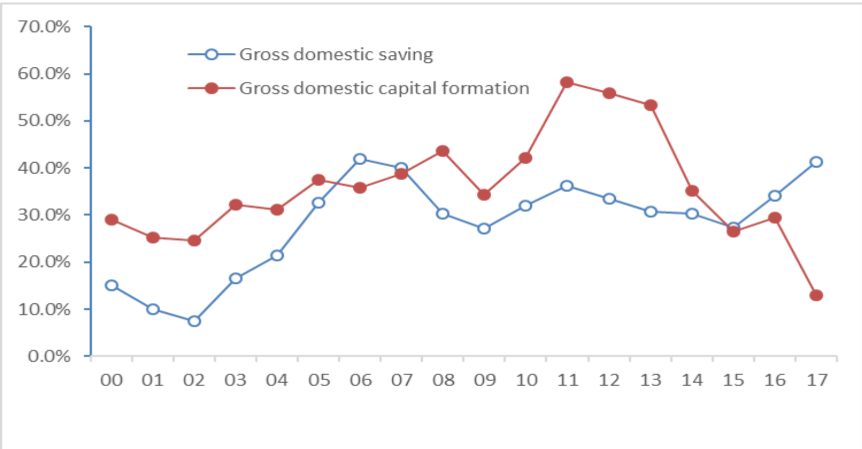
Source: Bank of Mongolia

Figure 2.5.1 Trend of Interest Rates



Note: Consumer price index is used
Source: Bank of Mongolia, MONSIS

Figure 2.5.2 Trend of Real Interest Rates



Note: Percentage to GDP at current prices.
Source: Key Indicators, World Bank

Figure 2.5.3 Investment and Saving Gap

2.6 Soundness of Banking Sector

2.6.1 Authorities Responsible for Bank Supervision

BOM, Financial Stability Council (jointly established by BOM, Ministry of Finance and FRC) and FRC are responsible for financial stability and supervision of the financial sector in Mongolia.

The Supervision Department of BOM is responsible for supervision of banks. The department consists of 3 divisions: Off-site Inspection Division, he On-site Inspections Division and Policy Regulation Division. BOM usually conduct at least one comprehensive examination of each bank every year. The laws, regulations, and decrees are uploaded to the website of BOM (https://www.mongolbank.mn).

The Regulation on Setting and Monitoring Prudential Ratios to Banking Operation in 2010 sets the prudential ratios such as capital adequacy ratio, liquidity ratio, credit concentration risk ratio, and forex risk ratio.

July 2011, the Bank minimum paid-in capital requirement increased from MNT 16 billion to MNT 50 billion in April 2015. Commercial banks should qualify to meet the requirement by the end of 2018.

BOM consistently receives assistance from IMF, World Bank, ADB and a number of international credit rating agencies to improve its banking sector supervisory activities. BOM has formulated the Medium Term Banking Supervision Strategy (2014 - 2019) for the purpose of introducing internationally-accepted best practices and methodologies in banking supervision taking into consideration specificities of the banking sector in Mongolia.

2.6.2 Credit Standing of Commercial Banks

The credibility of banks has fluctuated over the years depending on the economy, and fiscal and monetary policies.

The credibility of commercial banks is closely monitored by BOM through its prudential ratio requirements. The recent prudential ratios of the commercial banks are shown in the following table.

The capital adequacy ratio and liquidity ratio have continued to be much higher than BOM’s minimum requirements.

Commercial banks remain profitable, but profitability has continuously been smaller. The interest margin fluctuated from 5.0% to 7.6% after 2011. The return on assets (ROA) reached 2% as the highest in 2011 and lowered 0.7% and 0.87% in 2016 and 2017. The return on equity (ROE) has shown downturn since 2011; it dropped from 27.2% in 2011 to 7.5% in 2016. In 2017, ROE showed slight recovery reaching 9.2%. Loans to deposits ratio has constantly been more than 100. The highest was in 2014 due to mortgage loan and price stabilization programs implemented by BOM. However, it has significantly decreased since 2014 and was 121.1 in 2017.

Table 2.6.1 Mongolia: Commercial Banks Financial Stability Indicators, 2009-2017

Ratio	2009	2011	2012	2013	2014	2015	2016	2017
Capital Adequacy (=>12%)	5.5	15	16.1	16	17.5	17.9	18.6	13.3
Liquidity ratio (=>25%)	31.8	37.6	34.2	44.4	41.2	39.7	41.4	42.2
Foreign currency deposits to total deposits	33.5	25.1	29.1	23.1	26.7	26.4	32.5	22.6
Non-performing loans (NPL) to gross loans	17.4	5.9	4.3	5.3	5.0	7.4	8.4	8.5
Margin between loan and deposit ratios	7.9	5.0	6.5	5.3	7.0	5.8	6.1	6.1
Return on assets	1.1	2.0	1.7	1.1	1.4	1.2	0.7	0.9
Return on equity	17.2	27.2	20.1	17.3	15.3	10.3	7.5	9.2
Loans to deposits	105.3	145.0	141.0	168.4	169.4	158.4	145.3	121.1

Source: Bank of Mongolia and Financial Stability Reports

All banks have met prudential ratio requirements of BOM. However, asset quality might often-noted issues such as excessive credit growth, loose credit management, collusion lending, and large single borrower concentrations. The Asset Quality Review done in the late 2017 by PricewaterhouseCoopers Česká Republika company has affirmed that required capital of the banking system should be increased by equivalent to 1.9% of 2017's GDP (516 billion MNT) in order to meet capital adequacy ratio requirement. As most commercial banks are largely concentrated on specific sectors such as the mining, construction and trade sectors, they are vulnerable to sector-specific shocks that can arise from a sharp decline in commodity prices or economic recession. Banking sector statistics of 2014-2017 evidenced this vulnerability.

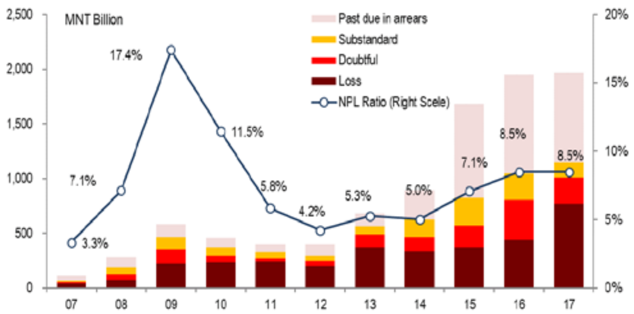
Under the economic downturn and serious recession, non-performing loans has become a serious issue of the banking sector. The definition of bad loans in Mongolia is as shown in the following table.

Table 2.6.2 Classifications of Bad Loans

Classification	Performing	Past Due	Substandard	Doubtful	Loss
Maturity term	Payment of loan principal and its interest are being made upon predetermined schedule.	Overdue up to **90** days from scheduled date, without any payment of loan principal and its interest made.	Overdue **91-180** days from scheduled date, without any payment of loan principal and its interest made.	Overdue **181-360** days from scheduled date, without any payment of loan principal and its interest made.	Overdue more than **361** days from scheduled date, without any payment of loan principal and its interest made.

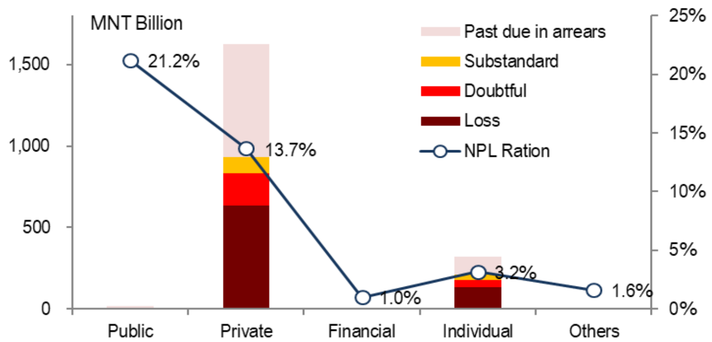
Source: Joint Resolution of the Governor of the Bank of Mongolia and the Minister of Ministry of Finance, August 11, 2010 No. 475/182

The non-performing loans ratio (classified as substandard, doubtful and loss) has been deteriorating since 2014. The NPL ratio was 5.0% at the endo of 2014, however it increased significantly in the next three years and reached to 8.5% as of the end of 2017. The quality of assets remains under big pressures considering an increase in past due loans. The pace of deterioration has tended to accelerate in 2017 with more losses and doubtful loans.



Note: As of the end of year
Source: Bank of Mongolia

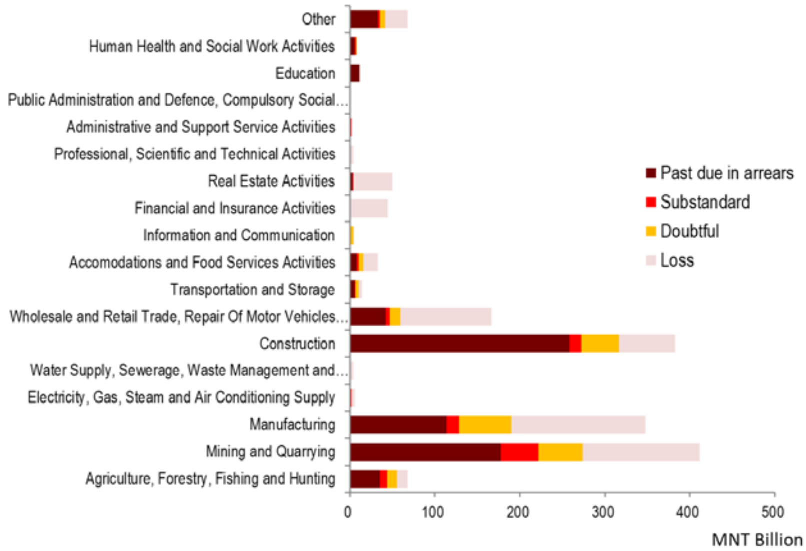
Figure 2.6.1 Outstanding NPL



Note: As of December 2017
Source: Bank of Mongolia.

Figure 2.6.2 NPL by Type of Loan

Most non-performing loans are concentrated in the mining and quarrying sector, construction, manufacturing and wholesale and retail sector. As mentioned above, commercial bank loans are concentrated to these sectors and these sectors are vulnerable to speculative investment and international business trends.



Note: As of December 2017
Source: Bank of Mongolia

Figure 2.6.3 NPL by Sector

Mongolia's commercial banks are rated low by international rating agencies[3] as they are of poor standing and are subject to very high credit risk. Currently 7 commercial banks (i.e., Bogd Bank LLC, Capital Bank LLC, Golomt Bank LLC, Khan Bank LLC, State Bank LLC, Trade and Development Bank of Mongolia LLC, and XacBank LLC) are rated by Moody's.

After continuous downgrading in 2016 and 2017, Moody's Investors Service has upgraded the long-term local currency deposit ratings of Bogd Bank LLC, Khan Bank LLC, State Bank LLC and Xac Bank LLC to B3 with a stable outlook from Caa1 in January 2018. It has also placed under review for upgrade the Caa1 long-term local currency deposit ratings of Golomt Bank LLC and Trade and Development Bank of Mongolia LLC. Long-term local currency deposit rating of Capital Bank remained at Caa1 and but revised the outlook to positive from stable.

Table 2.6.3 Rating of Mongolian Banks by Moody's

	18 July, 2014	29 August 2016	21, November, 2016	18, January, 2018
Local Currency Deposit	B2	B3	Caa1	B3
Foreign Currency Long-term Issuer	B3	Caa1	Caa2	Caa1

Source: Moody's

The reasons for downgrading were deteriorated the sovereign rating, vulnerability to deterioration in asset quality, high borrower concentration (especially to the mining sector), and unstable economic situation of the country. It was considered that the creditworthiness of the Mongolian banking system is highly correlated to that of the sovereign. The sovereign downgrade had been done by the sharp deterioration in fiscal conditions of weak growth and very low foreign exchange buffers and liquidity risks.

The key factors driving the rating upgrade in January 2018 are an alleviation in liquidity and external pressures and recovery of primary commodity prices in global markets and implementation of the IMF program. The refinancing of government debt at the end of 2017 also contributed to narrow the fiscal

3 Moody's downgraded the local currency long-term deposit ratings and the foreign currency deposits ratings of seven Mongolian banks from the rating downgrade on August 29, 2016, following the downgrade of Mongolia's sovereign rating to Caa1 from B3 with a stable outlook.

deficit. However, the volatility of economic and fiscal outcomes resulted from sudden potential changes in commodity prices, and demand still remains as the main challenge of Mongolian economy.

2.7 Credit Support Institutions

2.7.1 Credit Guarantee Fund

Collateral has been one of the major hurdles for SMEs to access financing. To tackle this issue, GOM, together with Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), decided to create a credit guarantee system. The Law on Credit Guarantee Fund was adopted by Parliament on 10 February 2012.

Based on the law, the government established a credit guarantee fund (Loan Guarantee Fund or LGF) on November 6, 2012. In terms of its structure, there is a governing board currently chaired by a member of FRC. LGF also has a supervisory council that is responsible for internal audit. Outside LGF's administrative unit, the Credit Guarantee Committee (CGC) serves as the body for making decisions on guarantee issuance.

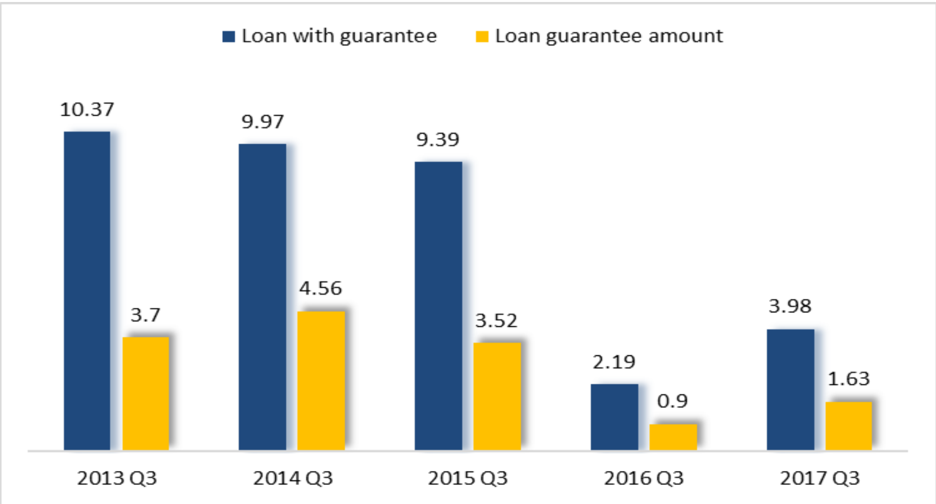
LGF started to operate in August 2013 with the State Bank as the only participating bank, and has expanded its members to 12 banks (including National Investment Bank), seven NBFIs and two saving cooperatives by the end of 2017. The basic conditions for LGF services are described in the table below.

Table 2.7.1 Conditions of Guarantee by LGF

Types of loans	Loans for working capital, loans for investment, and microcredit
Guarantee limits	Up to 60% of the loan, and maximum guarantee amount is MNT 250 million
Time required to issue guarantee	10 business days
Service fee	MNT 10,000 per application
Guarantee fee	Loans with maturity of up to 1 year - 1% of the guarantee amount Loans with maturity of 1-2 years - 2% of the guarantee amount Loans with maturity of more than 2 years - 3% of the guarantee amount

Source: LGF Procedure

As the following figure shows, the loan guarantee amount has been decreasing.



Source: FRC (2017) Overview of Non-Banking Financial sector – 2017 Q3

Figure 2.7.1 Guarantee Amount by LGF

The breakdown of guarantee by type of loan is shown in the following table. Guarantees for TSL Loans account for 8.0% in number and 13.6% by loan amount among the total.

Table 2.7.2 Guarantees by Type of Loan

Financing sources	No. of Guarantee	Guarantee Amount	Amount of Loans with Guarantee	
		MNT Billion	MNT Billion	Share
Bank loans	141	8,773	20,785	27.4%
SME Fund	92	7,538	18,362	24.2%
Chinggis Bond	79	8,756	22,120	29.2%
Employment Promotion Fund	50	141	269	0.4%
TSL Loan	33	4,476	10,329	13.6%
Municipal SME Development Fund	9	412	769	1.0%
Fund for promoting household micro manufacturing	3	37	74	0.1%
ADB Project on Employment Promotion	2	21	60	0.1%
Ministry of Industry: Leader processing project	1	360	1,500	2.0%
Price Stabilization Program Loan of Ministry of Construction	1	250	1,000	1.3%
Ministry of Industry: Wool & cashmere manufacturing	1	240	600	0.8%
Total	412	31,004	75,868	100.0%

Note: As of March 2016
Source: LGF

The LGF estimates that LGF-guaranteed projects have created 1,370 new jobs and preserved 3,363 jobs, by March 2016.

The LGF is faced with a budget issue. LGF is unable to make its operation plan in advance because the size of budget is uncertain every year due to its budget system. LGF also has the problem of its capacity, for example, credit analysis.

To expand SMEs access to finance and address existing shortcomings of the LGF, the Asian Development Bank (ADB) provided 60.8 million USD loan and technical assistance to the LGF under its "Supporting the Credit Guarantee System for Economic Diversification and Employment" Project. The assistance targets small businesses outside the mining sector which accounts for 25% of the gross national product but makes Mongolia highly vulnerable to swings in global commodity prices. The project started from April 2016 and will be completed in October 2021.

Strengthened LGF with the assistance of ADB is expected to support up to $432 million in loans to SME sub-projects by guarantees. The ADB's project may contribute to the establishment of a local market for 5-year time deposits, building confidence in the safety of these financial instruments, and encouraging the private sector to mobilize savings for longer-maturity bank loans. Participating financial institutions are required to use time deposit for new guaranteed projects targeting women entrepreneurs, rural SMEs, and projects creating non-mining sector jobs. Currently, four banks (State Bank, TDB, Xac bank and Khan bank) have been qualified for the project and signed MOUs.

The guarantee conditions under this project are: (i) loan amount up to 1 billion MNT, (ii) loan maturity up to 10 years, (iii) annual interest rate 12-15%, and (iv) guarantee amount 30-60% of loan amount (but up to 500 million MNT).

2.7.2 Credit Information Bureau

The Mongolia's Credit Information Bureau (CIB), owned by the state, started a credit information service (CIS) in 1993. CIB provides credit information online. All the banks, credit cooperatives, leasing companies are obligated to participate in CIS. The government's social insurance system and taxation authority system are obligated to be connected with the CIS database.

The database includes all positive and negative debtor information such as identification (ID) number, personal ID or company registration number, year of start of business operation (age in case of an individual), obligation such as loan amount, maturity, and its classification (non-performance, delay of payment, etc.). These data are kept by CIB for ten years. Financial institutions have to report all the payment and settlement data of customers right away to the CIB.

The CIB has a plan to enhance the current CIS to achieve a comprehensive system as follows:

- Direct connection with other government systems such as the social insurance and taxation systems to obtain more information.
- Inclusion of insurance companies and credit card companies.
- Accommodation for tax payment.

The Law on Credit Information allows a private entity to operate a credit information system. The members of the Mongolian Bankers Association (MBA) have organized a working group with the purpose of a private CIB in 2005. Since then, the US Agency for International Development (USAID) has supported this project. The Credit Information Bureau LLC, Mongolia (private CIB) was established in 2009 by the MBA with the assistance of the USAID-funded Economic Policy Reform and Competitiveness Project, and the International Finance Corporation (IFC).

In 2010, the private CIB signed a memorandum of understanding (MoU) with Dun & Bradstreet (USA) to establish the first private CIS provider in Ulaanbaatar. The joint venture company would initially provide consumer and commercial credit information services, but intends to add other credit risk management services in the Mongolian market. At this moment, the World Bank and IFC continue to support the private CIB to develop the database. The proposed private CIB needs to obtain a license from BOM. The public CIB welcomes the proposed private CIS.

2.8 SME Loan

2.8.1 Situation of SME Loan in Mongolia

In Mongolia, SMEs account for almost 98% of total registered business entities. The need for loans is high among SMEs in Mongolia. According to the SME studies by BOM (2016), 80% of respondents, out of total 2,285 surveyed SMEs, replied that they greatly need financing for expansion of business. However. similar to other countries, the access to financing is one of the main problems of SMEs.

The major constraints for SMEs to borrow from banks are high interest rates, rather short-term maturity, and strict collateral requirements. The manufacturing industry requires medium- to long-terms loans to get returns for repayment from their capital investment. In many cases, the current loan conditions do not satisfy their needs.

In a different way, commercial banks have the difficulty in providing long-term loans because of a mismatch of maturity with deposits. In addition, a SME loan has problems of comparatively high handling cost and high credit risk. Therefore, commercial banks are cautious in SME loans and they require strict collateral and other requirements from SMEs.

Under the above situation, SMEs usually borrow working capital loans and trade credits rather than capital investment loans with longer repayment period. According to BOM study (2012), there was a big gap between SMEs' needs for loans and actual loans by commercial banks as shown in the following table.

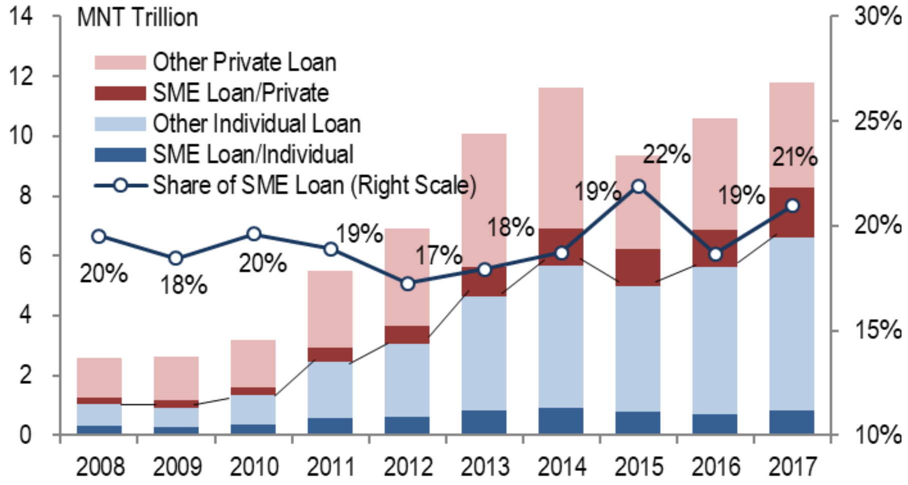
Table 2.8.1 Preference and Actual Conditions of SME loans (as of March 2016)

	Needs on Average	Actual on Average
Amount	MNT 100 million	MNT 15.2 million
Interest Rate	8.8% p.a.	Maximum case 36% p.a.
Maturity	4.5 years	Up to 2 years

Source: Bank of Mongolia

2.8.2 Size of SME Loans

The following Figure shows the trend of commercial bank loans to SMEs. SME loans consist of SME loans among private loans (for enterprises) and SME loans among individual loans (for individuals). As of the end of 2017, the size of loans to SMEs was MNT 2.5 trillion, and they were being provided to 45,735 SMEs and small entrepreneurs.



Source: Bank of Mongolia

Figure 2.8.1 Share of Loans to SMEs

Commercial banks provide loans to SMEs through various policy lending programs. The interests of these loans are considerably low. Currently, long-term and subsidized loans are provided to SMEs through the SME Development Fund[4], or some other SME promotion programs implemented by international donor organizations. These loans are only available for a limited number of SMEs that can meet certain requirements of programs implemented by the government and international donor organizations. According to the studies, 72% of respondents utilize bank loans whereas only 10% use SME project loans even though unfavorable conditions of bank loans.

2.8.3 Constraints of SMEs' access to finance

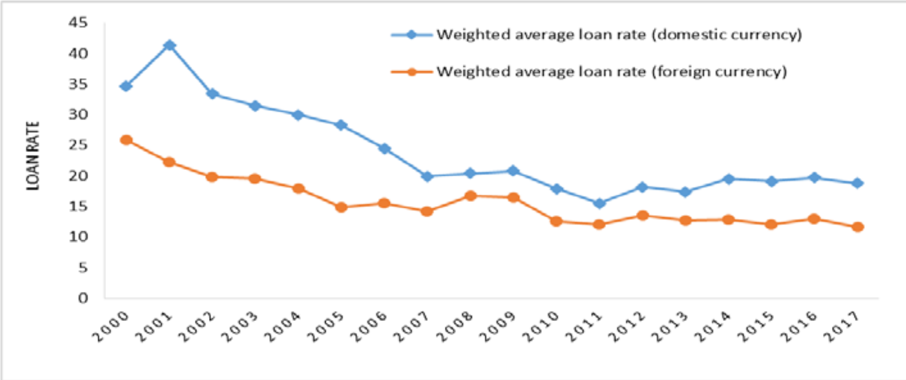
Despite this kind of improvement, many SMEs, microenterprises, and start-up businesses are still facing some difficulties in getting access to finances, which needs to be well understood and addressed by concerned stakeholders.

High Interest Rate / Short-Term Maturity

High interest rate is one of the most critical constraints for SMEs' access to investment loans. GOM, liberalized interest rates in the early 1990s. Although interest rates in Mongolia decreased in the first half of 2000s, they have remained high. Annual interest rates of nominal bank loans were approximately 27% during the 2003-2008 period in local currency and further declined down to approximately 18.5% during the 2009 - 2017 period. Possible factors for high interest rate are: i) high lending risks associated with the high leverage ratio of borrowing, ii) implicitly high NPL level, and iii) less reliable financial information[5].

[4] SME Development Fund is currently administered by the Ministry of Agriculture and Light Industry. Its operation is not active since 2015.

[5] Report and Recommendation of the President to the Board of Directors, Mongolia: Agriculture and Rural Development Project, Asian Development Bank.



Source: Bank of Mongolia, Monthly Statistical Bulletins

Figure 2.8.2 Trend of Average Bank Loan Rates

The JICA report (2009) points out that the private sector's demand for long-term capital has increased mainly due to accelerated economic growth.[6] However, the demand remains largely unmet by the supply side (i.e. domestic financial institutions) due to the short-term nature of bank deposits, as well as due to the lack of skills in project and credit assessment. Although many banks have begun to enter into the SME market since mid-2000s, they largely depend on funding from a limited source of international donors. In the long run, banks are required to diversify their financial sources in order to actively provide lending to SMEs. According to BOM (2014), the majority of SMEs preferred to receive loans with an annual interest rate of 8% and with over a 5-year maturity.

In December 2017, the Parliament members led by Mr. Erdene Sodnomzundui from the Democratic Party initiated a law proposal on defining lending rate ceiling and combating money usury and placed the proposal for public discussion in February 2018. If the proposal receives positive comments from a series of open discussions, then it will be discussed at the Parliament in 2018.

Insufficient Collateral and Undervalued Assets

Collateral is another major issue for Mongolian SMEs. More than one-third of respondents of BOM study (2014) replied that they were not able to get loans due to the strict collateral requirements of banks. Commercial banks only receive immoveable assets as collateral, and in a few cases vehicles. Commercial banks generally require borrowers to collateralize their assets far more than the loan value (in most cases over 120% after hair-cut value). When processing loan applications, banks tend to stress more weight on the aspect of collateral or credibility of the applicants, instead of the feasibility and cash flow projections of the proposed business plans. Real estate properties are considered to be the most preferred type of collateral. Other assets, such as machinery and equipment, vehicles and other movables tend to be undervalued or not accepted as collateral. Because of the absence of unified real estate registration systems and of the banks' tendency to undervalue collateral assets, SMEs have difficulties in accessing their needed loans.

The Law on Financial Leasing was passed in 2006 enabling SMEs to use leased equipment as collateral; however, leased equipment is rarely accepted in practice. Commercial banks spend a lot of time and expense to obtain the proprietary right of collateral assets for reselling in case of NPL. BOM plans to renew the legislation on collateral assets by proposing amendments to related laws to the Parliament, and to ease up legal requirements on transferring proprietary rights of collateral assets to banks.

To help with the problem of collateral, GOM, established its loan guarantee fund in late 2012, but its operations are in its early stages of development and need more time to accumulate experience to offer full-scale service to the public.

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[6] JICA (2009) "Final Report on Special Assistance for Project Implementation (SAPI) for Two-Step-Loan Project

Low Revenue Level at the Start-up Stage and insufficient Capital

Most SMEs face a low level of revenue at early stage of start-up. This causes difficulty for them to accumulate sufficient capital to invest in business expansion. Moreover, banks tend to reject applications of these clients with weak revenue base. This factor may prevent SMEs from accessing much needed loans in order for them to grow.

Weak Reporting Capacity and Business Planning

Although a well-conceived business plan is a roadmap for business, most SMEs lack the ability to prepare good business plans. It is said that more than 10% of loan applications of SMEs have been rejected by banks for this reason only. Insufficient and/or inaccurate financial record keeping, and poor use of accounting/financial information in business decision making are negative factors that cause constraints on SMEs' access to financing. In order to improve this situation, service providers are needed in this field such as business incubating centers with private banks and public institutions.

Other Constraints

There are several other constraints such as procedures and human factors. One problem is skills and capabilities of loan officers, who act as front officers for processing loan applications. BOM (2014) points out that 14% of SMEs replied that complicated and time-consuming bank procedures discouraged them from applying for bank loans.

The current SME definition under the current SME law needs some revisions to address its limitations. The definitions and policy measures provided in the law are too general or outdated and cause poor implementation of the law. For instance, the definition of SMEs by annual sales of up to MNT 1.5 billion is not appropriate to the existing economic situation as production and sales of most business entities are exceeding this amount. Additionally, some clauses of the SME law conflict with other laws and thus affect poor implementation of the law.

Therefore, the draft proposal of SME law amendment was prepared by the Ministry of Food, Agriculture and Light Industry in 2016 and circulated among stakeholders. Two times of public discussions were held in 2017 and the amendment proposal is expected to be discussed at the Parliament in 2018. The key changes in the new law will be the SME definition. According to the law proposal, there will be start-up, micro, small and medium enterprises with new definitions and thereby the government will address their needs, including financing needs, differently through the SME Development Fund, Soum Development Fund and Credit Guarantee Fund.

2.9 Government Special Funds for SMEs

The law on Government Special Funds so far has created 15 special funds, and the following are funds in close connection to the SME industry:

- SME Development Fund
- Investment and Development Fund
- Supporting Intensive Animal Husbandry
- Soum Development Fund

2.9.1 SME Development Fund

The SME Development Fund is traced back to the SME fund initially established by the former Ministry of Industry and Trade (MOIT) in 1992 in compliance with the agreement on "Help for Agricultural Products" between GOM, and the USA government. In 2000, the SME Fund was restructured as the SME Support Fund for agriculture and industry by the Ministry of Food, Agriculture and Light Industry (MOFALI). In 2009, the SME Support Fund was again restructured as the SME Development Fund under

MOFALI, and then transferred to the Ministry of Labour (MOL) in 2012. In 2014, the SME Fund transferred to the Ministry of Industry.

The primary purpose of the SME Development Fund is to retain existing employment and create new employment for SMEs in both rural and urban areas.[7] The SME Development Fund has no specific policy to strengthen certain economic sectors.

The table below shows the number of projects and amount of loans disbursed from the SME Development Fund during 2009 - 2012. MNT 283.3 billion were disbursed over 5,058 projects, out of which the majority of projects were concentrated in rural areas. The annual average of loans disbursed was MNT 70.8 billion.

Between 2012 and 2017, the SME Development Fund disbursed MNT 439.8 billion loans to 2,315 SMEs and individuals. The annual average of loans disbursed was MNT 73 billion.

Table 2.9.1 Number of Projects and Disbursed Loan Amount (SME Development Fund)

Unit: MNT billion

Year	Number of Projects		Disbursed Loan Amount	
	Rural	Urban	Rural	Urban
2009	1,604	34	25.7	12.8
2010	1,523	84	22.3	17.7
2011	1,526	181	57.2	118.6
2012	68	38	4.1	24.9
2013	360	181	22.7	54.3
2014	530	398	36.2	107.6
2015	290	108	17.5	42.8
2016	87	101	20.3	59.7
2017	117	37	35.5	14.2

Source: SME Development Fund

The terms and conditions of loans from the SME Development Fund is shown in the next table. The maximum loan amount varies between urban and rural areas, while interest rate, loan tenure, and grace period are the same for both urban and rural areas.

Table 2.9.2 Terms and Conditions of Loans of SME Development Fund

Category	Ulaanbaatar	Provinces	Regions	Leasing
Maximum Loan Amount	MNT 200 million	MNT 100 million	Over MNT 200million	Over MNT 200 million
Interest Rate	7% per annum	7% per annum	7% per annum	10.8% per annum
Loan Tenure	5 years	5 years	5 years	5 years
Grace Period	1 year	1 year	1 year	1 year
Recipient of Project Application	City and District Governor Office	Labour Department of the Local Government	MOL and SME Fund	MOL and SME Fund

Source: Website of the SME Fund

There is a criticism that loan projects in relations with politicians are adopted by the SME Development Fund and this has led to a higher nonperforming loan ratio.

[7] This was confirmed by the meeting with officers of the MOL on March 13, 2014

2.9.2 Investment and Development Fund (IDF)

MOF also established a special fund of MNT 9.0 billion called the Investment and Development Fund (IDF) in 2007. IDF was used to channel 2-year loans at a 9.96% annual interest rate, and MNT 500 million per borrower ceiling through four commercial banks. With all the domestically-owned enterprises eligible to apply for the fund, the fund resources have been underutilized and proven to be not very effective, again due to the small fund size.

IDF was subsequently changed to subsidize interest costs of policy support loans and was scaled up in fund size to MNT 30 billion in 2008. The new schemes subsidize 50% of an original interest cost of a bank loan with less than 15% interest rate per annum and five years of maturity (with no ceiling on the loan amount). Around a half of the fund is dedicated to the agriculture/animal husbandry sector, while the rest goes to the energy and food processing industries.

2.9.3 Supporting Intensive Animal Husbandry

Under the framework of the state policy on food and agriculture and the concept paper on regional development, the program on “Supporting Intensive Animal Husbandry” and “Mongolian Livestock Program” were ratified in order to develop crop farming with intensive animal husbandry in order to provide an adequate supply of healthy food to the nation. The “Support Intensive Animal Husbandry” in 2012 disbursed soft loans of MNT 1,172 million for individuals and enterprises engaged in crop farming and livestock breeding.

2.9.4 Soum Development Fund

GOM, has been keen on the development of Soums since 2011. It has identified priority areas to support at the local level, and set up councils responsible for monitoring projects implementation and loan use and repayment. As of 2013, loans to SMEs from the Soum Development Fund are in the range of MNT 150 million (minimum) to MNT 1 billion (maximum). So far Soum Development Funds has funded a total of MNT 72 billion.

2.10 Evaluation of the Banking Sector

The enhancement of banking sector is one of the major issues of the Memorandum of Economic and Financial Policies (MEFP). The Government of Mongolia should continue to its commitments to implement the legal reforms of the banking sector. It also needs to execute fiscal and financial policies for the reconstruction of Mongolian economy. The recovery of investor confidence is the first medicine for the suffering banking sector.

The following points are issues of the banking sector:

- **The banking sector is managed in an unstable business environment.**

  The Mongolian economy depends on a few sectors for economic activities (i.e., the mining, construction and trade sectors), and they are vulnerable to the world commodity prices and economic trend. The customer base of banks is generally rather weak because SMEs dominates in the country. Therefore, commercial banks must be run on an unstable economic basis.

  Balanced and diversified economic development is required for the sound and sustainable growth of banking sector. At the same time, the banking sector is expected to catalyze economic development. However, the banking sector do not fully respond to the needs of the economy at this moment.

- **The banking sector is considerably impacted by the government economic policy.**

  The government injected massive money to the banking sector to cushion the impact of declining FDI in 2013. The government started to inject liquidity equal to 17% of GDP through price stabilization and mortgage programs at subsidized interest rates in 2013. As the result, bank credit increased by 54% in 2013. This has led to a considerable change in banks' financial structure and loan quality management.

Mongolia has one of the largest ratios of government expenditure to GDP among Asian countries. The government expenditure was equal to 33.1% of GDP in 2017. The public budget should be managed with a rational and balanced strategy and with consideration of sound debt management.

- **The banking sector is still less developed for sufficient contribution to national development.**

  The banking sector of Mongolia is still less developed than other Asian countries. The size of domestic credit provided by the banking sector was 49.7% of GDP in 2017. This ratio is significantly lower compared to the developed Asian countries where the ratio is more than 100%.

  The gross domestic saving of Mongolia was 41.3% of GDP in 2017, and this figure is not low compared with other countries. The outstanding deposits at commercial banks is equal to 41% of GDP.

  The further growth in terms of scale and provision of more flexible and up-to-date financial services are expected for the banking sector in Mongolia.

- **Monetary policy is not effectively implemented.**

  In Mongolia, BOM's monetary policy is dysfunctional and has limited impact on monetary indicators such as interest rates and inflation. It is necessary to improve the effectiveness of monetary policy measures.

- **The banking sector dominates the financial sector in Mongolia.**

  The banking sector possesses more than 95% of total assets of financial institutions. The capital market is immature and non-bank financial institutions operate on a marginal basis. Top banks have also been expanding non-bank financial businesses.

  The development of a capital market and other financial services is needed for the financial sector to extend more options of fund raising for enterprises.

- **There is a big gap between top banks and lower banks in terms of capital, financial technology, and management.**

  Top 4 banks account for approximately 78% of total assets of the banking sector. Top banks have been introducing modern financial services, upgrading their technologies, and improving internal control. However, lower banks operate on a very small scale in terms of branches, deposits, and management resources. Small banks are faced scarce resources for necessary investment to develop

  Even top banks are still minor league players in the world. Top banks must continue to upgrade their financial basis and management capability. On the other hand, lower banks must establish their business models of sustainable development to compete in the sector.

- **A transparent and accountable banking system is needed in Mongolia.**

  The failure of Savings Bank in 2013 highlighted the importance of a transparent and accountable banking system. The recent jump of non-performing loan ration calls for close monitoring of loan quality.

The banking sector should establish internationally-accepted practice and compliance-base sound management. In addition, BOM is required to strengthen the banking sector supervision and law enforcement according to the Medium-term Banking Supervision Strategy.

Chapter 3 Overview of Small- and Medium-Scale Enterprise Sector in Mongolia

Since the policy shift to a market-oriented economy in the early 1990s, the private sector has experienced growth through structural changes of economy. Dominated by the medium- and small-size enterprises (SMEs), the private sector has worked as a driving force of the economy with their huge potentials.

3.1 Definition of SMEs

With the primary purpose of comprehensively promoting SME development in Mongolia, the Law on SMEs came into effect in June 2007[1] and provided newly definitions of SMEs as the targets of policy support measures. The purpose of the Law was to define SMEs and enable a governing body to make comprehensive SME policies and programs, to have an integrated SME registration and information database, and to effectively coordinate SME-targeted government programs. Based on the Law, financing organizations such as the SME Development Fund (2009) and Credit Guarantee Fund (2012) were established to foster SME development and address their financing needs.

The 2007 SME Law defines SMEs in terms of employee number, sales turnover and kind of industry. Table 3.1.1 shows the definition of SMEs by number of employees and annual sales for SMEs.

Table 3.1.1 Definition of SMEs Under the 2007 Law on SME

Category and Industrial Sector	No. of Employees	Annual Sales
Medium-Scale		
1) Industries* [excluding 2), 3) and 4) below]	Up to 199	Up to MNT 1.5 billion
2) Wholesale	Up to 149	Up to MNT 1.5 billion
3) Retail Trade	Up to 199	Up to MNT 1.5 billion
4) Services	Up to 49	Up to MNT 1.0 billion
Small-Scale		
5) Manufacturing	Up to 19	Up to MNT 0.25 billion
6) Trade	Up to 9	Up to MNT 0.25 billion
7) Services	Up to 9	Up to MNT 0.25 billion

Note: it includes the agriculture sector (Source: The 2007 Law on SMEs)
Source: 2007 SME Law

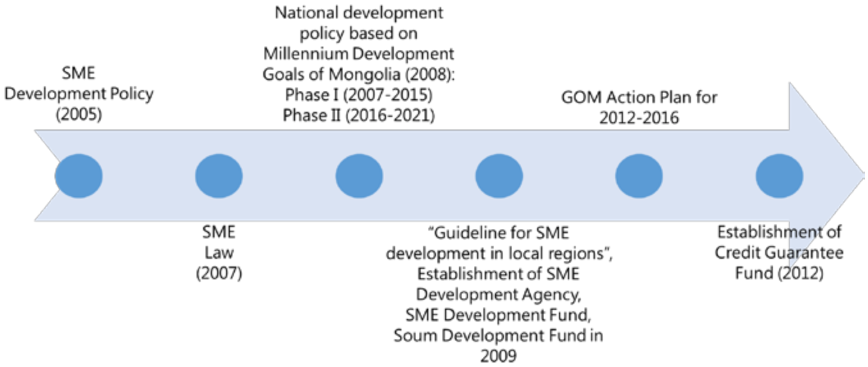
At the law's formulation, the definition of SMEs was changed. The new definition of SMEs is criticized by SMEs and other stakeholders. Although the number of employees remained almost unchanged, annual sales has increased over the years due to greater production of sectors, price increase in both inputs and outputs as well as domestic currency depreciation.

As mentioned in Chapter 2 the Ministry of Food, Agriculture and Light Industry drafted the amendment of SME Law in 2016 including the revision of definition of SME. It is expected that the draft will be discussed at the Parliament in 2018.

3.2 Government policy and legislative environment for SME development

GOM has recognized the SMEs' importance to socio-economic development of the country, such as playing a vital role in diversifying the mining and agriculture-dependent economy as well as generating employment opportunities. GOM implements SME development policies in the areas of i) legislation and policy, ii) institutional arrangement, iii) tax incentives and iv) financial support.

[1] The law was amended in 2012 and 2015. The main changes were regarding SME registration requirements, the governing body, establishment of the SME Council and clarifications of some articles.



Source: JICA Expert Team

Figure 3.2.1 Timeline of main SME development legislation and institutions

(1) Legislation and policy

In 2007, the Law on SME was approved by the Parliament. The law provided SME definition, registration of SMEs, scope and direction of government policy on SME development, roles and responsibilities of the government organization in charge of SME and need for incubation centers and information database. Based on the law, a number of policies and programs were initiated and implemented by GOM.

In 2005, GOM, approved a SME Promotion Programme and renewed it in 2009 and 2014. GOM, formulated a program for support of SMEs to ensure their robust growth through provisions on better legislative and regulatory environments. By Resolution 278 of August 28, 2014, the government renewed "the SME Promotion Programme" and proposed the following objectives:

- Improve the legal environment
- Promote cluster development
- Support research and innovation development
- Enhance capacity building of SMEs
- Increase financial resources and improve outreach of SME financing
- Support the market expansion for SMEs

In 2008, the Parliament passed "the National development policy based on Millennium Development Goals of Mongolia". The policy prioritized SME development as the key for economic diversification. The policy is to be implemented by 2 phases: Phase I (2007-2015) and Phase II (2016-2021). Article 5.2.1 of the policy specifies detailed policies for SME development policies as the second priority sector. There have been improvements in financial and technical support to SMEs in addition to the simplification of licensing, permits and registration procedures.

In 2009, GOM, formulated "Guideline for SME Development in Local Regions" and "Industrialization Programme", which acknowledged the importance of SME development in order to promote local development and value-added activities in Mongolia.

In addition, GOM, Action Plan for 2012-2016 was implemented to promote SMEs policies directing to the following objectives:

- Establishment of SME advisory service and business incubation centers for the purpose of easing government-related bureaucracies and procedures that stood as obstacles for SME development.
- Formulation of GOM's industrialization policy.
- Introduction of other support mechanisms, such as loan guarantee and insurance schemes, to improve SMEs' access to finance.

- Promotion of the processing industry, especially factories producing cashmere wool and hide products that are competitive enough in the international market.
- Allocation of funds from available sources such as government budget, development fund, and donors' assistance for the purpose of promoting SMEs and generating employment.

In 2016, the Parliament ratified the Sustainable Development Vision 2030 to be consistent with the Paris Agreement on Global Sustainable Development Goals of 2015. The Vision declares to implement 10 main goals, including to ensure average annual economic growth of no less than 6.6% through 2016 - 2030, and to be ranked among first 40 countries by the Doing Business Index and among first 70 countries by the Global Competitiveness Index in the world. To achieve these goals, 20 target indicators are specified in the Vision, including to increase the share of processing sector export from 17% in 2014 to 50% in 2030. In Objective 4 of agriculture sectoral development, the government will support small and medium sized farmers; provide modern techniques, technologies and electricity; and create a financial, economic and legal environment for sustainable production. In Objective 2 of tourism sector development, it states to introduce advanced technology in food industry, improve the competitiveness, increase domestic supply in main food products, and ensure that citizens are supplied with healthy and safe food products. The Vision also declared goals to foster favorable business environment, infrastructure development and sound banking and other financial market institutions to achieve economic and business competitiveness goals.

Consistent with the Sustainable Development Visions-2030, the Government of Mongolia proposed the Action Plan 2016-2020. The Action Plan includes actions to support SMEs by providing loans with lower rate and longer maturity, to promote the export-oriented processing sector, to initiate the light industry promotion program "industrialization 21:100" (100 manufacturers in 21 aimags), and to have the effective tax system. In line with this Plan, the Government also proposed actions to lower income tax to 1% for enterprises with annual revenue below 1.5 billion MNT and to provide tax exemption for domestic investors.

(2) Institutional arrangements

The SME Development Agency was established in 2008 as the main body of implementing SME development policies and regulations in Mongolia. The agency has formulated a number of SME development regulations and programs and coordinated them. The agency was originally under the supervision of the Ministry of Food and Agriculture. It was transferred to the Ministry of Industry, but it was returned to the Ministry of Agriculture and Light Industry in 2016.

The SME Development Fund was established in 2009 and the Soum Development Fund was established by GOM, in 2012. These funds aim to provide necessary financing for projects of selected priority sectors of SMEs.

In 2012, the Parliamentary Sub-committee on SME Development was established and started to develop enabling regulatory environment for SMEs.

(3) Tax incentives

In order to promote SME development, GOM, has offered tax incentives mainly through VAT and customs tariffs. The taxation law offers customs tariff and VAT exemptions for SME's import of equipment. As a result, more than 4,000 SMEs and entrepreneurs enjoyed these exemptions and saved MNT 15.5 billion between 2009 and 2011. For some years, GOM, provided 50% income tax deduction for agricultural SMEs and entrepreneurs.

(4) Financial support:

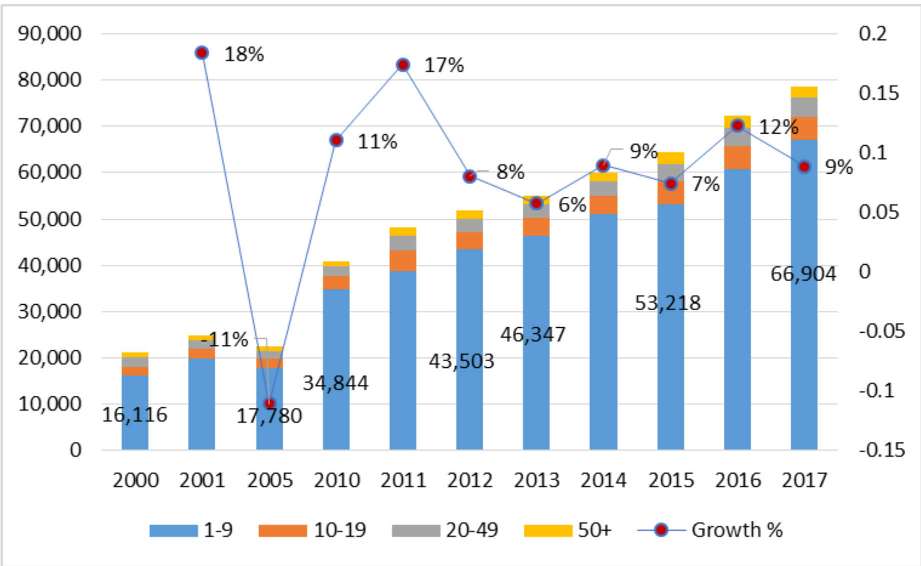
Based on the SME Law, GOM, has created four special funds closely connected with the SME industry: SME Development Fund, Investment and Development Fund, Supporting Intensive Animal Husbandry and Soum Development Fund. These is discussed on Section 4.3.

The government spent approximately MNT 400 billion through SME Fund, government bond financing, regional development loans, local loans, "Soum development fund", "Wool and Cashmere Programme", "Milk Programme" and others. In addition to the government support, foreign governments and international organizations contributed to the development of SME industry. For instance, USAID loan program provided guarantee for USD 25 million for SME loans. EU provided 4 million euro official development assistance to promote SME development and competitiveness improvement. The Japanese Government provided Yen loans of JPY 2,981 million and JPY 5,000 million for Phase I and Phase II respectively of Two-Step-Loan for SME development and environmental projects.

In sum, GOM, has initiated various activities to promote SMEs but most of them are fragmented and not effectively coordinated and implemented. Therefore, the legislative environment should be improved, and the government needs to provide comprehensive SME policy which consolidates all the existing policies and programs and provides effective coordination and clear implementing mechanism.

3.3 Growth of SMEs

The number of registered entities has gradually increased since 2000. During the last 17 years, the number of entities grew by 2.7 times. The main increase occurred for SMEs: entities with 1-9 employees grew by 3 times followed by entities with 10-19 employees. Despite the negative impact of the global financial crisis of late 2008, the total number of registered business entities has been steady increasing[2]. Figure 3.3.2 shows the number of registered and active business entities according to size of employment from 2000 to 2017.



Source: National Statistics Office

Figure 3.3.1 Number of Active Business Entities by Size of Employment

The registered SMEs (up to 50 employees) account for over 97% of the total private entities in Mongolia. The majority of SMEs are start-ups and newly established microenterprises, which employ less than 10 employees.

It is noteworthy that there are many non-active enterprises among the registered entities. As of 2017, 51% of the total registered entities were active, 25% had not started their activity, 22% were temporarily stopped their operation and remained 3% were either permanently stopped or were not found at the registered address.

[2] Please refer to 1.1 of Chapter 1.

3.4 Distribution of SMEs by Sector and Region

As shown in the following Table, SMEs in Mongolia have been largely concentrated in the trade and other service-oriented sectors by sharing over 79% of the total active enterprises as of 2017. Since 2000, there were some structural changes in the composition of economic sectors. Agriculture, manufacturing, public administration, health and education sector entities gradually decreased, whereas the number of entities in construction, wholesale and retail, and real estate services have increased over last 17 years.

Table 3.4.1 Number of Registered Enterprises by Economic Sector

Economic sectors	2000		2005			2010			2015			2017		
	Number	*Share (%)*	Number	*Share (%)*	*Growth %*	Number	*Share (%)*	*Growth %*	Number	*Share (%)*	*Growth %*	Number	*Share (%)*	*Growth %*
Agriculture, foresty and hunting	1,813	8%	2,208	6%	13%	3,183	4%	8%	6,661	5%	5%	7,626.	5%	8%
Mining and quarrying	217	1%	373	1%	26%	795	1%	10%	1,155	1%	22%	1,494.	1%	19%
Manufacturing	2,909	13%	3,087	8%	14%	4,912	7%	9%	9,934	8%	8%	11,229.	7%	8%
Electricity, gas and water supply	215	1%	236	1%	7%	267	0.4%	-5%	344	0.3%	-10%	363.	0%	5%
Construction	616	3%	1,154	3%	25%	3,057	4%	17%	10,496	8%	17%	12,103.	8%	6%
Wholesale and retail trade, repair of motor vehicles, household goods	7,635	34%	17,122	43%	19%	36,297	49%	24%	54,303	43%	11%	66,008.	43%	10%
Hotels and restaurants	839	4%	1,427	4%	35%	2,228	3%	3%	3,349	3%	3%	3,911.	3%	8%
Transport, storage and communications	686	3%	996	3%	38%	2,344	3%	9%	5,529	4%	9%	6,988.	5%	12%
Financial services	231	1%	1,217	3%	36%	1,208	2%	1%	1,920	2%	-7%	2,106.	1%	8%
Real estate, renting and other bussiness activities	930	4%	2,403	6%	48%	5,030	7%	12%	12,656	10%	9%	15,516.	10%	9%
Public administration and defence, compulsory social security	1,250	6%	1,357	3%	-0.1%	1,605	2%	1%	1,434	1%	0.1%	1,464.	1%	2%
Education	1,577	7%	1,972	5%	9%	2,528	3%	6%	4,209	3%	17%	5,241.	3%	8%
Health and social work	1,370	6%	1,994	5%	6%	2,678	4%	2%	3,831	3%	10%	4,270.	3%	5%
Other community, social and personal services	2,433	11%	4,129	10%	-6%	7,654	10%	2%	10,715	8%	28%	16,722.	11%	16%
Extra-territorial organization and bodies	3	0.01%	2	0.01%	-33%	9	0.01%	50%	24	0.02%	-4%	24.	0%	0%
TOTAL	**22,724**	**100%**	**39,677**	**100%**	**16%**	**73,795**	**100%**	**14%**	**126,560**	**100%**	**11%**	**155,065**	**100%**	**10%**

Note: SMEs in the above table are defined as those having 1 to 49 employees, while large ones have more than 50
Source: National Statistics Office

In terms of share, wholesale and retail trade accounted for 43% of total entities, followed by real estate (10%) and construction (8%). Entities in agricultural service comprised only 5% of registered entities which is quite small figure for the country with abundant animal herding. This is mainly due to the fact that nomadic herding in animal husbandry consists of individual herders rather than entities and less-available cultivated crop areas. Although Mongolia has huge potential in the mining sector and the country experienced the booming mining growth in 2010s, the number of registered mining entities were 1,494 (or 1%) as of 2017. This is related to the features of the sector: less human capital intensive, and the fact that most economically important big deposits are operated by foreign companies or joint ventures.

In terms of growth, the number of total entities grew 6.8 times during 2000 - 2017. Most outstanding growth was seen in the construction (19.6 times), real estate (16.7 times) and transportation (10.2 times) during this period.

As for regional distribution of SMEs, as shown in Table 3.4.3, Ulaanbaatar City accounts for around 64% of total active entities as of 2017, where nearly half the population of the country make it the largest market of business opportunities. The second concentrated region is Central region and border main points characterized by the major industrial and trading towns, such as Darkhan, Zamiin-Ud and Altanbulag, accounting for around 12%, followed by more distant regions such as Khangai (11%) and Western region (9%). The structure has remained almost unchanged for the last 17 years. This indicates that regional development is needed despite various regional development policies discussed at the central and local government levels since 2005.

Table 3.4.2 Number of Active (Registered) Business Entities by Region

Region	2000		2005		2010		2013		2016		2017	
	Number	Share	Number	Share	Number	Share	Number	Share	Number	Share	Number	Share
Ulaanbaatar City	9,715	46%	12,476	55%	26,852	66%	34,777	63%	46,153	64%	50,467	64%
Central Region	4,200	20%	3,685	16%	4,832	12%	6,851	12%	8,499	12%	9,050	12%
Khangai Region	3,159	15%	2,970	13%	4,175	10%	5,844	11%	7,924	11%	8,657	11%
Western Region	2,629	12%	2,209	10%	3,393	8%	5,262	10%	6,485	9%	7,087	9%
Eastern Region	1,382	7%	1,207	5%	1,669	4%	2,195	4%	3,121	4%	3,324	4%
Total	21,085	100%	22,547	100%	40,921	100%	54,929	100%	72,182	100%	78,585	100%

Source: National Statistics Office

3.5 Contribution of the Private Sector (including SMEs) to Industrial Output

The private sector has contributed largely to the economy of Mongolia. According to the National Statistics Office (NSO), the gross domestic product (GDP) shared by the private sector has increased from 57.0% in 1996, 68.4% in 2007, and 75.0% in 2012[3].

Table 3.5.1 Industrial Output by Size of Employees

Unit: MNT billion

Size	2009		2010			2011			2012*		
	output	*Share*	output	*share*	*growth rate*	output	*share*	*growth rate*	Output	*share*	*growth rate*
1-9	267.8	*10.3%*	382.5	*10.1%*	*42.8%*	516.2	*10.1%*	*35.0%*	599.3	*10.2%*	*16.1%*
10-29	81.2	*2.4%*	117.8	*2.4%*	*45.1%*	159.0	*2.4%*	*35.0%*	183.7	*2.4%*	*15.5%*
30-49	250.2	*7.3%*	363.7	*7.3%*	*45.3%*	490.9	*7.3%*	*35.0%*	566.6	*7.3%*	*15.4%*
Subtotal (1-49)	599.2	*20.0%*	864.1	*19.8%*	*44.2%*	1,166.1	*17.3%*	*34.9%*	1,349.6	*19.9%*	*15.7%*
Over 50	2,842.7	*80.0%*	4,122.9	*80.2%*	*45.0%*	5,563.7	*82.7%*	*34.4%*	6,427.1	*80.2%*	*15.5%*
Total	3,441.9	*100.0%*	4,987.0	*100.0%*	*44.9%*	6,729.8	*100.0%*	*34.9%*	7,776.7	*100.0%*	*15.6%*

Source: National Statistics Office, Statistical Yearbook 2012

According to the industrial output by size of employees, companies employing more than 50 people share about 80% of the total industrial output. The industrial output by companies with one to nine employees is just 10% while they account for more than 80% of active entities by number. This implies that average industrial output per company by companies with one to nine persons is considerably small.

3.6 Employment Generation by Sector

The government expects SMEs as the driving force for employment creation and has promoted SMEs for employment creation.

The employment created by the agriculture sector still remains at the top, sharing around 30% of the total employees. The majority of them are herders and crop farmers living on a subsistence level of income. The wholesale/retail trade sector employs over 172,668 people (15%) in 2016 and is still the second largest sector. Like the sectoral composition of the number of entities, the employment composition also indicates that the employment of the country is less concentrated in value-added manufacturing and industrial sectors and more concentrated on agricultural and trade sectors.

[3] Statistical data after 2012 is not available.

Table 3.6.1 Number of Employees by Sector

Unit: Thousand Persons

Economic sectors	2010			2012			2014			2015			2016		
	Number	Share	Growth	Number	Share	Growth	Number	Share	Growth	Number	Share	Growth	Number	Share	Growth
Agriculture, Forestry, Fishery, etc.	346,579	34%	-1%	369,961	35%	8%	310,719	28%	-6%	327,600	28%	5%	348,487	30%	6%
Mining and quarring	34,115	3%	-2%	46,696	4%	4%	40,927	4%	-19%	42,600	4%	4%	38,203	3%	-10%
Manufacturing	64,776	6%	3%	64,895	6%	-1%	85,497	8%	6%	81,300	7%	-5%	86,105	8%	6%
Electricity, gas, steam and air conditioning supply	12,397	1%	30%	14,495	1%	21%	15,454	1%	12%	15,600	1%	1%	16,162	1%	4%
Water supply; sewerage, waste management and remediation activities	7,791	1%	28%	6,679	1%	30%	7,140	1%	-10%	5,900	1%	-17%	6,031	1%	2%
Construction	48,758	5%	-2%	59,204	6%	14%	81,127	7%	12%	88,100	8%	9%	71,485	6%	-19%
Wholesale/Retail Trade, etc.	146,164	14%	-9%	131,341	12%	-14%	170,234	15%	9%	178,200	15%	5%	172,668	15%	-3%
Transportation and Storage	76,533	7%	11%	56,092	5%	-26%	69,815	6%	6%	72,700	6%	4%	65,931	6%	-9%
Accommodation and Food Service Activities	27,734	3%	19%	30,235	3%	15%	36,552	3%	15%	37,800	3%	3%	32,141	3%	-15%
Information and Communication	14,496	1%	43%	14,741	1%	28%	17,796	2%	6%	16,000	1%	-10%	18,132	2%	13%
Financial and Insurance Activities	15,163	1%	24%	17,373	2%	5%	22,914	2%	10%	23,800	2%	4%	21,863	2%	-8%
Real estate activities	474	0%	113%	1,208	0%	275%	1,081	0%	40%	1,000	0%	-7%	767	0%	-23%
Professional, scientific and technical activities	9,576	1%	-12%	11,342	1%	-1%	12,527	1%	-8%	14,100	1%	13%	12,676	1%	-10%
Administrative and support service activities	9,398	1%	6%	13,335	1%	45%	12,010	1%	-20%	16,000	1%	33%	15,042	1%	-6%
Public Administration, etc.	61,029	6%	9%	62,919	6%	13%	66,143	6%	1%	68,100	6%	3%	74,179	6%	9%
Education	85,293	8%	14%	86,271	8%	1%	89,552	8%	0%	89,000	8%	-1%	94,989	8%	7%
Human health and social work activities	40,326	4%	13%	37,528	4%	3%	37,487	3%	-7%	38,200	3%	2%	40,982	4%	7%
Others	24601	2%	123%	32126	3%	-5%	33723	3%	2%	35,200	3%	4%	32,000	3%	-9%
Total	**1,025,203**	**100%**	**4%**	**1,056,441**	**100%**	**2%**	**1,110,698**	**100%**	**1%**	**1,151,200**	**100%**	**4%**	**1,147,843**	**100%**	**-0.3%**

Source: National Statistics Office

The number of employees increased by 3.0% between 2010 and 2012, by 5.1% between 2012 and 2014, and 2.2% between 2014 and 2016. The trend of increase in employees differs according to sector. In 2012, the agriculture sector and the construction sector increased their employment by 23, 382 persons and 10,446 persons respectively. The transportation sector and the trade sector decreased their employment 20,441 persons and 14,823 persons. In 2014, the trade sector, the construction sector and the manufacturing sector significantly increased their employment, i.e., 38,893 persons, 21,923 persons, and 20,602 persons, respectively. On the other hand, the agriculture sector decreased 59,242 persons. In 2016 when the Mongolia economy faced stagnation, the construction sector, the hotel and restaurant sector, the transportation sector and the mining sector decreased their employment while the agriculture sector, the education sector and the health and social work sector increased their employment. It is considered that the agriculture sector plays the role of buffer against unemployment during a recession period.

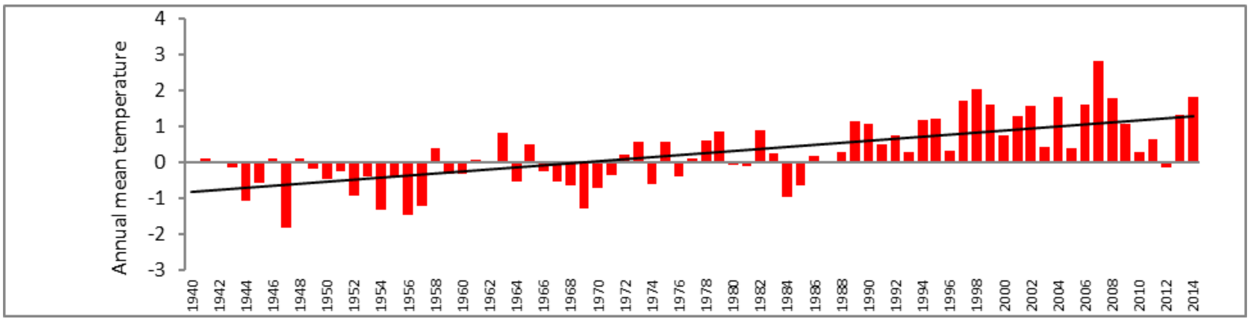
Chapter 4 Environmental Sector in Mongolia

4.1 Current Situation

4.1.1 Climate change

Mongolia is one of the last pastoral countries in the world, where climate plays important role in socio-economic circumstances. During the last 40 years, Mongolians witnessed noticeable alterations in the environment and ecosystems due to global climate changes. Changing climate has taken its toll on Mongolian environment, creating undesirable conditions including increased desertification, more frequent droughts and dzuds (harsh winters), increased scarcity of water resources and greater biodiversity loss, which, in turn, are causing adverse impacts on the national economy and livelihoods of Mongolian citizens.

Global warming is affecting Mongolia faster than other parts of the world. Over the last 70 years, the average air temperature has risen by 2.1^{0}C - one of the highest increases recorded on Earth, and at a rate much greater than global average temperatures, which increased by 0.74^{0}C. Refer the Table below.

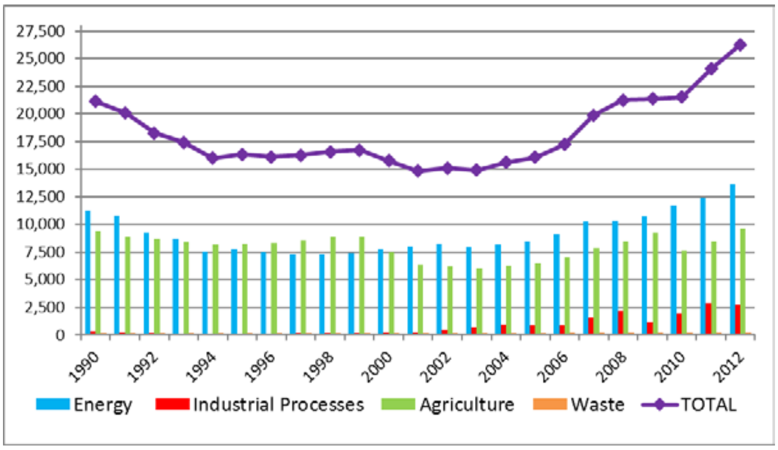


Source: Mongolian second assessment report of climate change, 2014 Ministry of Environment and Green Development.

Figure 4.1.1 Annual mean temperature

The effects of climate change on Mongolian environment can be described as follows:

- Decreasing snow caps of high mountains and thawing permafrost is observed.
- Severe aridity and desertification is occurring.
- Increasing soil erosion caused by wind and the number of dust storm days is increased by 3 to 4 times since 1960, as a result of snow cover melting up to one month earlier.
- Hundreds of springs, ponds and lakes have dried out, pasture production has declined and biological diversity has decreased due to increased dryness. As a result, pasture degradation and animal weight loss and inability to overcome dzuds are occurring.
- Greenhouse Gas (GHG) emissions is increasing. As of 2012-end, the total amount of GHG emission was 26,276 gigagrams (Gg), of which 53.2% was by the energy sector, 44.5% by agriculture and livestock and the remaining was from land use, change in forest area, industry in and waste sectors. Mongolia was leading in terms of per capita GHG emissions in the world, higher than the global average and most other developing countries.



Source: Mongolian second assessment report of climate change. 2014

Figure 4.1.2 Greenhouse gas emission 1990-2012

GHG emissions tend to increase further as Mongolian economy develops. Thus, mitigation policies need to be prepared and the programs need to be implemented including development of efficient electric and thermal power generation, introduction of environmentally sound technologies, improvement of fuel efficiency, promotion of renewable energy sources and reduction of air pollution.

4.1.2 Water resources

Mongolia has been divided into 29 river basins for water resources management purposes. Mongolia's total surface water resources are estimated to be 598.5 km3, of which 5.8% is from rivers, 83.5% from lakes, and the remaining is from glaciers. The total amount of renewable groundwater resources have been estimated to be 23.6 km3, with potentially exploitable resources of 10 km3. The long-term average of actual renewable water resources in Mongolia is estimated to be 34.800 million m3/year. This equals to actual renewable water resources per capita of 12.29 m3/inhabitant.

From the numbers provided above, it can be concluded that Mongolia has comparatively sufficient water resource. However, the geographic distribution of water resources relative to the location of the most highly populated areas and other water demand centers is such that there are localized water shortages in many parts of Mongolia1.

The Government of Mongolia has made considerable progress in improving its legal and institutional framework for the integrated water resources management (IWRM) and environmental protection of river basins in Mongolia. In accordance with the renewed Water Law (2012), the river basin authorities have been formally established throughout Mongolia. As of 2013, there are 23 river basin authorities established out of the 29 river basins. The government has also approved the National IWRM plan, and as of 2013, there are 13 IWRM plans have been prepared at the basin level.

4.1.3 Air Quality

Air pollution in Ulaanbaatar is caused by high emissions of pollutants due to raw coal burning and contributed by the unique geography and cold weather. Extreme winter temperatures, poor infrastructure and urban sprawl are creating one of world's worst cases of air pollution.

The city, which lies in a valley surrounded by mountains, has grown rapidly, with an influx of people from rural areas looking for better opportunities for themselves and their families. They settle on the outskirts, often bringing their gers (traditional circular felted tents), covering the hills surrounding

[1] Demand in the desert: Mongolia's water-energy-mining nexus, ADB&MNE, 2015.

Ulaanbaatar. These outskirts are known as the ger districts, although 60% of dwellings are single and two-storey homes.

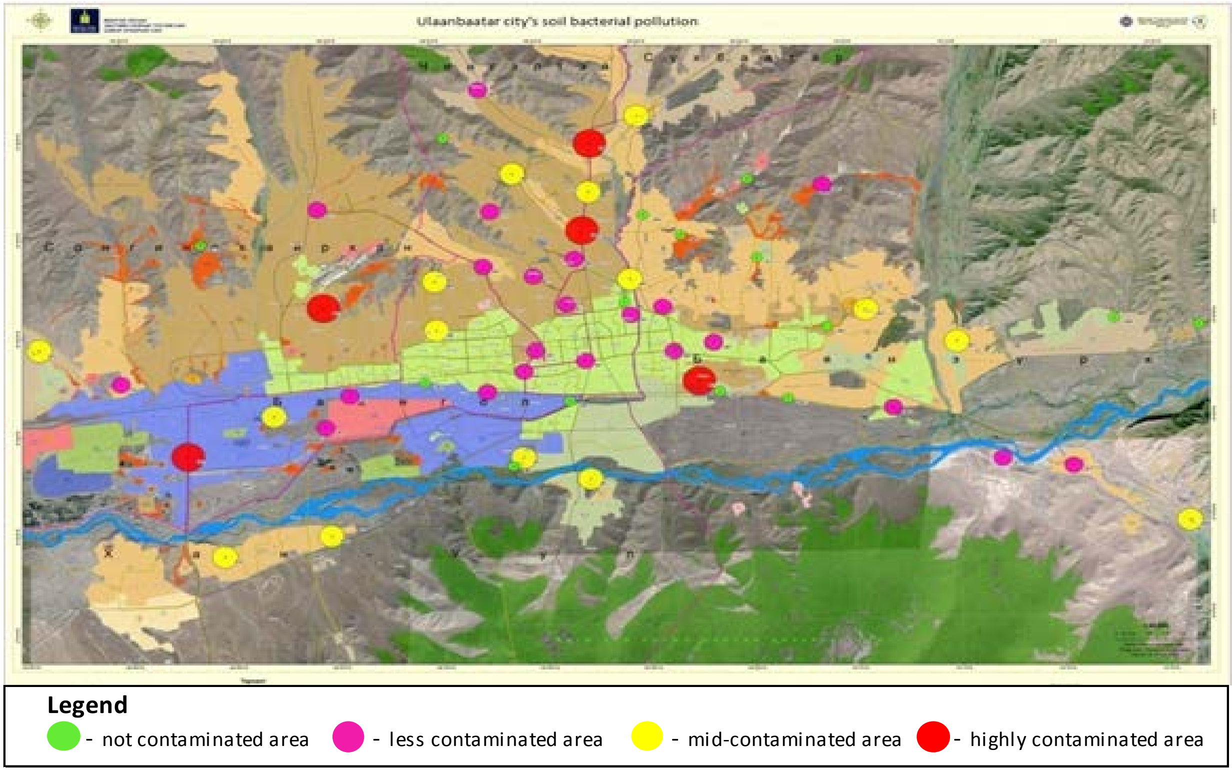
According to the Ministry of Environment and Tourism, the main sources of Ulaanbaatar's air pollution are: 80% from ger districts where households burn low-quality coal for heating and cooking, 10% from vehicles, 6% from power plants, 4% from solid waste and soil contamination.

Major air pollutants reach their maximum concentrations in January, the coldest month of the year, in Ulaanbaatar city (the trend can be seen from the air quality indexes). Although there has been a declining tendency of levels of coarse particles (PM10) and fine particles (PM2.5) since 2012 due to implementation of national policies as well as programs by donor organizations, air pollutant indexes are still higher than the permitted limits specified in the air quality standards.

4.1.4 Soil Quality

The city of Ulaanbaatar, at present, is densely populated with the half of population. However, Ulaanbaatar occupies 470,440 ha, which is 0.30% of Mongolia's total land area. Statistically, green area, including forest, woods and parks, per capita is 6 ha, while in Ulaanbaatar it is less than 0.07 ha. Within Ulaanbaatar city itself, density is still higher in certain parts only - areas of buildings, houses, ger districts, 6 cemeteries and the sites used as sand quarry are not big portion of the city's total land area. Hence, land degradation due to high density of people has become so severe that the adverse effects are reaching far beyond the city territory. Negative impacts of soil erosion include increased number of weeds, fewer varieties of grasses and an increased rate of sparsely growing plant species, causing more people suffering from allergies.

In accordance with the Ulaanbaatar's soil pollution survey - 2014, it is concluded that the overall heavy metal contamination level is within the normal range. However, it needs to be noted that in some parts where leather processing factories are located, the heavy metal presence, including lead, chromium and zinc, is higher than the average level. Moreover, pathogenic bacteria (salmonella, cl.perfringens, e.coli, and citro bacteria) have been found in the soil samples of literally all areas, i.e. 88% of total land area.



Source: Ulaanbaatar's soil pollution survey-2014, Ministry of Environment and Green Development.

Figure 4.1.3 Soil bacterial pollution of Ulaanbaatar

Soil pollution in the city can be mainly attributed to the Ger District, where there is lack of sewage systems. In ger areas, a large majority of households use pit latrines, a large hole in the ground, which has a structure over it to provide privacy, used as a toilet in each fence (each household in ger district lives in a fence). The hole in the ground would fill up and a new hole will have to be dug. This happens every 3-4 years. The deposited fecal matter has a significant negative impact on soil pollution. On a positive note, soil pollution in Ulaanbaatar is minimal during the large portion of the year as the majority of soil bacteria is killed by the below 10 winter temperatures. Unfortunately, soil bacteria levels rise up again during the summer time.

The level of desertification and prevailing factors of land degradation was estimated and mapped in 2013. Results of this research indicate that 77.8% of the country's territory is affected by degradation, of which 5.3% was defined as slightly, 25.9% was moderately, 6.7% severely and 9.9% extremely degraded. Natural factors contribute 56% and anthropogenic factors contribute 44% to heavy or very heavy desertification[2].

4.1.5 Biodiversity

<u>Flora</u>

Mongolia's diverse and distinctive vegetation composes an important part of Asia's plant life. Species that represent Siberia's coniferous taiga forest, Central Asia's steppe and desert, and the Altai and Sayan Mountains are all found here. More than 3000 species of vascular plants, 927 lichens, 437 mosses, 875 fungi, and numerous algae have been recorded. Many other species, however, remain to be classified. Mongolia's flora includes almost 150 endemic plants and nearly 100 relict species. Over 100 plant species are listed in the Mongolian Red Book as rare or endangered.

<u>Fauna</u>

Like its vegetation, Mongolia's fauna represents a mixture of species from the northern taiga of Siberia, the steppe, and the deserts of Central Asia. Fauna includes 136 species of mammals, 436 birds, 8 amphibians, 22 reptiles, 75 fishes, and numerous invertebrates.

Species is endemic to Central Asia are found primarily in the Gobi and desert steppe including the Mongolian subspecies of the saiga antelope, 4 species of jerboa, 8 species of reptiles, a vole and some birds and fish that are endemic to Central Asia only.

4.2 Global and National Policy Framework

4.2.1 Sustainable Development Goals

The Sustainable Development Goals (SDGs), also known as the Global Goals, are a universal call to end poverty, protect the planet and ensure that all people enjoy peace and prosperity. The SDGs were developed as the successor of the Millennium Development Goals, covering new areas such as climate change, economic inequality, innovation, sustainable consumption, peace and justice in addition to other priorities. The SDGs work in the spirit of partnership and pragmatism to make the right choices to improve the quality of life in a sustainable way for future generations. They provide clear guidelines and targets for all countries to adopt in accordance with their own priorities and the environmental challenges of the world at large. The SDGs are of inclusive agenda. The goals are to tackle the root causes of problems and unite the global population together to make positive changes for both people and planet.

4.2.2 Paris Agreement

The Paris Agreement is an agreement within the United Nations Framework Convention on Climate Change (UNFCCC) dealing with GHG emissions and its mitigation and adaptation. The Paris Agreement

[2] Mongolian desertification Atlas, 2013.

builds upon the Convention and – for the first time – brings all nations into a common cause to undertake ambitious efforts to combat climate change and adapt to its effects, with enhanced support to assist developing countries to do so. As such, it charts a new course in the global climate effort. The central aim of the Agreement is to strengthen the global response to the threat of climate change by keeping a global temperature rise below 2^{0}C above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5^{0}C. Additionally, the agreement aims to strengthen the ability of countries to deal with the impacts of climate change. To reach these ambitious goals, appropriate financial flows, a new technology framework and an enhanced capacity building framework will be put in place, thus supporting action by developing countries and the most vulnerable countries, in line with their own national objectives.

4.2.3 National Policy Framework

The national objectives to tackle environmental issues - Green Development Policy – was approved by the Parliament of Mongolia in 2014. Mongolia also joined the global commitment to address the global and national challenges: adopted the Mongolia Sustainable Development Vision 2030 in February 2016, and ratified the Paris Agreement in September 2016.

By 2030, Mongolia aspires to be amongst leading upper-middle-income countries based on per capita income. According to the policy, the objectives are defined as the country's development is to be based on pillars of economic development, social development, environmental sustainability and governance. The main targets of the policy include: to be ranked in the top 70 in terms of the human development index; to preserve ecological balance and to be ranked in the top 30 in terms of the Green economy index in the world; to be ranked in the top 40 in terms of the Doing Business Index and in the top 70 countries in terms of the Global Competitiveness Index in the world; and overall to build professional, stable and inclusive governance that is free of corruption and is adopted at all levels.

4.2.4 Green Development Policy

Government of Mongolia supports the global commitment to change current development trends and to transit to a socially inclusive environment where there are low greenhouse gas emissions, better waste management, and plans to conserve natural resources and ecosystem value, while improving human well-being and reducing poverty. In this connection, the Parliament of Mongolia approved the Green Development Policy in 2014. The main goal of the Policy is to ensure that Mongolia advances as a developed nation that has built conditions for environmental sustainability, to be inherited by future generations who will gain benefits from it in the long-run. Guiding principles of the policy include promotion of efficient and rational use of resources, planning of policies in consistence with green development concepts, promotion of clean and advanced technologies, citizens' participation in the creation of green economic growth, environmentally friendly attitudes, habits and enhancement of transparency and accountability.

4.2.5 Intended Nationally Determined Contributions

The Paris Agreement requires all Parties to put forward their best efforts through "nationally determined contributions" (NDCs is a term used under the UNFCCC for reduction in greenhouse gas emissions where all the countries signed the UNFCCC were asked to publish in the lead up to the 2015 - United Nations Climate Change Conference held in Paris, France in December 2015) and to strengthen these efforts in the years ahead. This includes requirements that all Parties report regularly on their emissions and on their implementation efforts. Government of Mongolia has adopted the Mongolia's NDC in 2015 and it has its conceptual roots in the Green development policy in Mongolia, to which key sectoral action plans at the national level, including energy sector, are being adjusted. Key indicators for measuring progress in the implementation of the Green development policy include, among others, efficient use of energy, GHG emissions and ecological footprint per unit of Gross Domestic Products. The National Action Programme on Climate Change (NAPCC) endorsed by the Parliament in 2011 includes concrete measures in response to climate change covering all principal sectors of the economy. These and other relevant national-level policy documents served as a basis for the development of Mongolia's NDC, which was shaped and finalized through comprehensive consultation exercises with broad range of stakeholders.

4.3 Environmental Financing in Mongolia

4.3.1 Current Situation of Finance for Environmental Sector in Mongolia

Within the framework of the international collaboration in environmental sector, there are number of projects and programs being implemented in Mongolia. These programs are in the areas of mitigation of and adaptation to climate change, biodiversity conservation, sustainable natural resource management and expansion of the protected area system. However, most of the projects and programs are often poorly managed and lack private sector participation.

As of the end of 2016, Ministry of Environment and Tourism has implemented around 25 projects utilizing funds of over USD 160 million from international organizations. To mention a few:

- "Biodiversity and Adaptation to Climate Change" is a development project implemented in accordance with the Financial Cooperation Agreement, signed on the 13th of November 2013, between the Government of Mongolia and the Federal Republic of Germany. The total amount of the project is 15.3 million Euro, to be implemented during 2015-2020 through the KfW Development Bank. The purpose of the Project is to strengthen the management of Protected Area Network (including the buffer zones and future ecological corridors) of Mongolia, the conservation of biodiversity and to improve the livelihood of local population.
- "Mainstreaming biodiversity conservation, sustainable forest management and carbon sink enhancement into Mongolia's productive forest landscapes" GCP/MON/008/GFF project is being implemented based on the agreement between the Government of Mongolia, Food and Agricultural Organization /FAO/ and Global Environment Facility /GEF/. The purpose of project is to support sustainable forest management in Mongolia, which secures the flow of multiple ecosystem services; including biological diversity, reduced degradation of forest land, and carbon storage, while enhancing resilience to climate change.
- The UNDP is implementing few projects such as 'Ecosystem Based Adaptation Approach to Maintaining Water Security in Critical Water Catchments in Mongolia MOH12/301'. This project will focus upon better tactics for grazing management, restoration of riparian zones, survivability of biodiversity, and efficiency of water use. Also will target two eco-regions, the Altai Mountain/Great Lakes Basin and the Eastern Steppe with aiming to maintain the water supplies of the mountain and steppe ecosystems.
- "GHG emission reduction from deforestation and forest degradation (REDD+)" is the project that is supporting the Government of Mongolia to design and implement its National REDD+ Strategy and to meet the requirements under the UNFCCC Warsaw Framework to receive REDD+ results-based payments.
- "Land Degradation Offset and Mitigation in Western Mongolia" project is focusing on reduction of negative impacts of mining on rangelands in the western mountain and steppe region by incorporating mitigation hierarchy and offset for land degradation into the landscape level planning and management.

As mentioned above, there are number of projects and programs being implemented utilizing funds extended from international organizations for the environmental protection purposes. However, a lot of problems still exist such as air, water and soil pollutions, as described below:

i) Air pollution: Ulaanbaatar city became one of the top 10 most polluted cities in the world, where the toxicity reached the critical level as announced by National Security Committee in January 2017.

ii) Soil pollution: The wastes from households in Ger district are causing major soil pollution, especially, the ammonium contamination spreading in 90% of Ulaanbaatar city's land territory.

iii) Burning of raw coal: Due to raw coal burning, the air pollution level never decreased, despite the Government's effort to distribute improved stoves at subsidized cost.

iv) Insufficient law enforcement: Although the environmental issues are specifically stated in the Mongolian laws, regulations and standards, their implementation is inadequate due to the weak coordination among Government institutions.

v) Adverse impact on health: Contamination problems are affecting human health adversely, by creating various types of diseases and allergies. If measure in terms of monetary evaluation, the assessment of the health effects is very high. Thus, projects and programs are required to consider the essential significance of the environmental issues on human health.

vi) The low economic importance: As the environment conservation projects and programs are oriented for human health and social welfare, rather than the economic significance, such projects cannot meet the credit requirements of banks.

In the future, it is necessary to tackle the environmental issues using concessional fund facilities and draw policies to promote such financing schemes. Main priorities for concessional funding include projects to reduce air pollution, to promote efficient stoves, heat-only boilers, clean coal technologies, energy efficiency in construction industry and to use small and medium size waste water treatment plants and to cultivate rare and useful plants.

4.3.2 GHG emission inventory and validation, verification

In Mongolia, GHG inventory was conducted 3 times during 1990-2006, based on short-term project approach, in order to fulfill the reporting requirement of UNFCCC.

Internal use and distribution and transmission losses account more than 30% of the total electricity produced by Combined Heat and Power Plants (CHPs) in Mongolia. Also there is much room for reducing GHG emissions by reducing losses and increasing energy efficiency.

The total GHG emissions of Mongolia are almost negligible, compared to other countries. Although the total amount of GHG emissions in Mongolia is very small, carbon intensity of energy sector is the highest among regional countries due to extensive use of raw coal for electricity and heat production.

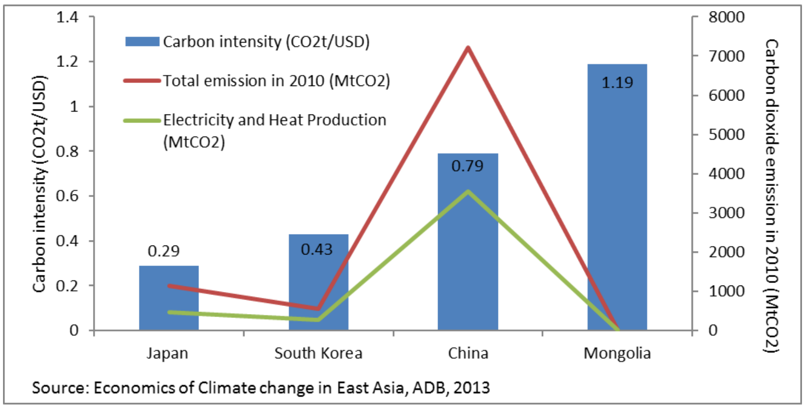


Figure 4.3.1 GHG emission

The reduction of GHG in the energy sector are mainly achieved through the increased usage of renewable energy, the increased supply of efficient energy, the introduction of clean coal technologies, and the improvement of energy efficiency in buildings and industries.

In order to further decrease the GHG emissions in Mongolia, strategic plans in the transportation sector are being implemented, including improvement of traffic conditions, usage of more fuel-efficient vehicles and implementation of shifts from individual road vehicles to rail and public transport systems. GHG reduction strategies in the agricultural sector include improvement of animal husbandry management and technology to increase the productivity of each type of animals. As for the waste sector, policies and measures to establish a foundation to minimize waste, increase recycling and expand waste management processes should be implemented. Policies to increase removals and decrease emissions are also being implemented in the forestry sector through efficient management and maintenance of forests and afforestation. Energy, agriculture, industry and transportation sectors have the highest portfolio of GHG emission in Mongolia.

The National Renewable Energy Center of Mongolia is accredited under ISO 14065 by an accreditation body (Mongolian Agency of Standardization and Metrology: MASM) based on ISO14064-2. Accredited sector scopes are energy oriented industries and eligible for validation/verification of the projects that are to reduce or remove the amount of GHG.

4.3.3 Sustainable financing program initiative of Mongolian Bank Association

Sustainable financing is an opportunity for the banking sector to take a lead in the Green Development and identify new markets. Recently, Mongolian banks have a trend to consider the social and environmental aspects as part of credit analysis in order to assist the preservation of the environment and support of the communities while being financially profitable. It can also create opportunities for the banks to take a first-mover advantage to expand into new markets such as low carbon financing. In Mongolia, 95% of investment funding comes from the banking sector. Therefore, sustainable financing could play a vital role in the efforts to turn the economy to green.

4.3.4 Xac Bank - an Accredited Entity of the Green Climate Fund (GCF)

The Green Climate Fund (GCF) is a unique global initiative to respond to climate change by investing into low-emission and climate-resilient development. GCF was established by 194 governments to limit or reduce greenhouse gas emissions in developing countries, and to help adapt vulnerable societies to the unavoidable impacts of climate change.

Xac Bank became an Accredited Entity (AE) of the GCF in October 2016, approved by the 14th board meeting of the United Nations' GCF held in South Korea. During this meeting, the GCF reached a new milestone with the approval of USD 745 million in funding for projects to help developing nations on climate change. Xac Bank, thereby, became the first private entity not only from Mongolia, but also from a developing country to receive accreditation.

Xac Bank, as an AE of the GCF, will promote the paradigm shift towards low-emission and climate-resilient development pathways, by providing support to the projects to mitigate the GHG emissions and to adapt to the impacts of climate change.

4.3.5 JICA-TSL Environmental Protection Loan

Air pollution control projects are the main target for the Environmental Protection Loans (EPL) under JICA-TSL project. Targeted projects can be categorized into three groups:

(i) HOB and its facilities: Replacement of old and manufacturing of high-efficiency HOBs and its facilities.

(ii) Coal fuel and energy: Production of clean coal briquette, semi cokes and development of renewable coal energy resources.

(iii) Others: Reduction of coal consumption, production of heat insulating construction materials, development of fuel conversion facilities and electric generation facilities such as solar panel, wind turbine etc.

Eligible companies can utilize the fund of USD 10,000 - 1,000,000, depending on the project cost, with the term of 3-10 years. EPL projects are required to fulfill both the bank's as well as TSL project's eligibility criteria, which require the projects to have possibility to express the result of the projects in numbers, meaning the reduction of air pollutants, such as CO_2, NO_x, SO_x, and coal consumption need to be measured and expressed numerically, in addition to fulfilling the criteria on credit-worthiness.

EPL loans under JICA-TSL Project can be considered as the model project that utilizes concessional funding source and private sector participation for the purpose of environment conservation.

Chapter 5 Other Donors' Assistance

5.1 Overview

This chapter reviews the trend of assistance to the areas of SME development and environmental protection by international financial institutions (IFIs) and bilateral donor organizations such as the World Bank, International Finance Corporation, European Bank for Reconstruction and Development (EBRD) and Asian Development Bank (ADB), U. S. Agency for International Development (USAID) and German Association for International Cooperation (GIZ).

5.2 World Bank (WB)

Mongolia joined the World Bank (WB) Group in 1991 soon after country's transition to democracy and market economy. There are 15 active WB-supported projects in Mongolia, with USD 358.38 million in commitments as of March 2018.

The current WB Country Partnership Strategy for Mongolia (FY2013-2017) identifies three areas which the WB Group will support over the next five years (FY13-FY17)[1]:

1) Enhance Mongolia's Capacity to Manage the Mining Economy Sustainably and Transparently.
   There are two outcomes: i) developing a regulatory environment, institutional capacity, and infrastructure for world-class mining, and ii) designing and implementing policies and systems for a more robust, equitable, and transparent management of public revenues and expenditures.
2) Build a Sustained and Diversified Basis for Economic Growth and Employment in Urban and Rural Areas.
   There are two outcomes: i) enhanced investment climate and financial intermediation, and ii) creation of more opportunities in the rural economy for enhanced livelihoods.
3) Address Vulnerabilities through Improved Access to Services and Better Service Delivery, Safety Net Provision, and Improved Disaster Risk Management.
   There are three outcomes: i) design, adaptation, and implementation of a comprehensive social protection system that supports the poor, ii) better delivery of basic services (education, health, justice, and infrastructure), and iii) reduced vulnerability of households exposed to natural hazards and pollution.

WB implemented "Private Sector Development Credit (PSDC)" in two phases. The phase I project (PSDC-I) (1999 - 2004) aimed to i) promote private sector development by increasing the availability of commercial bank term loans to private enterprises, ii) increase the institutional capacity of participating banks by strengthening their financial intermediation functions and resource allocation capabilities, and iii) increase the institutional capacity of the Bank of Mongolia (BOM) through improving its bank supervision functions. The phase II project, PSDC-II was implemented during the period of 2006 - 2011. The PSDC-II aimed to i) increase longer-term funding for viable capital investment projects; ii) strengthen institutional capacity in identified high priority areas of participating banks; and iii) improve enforcement of prudential regulation and supervision by the BOM. TDB, Golomt (withdrawn later on), Zoos Bank (transferred to State Bank) and Khan Bank were the beneficiaries.

The project performance was rated as "satisfactory" in WB's completion report[2][3]. It is difficult to measure the exact development effect of this project in overall. However, all the participants in the project evaluate

[1] WB, Performance and learning review of the country partnership strategy for Mongolia (Report No. 106796-MN), December 2016.
[2] The PSDC-I implementation completion report (IDA-32260) was releases on February 23, 2005.
[3] The PSDC-II implementation completion report (IDA40880) was releases on October 25, 2011.

that the project had some positive effect on the participated commercial banks, SMEs and the overall Mongolian economy.

WB provides supports on export development for SMEs in the non-mining sector with the purposes of strengthening their export capabilities and expanding access to export markets[4]. This project has three components as follows:

1) Finance, technology and institutional development through transfer of know-how and technology regarding the Agricultural Reinsurance Joint Stock Company (AgRe) and equity injection into AgRe's export insurance subsidiary.
2) Export competitiveness enhancement through export-related training and matching grants to promote export competitiveness.
3) Project implementation support will provide its services for all three components of the project.

This project is considered to complement JICA TSL project in terms of export development, financial support and technology transfer, and benefit TSL sub-borrowers.

5.3 International Finance Corporation

Since the International Finance Corporation (IFC) opened its office in Ulaanbaatar in 1997, it has financed more than USD 470 million. According to IFC, IFC's mandate in Mongolia can be summarized as the following:

<u>Broadening Access to Finance</u>

- Investment in Mongolian financial institutions, particularly banks, and capacity development to expand their services and access to finance for SMEs
- Promotion of international-level corporate governance and environmental and social standards in collaboration with regulators, Mongolian Banking Association, and financial institutions
- Support to financial infrastructure such as the establishment of an online registry of movable asset security and expansion of micro finance

<u>Developing Essential Infrastructure and Sustainable Mining Sector</u>

- Investment in essential infrastructure such as renewable power, telecommunication and housing
- Support to world-class sustainable mining projects that aim to global financing, international technology, and best environmental practices
- Awareness raising of stakeholders of the mining sector and standardization of water management in the South Gobi Desert

<u>Supporting Economic Diversification and Small Businesses</u>

- Investment in agribusiness and supports long-term reform for food-safety standards, competitiveness and market linkages
- Investment in hotel business for tourism sector development
- Support to key reforms such simplification of permits and licenses to improve business environment for SMEs

<u>Support to High Value Addition</u>

- SME banking, sustainable financing, and financial infrastructure
- Environmental and social risk management

[4] As defined in the Mongolia SME Law

- Corporate governance
- Enhancement of business and investment environment

IFC provided syndicated loans to Khan Bank and Xac Bank[5]. The syndicated loan to Xac Bank was signed on May 4, 2016 (A loan of up to USD 15 million and B loans or parallel loans of up to USD90 million). The syndicated loan to Khan Bank was signed in July 20, 2016 (A loan of up to USD 20 million and B loans to USD80 million).

The expected development impact includes the following: i) improvement of access to finance through provision of funds to the banks to extend loans to SMEs on the basis of their SME loan policies, ii) improvement of liquidity position and expansion of loan structure of the banks through provision of medium to long-term funds, and iii) improvement of access to global capital market by introducing the leading Mongolian banks to global capital market and familiarizing other Mongolian banks with global capital market. To date there has been no overlap between the TSL and EBRD financed projects in Mongolia.

5.4 European Bank for Reconstruction and Development

Mongolia became a country of operations of the European Bank for Reconstruction and Development (EBRD) in 2006. EBRD supports Mongolia in its transition to a full market economy and is currently the largest foreign investor (EUR 1.3 billion) in the country. EBRD's projects have been directed to the private sector, mostly local entrepreneurs and banks. In Mongolia, EBRD prioritizes infrastructure projects with private sector participation, including public-private partnerships (PPPs). The main priorities of EBRD in Mongolia are:

- Diversification: Expansion of the non-extractive private sector.
- Sustainable growth: Development of the financial sector through loan, equity and technical assistance to SMEs
- Responsible mining sector: debt and equity finance to reputable mining companies and institutional building
- Infrastructure and private sector development: infrastructure development including renewable energy with private sector involvement where possible

EBRD signed a financing package for Khan Bank in 2013 and Xac Bank in 2014 to strengthen their capacity on SME loans. EBRD has provided a USD 25 million senior loan to Khan Bank for on-lending to small businesses in 2013 and USD 60 million in 2015. The Facility comprises of i) a senior loan for on-lending to SMEs up to USD 30 million, and ii) an energy efficiency loan of up to USD 10 million under Mongolian Sustainable Energy Financing Facility (MonSEFF), iii) a Full Recourse Direct Risk Sharing Facility (RSF) of up to USD 10 million for the provision of long-term financing to local SMEs, and iv) trade finance up to USD 10 million. Under this project, Khan Bank is expected to expand its core business and improve its funding structure. EBRD has made equity participation in Xac Bank. EBRD has provided a sustainable energy loan in the amount of up to USD10 million under the MonSEFF in 2014. EBRD has also provided an SME loan in the amount of up to USD 5 million equivalent in MNT under Mongolian Financial Sector Framework II (MFSF II) in 2014.To date there has been no overlap between the TSL and EBRD financed projects in Mongolia.

[5] IFC's syndicated loan to Khan Bank : https://disclosures.ifc.org/#/projectDetail/SII/38121, Khan Bank's Annual Report 2016. IFC's syndicated loan to Xac Bank: https://disclosures.ifc.org/#/projectDetail/SII/37610, Xac Bank's Annual Report 2016 and 2017 (FMO, Finnfund, IIB, and Swedfund cofinanced.)

5.5 Asian Development Bank (ADB)[6]

ADB program in Mongolia has provided loans, grants and technical assistance to economic development and livelihood improvement, particularly livelihood of the poor, women, children and other vulnerable groups. ADB has been Mongolia's largest multilateral development partner since 1991, with USD 1.92 billion of assistance approved up to April 2016[7]

Major assistance by ADB is as follows:

- Project for Supporting the Credit Guarantee System for Economic Diversification and Employment.

  This USD 60 million project was signed in January 2016 aiming the development of SMEs in non-mining sectors. The expected development impact includes i) longer-term financing for SMEs, ii) development of longer-term deposit market and iii) enhancement of the Credit Guarantee Fund (CGM) of Mongolia.

- Senior loan to Khan Bank for supporting SMEs

  This USD 40 million project was signed in 2014 with the purpose of developing SMEs that contribute to environmentally sustainable growth, inclusive economic growth, and regional integration.

- Unsecured senior loans to Xac Bank for up to USD 30 million and to TenGer Financial Group (TFG) for on-lending to Xac Leasing for up to USD10 million

  This project was signed in 2013 and aimed to support SMEs through sub-loans by Xac Bank and leasing by Xac Leasing.

- Agriculture and Rural Development Project in Mongolia

  This project aimed to higher value-addition of agricultural resource through i) value chain investments by agro-enterprises and cooperatives, ii) capacity development of agricultural producers, iii) enhancement of improvement of marketing and technical capacity of agro-enterprises and cooperatives, and iv) development of Mongolian product brand(s). Assistance of approximately USD17 million was approved in 2008 and assistance of approximately USD52 million in 2015.

ADB's Project for Supporting the Credit Guarantee System for Economic Diversification and Employment is complimentary to TSL project in terms of its support for provision of loans to SMEs whereas ADB's Agriculture and Rural Development Project operates under the similar two-step-loan mechanism of TSL. It is considered that there is a good potential synergy between the above mentioned ADB projects and the TSL project.

In March 2017, the Government of Mongolia has requested financial assistance from the ADB in the form of a Policy-Based Loan (PBL) in line with the government's Economic Recovery Program (ERP) with the purpose of stabilizing and restructuring the banking industry, enhancing competition among banks and strengthening financial stability. In May 2017, ADB approved a loan of USD100 million for the Banking Sector Rehabilitation and Financial Stability Strengthening Program, USD40 million of which is used for the banking sector rehabilitation and support to non-performing loans (NPLs) held by commercial banks [8].

The expected outcomes of the program are as follows:

- *Output 1: Framework for bank restructuring completed*

[6] https://www.adb.org/sites/default/files/project-document/176337/48015-002-pam.pdf, https://www.adb.org/projects/47934-001/main, https://www.adb.org/projects/39229-033/main

[7] ADB has approved sovereign loans totaling $1.55 billion, non-sovereign loans totaling $96.1 million, grants totaling $229.4 million, and technical assistance projects worth $137.7 million for Mongolia.

[8] This USD100 million loan has 3-year grace and 15-year maturity and is priced at LIBOR 0.6%.

The program targets the development of a transparent road map for a banking industry rehabilitation program, and early establishment of an asset management company (AMC). The current high level of NPLs can not be resolved only by the effort of private sector. Therefore, an urgent task is to establish a nation-level AMC to effectively manage NPLs. In this context, a government will develop establish the legislation of AMC management that is i) transparent and effective, ii) legally protected for execution of duties, and iii) with mechanism of clear transfer of distressed assets.

- *Output 2: Financial stability enhanced*

  The government will amend the law governing Financial Stability Council (FSC) operations to clarify its mandate, authority, and tools and expand the FSC’s membership to include the Deposit Insurance Corporation of Mongolia (DICOM). The BOM will enhance supervisory function through necessary legislation to bring banking practices into compliance with international standards. Finally, the government will expand the DICOM’s capacity to deal with possible bank insolvencies by providing financing for the potential payout of deposit claims.

- *Output 3: Competition and governance strengthened*

  The banking sector needs the promotion of competition and enhancement of governance for the sector’s development and attraction of foreign capital. The government aims to enhance borrowing capability of individuals and companies as well as the sector’s capacity and governance for financial market development. The program also includes the improvement of legislation on foreign investment, permits, etc. and the privatization of state-owned bank.

- *Technical assistance*

  ADB provides technical assistance (T/A) of USD1.6 million over 24 months to support the above-mentioned activities. MOF is the executing agency and BOM is the implementing agency of T/A. The T/A has been implemented since July 2017.

This program aims to improve the soundness of the banking sector and is complimentary to TSL project objectives.

5.6 USAID[9]

USAID started assistance to Mongolia in 1991. Assistance prior to 1998 focused on emergency relief, including emergency cash and commodity transfer. During the period of 1998-2004, the assistance first shifted towards policy development, long term sustainable, private sector-led economic growth in transition and later on focused on private sector-led enabling environment, including better enforcement of the existing legal framework, building institutional building.

USAID support the formulation of new laws including the overhaul of tax laws. Most importantly USAID played a catalyst role in establishing the institutions required to support an open-market economy in Mongolia. USAID teamed up with Mongolian private-sector counterparts to establish several organizations: i) Mongolian Mortgage Corporation; ii) Corporate Governance Development Center; iii) Banking and Finance Academy. These organizations were established by the private sector and pursue sustainable development that enables profit for dividend payment. In these cases, USAID played roles of consensus making among related parties, formation of a working group, improvement of feasibility through business model, business plan, governance and bylaws, examination of legal aspect and capital structure of new organization, and assistance to human resource allocation to new organization.

Currently, USAID has scaled back its presence in Mongolia and its current operations in Mongolia are managed by USAID’s regional office in Manila. Two projects are currently active in Mongolia: so-called REACH project and LEAD project. USAID’s REACH project aims at supporting Mongolian SMEs in accessing finance. LEAD project aims at advancing democracy by educating young leaders of Mongolia.

[9] http://pdf.usaid.gov/pdf_docs/pdacw516.pdf

There are also smaller centrally funded projects in the areas of disaster preparedness, and the empowerment of people with disabilities.

The REACH project is a 2-year project (May 2016-April 2018) aims to improve and scale up access to credit of local SMEs by providing specific technical assistance including preparing a business plan, setting up accounting systems, and supporting loan application for a bank. REACH collaborates with financial institutions in Mongolia, including BOM and CGF. There is no partnership between JICA's TSL Project and USAID's REACH Project. A potential synergy could arise where REACH's assistance to SMEs in loan application process may be directed to assist SMEs and PFIs in developing bankable projects and documentation for TSL eligible projects.

5.7 Gesellschaft für Internationale Zusammenarbeit

Gesellschaft für Internationale Zusammenarbeit (GIZ) started is assistance to Mongolia in 1991 and opened its own office in Ulanbataar in 1998. GIZ' current program focuses on i) support for sustainable mineral resource management, ii) biodiversity and iii) energy efficiency for poverty reduction and environmental economic development in Mongolia.

In the area of SME development, GIZ implemented the Regional Economic Development Program (REDP) introducing a PPP model and implements the Integrated Mineral Resources Initiative (IMRI) Program, which has a component on SME development in select provinces.

REDP (2002 - 2013) worked on economic diversification and SME support in select provinces of Mongolia and the improvement of access to SME financial services in the project regions and consequently across Mongolia. REDP in collaboration with Mongolian Bankers Association (MBA) worked towards establishing a credit guarantee fund based on PPP model. MBA and group of commercial banks established CGF of Mongolia in 2010.The project supported the drafting of the Law on CGF and the Parliament of Mongolia adopted the Law on CGF in 2012. REDP transferred the seed capitalization of MNT 700 million to participating commercial banks.

IMRI Program component includes SME capacity building component in select pilot provinces (aimags). The main components of IMRI are i) sustainable local development at the mining regions, ii) macroeconomic management of commodity-driven economy, and iii) promotion of German Mongolian cooperation in the mining sector. Phase I of IMRI (2011 - 2014) mainly concentrated on organizing the dialogue platform, identifying key stakeholders, and corresponding design for effective support. Phase II (2014 - 2017) provided trainings and consultancy services in the topics of marketing, management and other areas to capacity development of SMEs in the selected aimags. GIZ currently implements Phase III of IMRI. No overlaps have been identified between IMRI's SME development sub-component and JICA TSL project.

5.8 International Monetary Fund

The Executive Board of the International Monetary Fund (IMF) on May 24, 2017 approved a three-year extended arrangement under Extended Fund Facility (EFF) for Mongolia in a total amount of USD434.3 million to support the country's economic reform program. Other financing partners, including the Asian Development Bank, the World Bank, Japan, and Korea, have also committed to provide budgetary and project support, and the People's Bank of China has agreed to extend its swap line with the Bank of Mongolia. In sum, the total financing package amounts to about $5.5 billion.

The Mongolian authorities announced a wide-rage reform program that includes fiscal adjustment and rehabilitation of the banking sector for the economic development led by the private sector. Major reforms in the financial sector are as follows.

- *Financial sector reforms will aim at creating a sound and stable financial system*

  This category of reform includes a comprehensive diagnosis of banks' balance sheets, recapitalization, restructuring and resolution of banks, realization of bank regulations based on international best practice, enhancement of bank supervision and monitoring and support to bank liquidity, a framework for resolving problem loans.

- *Every bank will be subject to an independent Asset Quality Review (AQR)*

  On the basis of results of Asset Quality Review (AQR) to be completed by the end of November 2018, banks will be required to present business and recapitalization plans, covering any shortfalls identified by the AQR, as well as their expected capitalization and profit and loss until 2019. In case of a capital shortfall revealed by either the AQR or the business-plan analyses, banks will raise capital from existing and/or new shareholders and must complete recapitalization by June 2018. Current estimates suggest that bank capital needs could amount to 7% of GDP.

- *Full recapitalization of banks by their shareholders without recourse to public funds*

  According to the consultation of IMF, the recapitalization effort will rely, in the first instance, on efforts to raise private capital. When this is not sufficient, use of public funds may be considered. The debt sustainability analysis (DSA) assumes a contingency of up to 3.5% of GDP.

- *Upgrading of the regulatory and supervisory framework*

  The authorities will introduce amendments to the Banking Law and Bank of Mongolia Law and related secondary legislation to i) improve asset classification and provisioning and collateral valuation, ii) strengthen fit and proper requirements for shareholders and management and upgrade rules on related party exposures and final beneficial owners, iii) improve the early-intervention framework, iv) strengthen bank resolution, v) upgrade liquidity requirements, and vi) enhance the BOM's powers to request additional capital and provisioning and to apply levies on banks to cover the cost of supervision. The authorities will also bring the Deposit Insurance Company (DICOM) law in line with international best practice. The new DBM law ensures that DBM shall be supervised by the BOM.

- *Effective debt resolution*

  An NPL resolution strategy will be formulated by analyzing banks' business environment and legal impediments related to insolvency, taxation, NPL sales. The authorities intend to request technical assistance in this regard. The BOM will also request banks to have adequate NPL resolution policies, strategies and resources, and to improve their reporting on NPLs. The authorities will further evaluate the potential role of a public-sector-led asset management company to handle NPLs that individual banks prove unable to manage.

- *Regular monitoring of the non-banking financial sector*

  The authorities will improve the supervision and monitoring of non-banking financial institutions by the Financial Regulatory Commission (FRC). The non-banking financial sector accounts for less than 5% of Mongolia's total financial assets. However, FRC's supervision and monitoring should be enhanced.

- *Strengthening of AML/CFT regime*

  Legal framework should be prepared to approach to anti-money laundering (AML) - combating the financing of terrorism (CFT). They are committed to further strengthening the resources and expertise of competent AML/CFT and anti-corruption authorities in the country.

In conclusion, the IMF-initiated financial sector reform is considered to bring good positive results to the Mongolian banking sector. In the medium-to-long term, TSL borrowers will benefit from the enhancement of banking sector in Mongolia.

Part 2:

Review of TSL Phase I and II

Chapter 6 Outline of the Project

6.1 TSL Project Phase I

The Loan Agreement (L/A) concerning the TSL Project for SME Development and Environmental Protection (TSL Phase I) between the Japan Bank for International Cooperation (JBIC: presently, Japan International Cooperation Agency: JICA), and the Government of Mongolia (GOM) was signed on 28 March 2006, and became effective on 25 July 2006.

Relevance, Objectives and Scope of the Project

In the Economic Growth Support and Poverty Reduction Strategy (EGSPRS) formulated in July 2003, GOM placed a high priority on the development of a favorable institutional environment, and human resources to promptly shift to a market economy, and realize economic growth driven by the private sector. Following EGSPRS, GOM formulated a program for support of small and medium enterprises (SMEs) in April 2005, which mainly highlighted the improvement of SMEs' access to finance, including long-term capital, improvement of legal environment, permit, and license system, support for market information provision, and human resources development. The biggest constraints to private sector development and environmental protection in Mongolia were deemed to be lack of term financing available to private enterprises, SMEs in particular, and the fund-offering capacity of financial institutions.

At the same time, GOM regarded environmental protection as one of the most important issues in the EGSPRS and identified issues which needed to be addressed such as air and water pollution, waste disposal in Ulaanbaatar City, deforestation and desertification, and protection of biodiversity.

With the provision of market-based long-term financing and technical assistance to commercial banks and SMEs, mainly in the agriculture and industrial sectors, and to projects for environmental protection, the private sector in Mongolia would gain access to term financing for investment, that play a significant role in employment creation and economic growth on a sustainable basis, which is the relevance of TSL Phase I.

Therefore, TSL Phase I aims to promote sustainable growth and poverty reduction in Mongolia through the provision of long-term financing to SMEs and technical assistance (TA) to the participating financial institutions (PFIs) and SMEs for private sector development and environmental protection. The scope of TSL Phase I comprises of the following components:

- SMEs development loan
- Environmental protection loan (EPL)
- Consulting services.

6.1.1 Borrower and Executing Units

The borrower is the Ministry of Finance (MOF), and the executing unit is the counterpart steering committee (CSC), composed of representatives of MOF, the former Ministry of Industry and Trade (MOIT), the former Ministry of Food and Agriculture (MOFA), the former Ministry of Nature and Environment (MONE) and Bank of Mongolia (BOM).

The seven PFIs are Capitron Bank, Golomt Bank, Khan Bank, TDB, Xac Bank, Zoos Bank, and Anod Bank (added after the Project commencement).

6.1.2 Scope, Terms and Conditions

Term loans have been provided to SMEs (sub-borrowers) through selected PFIs under the conditions listed in Table 6.1-1. PFIs receive the necessary funds from MOF in accordance with the on-lending loan agreement made between MOF and PFIs. Except for a difference in their focus, both sub-loans for SMEs development and environmental protection share the same terms and conditions.

Table 6.1.1 Terms and Conditions for TSL in Phase I

1) Eligible sectors	:	All sectors other than trade, entertainment business, real estate, military activities, mining extraction, as well as alcohol and tobacco/cigarette manufacturing (mainly agricultural and industrial sectors).
2) Eligible sub-loan borrowers	:	Private SMEs with the following qualifications - majority owned by Mongolian private investors - to which the preferential corporate tax rate at 10% is applied- with employees 50 or less
Preconditions to application	:	Loan-to-value ratio is 80% or less
	:	Debt-service coverage ratio is 1.3 or greater
	:	Financial internal rate of return of the project is 13% or greater no. previous default record
3) Region	:	Nationwide
4) Type of financing	:	Fixed asset financing
5) Currency	:	Either USD or MNT
6) Interest rate (on-lending)	:	Market-based (average demand deposit rate for Tugrik lending six months USD LIBOR, plus 1% for USD lending)
7) Interest rate (sub-loan)	:	Market-based and fixed over the sub-loan period, depending on discretion of each PFI[1]
8) Size of sub-loan	:	Within the range between USD 10,000 - USD 600,000 per subproject, or its MNT equivalent.
9) Repayment period	:	From three up to ten years (including up to three years of grace period)

Source: TSL Office

6.1.3 Consulting Services

Both international and national consultants with experience in the banking business, SME financiers, and development project managers were hired to conduct the tasks as listed in the Table below.

Table 6.1.2 Consulting Services in TSL Phase I

1) Project supervision	:	Preparation of a manual for PFIs on the usage of TSL
	:	Review of sub-loan application in line with the eligibility criteria as well as JBIC/JICA guideline for environmental and social impact consideration, and recommendation of the review results to CSC for its approval
	:	Support to CSC for JBIC/JICA concurrence of sub-loans as necessary
	:	Support to CSC for instruction to BOM of sub-loan disbursements to PFIs
	:	Support to CSC for production of necessary reports and external audit report
	:	Support to CSC for request of disbursements from JBIC/JICA
	:	Preparation and implementation of PR plan (including brochure to SMEs)
	:	Monitoring of TSL progress
2) Technical assistance	:	Training and advice to CSC on yen loan procedure
	:	Training and advice to PFIs on the usage of TSL and term loan operation
	:	Training of SMEs on the usage of TSL such as application and project formulation (in close coordination with JICA technical assistance)
3) Study	:	On development of domestic term-finance market strategy
	:	On development of private sector development and SME promotion strategy
4) External audit	:	Support for TSL auditing by outsourcing an internationally reputable auditor

Source: TSL Office

[1] In practice, MOF and PFIs agreed to set maximum interest margin for PFIs, and to revise the interest rates for on-lending semi-annually. As a result, the interest rates applied to sub-loan are revised semi-annually (not fixed over the sub-loan period.

6.1.4 Project Cost

The total cost of TSL Phase I was estimated at JPY 3,141 million (approximately USD 27.4 million as per then-exchange rate), out of which JPY 2,981 million was financed by a yen loan from the Government of Japan (GOJ) through JBIC (presently JICA). GOM was assumed to provide the rest of JPY 160 million equivalent for administration and other costs. The allocation of funds is indicated in Table 6.1-3 below. As of the completion of TSL Phase I, no change in cost allocation had been made, except for the consulting services (an increase of person/month to adequately meet TSL supervision needs as financed by MOF), and for the local currency portion.

Table 6.1.3 Allocation of Funds

Item (in JPY million)	Original						Actual (as of completion)					
	F.C. Portion		L.C. Portion		F.C.+L.C.		F.C. Portion		L.C. Portion		F.C.+L.C.	
	Total	JICA	Total	JICA	Total	JICA	Total	JICA	Total	JICA	Total	JICA
SME Loan	2,297	2,297	-	-	2,297	2,297	2,297	2,297	-	-	2,297	2,297
Environmental Loan	573	573	-	-	573	573	576	576	-	-	576	576
Consulting Services	50	50	-	-	50	50	130[2]	108	-	-	130	108
Contingency	61	61	-	-	61	61	0	0	-	-	0	0
Management Cost	-	-	160	-	169		-	-	0	0	-	-
Total	2,981	2,981	160	-	3,141	2,981	3,003	2,981	0	0	3,003	2,981

Source: TSL Office

6.1.5 Implementation

The implementation schedule of TSL Phase I was originally planned as shown in the Table below.

Table 6.1.4 Implementation Schedule of TSL Phase I

Item	Original	Actual
L/A	March 2006	March 2006
Selection of consultants	April 2006 - October 2006	August 2006 - October 2006
Initial disbursement	October 2006	May 2007 (SME loan) July 2007 (Environment)
Sub-loan utilization	October 2006 - December 2009	May 2007 - February 2010
Project completion[3]	December 2009	December 2009

Source: TSL Office

Sub-loans have been utilized on schedule in time for the assumed completion date, although the initial disbursement was deferred due to the delay in the conclusion of the on-lending loan agreements and the lengthy appraisal process of the first sub-loan application. The disbursement for the final SME development TSL was made in April 2009, and for the final environmental protection TSL in February 2010. The borrower declared the Project completed in December 2009 and submitted the project completion report in August 2010, while the consulting services were extended toward the end of 2010[4] in order to ensure the continuous revolving operation before the start of TSL Phase II.

In parallel with the declaration of the project completion, GOM requested for another official development assistance (ODA) yen loan for TSL Phase II. Promptly responding to GOM's request, JICA dispatched a fact finding (F/F) mission in May 2010. Following the F/F mission, JICA dispatched an appraisal mission in September 2010, which reached an agreement on the main points of TSL Phase II.

[2] The shortage of JPY 22 million was born by MOF.
[3] Project completion herein is defined as the disbursement for the final TSL.
[4] Consulting services had been extended up to January 2011.

6.2 TSL Project Phase II

The L/A concerning TSL Phase II for SME Development and Environmental Protection (TSL Phase II) between JICA and GOM was signed on 19 November 2010, and became effective on 18 March 2011.

6.2.1 Objectives and Scope of the Project

TSL Phase II has the same objectives, and is comprised of the same scope as TSL Phase I.

6.2.2 Borrower and Executing Units

The borrower is MOF, the same as TSL Phase I, and the executing unit includes CSC, composed of representatives of MOF, the Ministry of Food, Agriculture and Light Industry (MOFALI), the Ministry of Nature, Environment and Tourism (MONET), BOM, Mongolian National Chamber of Commerce and Industry (MNCCI).

The six PFIs include Golomt Bank, Khan Bank, TDB, XAC Bank, Capital Bank and Ulaanbaatar City Bank (UBC) (Capital and UBC added after the Project commencement).

6.2.3 Scope, and Terms and Conditions

The conditions for term loans to be provided to SMEs (sub-borrowers) through selected PFIs were in principle the same as TSL Phase I. In view of the SME law enacted in July 2007, the eligibility for sub-loan borrowers had been revised as shown in Table 6.2-1.

Table 6.2.1 Scope, and Terms and Conditions in TSL Phase II

Eligible sub-loan borrowers	Private SMEs with the following qualifications: - majority is privately owned by Mongolian investors; - to which the preferential corporate tax rate at 10% is applied; - with employees less than 200 for industrial enterprises, and less than 50 for service enterprises; - with an annual sales income less than MNT 1.5 billion for industrial enterprises, and less than MNT 1.0 billion for service enterprises; - with no previous default record.

Source: TSL Office

6.2.4 Consulting Services

Similar to the TSL Phase I, both international and national consultants with experience in the banking business, SME finance, and development project management were hired to conduct the tasks.

6.2.5 Project Cost

The total cost of TSL Phase II is estimated to be JPY 5,484 million (USD 65.9 million, approximately, as per then exchange rate), out of which JPY 5,000 million is to be financed by yen loan from GOJ through JICA. GOM provides the rest of JPY 484 million equivalent for administration and other costs. The allocation of funds is indicated in Table 6.2-2 below. As of 30 September 2016, the following changes were made in cost allocation with the Amendment-1 of 15 April 2015 (please refer to Table 6.2-2 below) and Amendment-2 of 28 March 2016 (please refer to Table 6.2-3 below).

Table 6.2.2 Allocation of Funds

Item (in JPY million)	Original						Actual (as of 30 September, 2016)					
	F.C. Portion		L.C. Portion		F.C.+L.C.		F.C. Portion		L.C. Portion		F.C.+L.C.	
	Total	JICA	Total	JICA	Total	JICA	Total	JICA	Total	JICA	Total	JICA
SME Loan	3,860	3,860	-	-	3,860	3,860	3,860	3,860	-	-	3,860	3,860
Environmental Loan	860	860	-	-	860	860	780	780	-	-	780	780
Consulting Services	250	250	-	-	250	250	330	330	-	-	330	330
Interest during construction	92	0	-	-	92	0	92	0	-	-	92	0
Commitment Charge	30	30			30	30	30	30			30	30
Management Cost	0	0	392	-	392	0	0	0	392	-	392	0
Total	5,092	5,000	392	-	5,484[5]	5,000	5,092	5,000	392	-	5,484	5,000

Source: TSL Office

Table 6.2.3 Allocation of Funds

Item (in JPY million)	Original						Actual (as of 30 September, 2016)					
	F.C. Portion		L.C. Portion		F.C.+L.C.		F.C. Portion		L.C. Portion		F.C.+L.C.	
	Total	JICA	Total	JICA	Total	JICA	Total	JICA	Total	JICA	Total	JICA
SME Loan	3,860	3,860	-	-	3,860	3,860	3,860	3,860	-	-	3,860	3,860
Environmental Loan	860	860	-	-	860	860	780	780	-	-	780	780
Consulting Services	250	250	-	-	250	250	352	352	-	-	352	352
Interest during construction	92	0	-	-	92	0	92	0	-	-	92	0
Commitment Charge	30	30			30	30	8	8			8	8
Management Cost	0	0	392	-	392	0	0	0	392	-	392	0
Total	5,092	5,000	392	-	5,484[6]	5,000	5,092	5,000	392	-	5,484	5,000

Source: TSL Office

6.2.6 Implementation

The implementation schedule of TSL Phase II was originally planned as shown in the Table below.

Table 6.2.4 Implementation Schedule of TSL Phase II

Item	Original	Actual
L/A	November 2010	November 2010
Selection of consultants	December 2010 - April 2011	January 2011 - June 2011
Initial disbursement	May 2011	August 2011 (SME loan) December 2011 (environment)
Sub-loan utilization	May 2011 - June 2014	• August 2011 - September 2013 for SME loan • December 2011- December 2016 for EP loan
Project completion	June 2014	December 2016

Source: TSL Office

[5] The shortage of JPY 484 million is borne by MOF.
[6] The shortage of JPY 484 million is borne by MOF.

Chapter 7 Review of Sub-loans

7.1 Operational Manual for Participating Financial Institutions

7.1.1 Manual for Participating Financial Institutions

The operational manual was originally drafted in December 2006 just after the project office (PO) was set up in November. The manual was delivered to the participating financial institutions (PFIs) in January 2007, which consisted of more than ten separate parts primarily because of a number of attachments in addition to the sub-loan application formats.

In the initial stage, PFIs prepared the loan applications in close consultations with the TSL project office consultants mainly on a face-to-face basis. The loan officers discussed the actual cases, which seemed quite effective for capacity building of PFI staff. Because the guidance of consultants to prepare applications was made on an on-the-job basis, the operational manual, especially its main parts, was quite practical to refer to. While preparing applications, the application formats were revised at the initial stage of implementation of TSL Phase I. The manual was put in one volume and delivered to PFIs.

When TSL Phase II started, the operational manual was thoroughly revised in August 2011. The manual consists of the three following parts: i) the scheme of the TSL Project, ii) the appraisal of the subproject, and iii) the procedures. Plus, a number of attachments were revised or newly prepared such as sub-loan application forms with their annexes, request for disbursement, and periodical review reports.

When the revised manual and formats were explained to PFIs at the earliest stage, they requested to change the annexes, which contained tables of various data for the feasibility study of the project, from Word file to Excel file. In November 2011, the conversion was completed and the new annexes formatted in the Excel file were distributed to PFIs. Since then, the operational manual had been fully utilized by the PFI staff in charge.

7.1.2 Application Formats

It should be noted that three types of application formats are prepared: namely: i) sub-loan application with full information, which is reviewed by PO, ii) sub-loan application to be submitted to the counterpart steering committee (CSC), in which sensitive information on the borrower is excluded, and iii) sub-loan summary report, which is submitted to the Japan International Cooperation Agency (JICA) together with the request for replenishment of the JICA loan fund. The present format is considered appropriate, and it is strongly suggested that the documents be used for PFI's credit committee decisions as well. It is quite regrettable; however, that instead, many PFIs insist that their internal appraisal documents should be allowed as other similar government or donor programs, or that application formats should be further simplified by deleting the details of the project feasibility study. Their request may not be acceptable as PFI's credit committee decisions are still dependent on the borrower's credit worthiness, the current business status, and the collateral to be secured.

7.2 Formulation of Subprojects and Application for Sub-loans

7.2.1 Stakeholders Concerned with the TSL Project

Five stakeholders of the JICA-TSL Project include sub-borrower SMEs, PFIs, PO, CSC, and JICA. The function of each stakeholder is summarized in the table below.

Table 7.2.1 Function of Stakeholders

Stakeholder	Roles and Assignments of each Counterpart
Sub-borrower SMEs	1) Identification of subprojects/business plans 2) Formulation/preparation of subprojects/business plans 3) Sub-loan applications to PFI 4) Project implementation 5) Payments of interests and principals on sub-loans
PFI	1) Identification of eligible sub-loan applications for TSL Project loan 2) Feasibility study and credit analysis on the sub-projects 3) Approval of the sub-loan applications by the bank's credit committee 4) Preparation of sub-loan applications for JICA-TSL 5) Translation of sub-loan application summary from Mongolian into English for JICA 6) Revision of sub-loan applications in accordance with the comments made by the JICA-TSL Office 7) Loan administration and project progress review of disbursed sub-loans 8) Repayment of interests and principals for on-lending loans
TSL Project Office (consultants)	**A. <u>Project Supervision:</u>** 1. Maintaining administrational and operational frameworks for the implementation of TSL Project scheme among the concerned stakeholders; 2. Maintaining necessary contacts with major stakeholders on the TSL Project implementation; 3. Assistance to MOF in speeding up the project implementation process; 4. Preparation of the manual for PFIs on the usage and purpose of the Project and of the TSL brochure for SMEs; 5. Promotion of the TSL project activities among the concerned PFIs through making necessary contacts or organizing individual meetings with the top/senior management; 6. Provision of advice and guidance on the Project purpose, procedures, requirements and eligibility criteria to PFIs; 7. Review (including contracts, meetings and site-visits with the concerned PFIs and applicant SMEs) of the sub-loan applications submitted from PFIs in line with the Project purpose and relevant eligibility criteria; 8. Review of the sub-loan applications for the feasibility study and project analysis and making necessary comments for revision to PFIs; 9. Preparation of assessment forms, which include the application review recommendations, on the sub-loan project applications to be submitted for the CSC approval. 10. Submission of necessary documents (assessment forms, application forms, business plans, etc) on sub-loan applications for CSC discussion and approval/disapproval; 11. Support to CSC with the necessary arrangements in making the policy discussions fruitful and effective; 12. Support to CSC with follow up actions for making remittance instructions and financing of the approved applications. 13. Assistance to CSC with monitoring of the Operation and Effect Monitor specified in the Project Memorandum and preparation of the Quarterly Progress Report for the reporting purpose to JICA. 14. Maintaining the collection of the funds in the revolving fund accounts for Phase I and II by making necessary administrational and monitoring arrangements with the concerned PFIs. 15. Monitoring the progress of each sub-loan project together with assistance to MOF in reviewing and monitoring the eligibility of the PFIs based on the selection criteria. 16. Monitoring the financial condition of the PFIs by the selection criteria, and reporting it to JICA. 17. Providing support with communication and coordination to the JICA experts on the Mongolia-Japan Center for Human Resources Development Project (Post Phase II). 18. Providing support with communication and coordination to the JICA experts on Capacity Development Project for Air Pollution Control in UB City by maintaining close contacts;

	19. Preparation of the financial statements and other reports on the Project for MOF and having auditing done on the financial statements by outsourcing an internationally reputed audit firm. **B. <u>Technical assistance:</u>** 1. Providing active update, advice and guidance on the purpose, usage and procedure of the Project to the members of CSC through constant contacts and interactions. 2. Providing active advice and guidance on the purpose, usage and procedure of the Project to the concerned PFIs with a specific focus on the procedural and administrational issues. 3. Through routine daily office interactions, providing advice and consultancy to the potential applicant SMEs on the purpose, usage and procedure of the Project with a specific focus on how to prepare the project or business plan. 4. Organization of the public promotional activities on the TSL Project through mass media and using the facilities of Mongol-Japan Center on Human Resource Development, which proved to be quite effective in interacting with and reaching out SME interested in applying to the TSL project loan. 5. Maintaining public relations activities through participating in the seminars and events organized by the PFIs and the concerned public organizations. 6. Upon request by some PFIs, providing individual consultancies to certain SMEs in the countryside through telephone or other mode of contact.
CSC/MOF	1. Concluding an on-lending loan agreement with PFIs in line with the sub-loan conditions under the Project; 2. Sub-loan approval in line with the eligibility criteria of the Project and in reference to recommendations by the TSL project office; 3. Request for concurrence to JICA as necessary, including for employment of consultants and sub-loan approval; 4. Instruction to BOM on disbursements of sub-loan funds to PFIs and due maintenance of special accounts established for the Project; 5. Production of quarterly P/R and PCR and their submission to JICA in the format of PSR in line with L/A and P/M; 6. Request for disbursements from JICA and payment of interest and principal on time; 7. Full cooperation to external audit of the special accounts and submission to JICA of unqualified annual external audit report; 8. Selection of PFIs, in consultation with JICA, under the same selection criteria as the first selection under open entry and exit policy; 9. Supervision of the day-to-day activities of the project.
JICA	1) Review of sub-loan summary report and other documents from CSC and PFI 2) Make replenishment for sub-loan funds 3) Review documents sent by CSC

Source: TSL Office

7.2.2 Preparation and Processing of Application

(1) Contents of application

The application is composed of three different parts and their contents are as given in the table below.

Table 7.2.2 Contents of Application

Application One (Sub-loan Project Information to be submitted to PO and JICA in case of the first three cases of PFI)
PART I: FINANCE FOR SUBPROJECT 1. Sub-loan borrower's information, which include name of sub-borrower, amount of the requested loan, outline of the bank's credit committee decisions, terms and conditions of sub-loan, list of collaterals and the repayment schedule. 2. Sub-loan project information, which include sub-loan project name, business plan/sub-project preparation status, type of sub-project, sector, location, major business activities, description about the sub-project, sub-project cost, usage of the sub-loan and schedule of the sub-loan implementation period. **PART II: FEASIBILITY OF SUB-PROJECT** 1. Information on the market research 2. Information on production and service technology

3. Financial projection (including major financial indicators)
4. Environmental impact assessment
5. Expected economic and social impacts of sub-project

PART III: BANK'S OVERALL EVALUATION OF THE PROJECT

1. Eligibility criteria of the borrower, including the number of employees and annual income
2. PFI's evaluation of sub-project

ATTACHMENTS (ANNEXES)

1. Location map of sub-project site
2. Supporting data sheet for financial projection of subproject
3. Financial statements of subproject (income statements, balance sheets, cash flows, and the calculation of FIRR and DSCR
4. Borrower's profile, including the year of establishment, business history in brief, and net sales, net profit, total assets, and net worth of past three years
5. Copy of environment impact assessment
6. Monitoring indicators for the sub-projects on EPL

Application Two (Sub-loan Project Information for JICA to be submitted reporting purpose)

PART I: FINANCE FOR SUBPROJECT

a. Sub-project information, including applicant name and amount and terms of loan
b. Description of the Sub-project, including name, sector, location, purpose, and cost of the sub-loan project

PART II: FEASIBILITY OF SUBPROJECT

a. Brief information about market analysis
b. Brief information about production and technology
c. Financial Projection
d. Environmental Impact Assessment
e. Social and Economic Impact

PART III: BANK'S OVERALL EVALUATION ON THE PROJECT

1. Eligibility criteria of the borrower, including the number of employees and annual income
2. PFI's evaluation of sub-project

ATTACHMENTS (ANNEXES)

1. Location map of sub-project site
2. Supporting data sheet for financial projection of subproject
3. Financial statements of subproject (income statements, balance sheets, cash flows, and the calculation of FIRR and DSCR
4. Borrower's profile, including the year of establishment, business history in brief, and net sales, net profit, total assets, and net worth of past three years

Source: TSL Office

(2) Flow of application

The sub-loan applications and other related documents are processed for appraisal as follows: Applicant SME => PFI => PO => CSC (=> JICA). The first three sub-loans (sub-projects) for each new PFI need to be approved by CSC and JICA, and the forth onward sub-loans/subprojects are to be approved by CSC alone.

With the commencement of Phase I operations in late 2006, the contracted banks called as PFIs proceeded with their first three applications and were able to get the final concurrences from JICA by spending considerable amount of time. Major reasons for taking time were the banks' inexperience of doing project analysis, unfamiliarity with long-term financing, difficulties with doing projections and filling in the application forms, especially in English. Despite this fact, it should be noted that this amount of time spent by the PFIs were not wasted in downtime, as it was a good experience for the banks to do real project analysis through on and off-job training sessions for their loan officers on actual so called 'case studies'. After clearing up the first three applications, PFIs did not have many difficulties in dealing with the fourth and onward sub-loan applications by accumulating more experience with project financing as time went further on. As for Phase II operations most of PFIs (Khan, TDB, Xac and Golomt banks) were considered as having experience with Phase I operation and thus, had not been required to have JICA concurrence on their first 3 sub-loan applications. As a result, the application processing time at the initial stage of Phase II operations were significantly shortened and PFIs were able to go on smoothly with dozens of applications in a relatively short period of time.

Now, over the two phases of operations, it should be considered that PFIs have already accumulated sufficient experience in handling the TSL sub-loan applications and with the improved manual for PFIs and the simplified application forms, the application processing time would no longer be a concern to the applicant SMEs.

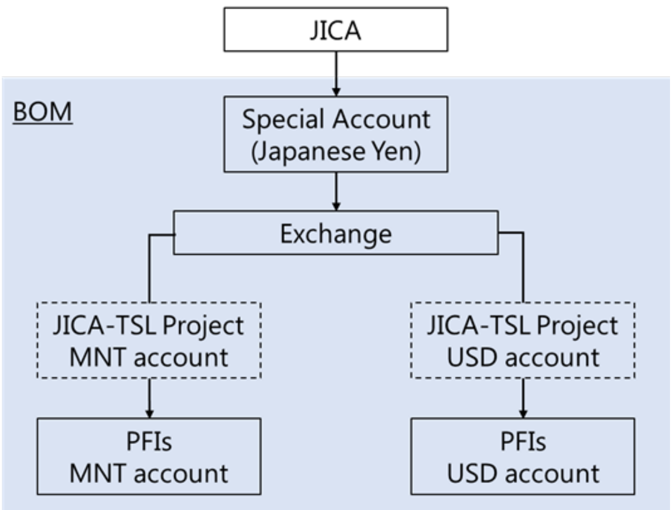
7.3 Disbursement Process

7.3.1 Yen Loan Flow

According to the loan agreement (L/A) and the standard form of the on-lending loan agreement agreed upon between Government of Mongolia (GOM) and JICA, the disbursement procedure is stipulated as follows:

- When GOM (represented by MOF) requests disbursement or replenishment, MOF is to submit a request for disbursement or replenishment to JICA, together with a summary sheet of payments and the supporting documents in case of replenishment.
- When JICA finds the documents in order and in conformity with the L/A, JICA is to make disbursement or replenishment of the loan in Japanese Yen.
- JICA is to make disbursement or replenishment by paying into GOM's non-resident Yen account with the MUFG Bank, Tokyo.
- GOM (represented by MOF) is to transfer the amounts to the special accounts (S/A) denominated in Japanese yen with BOM.
- CSC is to make the on-lending loans to PFIs.
- PFI is to make the sub-loans to end users.

The flow of the loan proceeds after its receipt at S/A has been changed several times, the current procedure, which has been practiced for a long time, is as follows:



Source: JICA Expert Team

Figure 7.3.1 Disbursement Scheme

The replenishment received in S/A was converted into MNT or USD through an exchange from S/A and directly transferred to PFIs without going through the TSL project accounts (see the outline of flow shown in the Figure above).

7.3.2 Actual Disbursement Made for Sub-loan Projects

During implementation of TSL Phase I, a total of JPY 2,870 million equivalent, the loan amount available from JICA had been disbursed to PFIs for sub-lending to SMEs for their 90 SME development projects and 18 Environmental Protection projects. All of 108 sub-loan projects under TSL Phase I are in operation, and continue to make payment of interests and repayment of sub-loans. In case of TSL Phase II, a total of JPY 4,639 million equivalent or approximately 99.9% of the loan amount available from JICA had been disbursed to PFIs for sub-lending to SMEs for their financing 190 subprojects for SME development and 35 for environmental protection. Out of 225 subprojects under TSL Phase II, 216 are in the operational stage. Practically, the implementation of both JICA-TSL Phases I and II is almost completed.

Actual disbursement made for each PFI subproject to date is shown in the table below.

Table 7.3.1 On-lending Loans Disbursed from S/A

PFI		Total	'07		'08		'09		'10		'11		'12		'13		'14		'15		'16.09.30	
			~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~9
Number of on-lending loans	Anod	2	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	Capital	34	-	-	-	-	-	-	-	-	-	-	-	19	10	2	2	-	1	-	-	-
	Capitron	32	-	2	5	22	2	-	-	-	-	1	-	-	-	-	-	-	-	-	-	-
	Golomt	73	-	-	17	2	4	-	-	-	-	5	15	17	8	2	3	-	-	-	-	-
	Khan	99	2	15	10	2	-	-	-	-	-	8	21	23	13	2	3	-	-	-	-	-
	TDB	50	-	-	2	1	1	2	-	-	-	10	19	8	3	1	3	-	-	-	-	-
	UB City	2	-	-	-	-	-	-	-	-	-	-	-	-	-	1	1	-	-	-	-	-
	XAC	31	-	1	2	-	2	-	-	-	-	4	6	13	2	-	1	-	-	-	-	-
	Zoos/ State	10	-	-	3	3	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	Total	333	2	18	39	32	13	2	-	-	-	28	61	80	36	8	13	-	1	-	-	-
Loan amount (JPY million)	Anod	73	-	-	-	73	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	Capital	983	-	-	-	-	-	-	-	-	-	-	-	503	300	59	53	-	68	-	-	-
	Capitron	1,232	-	74	205	873	64	-	-	-	-	16	-	-	-	-	-	-	-	-	-	-
	Golomt	1,540	-	-	398	42	133	-	-	-	-	194	291	186	235	14	47	-	-	-	-	-
	Khan	1,655	73	338	105	13	-	-	-	-	-	179	350	359	193	22	23	-	-	-	-	-
	TDB	1,139	-	-	28	23	6	33	-	-	-	296	516	146	37	10	44	-	-	-	-	-
	UB City	22	-	-	-	-	-	-	-	-	-	-	-	-	-	20	2	-	-	-	-	-
	XAC	631	-	7	36	-	58	-	-	-	-	67	100	302	14	-	47	-	-	-	-	-
	Zoos/ State	234	-	-	83	69	82	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	Total	7,509	73	419	855	1,093	343	33	-	-	-	752	1,257	1,496	779	125	216	-	68	-	-	-

Source: Compiled by the JICA Expert Team based on the Project Office "TSL Disbursement Information"

Actual disbursement made for subprojects in the SME development TSL, and the environmental protection TSL to date is shown in Table 7.3-2 below.

Table 7.3.2 On-lending Loans Disbursed from S/A

Category		Total	'07		'08		'09		'10		'11		'12		'13		'14		'15		'16.09.30	
			~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~9
Number of on-lending loans	SME Dev	280	2	15	36	27	8	-	-	-	-	27	57	75	28	2	3	-	-	-	-	-
	Envi. Protect.	53	-	3	3	5	5	2	-	-	-	1	4	5	8	6	10	-	1	-	-	-
	Total	333	2	18	39	32	13	2	-	-	-	28	61	80	36	8	13	-	1	-	-	-
Loan amount (JPY million)	SME Dev.	6,197	73	324	835	874	238	-	-	-	-	682	1,189	1,268	620	49	45	-	-	-	-	-
	Envi. Protect.	1,312	-	96	21	218	107	33	-	-	-	65	69	228	159	76	172	-	68	-	-	-
	Total	7,509	73	420	856	1,092	345	33	-	-	-	747	1,258	1,496	779	125	217	-	68	-	-	-

Source: Compiled by JICA Expert Team based on the Project Office "TSL Disbursement Information"

As shown in the above tables, most of the funds for both phases (around 78%) were disbursed during the second and third years of the project implementation in a relatively short period of one year and half. It shows a high demand for the long-term project financing among the targeted SMEs in Mongolia and the appreciation of the participating banks to serve the needs of their business clients.

As for the actual disbursements, there have been several irregular cases during the course of disbursement of sub-loans for subprojects in both phases.

An irregular case experienced in 2008, wherein MNT 53 million was disbursed by Xac Bank to the "Building and operation of waterproof adhesive plant", which was only disbursed to the sub-borrower five months after disbursement to PFIs. Xac Bank started its preparations for the loan documents with the sub-borrower only after receiving disbursement of JICA-TSL from MOF, and as a result, it took them long time to materialize the documentation for the collateral due to various reasons.

Another irregular case experienced in 2009 wherein MNT 50 million was disbursed by Zoos Bank to the "Renovation and expansion of brick production processing factory" sub-project, which was only approved 16.5 months after submission to PO. During this waiting period, the company had experienced the construction business boom in the region and used the most part of their available collateral for other investment purposes. When Zoos Bank received TSL project funds for the approved sub-loan application, they found that applicant's collateral was not fully available. Consequently, the received sub-loan amount was downscaled to half, and disbursed to the final end-user.

There is another case of disbursement not made to the borrower. The case was a new resort development project. The prolonged processing time resulted in price increase of land to be purchased. When the loan fund was received by the bank, it was found out that the owner of the project site would not sell the land at the price estimated at the planning stage. So, this project was cancelled and the fund received was returned to MOF. It may be worth noting that, even now, sometimes the processing of applications takes an exceptionally long time, particularly in summer when CSC meetings are practically not held for two to three months.

During Phase II operations, there have been two cases, in which TSL Project funds were not disbursed to the final borrowers. One case was with the maternity sanatorium centre establishment project, where the applicant company withdrew their application at the final stage of disbursement from the bank, due to the land ownership dispute at the project implementation site in the Sanzai area, UB city. The other case was with the mushroom farm expansion project, where the owner of the company became sick and could not implement the project. As a result, the bank did not make the disbursement to the applicant and returned the funds back to the RFAs.

7.3.3 Revolving Fund Flow

The repayment of principals and interest payments of the disbursed sub-loans are received by PFIs, which in turn transfers such funds to Revolving Fund Accounts (RF/As) under the control of MOF, after deducting their margin in case of interests received. In practice, the payment of the borrowers is based on the sub-loan agreement, and the payment of PFIs is based on the on-lending agreement. These two payments are independent of each other, and the payment of PFIs is not dependent on the payment of the borrowers. PFI is obliged to make repayment of principal and payment of interests whether or not the sub-borrower has made their part of repayments.

In TSL Phase I, a clause in the on-lending L/A causes an issue on the repayment schedule. The Section 2.01 (b) of the on-lending L/A stipulates that, maturity of each on-lending loan shall be equal to the maturity of the sub-loan financed therefore plus six months. The understanding on this clause is that PFI is allowed to keep the money repaid by the sub-borrowers for six months after each repayment was made. It is hard, however, to justify the gap of repayment dates between sub-loans and on-lending loans. It may be more reasonable if the money paid by the sub-borrowers is to be used for the repayment of on-lending loan without a substantial time gap, which shall be used to finance other subsequent sub-projects. This issue was resolved in the case of TSL Phase II as all the parties including PFIs agreed to change the relevant clause, and PFIs are now obliged to repay on-lending loans upon receipt of the sub-loan repayment for TSL Phase II.

In addition, another issue was recognized when PFI started to make payments of interest in TSL Phase I. The agreement for on-lending loans between GOM and PFI stipulates that the interest on loans as well as the repayment of principal shall be made, naturally on the corresponding date to the disbursement date of the Loan. When the number of loans substantially increased, each of which has a different disbursement date, PFI recognized that they had to keep on making payments almost every day of the month. Then, PO agreed to bundle the payments of interest for a month and receive them only once at the end of the month. This practice is quite beneficial for both parties as PO can simplify their operation to issue invoices and check PFIs' payments. When TSL Phase II started, both sides went ahead to bundle even the repayments of principal to make once-a-month payments. The repayment schedule attached to the on-lending agreement eliminated the date. So, for TSL Phase II, each PFI makes two payments at the end of the month, one for payment of interests and the other for repayment of principals. All the parties recognized that this payment practice simplifies relevant operations, reducing human errors and mistakes, which benefits to all the parties concerned. This approach was finally approved by CSC, and now is practiced for both Phase I and Phase II.

Table 7.3.3 On-lending Loans Disbursed from RF/A

	PFI	Total	'07		'08		'09		'10		'11		'12		'13		'14		'15		'16.09.30	
			~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~9
Number of on-lending loans	Anod	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	Capital	16	-	-	-	-	-	-	-	-	-	-	-	-	5	1	2	1	2	4	1	-
	Capitron	58	-	-	-	1	2	3	4	1	-	5	9	2	7	7	5	2	2	1	4	3
	Golomt	70	-	-	-	1	1	2	1	4	8	6	-	-	9	4	10	2	5	9	5	3
	Khan	73	-	-	-	-	1	2	6	2	3	3	-	-	13	7	11	4	8	8	3	2
	TDB	57	-	-	-	-	-	1	1	2	2	-	-	-	5	2	8	3	7	12	7	7
	UB City	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	3	1	-	-	-	-
	XAC	53	-	-	-	-	-	1	-	2	1	-	-	-	10	1	4	6	9	7	7	5
	Zoos/ State	35	-	-	-	-	1	-	1	-	-	1	4	1	3	-	1	5	4	3	7	4
	Total	366	-	-	-	2	5	9	13	11	14	15	13	3	52	22	44	24	37	44	34	24
Loan amount (JPY million)	Anod	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	Capital	391	-	-	-	-	-	-	-	-	-	-	-	-	110	22	42	31	70	72	44	-
	Capitron	935	-	-	-	19	15	26	63	16	-	67	157	40	89	102	94	25	25	22	95	80
	Golomt	1,178	-	-	-	23	41	8	2	26	98	64	-	-	167	54	163	26	77	260	118	51
	Khan	1,345	-	-	-	-	7	4	55	23	18	64	-	-	238	149	213	59	150	259	71	35
	TDB	1,232	-	-	-	-	-	5	10	33	22	-	-	-	85	30	192	76	147	376	164	92
	UB City	118	-	-	-	-	-	-	-	-	-	-	-	-	-	-	103	15	-	-	-	-
	XAC	814	-	-	-	-	-	18	-	32	3	-	-	-	158	13	65	86	111	130	109	89
	Zoos/ State	824	-	-	-	-	5	-	13	-	-	15	54	17	42	-	25	137	142	84	171	119
	Total	6,837	-	-	-	42	68	61	143	130	141	210	211	57	889	370	897	455	722	1,203	772	466

Source: TSL Project Office

Table 7.3.4 On-lending Loans Disbursed from RF/A

Category		Total	'07		'08		'09		'10		'11		'12		'13		'14		'15		'16.09.30	
			~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~9
Number of on-lending loans	SME Dev	333	-	-	-	2	5	8	13	11	14	15	13	2	46	18	39	22	34	42	30	19
	Envi. Protect.	33	-	-	-	-	-	1	-	-	-	-	-	-	7	4	5	2	3	2	4	5
	Total	366	-	-	-	2	5	9	13	11	14	15	13	2	53	22	44	24	37	44	34	24
Loan amount (JPY million)	SME Dev.	6,246	-	-	-	41	68	56	143	131	141	210	212	40	829	283	815	429	649	1,125	693	381
	Envi. Protect.	591	-	-	-	-	-	5	-	-	-	-	-	-	80	86	81	26	72	78	78	85
	Total	6,837	-	-	-	41	68	61	143	131	141	210	212	40	909	369	896	455	721	1,203	771	466

Source: TSL Project Office

7.3.4 Actual Payment Made by PFIs

According to the loan agreement for JICA-TSL Project Phase I, RF/As fund shall be used for the following:

- To repay the principal and pay interest of the official development assistance (ODA) loan.
- To make loans to the PFIs for the same objectives and terms and conditions of the Project.

By accumulating payments of interest and repayments of principal from outstanding on-lending loans, GOM is effectively creating revolving funds for the continuous provision of term financing to the SME sector through eligible PFIs.

As of June 30, 2015, MNT 30,109 million and USD 8.1 million had been received in RF/As from SME development TSL Phase I, out of which MNT 28,896 million and USD 7.1 million have already been utilized to finance 164 subprojects. Simultaneously, MNT 2,987 million and USD 1.4 million had been received in RF/As from environmental protection TSL Phase I, out of which MNT 2,754 million and USD 1.4 million had already been utilized to finance 19 subprojects. Similarly, MNT 26,122 million and USD 1.1 had been received in RF/As from SME development TSL Phase II, out of which MNT 24,967 million and USD 507 thousand had already been utilized to finance 76 subprojects. Simultaneously, MNT 2,578 million and USD 25 thousand had been received in RF/As from the environmental protection TSL Phase II to finance 5 EPL subprojects. Please see the tables below.

Table 7.3.5 Collection Activities in RF/As for the SME Development TSL Phase I & II

Year	Transaction	TSL Phase I								TSL Phase II							
		MNT account (in MNT million)				USD account (in USD thousand)				MNT account (in MNT million)				USD account (in USD thousand)			
		No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance
2008	Interest Paid			523				240				-				-	
	Repayment			108				4				-				-	
	Disbursement	2	550		81		-		244	-	-		-		-		-
2009	Interest Paid			1,051				248				-				-	
	Repayment			638				85				-				-	
	Disbursement	11	1,476		294	2	524		53	-	-		-	-	-		-
2010	Interest Paid			1,048				129				-				-	
	Repayment			2,034				1,144				-				-	
	Disbursement	18	2,683		693	5	1,051		275	-	-		-	-	-		-
2011	Interest Paid			989				91				66				1	
	Repayment			2,884				1,079				4				-	
	Disbursement	25	3,979		587	3	1,312		133	-	-		70	-	-		1
2012	Interest Paid			963				103				851				48	
	Repayment			4,878				1,641				585				1	
	Disbursement	13	3,436		2,992	2	551		1,326	-	-		1,506	-	-		49
2013	Interest Paid			911				72				2,022				61	
	Repayment			5,794				1,363				3,581				38	
	Disbursement	39	8,445		1,252	11	2,178		583	14	4,654		2,455	-	-		148
2014	Interest Paid			890				51				1,842				50	
	Repayment			4,667				1,209				9,896				559	
	Disbursement	18	6,103		706	9	1,502		341	34	12,017		2,176	-	380		377
2015. 06.30	Interest Paid			457				19				826				18	
	Repayment			2,274				644				6,449				348	
	Disbursement	6	2,224		1,213				1,004	27	8,296		1,155	1	127		616
Total		132	28,896	30,109	1,213	32	7,118	8,122	1,004	75	24,967	26,122	1,155	1	507	1,123	616

Source: Compiled by the JICA Expert Team Based on BOM "Statement of Accounts and Transaction Slips"

Table 7.3.6 Collection Activities in RF/As for the Environmental Protection TSL Phase I & II

Year	Transaction	TSL Phase I								TSL Phase II							
		MNT account (in MNT million)				USD account (in USD thousand)				MNT account (in MNT million)				USD account (in USD thousand)			
		No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance
2008	Interest Paid			34				31				-				-	
	Repayment			5				-				-					
	Disbursement	-	-		39	-	-		31		-		-		-		-
2009	Interest Paid			78				74				-				-	
	Repayment			27				27				-				-	
	Disbursement	1	118		26	-	116		16	-	-		-	-	-		-
2010	Interest Paid			119				40				-				-	
	Repayment			58				108				-				-	
	Disbursement	1	85		118	-	66		98	-	-		-	-	-		-
2011	Interest Paid			116				28				-				-	
	Repayment			262				163				-				-	
	Disbursement	1	38		458	-	-		289	-	-		-		-		-
2012	Interest Paid			98				31				54				9	
	Repayment			438				270				-				-	
	Disbursement	-	-		994	-	-		590	-	-		54		-		9
2013	Interest Paid			99				21				242				9	
	Repayment			633				299				197				-	
	Disbursement	8	1,408		318	3	733		177	-	-		493	-	-		18
2014	Interest Paid			132				15				317				7	
	Repayment			483				218				877				-	
	Disbursement	2	624		309	2	276		134	3	925		762	-	21		4
2015. 06.30	Interest Paid			70				7				210				-	
	Repayment			335				118				681				-	
	Disbursement	1	481		233	-	160		99	2	913		740	-	-		4
TOTAL		14	2,754	2,987	233	5	1,351	1,450	99	5	1,838	2,578	740	-	21	25	4

Source: Compiled by the JICA Expert Team Based on BOM "Statement of Accounts and Transaction Slips"

After 30 June 2015, the revolving fund accounts for both phases, managed under GOM were merged upon recommendation by the National Audit of Mongolia and approval by the CSC meeting of 8 July 2015. As of the latest, the operational results of both phases after the merger of the accounts are shown in the tables below.

Table 7.3.7 Collection Activities in RF/As for the SME Development TSL Phase I & II

Year	Transaction	TSL Phase I&II							
		MNT account (in MNT million)				USD account (in USD thousand)			
		No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance
2015.12.31	Fund received (Phase I account balance)			1,213				1,004	
	Interest Paid			1,697				39	
	Repayment			10,218				1,301	
	Disbursement	29	12,755		1,528	13	2,811		149
2016.09.30	Interest Paid			2,279				27	
	Repayment			14,674				811	
	Disbursement	44	17,519		962	5	550		437
Total		73	30,274	30,081	962	18	3,361	3,182	437

Source: Compiled by the JICA Expert Team Based on BOM "Statement of Accounts and Transaction Slips"

Table 7.3.8 Collection Activities in RF/As for the Environmental Protection TSL Phase I & II

Year	Transaction	TSL Phase I & II							
		MNT account (in MNT million)				USD account (in USD thousand)			
		No. of Projects	Debit	Credit	Balance	No. of Projects	Debit	Credit	Balance
2015.12.31	Fund received (Phase I account balance)			233				99	
	Interest Paid			312				7	
	Repayment			1,523				139	
	Disbursement	2	1,254		1,554	-	-		249
2016.09.30	Interest Paid			402				9	
	Repayment			2,117				179	
	Disbursement	9	3,190		883	-	-		437
Total		11	4,444	4,587	883	-	-	433	437

Source: Compiled by the JICA Expert Team Based on BOM "Statement of Accounts and Transaction Slips"

7.3.5 Rejection of Loan Applications

During the early stages of JICA-TSL, the applicant SMEs had to wait a long processing time caused by the L/A requirement that the first three applications of new PFI had to be thoroughly screened by PO, CSC and additionally by JBIC/JICA. The idea of this screening was to provide PFIs with the training experience on the purposes and procedures of the TSL Project financing. Depending on each bank's capacity and the nature of the applications, PFI spent a varying degree of time to clear off these first three applications and once cleared, the application processing time became much faster. During this time, there were several applications withdrawn by PFI because the applicants could not wait for the long processing time. There is a case in which the applicant was provided with another concessional loan and withdrew the JICA-TSL application. There is another case in which the prolonged processing time resulted in a price increase of the land to be purchased. When the loan fund was received by the bank, it was disclosed that the then current owner refused to sell the land at the price estimated at the planning stage. So, this project was cancelled.

As for the actual cases of rejection by CSC, the review of the operational results of both phases has revealed that CSC has rejected a number of applications with reasons specified in the next table.

Table 7.3.9 Rejection or Withdrawal of Applications Submitted to PO/CSC

No.	Reasons for Rejection or Withdrawal	Number of Applications
1	Policy Priorities (applications, which do not meet the policy priorities of GOM, in terms of industrial sectors, employment, hygiene standards, etc.)	19
2	Eligibility Criteria (applications, which do not meet the eligibility criteria of the Project, in terms of SME definition, usage of loan, etc.)	13
3	Feasibility Aspect (applications, which are considered as not feasible enough to be implemented by the applicant company, due to the market, currency exchange risk, insufficient experience, etc.)	10
4	Others (applications, which are rejected due to other various reasons, such as inappropriate length of tenure or grace period, or having not grace period, where the sub-loan project still needed some time for “the construction period”, etc.)	17
	Total	59

Source: TSL Project Office

As it can be seen from the above table, the rate of rejection by CSC is less than 10% and the major approach taken by the CSC members on deciding the fate of applications is the policy discussion of making sure that the applications are in line with or adhere to the government’s socio-economic and environmental policies for the country’s development.

With regard to rejections by the credit committee, the number of cases experienced is different from one bank to another and the actual data is not readily available, due to the fact that the banks do not maintain such registry or the person in charge is frequently changed. It should be noted, however, that the rejection rate of applications for JICA-TSL by the credit committee are comparatively low and the major reasons for rejection are as follows:

- Loan amount requested exceeds the ceiling of JICA-TSL
- Major business activity is outside of the scope of JICA-TSL
- Debt service ratio is not high enough to show the ability to pay back
- The project itself is not compliance with the loan policy of the bank
- Applicant’s credit history shows bad records
- The project is formed with unreasonable or too-optimistic assumptions, particularly on the market situation, resulting in the inflated or not very realistic profit estimation.
- Collateral cannot be provided as per bank’s regulation.
- Experience in the project business is insufficient.

7.3.6 Monitoring of Repayment

The repayment schedule for each on-lending loan is agreed upon between MOF and PFIs, and is attached to the contract letter of each on-lending loan. It is important that the schedule shall actually be reflected in the PFIs’ action as scheduled. CSC or MOF is required to monitor the PFIs’ accomplishment every month, and to take proper action if deviances are found. CSC or MOF is also required to watch the repayment by SMEs on a quarterly basis and to report to JICA on its status. In this context, PO on behalf of CSC/MOF has established a payment administration system, which functions for money flow projection as well. It should be noted, however, that this payment administration system is established on the basis of an Excel system in an ordinal computer, which may be acceptable for simple support for monitoring, but not suitable for long-term operation. For business administration purposes including money flow projection, a well-designed solid electronic data processing system (EDPS) should be formulated.

In addition, CSC or MOF is required to effectuate further use of the revolving fund, incoming from SMEs’ repayments and interest payments, for the purpose of the TSL Project. So far, it seems that CSC or MOF has successfully performed such functions. The fact is that the PO, under the control of MOF, manages daily operations, although all the staff of this office comprises consultants with only limited time contracts, which was just enough for the disbursement period of the ODA loan. At present, MOF's involvement in the JICA-TSL Project is limited to the disbursement process only. Obviously, it lacks operational staff. This issue has been raised to MOF repeatedly but is yet to reach conclusion as managing the TSL Project operations may cause additional costs. Although the consultants manage daily operations for the time being, it would be difficult to maintain the current operation once their contract is over. Even after this period, the operation of JICA-TSL project needs to be continued in order to secure the repayment from PFIs and finance the next generation of sub-loan projects out of the revolving fund. For this purpose, the sustainability of PO needs to be well addressed after the completion of the on-going operation.

7.4 Reporting to JICA

From the fourth subproject onwards, it has been practiced that CSC timely furnishes JICA with an outline of each sub-loan project financed out of the proceeds of the TSL Project. Some of the PFIs request a simplified, English version of the report on sub-loans because of their difficulty to prepare such reports at a satisfactory level. When TSL Phase II began, the form of this English version was substantially simplified, including only key information, from the one used in TSL Phase I. It may be necessary to further simplify the form if TSL Phase III will be materialized.

The L/A requires that, in order to provide JICA with the basis for supervision and monitoring of the TSL Project, CSC furnishes the project status report every quarter during the implementation of the TSL Project. In order for the PO to timely prepare the project status report, it is suggested that a periodical reporting system for PFIs should be introduced.

7.5 Overall Review of the Two-Step Loan (TSL) Component

During the implementation of TSL Phase I, a total amount of JPY 2,870 million equivalent, which was the loan available from the Japan International Cooperation Agency (JICA), had been disbursed to Participating Financial Institutions (PFIs) for sublending to Small and Medium Enterprises (SMEs) up to February 24, 2010. The number of subprojects financed under TSL Phase I is 90 for SME development and 18 for environment protection. All of 108 subprojects under TSL Phase I are in operation, and have already been in the repayment stage of subloans.

In case of TSL Phase II, a total amount of JPY 4,639 million equivalent or approximately 99.9% of the loan amount available from JICA had been disbursed to PFIs for sublending to SMEs up to 15 February 2015. The number of subprojects financed under the TSL Phase II is 190 for SME development and 35 for environment protection. Out of 225 sub-loan projects under TSL Phase II, 216 are on the operational stage as of the latest.

As for the repayments, the principal and interest payments are received by PFIs, which, in turn, transfer such money to the Revolving Fund Account (RF/A) under control by the Ministry of Finance (MOF), after deducting their margin. As of 30 September 2016, the total of MNT 86,312 million and USD 12.4 million have been received in RF/As for SME development TSL Phase I and II, out of which MNT 84,137 million and USD 10.9 million have already been utilized to finance 331 sub-loan projects. Simultaneously, the total of MNT 10,152 million and USD 1.9 million had been received in RF/As from environmental protection TSL Phase I and II, out of which MNT 9,036 million and USD 1.3 million had already been utilized to finnance 35 sub-loan projects.

7.6 Sub-loan Borrowers and their Present Status

7.6.1 Corporate Size

There was no official definition of SME established by the Government of Mongolia (GOM) when TSL Phase I was formulated. Under such situation, the size of sub-borrowers had been stipulated in the On-lending Loan Agreement and that the number of core staff be 50 or less. In July 2007, the SME Law was adopted, which defined SME as follows:

- With employees less than 200 for industrial enterprises
- With employees less than 50 for service enterprises
- With annual sales income less than 1.5 billion for industrial enterprises
- With annual sales income less than 1.0 billion for service enterprises.

The new definition of SME was incorporated in the TSL Project when On-lending Loan Agreement was revised for TSL Phase II.

More than 60% of sub-borrowers are rather smaller in size with core staff of 20 or less, while this group occupies less than half of the sub-loan amount disbursed. This trend is understandable because medium-sized companies may engage in business for longer period and try to invest more than the smaller group. Over the phases of implementation of the project, there is no significant difference observed.

As mentioned in the Chapter 2, GOM has been making efforts to amend SME law under the initiative of MOFALI. The key issue in the new SME law is a revision of the definition of SMEs to allow provision of suitable SME loans to fill the gap between SME's actual situation and its needs. In 2018, the amendment proposal is expected to be discussed in the Parliament.

Table 7.6.1 Sub-loans by Corporate Size

Core Staff		Phase I				Phase II				Total		Number of Establishments	
		SA funded		RF/A funded		SA funded		RF/A funded					
Number of Subloans	10 or less	25	23%	88	42%	99	44%	100	64%	312	45%	114,463	90%
	Over 10 to 20	39	36%	50	24%	50	22%	24	15%	162	23%	5,556	4%
	Over 20 to 50	43	40%	63	30%	54	24%	22	14%	182	26%	4,092	3%
	Over 50 to 100	1	1%	6	3%	20	9%	11	7%	39	6%	2,449	2%
	Over 100 to 199	-	0%	2	1%	2	1%	-	0%	4	1%		
	Total	108	100%	209	100%	225	100%	157	100%	699	100%	126,560	100%
Loan Amount (JPY million)	10 or less	402	14%	1,047	30%	1,206	26%	1,740	52%	4,395	31%		
	Over 10 to 20	890	31%	977	28%	974	21%	301	9%	3,142	22%		
	Over 20 to 50	1,550	54%	1,256	36%	1,716	37%	736	22%	5,259	37%		
	Over 50 to 100	29	1%	175	5%	603	13%	569	17%	1,375	10%		
	Over 100 to 199	-	0%	35	1%	139	3%	-	0%	174	1%		
	Total	2,870	100%	3,490	100%	4,639	100%	3,347	100%	14,346	100%		

Note: Number of active enterprises does not include wholesale and retail trade, financial services, real estate and renting, etc., which are not eligible for JICA-TSL.

Source: Compiled by the JICA Study Team based on the Project Office for JICA-TSL "Applications for Sub-loan", and National Statistics Office "Statistical Yearbook, 2015"

Table 7.6.2 Sub-loans by Corporate Size

Annual Sales (MNT million)		Phase I				Phase II				Total	
		SA funded		RF/A funded		SA funded		RF/A funded			
Number of Sub-loans	100M or less	46	43%	77	37%	54	24%	100	64%	278	40%
	Over 100M to 500M	38	35%	75	36%	83	37%	13	8%	209	30%
	Over 500M to 1,000M	13	12%	29	14%	43	19%	22	14%	107	15%
	Over 1,000M to 1,500M	6	6%	13	6%	41	18%	11	7%	71	10%
	Over 1,500M	4	4%	15	7%	5	2%	11	7%	34	5%
	Total	108	100%	209	100%	225	100%	157	100%	699	100%
Loan Amount (JPY million)	100M or less	947	33%	907	26%	603	13%	1,807	54%	4,265	30%
	Over 100M to 500M	890	31%	1,256	36%	1,345	29%	33	1%	3,525	25%
	Over 500M to 1,000M	545	19%	593	17%	1,067	23%	669	20%	2,875	20%
	Over 1,000M to 1,500M	287	10%	314	9%	1,345	29%	569	17%	2,515	18%
	Over 1,500M	201	7%	419	12%	278	6%	268	8%	1,166	8%
	Total	2,870	100%	3,490	100%	4,639	100%	3,347	100%	14,346	100%

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL "Applications for Sub-loan", and National Statistics Office "Statistical Yearbook, 2015"

Although the Phase II defined eligible SMEs of having the annual sales no more than MNT 1,500 million, there were a few cases approved by CSC. The main reason for this approval was that the CSC members considered the SME Law as outdated and did not reflect the actual size of SME in terms of annual sales. With this approach taken, the members of CSC mainly focused on policy priorities and the SME definition in terms of employee number to approve the applications.

7.6.2 Business Length

The share of sub-borrowers in each range of their business length appears to be well-balanced, as it is quite natural that the share of newly established enterprises is smaller. About 40% of sub-borrowers have continued business more than ten years, about one-third operate business 5 to 10 years, and another one-fourth have business experiences less than five years. Less than 10% of sub-borrowers are newly established companies. Over the phases of implementation of the project, there is no significant difference observed.

Table 7.6.3 Sub-loans by Business Length

Business Length		Phase I				Phase II				Total	
		SA funded		RF/A funded		SA funded		RF/A funded			
Number of Subloans	Less than 1 year	10	9%	13	6%	14	6%	44	28%	80	11%
	1 to 5 years	28	26%	42	20%	52	23%	57	36%	178	25%
	5 to 10 years	39	36%	65	31%	72	32%	11	7%	187	27%
	More than 10 years	31	29%	90	43%	88	39%	46	29%	254	36%
	Total	108	100%	209	100%	225	100%	157	100%	699	100%
Loan Amount (JPY million)	Less than 1 year	431	15%	279	8%	93	2%	1,506	45%	2,309	16%
	1 to 5 years	718	25%	524	15%	835	18%	669	20%	2,745	19%
	5 to 10 years	1,033	36%	1,047	30%	1,577	34%	335	10%	3,992	28%
	More than 10 years	689	24%	1,640	47%	2,134	46%	837	25%	5,300	37%
	Total	2,870	100%	3,490	100%	4,639	100%	3,347	100%	14,346	100%

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL “Sub-loan Applications”

7.6.3 Eligibility for Sub-loan Borrowers

It has not been identified that PFIs had to reject important and significant sub-loan applications due to eligibility for sub-borrowers. As such, they do not have any requests to revise requirement on current number of core staff, which is less than 200 for industrial enterprises and less than 50 for service industry. However, all the PFIs considered that the current maximum level of sales, which is stipulated in the SME Law enacted in 2007, is too small and does not match with the current economic situation and should be raised to the level of MNT 5-8 billion as growth of SMEs is important. It should be noted that an amendment to the SME law has been under preparation, which will include revision on annual sales amount.

7.7 Sub-loan Projects for SME Development

7.7.1 Sub-loans Projects by Sector

According to the L/A, the following sectors are specified as non-eligible for the usage of TSL project fund proceeds:

- Loans for trade (wholesale and retail)
- Loans for entertainment business that is harmful to the society (e.g. prostitution, gambling)
- Loans for environmentally-damaging projects
- Loans for military activities
- Loans for consumers
- Loans for mining extraction

- Loans for individuals, and
- Loans for alcohol and tobacco/cigarette manufacturing

As it was designed from the start, the sub-loans in both phases have been disbursed mainly for manufacturing, services, and agriculture (including dairy cow and pig farms) sectors. In the manufacturing industry, many sub-loans have been provided for the following subprojects:

- Construction materials and furniture:
  - Bricks
  - Concrete blocks
  - Metal fabrication
  - Doors and plastic windows, etc.
  - Wooden furniture
- Food and beverages:
  - Dairy foods
  - Bakery (bread / confectionary / biscuits / chips)
  - Mongolian semi-processed foods, etc.
  - Bottling (water / juice)
- Textiles and wearing apparel:
  - Felt
  - Wearing apparel sewing (wool / cashmere)

As for the service sector, more than 20% of sub-loans were earmarked for service industries, which include various hospitality and social services such as clinics, sanatoriums and kindergartens. The proportion of service industries in TSL is considered acceptable as it is far below the proportion of active establishments of this sector.

Table 7.7.1 Sub-loans by Industrial Sector

	Industrial Sector	Phase I				Phase II				Number of SMEs/ Investment (MNT billion)	
		SA funded		RF/A funded		SA funded		RF/A funded			
Number of Sub-loans	Agriculture & Forestry	15	14%	36	17%	32	14%	23	15%	3,351	12%
	Mining	1	1%	-	0%	-	0%	-	0%	655	2%
	Manufacturing total	68	63%	119	57%	138	61%	96	61%	5,190	19%
	Construction Materials	23	21%	17	14%	37	27%	17	18%		
	Food & Beverages	18	17%	33	28%	34	25%	35	36%		
	Apparel & Textiles	6	6%	24	20%	23	17%	11	11%		
	Electricity, gas, steam (HOB)	7	6%	6	3%	13	6%	2	1%	251	1%
	Service & others	17	16%	48	23%	42	19%	36	23%	18,112	66%
	Total	108	100%	209	100%	225	100%	157	100%	27,559	100%
Loan Amount (JPY million)	Agriculture & Forestry	252	9%	463	13%	585	13%	377	11%	78	2%
	Mining	61	2%	-	0%	-	0%	-	0%	904	28%
	Manufacturing total	1,907	66%	2,150	62%	2,925	63%	2,171	65%	361	11%
	Construction Materials	815	28%	409	19%	966	33%	444	20%		
	Food & Beverages	497	17%	455	21%	733	25%	810	37%		
	Apparel & Textiles	174	6%	412	19%	378	13%	260	12%		
	Electricity, gas, steam (HOB)	237	8%	136	4%	311	7%	25	1%	287	9%
	Service & others	413	14%	742	21%	817	18%	774	23%	1,582	49%
	Total	2,870	100%	3,490	100%	4,639	100%	3,347	100%	3,212	100%

Note: Number of active enterprises in Service and Others does not include wholesale and retail trade, financial services, real estate and renting, etc., which are not eligible for JICA-TSL, but include education, medical care, community / social services, etc.

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL “Sub-loan Applications” and National Statistics Office “Statistical Yearbook, 2015” etc.

One of the PFIs pointed out an issue on sector eligibility for sub-borrowers to be considered. According to them, many trading companies apply for JICA-TSL, while the Counterpart Steering Committee (CSC) rejected them just because trade sector is excluded from the JICA-TSL Project. It may be true that the Mongolian economy has reached to such a level that trading sectors also require fixed assets investment to upgrade their operations. Wholesalers may need their own facility for logistics such as transportation facilities and cold storage. Retailers may need shops equipped with facilities for upgrading their services such as delivery trucks and refrigerators. Similarly, construction companies may need modern machinery. Another PFI proposed that mining should be eligible if they are to introduce modern technology which is less harmful to the environment. Eligible industrial sectors will surely be an issue to be discussed among ministries/agencies concerned.

7.7.2 Sub-loans Projects by Location

In terms of accessing SMEs in the country, the TSL project performed well enough to reach out SMEs in the urban and rural areas. It should be noted that every province has received the JICA-TSL project funds and over 35% of all sub-loans had been disbursed in the regions. Compared with active establishments in each region, JICA-TSL is involved in approximately proportional to location of active enterprises.

Table 7.7.2 Sub-loans by Project Location

Region		Phase I				Phase II				Total		Number of Active Establishments / Loans Outstanding (MNT billion)	
		SA funded		RF/A funded		SA funded		RF/A funded					
Number of Subloans	Ulaanbaatar	66	61%	122	58%	143	64%	100	64%	431	62%	40,831	63%
	Central	24	22%	41	20%	41	18%	22	14%	128	18%	7,862	12%
	Khangai	8	7%	19	9%	23	10%	9	6%	59	8%	7,113	11%
	Western	7	6%	21	10%	10	4%	18	11%	56	8%	6,119	9%
	Eastern	3	3%	6	3%	8	4%	8	5%	25	4%	2,826	4%
	Total	108	100%	209	100%	225	100%	157	100%	699	100%	64,751	100%
Loan Amount (JPY million)	Ulaanbaatar	2,095	73%	2,289	66%	3,268	70%	2,571	77%	10,222	71%	9,125,838.7	78%
	Central	527	18%	610	17%	602	13%	336	10%	2,074	14%	878,923.0	8%
	Khangai	63	2%	271	8%	485	10%	126	4%	945	7%	784,049.8	7%
	Western	165	6%	225	6%	90	2%	173	5%	652	5%	554,763.6	5%
	Eastern	19	1%	96	3%	195	4%	142	4%	451	3%	352,188.5	3%
	Total	2,870	100%	3,490	100%	4,639	100%	3,347	100%	14,346	100%	11,695,763.6	100%

Source: Compiled by the JICA Expert Team based on Project Office for JICA-TSL “Sub-loan Applications” and National Statistics Office “Statistical Yearbook, 2015”

7.7.3 Loan Size

The average loan sizes shown in the table below are JPY 27 million for the first generation of TSL Phase I, JPY 17 million for the subsequent generations of TSL Phase I, JPY 21 million for the first generation of TSL Phase II, and JPY 21 million for the subsequent generations of TSL Phase II, which are about half of the maximum loan amount of USD 600,000 for TSL Phase I and one-third (1/3) for TSL Phase II. It should be noted that the average loan size in Phase II is smaller than that in Phase I. This is an unexpected situation because the availability of fund is bigger in Phase II. It may indicate PFIs’ overall cautious attitude toward SME lending, particularly after the “Lehman Shock” global financial crisis (2008/09), and that they have become very selective in providing big amount of loan to SMEs.

If the number of sub-loans in categorized size is focused on, each group of loan size has a relatively similar share, i.e., 33% for smaller group of less than JPY 10 million, 41% for less than JPY 30 million and about 20% for medium group of up to JPY 50 million. For larger group of more than JPY 50 million, a significant share in number and in amount for Phase I may be considered exceptional, as this big share is traced back to only one PFI, Capitron Bank.

It should be noted that most of the disbursed sub-loans (74%) had the average loan amount of less than JPY 30 million.

Table 7.7.3 Sub-loan Distribution by Size

Sub-loan Amount		Phase I				Phase II				Total	
		SA funded		RF/A funded		SA funded		RF/A funded			
Number of Sub-loans	Less than JPY10 million	35	32%	72	34%	82	36%	45	29%	234	33%
	JPY10 ~ 30 million	32	30%	106	51%	81	36%	66	42%	285	41%
	JPY 30 ~ 50 million	18	17%	30	14%	54	24%	43	27%	145	21%
	More than JPY 50 million	23	21%	1	0%	8	4%	3	2%	35	5%
	Total	108	100%	209	100%	225	100%	157	100%	699	100 %
Loan Amount (JPY million)	Less than JPY10 million	185	6%	424	12%	436	9%	255	8%	1,301	9%
	JPY10 ~ 30 million	593	21%	1,900	54%	1,521	33%	1,240	37%	5,254	37%
	JPY 30 ~ 50 million	704	25%	1,116	32%	2,156	46%	1,682	50%	5,657	39%
	More than JPY 50 million	1,388	48%	50	1%	526	11%	170	5%	2,134	15%
	Total	2,870	100%	3,490	100%	4,639	100%	3,347	100%	14,347	100 %

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL “TSL Project Status Table”

GOM especially, the Ministry of Food, Agriculture and Light Industry (MOFALI) had an opinion that the maximum loan amount should be raised to USD 1,000,000 from the current level of USD 600,000 which is not enough for SMEs to introduce latest technology when purchasing modern production machinery and equipment. Similarly, almost all PFIs request to raise the maximum loan amount to USD 1,000,000 as the financial needs of SME keep increasing. In the case of cashmere products manufacturing, the knitting machines, particularly produced by *“Shima Seiki”*[1] a brand from Japan, are considered as expensive and needed a lot of investment. It has been commonly observed among SMEs that they will introduce advanced technology and improve productivity or quality of their products. In fact, several SMEs have purchased brand-new machinery instead of second-hand ones which had been in almost all cases in Phase I. Since the average loan size in Phase II is smaller than that in Phase I, raising the ceiling of the loan may not affect much the overall availability of the loan funds. It seems that revising the maximum loan amount to USD 1.0 million may be appropriate in order to support those SMEs who want to upgrade their operation.

On the other hand, one of the PFIs requests to raise the minimum amount of USD 10,000 in view of operational cost. Otherwise, there should unreasonable amount of paper work for small amount. The government (MOFALI) viewed that the minimum amount may be raised even to USD 200,000 in order to promote SMEs to purchase advanced high technology machinery and equipment.

7.7.4 Use of Sub-loan Proceeds

As for the loan usage, there is only a list of negative items, wherein proceeds of the sub-loan shall not be used for financing. In “Project Memorandum on TSL Project between JICA and the Executing Agency” attached to the Loan Agreement between JICA and GOM, it is stipulated that proceeds of the sub-loan shall not be used to finance the following items:

- Purchase of real estate
- Refinancing
- Working capital.

For PFIs, in the “Procedures for and Terms and Conditions of Sub-loans” attached to On-lending Loan Agreement between the government and PFIs, it is stipulated that proceeds of the sub-loan shall not be used to finance the following items:

- Purchase of land and other real properties (Later, it was amended to accommodate purchase of real property required for sub-loan project implementation).

[1] Shima Seiki Manufacturing Ltd., is the leader in computerized knitting technology with the world’s largest market share in the field.

- Purchase of military equipment and cost of such activities.
- Resettlement and other compensation costs, consumer loans and existing loans (If the loan initially provided is recognized as "Bridge Loan" for the JICA-TSL Project in the minutes of "Credit Committee" of PFIs, then, it is acceptable.)

As a result of this flexibility in the use of sub-loan proceeds, sub-loans have been disbursed for procurement of various items, not only machinery and equipment but also other requirements for production such as livestock and bees. Although more than 60% of sub-loan proceeds was used to finance purchase of machinery and equipment (including transportation facilities), nearly 30% was used to finance acquisition of production facilities such as factory buildings, warehouses, and various service buildings.

For the first generation of TSL Phase I, more than 70% was used for procurement of machinery and equipment, which had been the main target of fund use. For subsequent generations of TSL Phase I, the first generation of TSL Phase II and subsequent generations of TSL Phase II, it should be noted that more than 20% of loan proceeds was used for procurement of real estate. Furthermore, the number of projects, in which the proceeds of the JICA loan were mainly used for construction of buildings, is increasing. PFIs explained that most of the sub-loans were for newly buildings or expanding their factories as well as purchasing some equipment, and many companies apply to construct building as they already purchased machines and/or they rented factory buildings.

Table 7.7.4 Use of Project Cost by Industrial Sector

Use of Sub-loan Proceeds		Phase I	Phase II	Total
		SA&RFA funded	SA&RFA funded	
Project Cost financed by TSL Loan (MNT million)	Machinery and Equipment	113,158 (71%)	150,476 (62%)	263,634 (66%)
	Transportation Facility	1,594 (0%)	4,854 (2%)	6,448 (2%)
	Factory/Warehouse/ Service Building	31,876 (20%)	72,811 (30%)	104,687 (26%)
	Livestock / Plants, including Bees	3,188 (2%)	2,427 (1%)	5,615 (1%)
	Working Capital[2]	9,563 (6%)	12,135 (5%)	21,698 (5%)
	Total	159,378 (100%)	242,703 (100%)	402,081 (100%)

Note: Figures in MNT million; Percentages indicate composition in each phase.
Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL "Sub-loan Applications"

Financing for working capital by TSL proceeds is not allowed under the agreement between two parties. In accordance with this regulation, none of the loan proceeds for both phases have been used to finance the sub-loan requests only for working capital purpose. However, it was agreed by CSC that certain percentage (up to 20%) of the sub-loan per application could be used for the inventory purpose only, meaning that inventories were the raw materials vitally needed to start the production and service of the sub-loan projects. As shown in the table above, only 6% of the loan proceeds were used for this purpose and this means that the main usage of the TSL project loan was the capital investment purpose, which is well in line with the long-term project financing nature.

In view of the substantial demands for JICA loan funds far exceeding its availability, it may be necessary to strictly stipulate for what sub-loan proceeds shall be utilized in order to induce the proceeds of JICA-TSL to foreign components in order to support more projects directly effectuating economic development of the country.

[2] Only for the inventory purpose and not exceeding 20% of the sub-loan project cost per application

7.8 Sub-loan Projects for Environmental Protection in TSL Phase II

7.8.1 Eligibility and Minimum Requirements of the Environmental Protection Loan (EPL) Projects

With regard to the eligibility of the EPL projects, its clear criteria and monitoring indicators were described in Phase II - EPL Guideline, of which the first version was developed in August 2011.

In Phase II, the air pollution reduction projects are the main target area for EPLs, which are mainly categorized into three groups: (i) HOB and stove; (ii) Coal fuel energy; and (iii) Energy efficiency, renewal energy, and others.

Each category of the EPL projects should satisfy the following minimum requirements, which would ensure provision of positive environmental impacts before its implementation.

(1) HOB and Stove Projects

In this category, sub-loan projects for replacement of old and low efficient boilers, manufacturing of high efficiency HOBs and heat stoves, and development of air pollution control facilities such as cyclone, scrubber, bag filters, and other facilities, are considered eligible.

The sub-loan projects for replacement and development of HOB should satisfy the following minimum requirements to mitigate air pollution in Mongolia:

- Energy efficiency of new HOB should be 75% at the minimum.
- Boiler fan such as forced draft fan or induced draft fan should be installed.
- Dust collectors and air pollution control facility such as cyclone and filter to mitigate dust (fly ash) should be installed in HOB.
- Water purifying facility for HOB such as water filter should be installed and used.

(2) Fuel Production Projects

The coal fuel energy projects are defined as clean coal briquette, semi-cokes production, and development of renewable coal energy sources.

This category of sub-loan projects should satisfy the following minimum requirements to mitigate air pollution in Mongolia.

- Coal size and coal production area should be informed.
- Unburned combustible of fuel coal must be less than 15%.
- Sub-borrowers should measure exhaust gas from use of coal fuel energy, and report it to PFIs and related organizations.

(3) Energy Efficiency, Renewal Energy, and Other Projects

Sub-loan projects for production of heat insulating construction materials to reduce energy consumption, development of fuel conversion facilities and alternative sources of energy such as solar panel, PV, wind turbine, and other environmental projects such as carbon capture, recycling, 3R are considered eligible in this category.

This category of sub-loan projects should satisfy the following minimum requirements to mitigate air pollution in Mongolia:

- Information of before- and after-implementation of sub-loan project should be reported.
- Energy reduction rate of heat insulating construction materials should be at least 15% after the renewal of the materials compared to previous ones.

Sub-borrowers for heat insulating construction materials production, fuel conversion facilities, and others should report their products' effects and improved results.

7.8.2 Environmental Monitoring Indicator

Environmental monitoring indicators for the TSL project are set as follows.

- Energy saving (kWh/year)
- Coal consumption (ton/year)
- Concentration of stack gas: Dust (mg/m^{3}N), SO_2 (ppm), NOx (ppm), CO (ppm), and CO_2 (ppm)
- Emission amount (ton/year): Dust, SO_2, NOx, CO, and CO_2

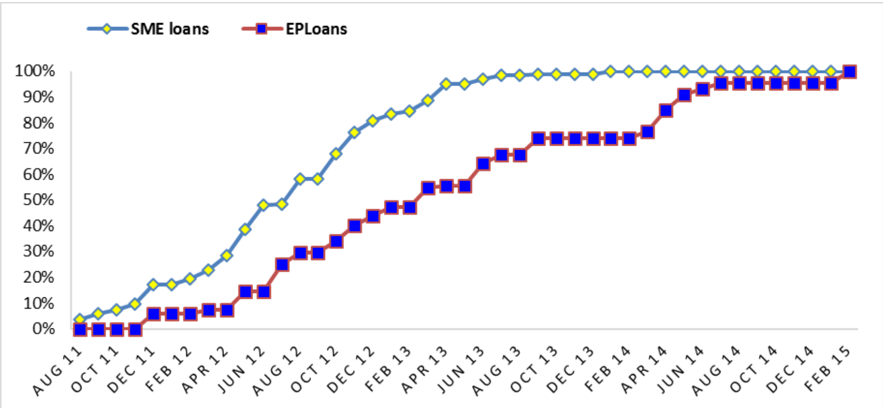
The main pollutant sources in the air in Mongolia are dust and SO_2, which are primary target pollutants. HOB, household heating stoves, and coal fuels can directly reduce dust and SO_2 emission amount by air pollution control facilities or by the improvement in the quality of fuels to burn. NOx, CO, and CO_2 are secondary pollutants as monitoring indicators.

All EPL sub-borrowers need to submit above monitoring indicators to CSC through the TSL Project Office. In the process of application, most of PFIs and sub-borrowers; however, experience difficulties in calculating the emission because of the methods for estimating the emission levels are relatively difficult. The Project Office was quite helpful for the applicants in getting the estimations on emission levels. When deciding the monitoring indicators for the future EPL projects' indicators, of which concentration and emission can easily be estimated, should be reconsidered.

7.8.3 Disbursement Progress

The disbursements of EPLs started in December 2011, four months later than the first SME loan had been disbursed. The first version of the EPL Guideline for Phase II operation was developed in August 2011, describing a clear list of criteria and evaluation guidelines for the EPL projects on reduction of air pollution, and distributed to PFIs for the promotion and evaluation of the EPL projects.

An EPL project is required to provide additional information on monitoring data for before and after the sub-loan project implementation. As for the actual demand, EPL has not been keeping up with the demand for SME Development loan and this is very much related to the nature of EPL project of being not very profitable and taking a long period to be implemented. The EPL disbursements have gradually increased, as shown in the following Figure.



Note: Cumulative percentage to the respective ODA Loan allocations, as of December 31, 2013
Source: JICA Expert Team

Figure 7.8.1 Disbursement Progress

7.8.4 Disbursed Sub-loans for Environmental Protection

As of September 30, 2016, a total of JPY 1,013.13 million has been disbursed for the implementation of 46 EPLs, reaching 100% of the total EPL loan disbursement for Phase II.

Table 7.8.1 Disbursed Sub-loans for Environmental Protection

Disbursement date by quarter	PFI	Sub-loan No.	Sub-borrower	Sub-project description	Amount (million JPY)
2011 Q4	Golomt Bank	1 (B)	Shilen khiits LLC	(iv) Renewable energy generation	45.24
2012 Q1	Golomt Bank	8 (B)	Dorniin ilch LLC	(i) HOB manufacturing	11.53
2012 Q2	Golomt Bank	18 (B)	Surt ider LLC	(i) Ger stove manufacturing	3.01
	TDBank	25 (B)	Tara LLC	(ii) Clean fuel manufacturing	7.22
	Xac Bank	8 (B)	Protech LLC	(iii) Energy efficient products manufacturing	46.93
2012 Q3	Capital Bank	2 (B)	Ekh golomtiin ilch LLC	(i) HOB renovation	81.63
	Capital Bank	2 (B)	Ekh golomtiin ilch LLC	(i) HOB renovation	34.98
2012 Q4	Capital Bank	8 (B)	Erdenet chandmani LLC	(v) Dust reduction	26.12
	Khan Bank	48 (B)	Uv ilch LLC	(i) HOB renovation	8.49
	Capital Bank	10 (B)	Delger construction LLC	(iii) Energy efficient products manufacturing	46.67
	Xac Bank	28 (B)	Grand electro technokom LLC	(iv) Renewable energy generation	30.34
2013 Q1	Golomt Bank	46 (B)	Tumen tulguur LLC	(iii) Energy efficient products manufacturing	17.18
	Khan Bank	60 (B)	Undrakh LLC	(i) HOB renovation	9.54
	Capital Bank	29 (B)	Ekas international LLC	(iii) Energy efficient products manufacturing	57.12
2013 Q2	Khan Bank	66 (B)	Duursakh altai LLC	(iii) Energy efficient products manufacturing	5.63
	TDBank	46 (B)	MNT project LLC	(iii) Energy efficient products manufacturing	11.32
	Golomt Bank	35 (B)	Arvai ilch LLC	(i) HOB manufacturing	8.24
	Golomt Bank	52 (B)	Medbar LLC	(iii) Energy efficient products manufacturing	36.38
	Khan Bank	67 (B)	Elbeg dulaan LLC	(i) HOB renovation	12.35
2013 Q3	Khan Bank	71 (B)	Epu khairkhan LLC	(iii) Energy efficient products manufacturing	10.35
	Golomt Bank	53 (B)	Amid gazar LLC	(v) Dust reduction	5.89
	TDBank	47 (B)	Khurimt star LLC	(iii) Energy efficient products manufacturing	9.82
	Capital Bank	37 (B)	L-Boss trade LLC	(ii) Clean fuel manufacturing	29.64
	Golomt Bank	54 (B)	Uv bayan ulaan LLC	(i) HOB renovation	7.86
	Khan Bank	72 (B)	Mungut khairkhan LLC	(i) HOB renovation	12.10
2013 Q4	-	-		-	-
2014 Q1	Khan Bank	74 (B)	Ilfratello LLC	(ii) Clean fuel manufacturing	1.84
	TDBank	50 (B)	Novelty LLC	(v) Dust reduction	15.00
	Khan Bank	62 (B)	Bindermunkh LLC	(vii) Soil pollution reduction	4.61
2014 Q2	Capital Bank	40 (B)	Zooku LLC	(iii) Energy efficient products manufacturing	24.15
	Capital Bank	41 (B)	Technomarket LLC	(ii) Clean fuel manufacturing	28.57
	Golomt Bank	62 (B)	Nomin tengeriin od LLC	(iii) Energy efficient products manufacturing	11.42
	UBCity Bank	3 (B)	Rezin edlel LLC	(vi) Recycling	7.96
	TDBank	55 (B)	Aniflo LLC	(v) Dust reduction	13.93
	Golomt Bank	64 (B)	Khulgiin deed LLC	(i) HOB renovation	8.91
	Xac Bank	35 (B)	Pyramid industry LLC	(iii) Energy efficient products manufacturing	30.09
	Khan Bank	80 (B)	Super space LLC	(vi) Recycling	16.75
	Golomt Bank	60 (B)	Arvijikh uvs LLC	(iii) Energy efficient products manufacturing	34.29
2014 Q3	Xac Bank	36 (B)	Ariun bilguun LLC	(i) HOB renovation	7.22
	Xac Bank	35 (B)	Pyramid industry LLC	(iii) Energy efficient products manufacturing	16.46
2015 Q1	Xac Bank	42 (B)	Khunnu Sunnu LLC	(ii) Fuel	18.06
	Capital Bank	45 (B)	Erdem Gaz LLC	(iii) Energy efficiency	68.03
2015 Q2	Golomt Bank	73 (B)	Make Green LLC	(iii) Other	6.25
2015 Q3	TDBank	70 (B)	New server LLC	(iii) Other	44.10
2015 Q4	Khan Bank	99 (B)	Mongol Polymer Khooloi LLC	(vi) Recycling	33.63
2016 Q1	-	-		-	-
2016 Q2	TDBank	86 (B)	MNT project LLC	(iii) Energy efficiency	5.95
	TDBank	89 (B)	Element LLC	(vi) Recycling	23.83
2016 Q3	TDBank	94 (B)	Monscan LLC	(vi) Recycling	6.69
	TDBank	95 (B)	Manlai guulin LLC	(ii) Fuel	9.81
Capital Bank			No. of sub-loan:	8	396.92
Golomt Bank			No. of sub-loan:	12	196.19
Khan Bank			No. of sub-loan:	10	115.29

TDBank	No. of sub-loan:	10	147.68
Xac Bank	No. of sub-loan:	5	149.099
UBCity Bank	No. of sub-loan:	1	7.96
Total	**Total disbursement:**	**46**	**1013.13**
	Disbursed from SA:	37	823.308
	Disbursed from RFA:	9	189.83

Note: Disbursed amounts are based on CSC reporting for replenishment requests to JICA
Source: JICA Expert Team

In terms of the PFI performance, Golomt Bank, which submitted the first three EPL applications, has been the most active and has taken the biggest share in terms of the number of EPL projects in Phase II. As for the total disbursement amount; however, Capital Bank has the largest share, mainly due to the disbursement of a HOB project in Arkhangai Province.

Reflecting the nature of all disbursed EPL projects in Phase II, 46 sub-loans could be classified into three categories as described below (the detailed evaluation by environmental monitoring indicator is described in Chapter 12.2 Environmental Impacts and Benefits).

(1) HOB and Stove Projects

The sub-loans in this category are within the main targeted area for the reduction of pollution in cities and the urban area. The reason for promoting this type of sub-loan projects was to replace the outdated inefficient HOB with more efficient up-to-date boilers, which would meet air-quality standards. There are 11 sub-loan projects in this category, of which 10 are for HOB and one is for the household heating stove project. There are only two HOB projects in the outskirt area of Ulaanbaatar and this is because most of the privatized HOBs in Ulaanbaatar have already been renovated, mainly with the investment made by the HOB operators themselves or with the help from the Millennium Challenge Account (MCA) project for the last three years.

Table 7.8.2 HOB and Stove Subprojects

Sub-category		PFI	Loan No	Sub-project	Amount (JPY million)	Location
1	HOB	Golomt	8 (B)	HOB manufacturing factory expansion	11.53	Ulaanbaatar
2	Stove	Golomt	18 (B)	Ger stove manufacturing factory expansion	3.01	Ulaanbaatar
3	HOB	Capital	2 (B)	HOB renovation	116.61	Arkhangai
4	HOB	Khan	48 (B)	HOB renovation	8.49	Uvurkhangai
5	HOB	Khan	60 (B)	HOB renovation	9.54	Zavkhan
6	HOB	Golomt	35 (B)	HOB manufacturing factory expansion	8.24	Uvurkhangai
7	HOB	Khan	67 (B)	HOB renovation	12.35	Ulaanbaatar
8	HOB	Golomt	54 (B)	HOB renovation	7.86	Uvurkhangai
9	HOB	Khan	72 (B)	HOB renovation	12.10	Uvurkhangai
10	HOB	Golomt	64 (B)	HOB renovation	8.91	Uvurkhangai
11	HOB	Xac	36 (B)	HOB renovation	7.22	Uvurkhangai
Total Disbursement:					205.86	

Source: JICA Expert Team

(2) Fuel Production Projects

The sub-loans in this category take 8.3% of all EPLs shares and involve sub-loans related to the processing of raw coal and the production of sawdust compressed blocks. These sub-loan projects are also within the targeted area of reduction of air pollution in the cities and towns. From the start of the project it was expected that there would be more sub-loans related to the production of processed coal briquettes, but due to the different factors, such as the high investment cost, uncertainty with the technology and the sales channels, there have been only two sub-loans despite the high market demand, caused by the deterioration of the air pollution in the urban areas. Instead there have been more sub-loans for the production of sawdust briquettes, which on the contrary has a simple production technology and use waste sawdust as a main source of raw material.

Table 7.8.3 Coal Fuel Energy Subprojects

	Sub-category	PFI	Loan No	Sub-project	Amount (JPY million)	Location
1	Sawdust Briquette	TDB	25 (B)	Saw sand briquette production factory expansion	7.22	Selenge
2	Semi coke Briquette	Capital	37 (B)	Briquette production factory establishment	29.64	Orkhon
3	Sawdust Briquette	Khan	74 (B)	Saw sand briquette production factory expansion	1.84	Tuv
4	Sawdust Briquette	Capital	41 (B)	Sawdust fuel manufacturing factory establishment project	28.57	Selenge
5	Semi coke Briquette	Xac	42 (B)	Briquette factory expansion project	18.06	UB/Nalaikh
6	Sawdust Briquette	TDB	95 (B)	Saw sand briquette production factory expansion	9.81	Ulaanbaatar
Total disbursement:					95.14	

Source: JICA Expert team

(3) Energy Efficiency, Renewal Energy, and Others

All other EPL sub-loans not included in the above categories, were categorized into the third group, which include the sub-loans related to the production of energy efficient materials, recycling and others such as the protection of soil and water. Please refer to the following table.

Table 7.8.4 Energy Efficiency, Renewable Energy, and Other Sub-loan projects

	Sub-category	PFI	Loan No.	Sub-project	Amount (JPY million)	Location
1	Heat insulating materials	Capital	10 (B)	Eco-panel factory establishment project	46.67	Ulaanbaatar
2	Heat insulating materials	Capital	29 (B)	Insulated wooden panel factory project	57.12	Ulaanbaatar
3	Heat insulating materials	Golomt	46 (B)	Heat insulating foam board factory establishment project	17.18	Ulaanbaatar
4	Heat insulating materials	Khan	66 (B)	Polystyrol light blocks factory establishment project	5.63	Gobi-Altai
5	Heat insulating materials	Khan	71 (B)	Felt covering factory expansion project	10.35	Khovd
6	Heat insulating materials	TDB	46 (B)	Polystyrol foam blocks factory expansion project	11.32	Ulaanbaatar
7	Heat insulating materials	TDB	47 (B)	Foam panel factory establishment project	9.82	Orkhon
8	Heat insulating materials	Xac	8 (B)	Canadian wooden house factory establishment project	46.93	Ulaanbaatar
9	Heat insulating materials	Golomt	52 (B)	Foam blocks production factory expansion project	36.38	Ulaanbaatar
10	Heat insulating materials	Xac	35 (B)	Insulated foam panel manufacturing project	46.55	Ulaanbaatar
11	Heat insulating materials	Golomt	60 (B)	Insulated light foam block manufacturing project	34.29	Uvs
12	Heat insulating materials	Golomt	62 (B)	Heat insulated block factory expansion project	11.42	Ulaanbaatar
13	Heat insulating materials	TDB	86 (B)	Foam panel factory expansion project	5.95	Ulaanbaatar
14	Heat insulating materials	Capital	40 (B)	Vacuum window factory expansion project	24.15	Ulaanbaatar
15	Heat insulating materials	TDB	70 (B)	Keramzit factory expansion project	44.10	Ulaanbaatar
16	Recycling	Khan	80 (B)	Waste fabrics recycling factory establishment project	16.75	Ulaanbaatar
17	Recycling	Capital	8 (B)	Waste sand recycling factory establishment project	26.12	Orkhon
18	Recycling	UBCity	3 (B)	Rubber pads factory expansion project	7.96	Ulaanbaatar
19	Recycling	Khan	99 (B)	Polymer pipe factory expansion project	33.63	Ulaanbaatar
20	Recycling	TDB	89 (B)	Plastic waste recycling factory establishment project	23.83	Ulaanbaatar
21	Recycling	TDB	94 (B)	Plastic tiles factory establishment project	6.69	Ulaanbaatar
22	Dust reduction & Carbon capture	Golomt	53 (B)	Tree nursery establishment project	5.89	Tuv
23	Dust reduction & Carbon capture	Golomt	73 (B)	Tree nursery expansion project	6.25	Tuv
24	Dust reduction & Carbon capture	TDB	55 (B)	Hydro seeding service expansion project	13.93	Ulaanbaatar
25	Others (Nano material)	TDB	50 (B)	Nanoprotect spray manufacturing project	15.00	Ulaanbaatar
26	Others (Soil pollution reduction)	Khan	62 (B)	Sewage reservior production project	4.61	Ulaanbaatar
27	Others (Energy efficiency)	Capital	45 (B)	Canned gas factory establishment project	68.03	Ulaanbaatar
28	Others (Solar panel)	Golomt	1 (B)	Solar panel assembling factory establishment project	45.24	Ulaanbaatar
29	Others (Geothermal energy)	Xac	28 (B)	Geothermal system installation project	30.34	Ulaanbaatar
Total disbursement					712.13	

Source: JICA Expert Team

Most of sub-loans in this category involve the production of energy efficient materials that are considered as saving energy indirectly effecting the reduction of air pollution. Compared with other EPL sub-loans, the demand for these types of construction materials has been quite high and this is very much related to the profitability level of these materials, especially during the construction sector boom of recent years. The next group of sub-loans in this category is related to the recycling initiatives and these types of sub-loan projects use waste materials, such as plastic bottles, rubber, etc. as raw material. Because of low cost of raw materials, these sub-loan projects are considered as profitable and feasible to be implemented by SME applicants.

7.9 Loan Operations by PFIs

7.9.1 Submission of Sub-loan Applications

One of the important development objectives for the introduction of TSL Project in Mongolia is to enhance the financial sector through capacity building of the participating banks in long-term project financing. As part of this effort, the Project Office was engaged in PFI training activities and assisted PFIs in clearing out the JBIC/JICA concurrences on the first three sub-loan projects. During this period, the sub-loan applications from PFIs were limited to three only and PFIs were primarily focused on learning more about the project purpose, procedures, and methods of doing the project analysis. This training process had to last a certain amount of time for the PFIs “to digest the knowledge” and depending on the capacity and nature of banks, PFIs spent varying degree of time from 6 to 18 months. After the clearance of the first three applications, PFIs started to accumulate more experience with the project financing and procedures and as a result, the number of sub-loan applications submitted to PO had gradually increased.

As for the actual number of sub-loan applications submitted to CSC, major three banks, namely Khan, TDB and Golomt have dominated other banks with over 100 applications for the operations of both phases. The banks performance very much depended on the availability of seed funds with JICA and it very much reflected in the table below. With the seed funds running low with JICA, the recovery stage for both phases had to start and this procedure of ending up the replenishment process with JICA affected the availability of TSL funds for PFIs. This recovery stage followed by the financing made from RFA slowed down the disbursement procedures with PO and thus, the banks had to slow down their applications.

Table 7.9.1 Sub-loans Submitted by Each PFI

	PFI	Total	’07		‘08		’09		‘10		’11		‘12		‘13		‘14		‘15		‘16.09.30	
			~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~12	~6	~9
Number of Subloan application submitted to CSC	Anod	8	2	3	3																	
	Capital	51											4	16	16	2	5	-	4	3	1	0
	Capitron	96	3	1	8	22	4	3	5	-	-	7	8	1	8	8	7	-	3	1	4	3
	Golomt	160	2	17	-	8	1	3	2	7	5	10	18	18	21	5	15	3	7	7	7	4
	Khan	182	13	8	8	1	1	5	4	4	4	10	22	26	31	5	14	5	6	9	4	2
	TDB	122	2	2	1	-	1	3	4	2	-	11	22	9	10	5	9	3	11	9	12	6
	UB City	7												1	1	1	3	1				
	XAC	92	1	2	-	1	1	2	-	2	2	4	6	16	13	-	8	7	8	5	14	-
	Zoos	50	1	1	1	6	1	1	-	-	-	1	4	1	3	-	5	5	2	3	8	7
	Total	768	24	34	21	38	9	17	15	15	11	43	84	88	103	26	66	24	41	37	50	22
Amount of Subloans requested (JPY million)	Anod	203	59	72	72																	
	Capital	1,025											117	299	287	37	98	-	113	40	35	-
	Capitron	1,814	62	30	259	675	52	26	55	-	-	91	110	18	74	98	80	-	26	15	72	71
	Golomt	2,468	104	242	-	225	26	7	9	65	38	264	267	203	282	74	161	32	92	153	137	87
	Khan	2,424	212	90	24	4	4	20	33	27	60	205	328	359	322	83	213	60	78	209	86	7
	TDB	2,064	17	26	11	-	4	27	50	24	-	252	468	124	88	98	139	49	209	174	212	92
	UB City	122												13	1	7	90	11				
	XAC	1,254	3	17	-	15	22	20	-	17	23	64	86	321	132	-	125	64	78	80	187	-
	Zoos	911	2	19	22	71	3	9	-	-	-	11	41	13	29	-	110	105	65	35	196	180
	Total	12,285	459	496	388	990	111	109	147	133	121	887	1,417	1,350	1,215	397	1,016	321	661	706	925	437

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL “TSL Project Status Table”

In terms of the individual performance, Khan Bank and Golomt Bank, which participated in both phases, have submitted the highest number of applications, which were 182 and 160 respectively. TDB has been the next active PFI with its 122 applications. Their TSL operation was not so active in TSL Phase I, but they seem to have changed their policy for TSL in Phase II and keep submitting more than ten applications every six months since then. According to them, it took so long to obtain JICA's concurrence for the first three applications, and, when they established an institutional structure after substantial internal training, they found most of the TSL funds went through other PFIs. PFI of Phase I, Capitron Bank has also been active in TSL operation, submitting 96 applications in total. XAC Bank, submitted 92 sub-loan applications in total, was also considered to have been rather inactive in TSL Phase I. Out of the 92 applications, 83 were submitted after 2011 when TSL Phase II was initiated. XAC Bank submitted its first application in early 2007. After that, however, XAC Bank had submitted only one application in every six months. They explained that they had been engaged in micro finance for long time, and just started to enter the SME market when TSL Phase I had commenced. They needed certain amount of time to train their staff for promoting SME financing.

The average size of a sub-loan submitted by most PFIs is within a range from JPY 13.3 million of Khan Bank to JPY 27 million of Capital Bank. Khan Bank concentrates in rather small projects as more than half of loans are less than JPY 10 million. The highest average loan size is with Capital Bank and this is a result of one EP sub-loan with the largest sub-loan amount per application of MNT 2.0 billion (equivalent to USD 875,507[3]). It also should be noted that nearly half of loans by Capitron Bank in Phase I are more than JPY 50 million. The other banks do not show concentration in any size of loan, covering from smaller to larger.

The sub-loan projects submitted by most of PFIs are located in Ulaanbaatar, followed by Central or Khangai regions. All the sub-loan projects submitted by UB City Bank are located in Ulaanbaatar. Khan Bank is unique in this sense, covering all the provinces of the country with a significant exposure. It should be also noted that Golomt Bank has extended significant number and amount of sub-loans for Eastern Region, where it is generally considered the least in industrial development level.

Table 7.9.2 Location of Subprojects Submitted by Each PFI

PFI	Total		Region									
	No.of subloan spplication	Subloan Amount requested (JPY million)	Ulaanbaatar		Central		Khangai		Western		Eastern	
Anod	8	203	7	171	1	32	-	-	-	-	-	-
Capital	51	1,025	35	705	7	149	3	119	6	52	-	-
Capitron	96	1,814	66	1,408	27	363	3	43	-	-	-	-
Golomt	160	2,468	103	1,890	22	209	14	91	8	64	13	214
Khan	182	2,424	98	1,589	42	424	26	273	13	135	3	3
TDB	122	2,064	100	1,734	15	185	2	57	-	-	5	88
UB City	7	122	7	122	-	-	-	-	-	-	-	-
XAC	92	1,254	42	828	13	155	10	70	22	129	5	72
Zoos	50	911	22	448	15	260	4	75	8	93	1	35
Total	768	12,285	480	8,895	142	1,777	62	728	57	473	27	412

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL "Sub-loan Applications"

7.9.2 Currency of Loan

When the TSL Phase I started, some PFIs advised their applicants to avoid US dollar borrowing considering the possible future exchange risk, except those cases in which the sub-loan applicants were earning foreign exchange, such as export-oriented manufacturing or tourist service for foreigners, etc. Yet, over one-fifth (1/5) of sub-loans have been disbursed in US dollar, only because the applicants wanted the lower interest rate. The exchange risk, however, was widely recognized when the so-called "Lehman shock" affected the exchange rate between tugrik and USD, i.e., tugrik depreciated by 36% against US dollar, which put the end-borrowers into higher risk. Since then, US dollar lending has been observed only in exceptional cases. Selection of currency of loans may not be an issue any more in the future, except for those existing ones in US dollar.

[3] As of the Bank of Mongolia rate of 30 September 2016

Table 7.9.3 Sub-loans in Tugrik and US Dollar by PFI

PFI		Phase I				Phase II				Total	
		SA funded		RF/A funded		SA funded		RF/A funded		(JPY million)	
		MNT	USD	MNT	USD	MNT	USD	MNT	USD	MNT	USD
Number of Sub-loans	Anod	1	1							1	1
	Capital					33	1	16	-	49	1
	Capitron	21	11	54	4					75	15
	Golomt	17	6	39	1	47	3	30	-	133	10
	Khan	26	4	43	2	68	1	28	-	165	7
	TDB	5	1	12	2	42	2	42	1	101	6
	UB City					2	-	4	-	6	-
	XAC	5	-	16	1	25	1	36	-	82	2
	Zoos	1	-	0	0					1	-
	State	9	-	35	0					44	-
	Total	85	23	199	10	217	8	156	1	657	42
Loan Amount (JPY million)	Anod	41	32							41	32
	Capital					972	12	391	-	1,362	12
	Capitron	636	592	881.6	53.9					1,518	646
	Golomt	367	207	537.0	17	843	125	625	-	2,372	349
	Khan	356	214	650.3	67	1,082	48	628	-	2,716	329
	TDB	85	5	192.6	32	974	75	958	50	2,210	162
	UB City					22	-	119	-	140	-
	XAC	100	-	199.1	35	479	8	577	-	1,355	43
	Zoos	38	-	0	0					38	-
	State	197	-	824.5	0					1,021	-
	Total	1,819	1,050	3,285	204.9	4,372	267	3,297	50	12,773	1,572

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL “TSL Project Status Table”

7.9.3 Terms and Conditions

The standardized terms and conditions are applied for all sub-loans at each lending stage, without consideration of industrial sectors or corporate size of sub-borrowers. There have been some requests for modification of terms and conditions have been received from both PFIs and SMEs, particularly the sub-loan interest rate and the collateral requirements. The issues on financing for working capital and trade sector were also raised.

(1) On-lending Interest Rate

Under the current scheme of JICA-TSL, MOF revises interest on on-lending loans every six months based on the market interest rate (average demand deposit rate for tugrik lending, and 6-month US dollar LIBOR + 1% for US dollar lending). Some PFIs requested a better margin by lowering on-lending interest rate if SMEs are allowed to enjoy the current sub-loan interest rate lower than the market rate. The reason was that another similar a GOM-run program for SME development, SME Fund Program, allows 6% of margin for PFIs.

(2) Sub-loan Interest Rate

It is commonly perceived by the public that banks earn too much from the margins, and their profit margin should be reduced in order to lower the lending rates. Moreover, based on the idea that SMEs are the main target group for TSL Project, MOF restricted maximum margin on this operation for PFIs to be 4% for Tugrik loans and 3.6% for US dollar loans. On the contrary, reflecting the for-profit nature of the banks, PFIs applied the maximum margin on all on-lending rates, resulting in having the same interest rate for all sub-loans as if were regulated (not-market-based). They considered that the current allowance for margin could cover only their operational cost, not covering the risk factors. It is surprising however that one of the big banks expressed the current restriction on PFIs’ margin worth to be maintained as the GOM’s program should provide unified terms and conditions to borrowers. Since most of the current interest rates for borrowers under the various GOM’s or donors’ program are set at lower level then the market rate, the restriction on PFIs’ margin to certain level may be justifiable.

For borrowers, the sub-loan interest rate, which is revised semi-annually, is 7% as of 2016, seems to be favorable enough compared with most of other borrowing facilities (about 18% p.a. for tugrik loans at present), and very little complain or dissatisfaction has been received from the borrower side. Many potential borrowers want to enjoy the current interest rate because they recognize this is one of the best terms and conditions on bank loans available.

(3) Loan Tenure and Grace Period

The average loan tenure shown in the table below is 6.5 years, ranging from 3 to 10 years. It may be noted that Capital Bank and Capitron Bank tend to provide longer loan tenure, while others average six years and more. The average grace period is 1.3 years, ranging from 0 to 3 years. Only Capitron Bank agrees to provide relatively longer grace period on average.

Although no banks request for revision of loan tenure except for EPL which usually takes longer time to pay back because of less profitable nature without big cash inflow projection, Khan Bank insists that the grace period should be shorter (up to two years) as borrowers want to enjoy longer grace period even after they completed their sub-loan projects. Only Capitron Bank and Golomt Bank provide over two-year grace period for a number of sub-loan projects. Since the construction of large office buildings and residential apartments are out of the scope of the TSL Project, those projects with construction activities requiring over two years seems to be exceptional cases. The revision of grace period not exceeding two years may be justifiable.

Table 7.9.4 Sub-loan Distribution by Tenure and Grace Period

PFI	Loan Tenure					Grace Period				
	3 years	3 ~ 5 years	5 ~ 8 years	8 ~ 10 years	Average (years)	No Grace	Within 1 year	Within 2 years	Within 3 years	Average (years)
Anod	0	1	1	0	5.5	0	2	0	0	0.8
Capital	0	9	32	9	7.5	1	32	17	0	1.2
Capitron	0	21	47	22	7.3	2	28	39	21	1.8
Golomt	13	81	37	12	5.6	8	79	38	18	1.3
Khan	8	63	83	18	6.3	12	93	61	6	1.2
TDB	6	34	51	16	6.5	9	60	27	11	1.2
UB City	1	2	3	0	6.0	0	4	2	0	1.2
XAC	3	38	31	12	6.4	1	49	31	3	1.3
Zoos/State	0	17	15	13	7.1	0	28	10	7	1.4
Total	31	266	300	102	6.5	33	375	225	66	1.3

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL "TSL Project Status Table"

(4) Collateral

In order to apply for sub-loans from PFIs, the applicants have to fulfill the collateral requirement of PFIs, on the average at 159% of the sub-loan amount after strict evaluation of recoverable value of collateral by PFIs. While PFIs are successful in securing collateral evaluated as more than 100% of sub-loan amount in most cases so far, many potential SMEs expressed their concern on the unavailability of their collateral to get sub-loans. In fact, several applications have not reached disbursement as the collateral initially expected to be offered were found unavailable and those applications were withdrawn before or after being approved.

Table 7.9.5 Sub-loans and Collateral Provided

PFI	Total Amount of Sub-loans disbursed (MNT million)	Total Value of Collaterals (MNT million)						Coverage Ratio
		Property for Business	Residence	Production Machinery, Equipment	Inventories, others	LGF	Total	
Anod	1,271	2,583 (1%)	102 (4%)	0	0	0	2,685	211%
Capital	22,498	17,865 (70%)	6,392 (25%)	212 (1%)	1,138 (4%)	0	18,745	117%
Capitron	29,917	21,179 (57%)	4,115 (11%)	9,834 (27%)	1,935 (5%)	0	30,539	131%
Golomt	42,170	47,275 (62%)	19,993 (26%)	5,463 (7%)	3,056 (4%)	558 (1%)	54,398	187%
Khan	46,624	42,073 (52%)	16,703 (21%)	13,924 (17%)	6,881 (9%)	700 (1%)	49,520	155%
TDB	39,312	38,716 (59%)	18,444 (28%)	4,943 (8%)	3,367 (5%)	0	35,716	166%
UB City	2431	4,335 (87%)	635 (13%)	0	0	0	985	328%
XAC	23,836	27,071 (58%)	12,065 (26%)	5,090 (11%)	2,092 (4%)	482 (1%)	23,163	193%
Zoos	17,116	18,413 (69%)	3,237 (12%)	3,615 (13%)	783 (3%)	930 (3%)	10,707	167%
Total	225,175	219,510 -60%	81,686 -22%	43,081 -12%	19,252 -5%	2,670 0%	226,457 -100%	158%

Source: Compiled by the JICA Expert Team based on the Project Office for JICA-TSL "Sub-loan Applications"

(5) Other Terms and Conditions

No specific changes have been requested on maturity or loan-to-value ratio.

During the Phase I operation, CSC had been pursuing a policy of creating more employment opportunities through TSL project financing and required a certain number of new jobs per application, i.e., for an application amounting to MNT 100 million, 5 new jobs had to be created, meaning MNT 20 million per job. Despite the fact that this policy very much reflected the government employment policy of that time, most PFIs had disagreement with this policy as: 1) advanced technology may not be introduced and 2) the projected new jobs might be difficult to verify after the completion of the sub-loan projects. It seems that PFIs would prefer to support those SMEs to be upgraded through introduction of modern technology. With the start of Phase II operation, CSC had changed its policy of asking number of new jobs to be created under the sub-loan projects reflecting the shift of the government policy from labour intensive to the technology intensive production.

7.10 Status of Repayment

There are two repayments related to the TSL project operations: namely (1) the on-lending repayment or repayments of principals and interests from PFIs to MOF, and (2) the sub-loan repayment or repayments of principals and interests from sub-loan borrowers to PFIs. The on-lending repayment is made by PFIs to MOF after the deduction of banks' margin and as of June, 2016, PFIs have been making these repayments for the operation of both phases without any delay in accordance with their on-lending agreements, except for the one case mentioned below.

During the Phase I operation, Anod bank had a sub-loan project named “Construction of Semi-processed Cokes and Briquette Plant Project” with the sub-loan amount of USD 300,000. When Anod Bank suffered a bankruptcy in 2008, the consultants on behalf of MOF struggled to identify solutions for the sub-loan projects provided by Anod Bank. Although they succeeded in finding another PFIs to take over Anod's sub-loan projects one by one, after spending substantial time and energy, only this project could not be transferred to any other PFI, despite its successful implementation. As no banks looked after this project, the borrower has not been able to do debt servicing. It seems that all the cash generated from the operation of this project were accumulated within the company and used for further expansion of the factory. As advised by CSC, this sub-loan with related contracts and documents were transferred from the Project Office to the Debt Service Division, MOF in June 2016 for them to take further actions.

As for the sub-loan repayments, the first sub-loan which made repayment in the amount of MNT 12 million by Khan Bank disbursed on 25 May 2007 was the “Felt and Felt Shoes Project”. This sub-loan had no grace period, so repayment by the sub-borrower should have been started in June 2007. But repayment of relevant on-lending loan started only in December 2007 because of the six months' gap in maturity between Sub-loan Agreement and On-lending Loan Agreement. At that time, RF/A whose purpose was to receive repayment had not been opened yet, and the first repayment of the principal was received only in February 2008 in the amount of MNT 750,000, to be repaid for three months.

Since then, repayments of the principal had been received on schedule as per agreed upon by all PFIs in most cases. However, it should be noted that several loans were rescheduled when the Mongolian economy, as well as, the world-wide economy had suffered after the so-called “Lehman Shock” (2008/09). As of 2013, the repayment from SMEs to PFIs, it was found 15 cases of delayed repayments among which ten cases were initially provided by Capitron Bank and one each by Anod, Zoos, Golomt, and Khan banks. In addition, Khan Bank had one case, which had already been written-off in 2009.

Lately, there are a number sub-loan cases with repayment delay, as shown in the table below.

Table 7.10.1 Sub-loans with Repayment Delay

Borrower	PFI	Sub-loan Project Name	Amount of Sub-loan	Reason of Delay
A	Golomt	Sea-buckthorn processing factory establishment project	500,000,000	Insufficient income due to the economic crisis
B	Golomt	Plastic cap production factory project	100,000,000	Payment dispute over the rented premises
C	Golomt	Plastic pipe production factory project	125,000,000	Insufficient income due to the economic crisis
D	Golomt	Establishment of irrigation facility project	170,000,000	Insufficient income due to the economic crisis
E	Golomt	Expansion of intensified farm project	38,800,000	Lack of competitive edge
F	Golomt	Light blocks factory establishment project	600,000,000	Delay with the project implementation due to the economic crisis
G	Golomt	Buuz and bansh factory expansion project	450,000,000	Lack of competitive edge
H	Golomt	Wool and cashmere factory expansion project	150,000,000	Insufficient income due to the economic crisis
I	Golomt	Ballet school expansion project	500,000,000	Insufficient income due to the economic crisis
J	Golomt	Intensive pig farm expansion project	90,000,000	Lack of competitive edge
K	Capital	Bottled water factory establishment project	200,000,000	Could not implement the project due to licensing problem.
L	Capital	Scaffolding framework factory expansion project	350,000,000	Insufficient income due to the economic crisis
M	Capital	Light blocks factory establishment project	400,000,000	Insufficient income due to the economic crisis
N	Capital	Eco panel factory establishment project	820,000,000	Insufficient income due to the economic crisis
O	Capital	Traditional medicine clinic establishment project	480,000,000	Insufficient income due to the economic crisis
P	Capital	Sanatorium establishment project	500,000,000	Cannot complete the project due to the shortage of funds
Q	Capital	Bread and cookies factory expansion project	380,000,000	Insufficient income due to the economic crisis
R	Khan	Buuz and dumpling factory establishment project	160,000,000	Insufficient income due to the economic crisis
S	Khan	Auto service and metal works factory expansion project	130,000,000	Insufficient income due to the economic crisis
T	Khan	Window cleaning service expansion project	107,000,000	Insufficient income due to the economic crisis
U	Khan	Heavy duty bag factory expansion project	$400,000	Accumulation of receivables caused by the economic crisis
V	Khan	Bread and pastries factory expansion project	280,000,000	Loan misuse
W	Khan	Kimchi factory expansion and service center establishment project	40,000,000	Loan misuse
X	Khan	Toilet paper and tissue factory establishment project	80,000,000	Could not run the production due to the purchase of old outdated equipment
Y	Capitron	Renovation of boiler facility	$ 582,000	Exchange risk
Z	Capitron	Renovation of boiler facility	$ 600,000	Exchange risk
AA	Capitron	Metal works factory expansion project	420,000,000	Cannot implement the project due to the health condition of the borrower
BB	Capitron	Carpet Factory	170,000,000	Could not complete the project due to the shortage of funds.
CC	Xac	Briquette factory expansion project	300,000,000	Loan misuse
DD	Xac	Sea-buckthorn processing factory project	51,500,000	Insufficient income due to the economic crisis
EE	Xac	Wood works factory expansion project	$355,000	Dispute with the bank over the exchange rate risk
FF	State	Foam panel factory establishment project	450,000,000	Could not implement the project due to the health condition of the borrower

Source: Compiled by the JICA Expert Team based on the “PFI Report on Current Repayment and Overdue Status”

The most number of sub-loans with repayment delay is related to the economic crisis and there are 16 of such cases. These cases are the sub-loans which were implemented in accordance with the initial applications, but are failing to generate sufficient revenue to pay off the monthly payments due. The remaining half of the sub-loans have other varying reasons for the delay, such as exchange risk, misuse of the loan proceeds, health condition of the borrowers, disputes, etc. In terms of the sub-loan sector, most of the sub-loan are related to manufacturing and this is obvious at the present state of the economic slow-down with over 60% of all TSLs lending extended to this target sector specifically.

As for the individual PFI cases, Capitron bank has recently made a good effort to work with their failing sub-loan projects and has been able to reduce the number from 10 sub-loans, mentioned in previous SAPI-1 report, down to 4 cases. On the contrary, Golomt bank has the most number of sub-loans (10) with delaying repayments, including three cases of actual bankruptcy. The reason for this failure could be attributed to the bank's lending policy of providing sub-loans with shorter period of tenure compare with other PFIs and the loan officers' capacity to do a long-term projection.

For the reporting purposes, the ratio of the delayed repayments was calculated for the Phase II operation. The latest the ratio has been calculated as follows:

Table 7.10.2 Ratio of Sub-loans with Repayment Delay

NPL	2011	2012	2013	2014	2015	2016	2017Q1	2017Q2
Banking sector average	5.8%	4.2%	5.3%	5.0%	7.1%	8.5%	8.2%	8.8%
TSL	0.0%	1.9%	2.1%	4.2%	5.9%	5.7%	5.3%	7.1%

Source: TSL Project Office

It can be seen from the above Figure, that the ratio of the sub-loans with delayed repayments has been increasing notably since 2013. The main reason for this increase is the economic slow-down of the last few years, which severely affected the construction sector and the consumer spending confidence. Although the number of sub-loans with delayed repayments were increasing, the TSL project ratio has been below the banking average and it reflects the different nature of the project financing, which is based more on project feasibility analysis rather than the credibility analysis made by the commercial banks.

7.11 Repeating Funding

In each phase of the TSL project, the maximum amount of sub-loan per borrower was specified as not exceeding USD 600,000 or equivalent in MNT. Within this range, the SMEs were allowed to apply to and access the TSL project seed funding, mostly one time and in some cases two times, depending on their investment needs and justifications to apply again. Refer to the table below.

Table 7.11.1 Number of Borrowers with 2nd time Sub-loans

Category	Sub-loans	Note
Total number for Phase I and II	699 (100%)	As of September, 2016
Borrowers with the 2nd time sub-loans	54 (7.7%)[4]	19 sub-loans (3.5%) for new sub-loan projects
		35 sub-loans (5.8%) for expansion of the existing operations

Source: TSL Project Office

As it can be seen from the table above, the number of borrowers with sub-loans for the second time is less than 8% of the total shares, and out of these 54 cases 19 sub-loans were actually disbursed for new sub-loan projects for the second time. The other 35 sub-loan cases were related to the disbursement of additional loans for completion or expansion of the previous ongoing sub-loan project financing. While the second time sub-loans for new sub-loan projects were disbursed based on the result of or success of the first sub-loan project implementation, the sub-loans for supplementary purposes were disbursed mainly on the following reasons, such as i) increased project cost caused by inflation, ii) shortage of funds

[4] Note: this number includes three borrowers, who had access to the TSL project funding 3 times in total.

to complete the project caused by the exchange risk, iii) the banks' or applicant SMEs' precaution to implement the sub-loan projects in stages of financing, iv) shortage of collateral, and v) the need to expand the operational capacity, etc. These statistics show that the second-time borrowers do not pose any risks to crowd out other new comers to access the TSL project loan, and hence, there is no need to restrict the number of times they could access this type of loan as long as they meet the eligibility criteria and do not exceed the ceiling amount per applicant. Instead, giving them the opportunity to access the TSL project loan in the future could be a strong reason or encouragement for them to do well with their first or previous sub-loan project implementation. Moreover, it could be considered that additional loans have provided significant benefits to SMEs to upgrade their operation.

7.12 Major Implications

The following are implications identified from the review of operational performance of JICA-TSL Phase I and II:

The current eligibility for sub-loan borrowers with regard to the number of core staff has to be 199 or less for the industrial sector and 49 or less for the service sector. However, the Mongolian economy may reach a certain level to require further strengthening of private industries, not only the SMEs but also core enterprises in the middle range. Various views on eligibility of sub-borrowers, particularly on scale of sales which seems outdated, should deliberately be studied in order to achieve further development of the Mongolian economy.

Although, in the JICA-TSL Project, sub-loans have been disbursed mainly for manufacturing and agriculture projects, about one-fourth (1/4) of the sub-loans are earmarked for service industries, which include hotel businesses and various social services, the strategic industries to be developed in the regions. Moreover, trading firms, construction and mining companies may need to introduce modern technologies. The eligibility requirement on these industries should be carefully reviewed further among the concerned government agencies.

Sub-loan projects submitted by most of PFIs are located in Ulaanbaatar, Central, or Khangai regions. It may be preferable to encourage the long-term finance spread out into localities of the country. On the other hand, in view of rather smaller population of the country, it may not be efficient to promote smaller industries in rural areas. Various views should deliberately be studied and reflected on the formulation of TSL Phase III.

It is worth reviewing the minimum and maximum loan amount in view of the growing economy of the country. Also, it has been commonly observed among SMEs that they would introduce advanced technology and improve productivity or quality of their products.

GOM's policy on the restriction of PFI's margin should be reviewed further among concerned government agencies. Even if the current policy is reasonably justifiable, the current margin of 4% may be reviewed in comparison with other GOM's similar programs such as the SME Fund, or other donors' programs.

The review of loan tenure and grace period may also be necessary, since the retained earnings can help the businesses to achieve a faster growth and expansion, and thus, if SMEs need to be promoted, the longer tenure with an appropriate duration of grace period has to be considered as an integral part of the financial support measures. Longer loan tenure may be required for some of the EPL projects in view of its impacts on the society. Also, except for those projects really requiring construction period over two years, it may be justifiable to shorten the grace period up to two years. Exceptional cases may be solved by exceptional approval if evidence for longer construction period is submitted.

In order to obtain sub-loans from PFIs, sub-borrowers are obliged to provide collaterals to PFIs, on average 159% of the sub-loan amount after strict evaluation of recoverable value of collaterals by PFIs. It is widely observed that many potential SMEs expressed their concern on the unavailability of their collaterals to get sub-loans. The services provided by the Credit Guarantee Fund and other donor programs to supplement this shortage of collateral or securities should be explored and effectively used to improve SME's access to financial support.

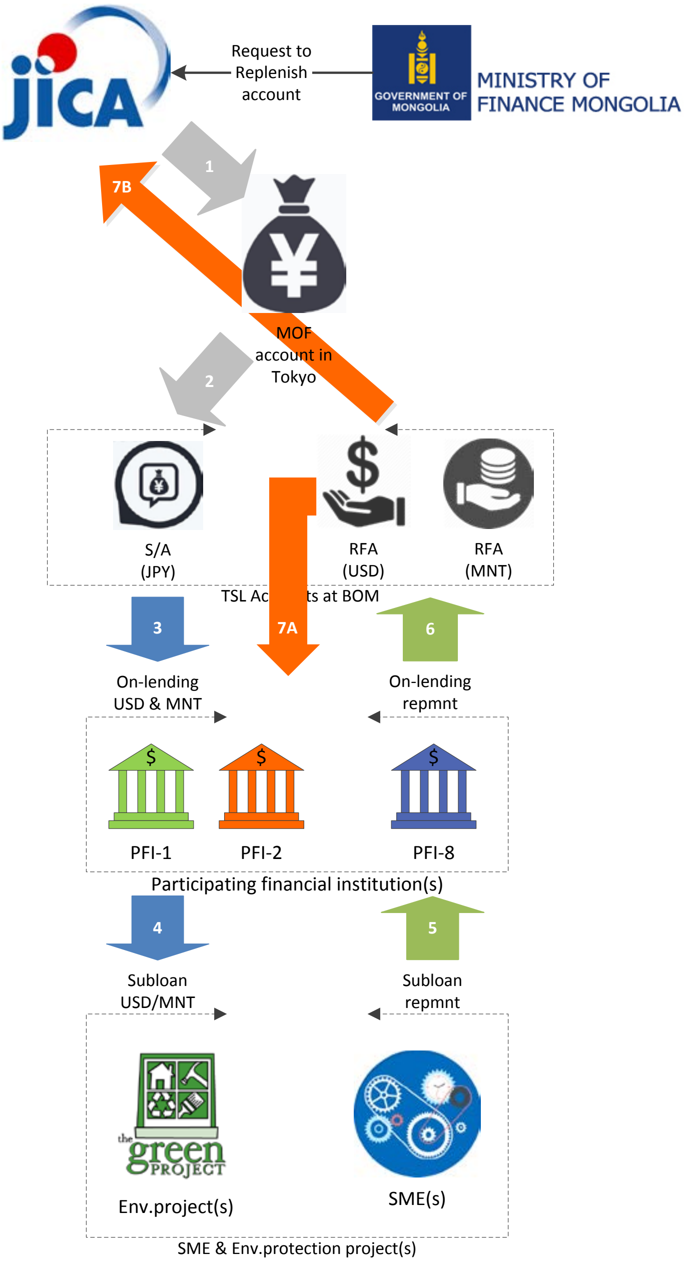
In view of substantial demands for the JICA loan funds far exceeding its availability, it may be necessary to strictly stipulate for what sub-loan proceeds shall be utilized in order to induce the proceeds of JICA-TSL to foreign components in order to support more projects directly effectuating economic development of the country.

Despite the fact that the creation of employment opportunities is one of the important objectives of the TSL Project, this issue should carefully be reviewed as the requirement on job creation can impede the introduction of advanced technology with the TSL funds and it might difficult for PFIs to verify the actual number of jobs created after the implementation of sub-loan projects.

Chapter 8 Financial Performance of the TSL Project

8.1 Flow of Funds

The funds disbursement and utilization of revolving account processes are documented and described in the loan agreement (L/A) and the standard form of the on-lending loan agreement executed between the Government of Mongolia (GOM) and the Japan International Cooperation Agency (JICA). The disbursement process described in the figure below.



(1) JICA replenishment/disbursement of loan proceeds to the GOM's non-resident JPY account at Bank of Tokyo-Mitsubishi UFJ, Tokyo.

(2) GOM (represented by MOF) transfers the funds to the JPY denominated S/A at BOM

(3) upon approval of on-lending loan(s) by the CSC the JPY at S/A converted into MNT or USD (per currency approved for sub-loan) and transferred to PFIs account for disbursement of sub-loan(s).

(4) PFI(s) disburse sub-loans to SMEs in MNT or USD as requested by SME and approved by CSC.

(5) SME(s) service sub-loans to PFIs per sub-loan repayment schedule.

(6) PFI(s) service on-lending loans to MOF and transfer both principal repayments and interest payments to RFA accounts in MNT or USD.

(7) Proceeds, including both repayment of principal and payment of interests, collected at RFA are disbursed for: (7A) new on-lending loans to PFI(s) for financing new sub-loans, i.e. Step-4; or (7B) for repayment of JICA's loan.

Source: JICA Expert Team

Figure 8.1.1 TSL flow of funds

As described in the chart above and clearly stipulated in the L/A the loan proceeds of JICA are to be utilized for the intended project objectives of SME development and Environmental protection for the entire duration of the loan term. As described in the L/A the loan proceeds shall flow as follows:

GOM (represented by MOF) requests disbursement or replenishment by submitting the request along with supporting documents.

(i) Upon review and conformity JICA disburses the funds to the GOM's of GOM's non-resident JPY account at Bank of Tokyo-Mitsubishi UFJ, Tokyo.

(ii) MOF transfers loan proceeds from its non-resident account at Tokyo to its JPY denominated Special Account (S/A) at BOM.

(iii) Upon review and approval of on-lending loan(s) by the CSC the JPY at S/A are converted into MNT or USD (per currency approved for sub-loan) and transferred to PFIs account for disbursement of sub-loan(s).

(iv) PFI(s) disburse sub-loans to SMEs in MNT or USD mirroring terms of loan approved by CSC.

(v) SME(s) service sub-loans received from/to PFIs as per sub-loan repayment schedule.

(vi) PFI(s) service on-lending loans to MOF and transfer both principal repayments and interest payments to RF/A accounts in MNT or USD.

(vii) Proceeds, including both repayment of principal and payment of interests, collected at RF/A are disbursed for: (a) new on-lending loans to PFI(s) for financing new sub-loans, i.e. Step-4; or (b) repayment of JICA's loan.

In practice, the execution of each agreement and obligations against the corresponding borrower is dual:

(i) L/A is executed between GOJ, represented by JICA and GOM represented by MOF. That is, GOM is obliged for the repayment of JPY denominated loan proceeds, covering exchange risks of JPY/USD and JPY/MNT.

(ii) On-lending loan agreement(s) executed between MOF and PFIs. The service of on-lending loan is responsibility of each PFI received the Loan proceeds through the MOF.

(iii) Each sub-loan granted by PFIs based on sub-loan agreement(s) between PFIs and SME borrowers. Sub-loan terms and obligations are agreed between PFI and SME.

The repayments under each agreement(s) are independent of each other. That is, MOF services JICA loans in JPY independently of the PFIs service of on-lending loan and exchange rate evolution; PFIs are obliged to make repayment of principal and payment of interest in the same currency it received the funds, whether or not the sub-borrower has made repayment of principal and payment of interest; and PFIs and SMEs are the counterparties for sub-loan agreement.

8.2 Repayment of the JICA Loan

Per L/A MOF shall pay interest and principal of loan to JICA semi-annually per agreed upon repayment schedule.[1] So far, MOF regularly pays interest payment and principal repayment to JICA from budgetary resources. That is the funds necessary for loan service to JICA under the L/A Phase I and Phase II are included in the annual budgetary expenses.

The repayment of principal for Phase I proceeds commenced in March 2016 and the repayment of principal for Phase II commences in November 2020.

So far all payments of interest and repayment of principal of both Phase I and Phase II are serviced through budgetary resources. That is no funds withdrawn from RF/A accounts of Phase I and Phase II.

[1] Article II: Repayment, Interest and Commitment Charge, Section 1 and Section 2 of the L/A for Phase I & II.

8.3 Repayment of the on-lending loan(s)

The repayments of principal and payments of interest of the on-lending loan have consistently well performed. During ten years of the project implementation, during which at least three cases of bankruptcy and receivership of three commercial banks, and provision of over 700 on-lending loans, there has been one sub-loan case where the Anod Bank went bankrupt and the transfer of subject loan asset has failed and there is no subsequent entity to collect and enforce the sub-loan collection. The loan has been transferred to MOF for further action of MOF. By design TSL Project takes no credit risk, but only counterparty risk, which in turn largely managed and covered by MOF.

The conditions and requirements of on-lending loan agreement are consistently enforced and followed up except recent few cases where PFIs serviced the on-lending loans in arrears (from few days up to 56 days). Most recently, Capital Bank repayments of August 2016 were received in 56 days of arrears. The arrears in on-lending loan service are to be followed up and investigated with assistance of MOF and BOM as significant arrears in repayments may indicate counterparty risks.

Where applicable the undue loss payment of 0.1% a day need to be imposed per Section 2.01(C)(3) of the on-lending agreement to ensure prudential enforcement of the on-lending agreement and prompt payment by PFIs. Few occasions in the past are identified and noted in the audit recommendations. The audit recommendations are to be followed up and implemented properly to the extent possible.

8.4 TSL Sub-loan performance

The repayment schedule for each on-lending loan is agreed upon between MOF and PFIs, and executed as an attachment to the on-lending L/A. While PFIs aim to match the Asset and Liability sides by exactly mirroring sub-loan repayment schedule to the one approved by CSC and minimize the carry over at its balance, practically it is very difficult to implement due to reasons exogenous to PFIs. Some PFIs even don't bother to match the on-lending loan to sub-loan and the on-lending loan accounts are opened mirroring repayment schedules while sub-loan repayments are agreed with SME clients, with differing interest calculation, but within BOM guidelines, i.e. Actual/Actual instead of 30/360[2]. One PFI requested to switch to Actual/Actual if possible as its system does have 30/360 configuration on its core system, and therefore recalculates all the interests on MS Excel sheet.

While there are no arrears[3] in the repayments of the on-lending loans to the TSL Project, the quarterly reports collected from PFI show NPL ratios of sub-loans financed by TSL Project. The next table presents the NPL as of December 2015 and 2016.

Table 8.4.1 Summary of the Sub-loans in Arrears

Duration of arrears	Outstanding principal balance of sub-loans in Arrears, 12/30/2016			Outstanding principal balance of sub-loans in Arrears, 12/30/2015		
	MNT denom.	USD denom.	TOTAL	MNT denom.	USD denom.	TOTAL
	(mln.MNT)	(thous.USD)	(mln.MNT)	(mln.MNT)	(thous.USD)	(mln.MNT)
3–6 months	1,382.75	-	1,382.75	1,891.76	-	1,891.76
6–12 months	1,953.49	-	1,953.49	1,093.98		1,093.98
1–2 years	509.16	324.9	1,318.78	2,075.11	350.58	2,774.81
Over 2 years	420.21	1,124.24	3,219.04	137.23	958	2,049.24
TOTAL	4,265.61	1,449.14	7,874.06	5,198.08	1,308.58	7,809.79
TSL Sub-loan portfolio	131,022.31	3,073.00	138,672.64	122,853.79	5,014.75	132,863.12

[2] 30/360" and "Actual/Actual" are the way of day count convention to calculate interest. Before, 30/360 was applied but after 2013, Actual/Actual is also allowed to apply.

[3] For the purposes of this document the Arrears are defined as late payments over 90 days.

NPL ratio	5.7%		5.9%
*–BOM XR, as of Dec 30, 2016	2,489.53	**–BOM XR, as of Dec 30, 2015	1,995.98

Source: Estimated by TSL Project Office based on, i) audited financial statements 2016 of the TSL Project, and ii) data collected from PFIs.

The NPL ratios are calculated per BOM guidelines: as total outstanding principal of non-performing loans over the gross loan portfolio. To ensure comparable measure the outstanding principal balance of non-performing loans of the TSL portfolio matched to outstanding balance reported by PFI's to BOM.

It should be noted that the NPL ratio remained relatively stable during the last 12 months. The most disturbing factor was the depreciation of MNT by 14.6%. In an environment of depreciating MNT the USD denominated portfolio is in further risk of deterioration, not only on recovering existing NPLs but for performing sub-loans due to increasing monthly installments. As mentioned earlier there are requests coming both from PFI(s) and SME clients for restructuring/rescheduling the sub-loans due to economic slowdown as well as deterioration of the MNT. It is recommended to carefully consider those requests, even though the credit risks are borne by PFIs.

About 3.3% of the non-performing portfolio has arrears of over 12 months, of which 2.6% is USD denominated loans; 1.4% 6-12 months; and 1.0% of the NPL are at arrears of 3-6 months. The proportion suggests that the bulk of the deteriorated sub-loans are for quite some time already and banks are either in a process of restructuring the sub-loans or already built sufficient loan loss reserves in their books.

The detailed list of sub-borrowers with arrears is presented in the Tzzable below.

Table 8.4.2 List of Sub-loan borrowers in Arrears

Duration of arrears	PFI	Sub-loan Borrower	Sub-loan(s) in Arrears		
			Initial loan	Principal repayments	Outstanding balance
MNT denominated Sub-loans (mln.MNT)					
3 to 6 months	Golomt	a	500.00	37.63	462.36
		b	70.00	34.00	36.00
		c	280.00	78.00	202.00
	Xac	d	100.00	54.18	45.82
	State	e	300.00	7.48	292.52
	Khan	f	500.00	216.63	283.37
		g	30.00	14.81	15.18
		h	100.00	54.50	45.50
6 months to 1 year	Golomt	i	500.00	87.69	412.31
		j	600.00	180.10	419.90
	Khan	k	160.00	92.65	67.35
		l	130.00	32.90	97.11
		m	280.00	7.89	272.11
	State	n	450.00	64.42	385.58
	Xac	o	300.00	0.87	299.13
1 to 2 years	Golomt	p	90.00	33.60	56.40
	Khan	q	80.00	17.20	62.80
		r	107.00	88.01	18.98
	Capital	s	400	63.34	336.66

	Xac	t	51.5	17.18	34.32
Over 2 years	Khan	u	40.00	16.00	24.00
	Capitron	v	420.00	23.78	396.21
Sub-total (MNT denominated)			5,488.50	1,222.86	4,265.61
USD denominated Sub-loans (thous.USD)					
3 to 6 months			-	-	-
6 months to 1 year			-	-	-
1 to 2 years	Khan	aa	400	75.1	324.9
Over 2 years	Capitron	bb	600	112	488
		cc	582	112	470
	Xac	dd	355	188.75	166.24
Sub-total (USD denominated)			1,937.00	487.85	1,449.14
TOTAL (mln.MNT)					7,874.06

Source: Compiled by TSL Project Office based on data collected from PFIs.

The detailed table above suggests that of the non-performing sub-loan initial portfolio MNT 10.3 billion, MNT 2.4 billion or 23.6% have been recovered; and USD 487,850 or 25.2% serviced out of USD 1.937 million; with many borrowers who have not serviced the sub-loans from the very beginning. This suggests that there is still significant gaps remaining in doing due diligence by the PFIs. PFIs should also complement current procedures in evaluation of sub-applications beyond collateral requirements.

8.5 TSL Revolving Fund

Under the TSL Project Phase I funds of total JPY 2,870 million, and Phase II JPY 4,639 million equivalent equivalent had been disbursed to PFIs for sub-lending. Each sub-project funded by TSL Project proceeds are required to make payment of interests and repayment of sub-loans, which, in turn, transferred to RF/As, upon deduction of PFIs' service charge.

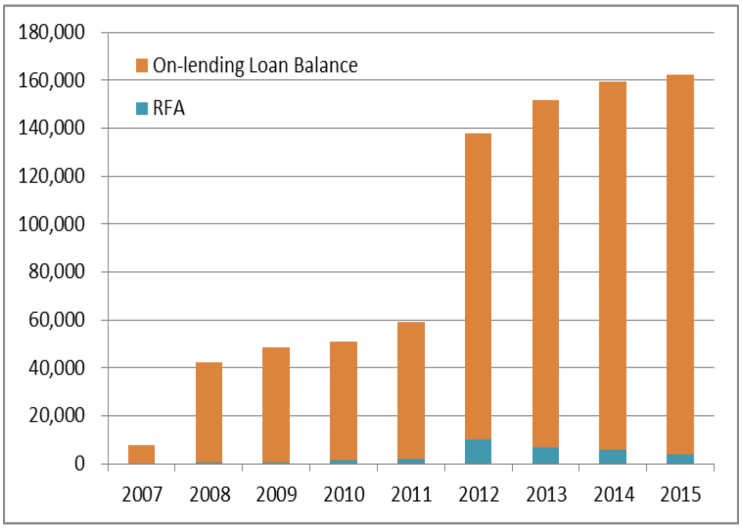
Per L/A for both Phase I and Phase II, funds collected at RF/A shall be utilized for two purposes only:

(i) Repayment of principal and payment of interest of the JICA loan.

(ii) Financing of new on-lending loans to PFIs for the same purposes and terms and conditions of the TSL project.

To date, all payments, including interest payment and principal repayments of on-lending loan are accumulated and disbursed for the latter purpose only. JICA loans are services from budgetary resources only allowing for accumulation of the fund. By accumulating payments of interest and repayments of principal of the on-lending loan, GOM effectively creates revolving fund for continuous provision of term financing to SMEs and environmental projects through PFIs.

Therefore, TSL Project funds have steadily built up mainly because of outstanding performance of on-lending loan repayments and absence of loan service to JICA from the RF/A as shown in the Figure below.



Source: TSL Project Office

Figure 8.5.1 Outstanding balance of TSL Project funds

As of December 2016, TSL Project assets reached MNT 142.8 billion, of which MNT 138.7 billion is on-lending loan assets to eight PFIs, MNT 4.1 billion of outstanding balance at RF/A and MNT 81.8 million of accumulated interest.

Initial facility of JPY 2,870 million and JPY 4,639 of Phase I and Phase II accounts for MNT 116.3 billion and the remaining MNT 26.5 billion is the accumulated interest of the on-lending loans.

Per L/A monies of RF/A are held at an account of BOM owned by MOF. In July 2015, Phase I and Phase II accounts were consolidated per audit recommendations and in consultation with MOF.

8.6 Financial and other reporting requirements of TSL Project

8.6.1 Reporting to JICA

Per L/A requirements[4] the Executing Unit shall furnish JICA with the following reports and information for the implementation and administration of TSL Project:

(i) Quarterly Progress Report outlining each sub-loan project financed out of the proceeds of the TSL until completion of disbursement from JICA.

(ii) Statement of S/A and RF/As on a quarterly basis, until five (5) years after the completion of disbursement from JICA.

(iii) Repayment status of the On-lending loans and the Sub-loans on a quarterly basis until five (5) years after the completion of disbursement from JICA.

(iv) Annual report of the PFIs, including balance sheet, the profit and loss statement, and the auditor's report) annually, until five (5) years after completion of disbursement from JICA.

(v) Project completion report after completion of the Project.

The Project Office (PO) prepares and submits above reports and information to JICA through CSC.

While it has been already more than five years since the final disbursement of TSL Project Phase I proceeds, it has not been yet five years since full disbursement of Phase II. It should be noted that since

[4] Article III, Section 4(6) of the L/A of Phase I ; and Article III, Section 4(5) of L/A of Phase II

the consolidation of the accounts of Phase I and Phase II it is no longer practical to segregate between Phase I and Phase II proceeds.

8.6.1 Reporting to GOM

Commencing 2012, TSL Project submits annual financial statements to MOF per requirements set by Budget Law of 2011 and Minister of Finance Resolution#86 of 2011 and Resolution#196 of 2015. The annual financial statements are prepared through sub-contract to local professional accounting firm. The reporting requirement is for budgetary entities and accommodates features of those types of entities. By design TSL Project provides sub-loans to SME through on-lending loans to PFIs from RF/A. Hence its activities of financial institution are quite unique in that it provides loans to PFIs, earns marginal interest revenues and repayments of on-lending loan.

Per requirements and mandates granted by Section 8.9.1 of Budget Law of Mongolia and Section 15.1.3 of State Audit Law of Mongolia, TSL project financial statements are regularly audited by National Audit Office or by its approved sub-contractor since 2012.

The financial control and risk management department of MOF conducts annual monitoring and evaluation for MOF Projects, which covers both financial and operational performance of the project activities. To this end TSL Project submits operations performance report to the Financial control and risk management department of MOF on an annual basis.

The Law of Mongolia on Glass Accounts entered into force on January 1, 2015. The law obliges all government agencies and legal entities with state involvement to make information on budgets and financial matters, including the utilization of financing and other government indebtedness, available to the public. Per requirements of the law TSL project provides monthly reports on operational expenses and on-lending loan disbursements in the glass account reporting system.

Utilization report is prepared and submitted to MOF's Public administration and management department, who is responsible for administration of the Finance Minister's budget portfolio. The report is collected on a monthly basis and focuses on the utilization of budget resources including loan proceeds and project management expenses. Hence, the initial utilization of the JICA loan proceeds as well as TSL PO expenses is reported.

Official Development Assistance (ODA) Management Information System (ODAMIS) consolidated management system of ODA and maintained at Development Financing Department of MOF. The system requires reports for annual utilization and disbursement of ODA proceeds. The TSL office regularly services the reporting requirement of the ODAMIS.

8.7 Financial Statements of the TSL Project

8.7.1 Financial Statement of the TSL Project Unit for Phase I

Under the L/A, the Project's management is responsible for the preparation and fair presentation of the financial statements in accordance with the international accounting standards. The financial statements required to prepare is Statements of the Special Accounts and the Revolving Fund Accounts, which shall be audited and submitted to JICA up to five years from the completion of the Project, i.e., disbursements of all the money available under the L/A.

Statements of the Special Accounts and the Revolving Fund Accounts of the Project are prepared on the cash basis of accounting. Under this method, receipts are recognized at the date of funds received and expenditures are recognized at the date of actual payments.

The L/A also stipulates that the Project prepares its financial statements in JPY. The S/A and RF/As consist of current accounts at BOM, which is reflected at its nominal value. The Project holds S/A in JPY for each category, through which the Project receives loan from JICA and provides on-lending loans to PFIs. The Project also holds RFAs in MNT and USD at BOM for each category, through which the Project receives repayment of principal payment and loan interest payment, and provides on-lending loans to PFI. As such, the Project records the S/A transactions in JPY, and the RF/A transactions in MNT and USD. The closing balances of these accounts denominated in currencies other than the reporting currency are converted at the official exchange rates of BOM on December 31, closing date of the fiscal year.

So far, the PO prepares financial statements (Statements of the Special Accounts and the Revolving Fund Accounts) as required in accordance with L/A. Those financial statements such as Income Statement and Balance Sheet usually required for private companies are not requested by JICA and have not been prepared.

Per audit recommendations and consultation with MOF, TSL Project Phase I and II accounts were consolidated in 2015.

8.7.2 Financial Statement of the TSL Project Unit for Phase II

In 2011, the Budget Law was adopted, which stipulates that a Project Unit of bilateral concessional loan project implemented through GOM shall be considered as a budgetary organization. Such organizations shall record accounting entries in accordance with International Accounting Standards and the relevant Mongolian laws. Also, the Project Unit shall prepare financial statements, i.e., statement of financial position, statement of cash flows, income statement and statement of changes in equity by using accounting software in accordance with International Public Sector Accounting Standards (IPSAS), and corresponding Finance Minister’s Resolutions on accounting regulations and procedures.

According to the Accounting Law and the statement of Finance Minister’s Resolution, the organization shall base on accrual basis when acknowledging and valuating income and expenses in the financial statements. Interest payments shall be acknowledged as interest income in the income statement and loan interest receivables in the statement of financial position accordingly with or without actual cash payments, and accumulated amount occurred during the reporting period shall be recorded.

Also, according to the Accounting Law and the statement of Finance Minister’s Resolution, a unit of accounting shall be denominated in MNT– the currency of Mongolia.

The PO, with assistance of outside professional accountant, prepares financial statements in accordance with the accounting guidelines of the Finance Minister’ Resolution. However, the PO does not record primary accounting entries as it lacks professional accountant(s) within the team. The absence of a professional accountant results in incorrect reports of accounting documents prepared by non-professional staff at the project unit for preparation of financial statements by an outside professional accountant.

8.8 Recommendations for improving the financial management and reporting

So far, it seems that CSC/MOF has successfully performed such functions. The fact is that the TSL Project daily operations and management is implemented by consultants under TA contract. At present, MOF’s involvement in the daily operations of the Project is limited to the disbursement process only. Obviously, it lacks operational staff. This issue has been raised to MOF repeatedly but is yet to reach conclusion as daily management of operations of the Project may cause additional cost, such as staff requirement. It is worth to note that the TA contract went to end in May 2016 and was extended for another year until May 2017. On the other hand, the operation of the Project will continue in order to secure the repayment from PFIs and finance the next generation of subprojects out of the revolving fund. For this purpose, the TA contract needs to be extended until suitable instrument/mechanism for long term sustainability of the Project activities is established.

It is highly recommended to hire a professional accountant or sub-contract professional financial institution to maintain accounting entries and prepare accounting statements on a quarterly basis as the project carries over financial operations on a daily basis. This is particularly important in light of the potential establishment of Special Purpose Entity (SPE) for sustainable operations of the TSL Project and transfer of financial assets to the SPE, who is envisioned to become a professional financial institution with commercial operations and therefore financial management. Even in the event of termination and/or conclusion of the TA contract it is important to have proper accounting and financial records and monitoring to ensure smooth transition. It is regrettable that the auditors have repeatedly pointed out that the Project has no accounting professional or unified financial system for the effective control of the Project operation. The PO is recommended to hire professional accountant and to develop their own computer system to effectively and efficiently process not only the financial information in compliance with Accounting Law but also the on-lending loan applications, make disbursement to PFIs, and monitor the payments by PFIs. In addition, it is preferable for such computer system to produce management information for the overall management of the Project, including fundamental information on the implementation of the sub-projects and the status of sub-borrowers. Since the beginning of the Project, sub-loans have been disbursed to more than 700 clients, and clients' information on loan amount, interest and payment is recorded. This situation leads to the high possibility of making technical errors resulted by undeliberate actions of the data entry staff.

There have been continuous improvements in the record keeping and calculations of the interests and repayments of the on-lending loans to PFIs. While it is meeting intermediate needs of the project and reporting requirements those would not meet requirements for concluding the TA contract, transferring assets to subsequent asset manager(s), transitioning into commercial operations of the SPE and therefore new shareholder(s). A suitable accounting software and dedicated accountant and/or professional are added to the TSL Office to enhance its operations and prepare for the transition.

The distribution of on-lending loans and therefore sub-loans suggests that certain rules and principles should be applied in relation to the distribution and allocation among PFIs depending on the market size, performance of the sub-loan portfolio, servicing of the on-lending loan etc.

Clear guidelines and rules need to be in place when there are signals of increased counterparty risks. The late servicing of on-lending loans and deteriorating sub-loan as well as overall portfolio need to be reviewed routinely and responsive to situation(s) developed.

Going forward the TSL Project shall seek to reduce counterparty risks by: i) enhancing On-lending agreements by adding clauses closely tying the on-lending loan to higher ranking in case of bankruptcy; ii) by regularly consulting with and confirmation from the BOM if the PFI meets regulatory requirements. This is particularly important in the light of the transfer of loan assets to the SPE. The sub-loans provided under the TSL Project have maturity period of up to 10 years, period within which at least three banks went bankrupt in Mongolia in the past. GOM is to cover counterparty risks of the assets if it is to transfer sub-loan assets to any institution in return for repayments of the JICA loan to JICA. The sub-loan portfolio is easily deteriorated in case only one minor PFI goes bankrupt, therefore impossible to service its obligations vis-à-vis MOF and therefore JICA.

Audit recommendations are to be followed up and implemented properly to the extent possible and reported back to the CSC as well as JICA.

Accounting and financial management policies need to be in place to enhance financial control, avoiding technical and human errors and for stronger governance and control of funds, particularly in the event that TSL Office manages TSL Phase 3 funds. This would require at least clearly stated job description for each position, and clear segregation of duties between positions/staff, decentralization of duties and authorities.

Chapter 9 Financial Performance of Participating Financial Institutions

9.1 Selection of Participating Financial Institutions

9.1.1 Selection of PFIs in Phase I

As the selection of the participating financial institutions (PFIs), the PFI Selection Task Force (PSTF) was established by inviting representatives from the Ministry of Finance (MOF), Bank of Mongolia (BOM), and then the Japan Bank for International Cooperation (JBIC) Study Team as an advisor in 2005. The PSTF selected six banks (Khan Bank, Golomt Bank, TDB, Xac Bank, Capitron Bank, and Zoos Bank) out of the 17 commercial banks for the TSL Project Phase I. The PSTF made the selection in accordance with the selection criteria agreed in the discussion. The PSTF analyzed the financial performance of all commercial banks based on four criteria: namely, i) the growth of the bank, ii) management capability, iii) observance of prudential principles, and iv) experience in corporate finance.

In late 2007, Anod Bank newly applied to participate in the TSL Project. The selection of the bank was made by the MOF using similar approach done in previous PFIs' selection. As a result, the CSC approved Anod Bank as the seventh PFI of the TSL Project Phase I.

9.1.2 Selection of PFIs in Phase II

At the start of the TSL Project Phase II, five banks (Khan Bank, Golomt Bank, TDB, Xac Bank, and Capitron Bank) out of 14 commercial banks sent their official expression of interest in 2011. As Khan Bank, TDB, and Xac Bank met all selection criteria, the MOF sent their requests for JICA's concurrence. However, the request of Capitron Bank was denied due to Capitron Bank's overall assessment which exceeded the benchmark of 2.5 (as the threshold is less than 2.5), and Golomt Bank was not selected this time due to suspended evaluation for prudential requirements of the bank by BOM.

Afterwards, the MOF evaluated and approved additional four banks (Golomt Bank, State Bank, Ulaanbaatar City Bank, and Capital Bank) in accordance with the revised PFI selection criteria, and sent a request for concurrence to JICA. Golomt Bank and Capital Bank were approved as PFIs on 9 December 2011. The State Bank was rejected due to its operation period which could was less than the requirement of three years. At first, Ulaanbaatar City Bank was not eligible due to its rating which was exactly 2.5 points, equal to the requirement, but the bank reapplied in the following year with improved operational results and was successfully admitted as a PFI in June 2012.

9.2 Sub-loans to PFIs under TSL

The disbursement of sub-loans as of December 2017 is as shown in the following Table. During the period from 2009 until December 2017, totally MNT 243.7 billion and USD 15. million were disbursed to 741 projects and 40 projects respectively. Golomt Bank, TDB and Khan Bank are three major borrowers of sub-loans.

Table 9.2.1 Disbursement of Sub-Loans of TSL

Bank		MNT			USD Thousand		
		No. of Loans	Amount		No. of Loans	Amount	
			MNT Million	%		USD Thousand	%
Phase I	Anod	1	500	0.5%	1	300	2.5%
	Capitron	83	25,105	26.8%	13	6,145	51.5%
	Golomt	56	13,006	13.9%	7	2,132	17.9%
	Khan	69	14,152	15.1%	6	2,561	21.5%
	State	70	32,118	34.3%	0	0	0.0%
	TDB	17	4,127	4.4%	3	431	3.6%
	Xac	21	4,322	4.6%	1	355	3.0%
	Zoos	1	424	0.5%	0	0	0.0%
	Sub-total	318	93,754	100.0%	31	11,924	100.0%
Phase II	Capital	49	22,291	14.9%	1	150	4.0%
	Golomt	85	27,636	18.4%	3	1,600	42.3%
	Khan	111	35,033	23.4%	1	600	15.9%
	TDB	103	39,935	26.6%	3	1,330	35.2%
	UB City	10	4,310	2.9%	0	0	0.0%
	Xac	65	20,718	13.8%	1	100	2.7%
	Sub-total	423	149,923	100.0%	9	3,780	100.0%
Total	Anod	1	500	0.2%	1	300	1.9%
	Capitron	83	25,105	10.3%	13	6,145	39.1%
	Capital	49	22,291	9.2%	1	150	1.0%
	Golomt	141	40,642	16.7%	10	3,732	23.8%
	Khan	180	49,185	20.2%	7	3,161	20.1%
	State	70	32,118	13.2%	0	0	0.0%
	TDB	120	44,062	18.1%	6	1,761	11.2%
	UB City	10	4,310	1.8%	0	0	0.0%
	Xac	86	25,040	10.3%	2	455	2.9%
	Zoos	1	424	0.2%	0	0	0.0%
	Total	741	243,677	100.0%	40	15,704	100.0%

Source: TSL Office

The balance of TSL on-lending loans was MNT 137.9 billion as of the end of 2017. This amount was 0.5% of the total liabilities (MNT 25,623 billion) of the banking sector. At the same time, this amount was equivalent to 1.1% of the loan balance (MNT 12,948 billion) of the banking sector. The following table shows the shares of TSL in loan balance of individual PFIs as of the end of 2016. TSLs accounted for 1.2% of loan balance of PFIs as of the end of 2016. The shares of TSLs were relatively higher for Capital Bank and Capitron Bank.

Table 9.2.2 Share of TSL in Loan of PFIs

	Loan Balance (Billion MNT)	TSL Loan Balance (Billion MNT)	Share of TSL (%)
TDB	2,835	27.0	1.0
Khan Bank	3,093	26.2	0.8
Golomt Bank	2,035	19.1	0.9
Xac Bank	1,157	16.4	1.4
State Bank	1,129	17.3	1.5
UB City Bank	572	1.8	0.3
Capital Bank*	545	15.7	2.9
Capitron Bank	174	15.2	8.7

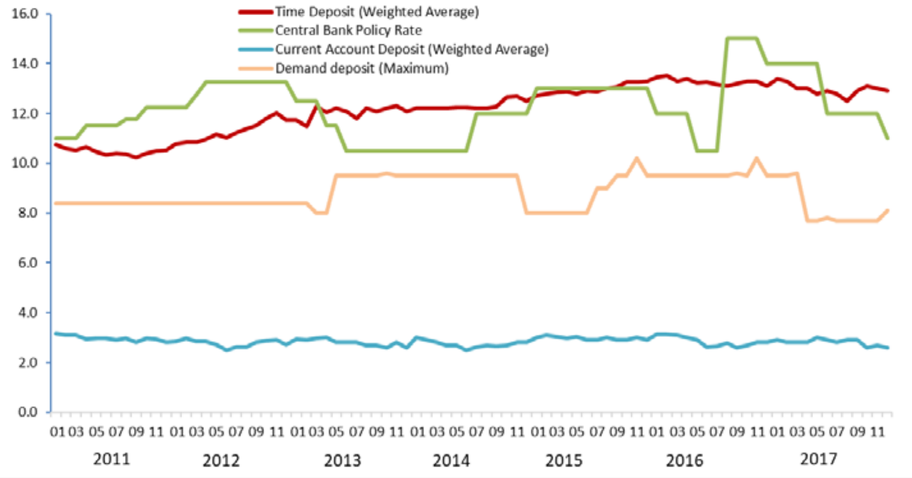
Note: As of the end of 2016. * The figures of 2015 are used for Capital Bank.
Source: Annual reports of PFIs

The share of TSL has been definitely small in terms of both total fund raising and loan allocation of PFIs. However, TSL has had significance for PFIs in the following ways.

(1) A TSL on-lending loan is a very low-interest fund.

An interest rate of an on-lending loan is an average demand deposit rate for Tugrik lending and six-month USD LIBOR plus 1% for USD lending. An interest rate of a sub-loan is decided by adding a margin (4% for MNT-base loan and 3.6% for US dollar-base loan) to cover handling cost, risk and profit.

The trend of interest rates is as shown in the following Figure. PFIs have been obtain lower-cost fund compared with time deposits and the central bank's policy rate.



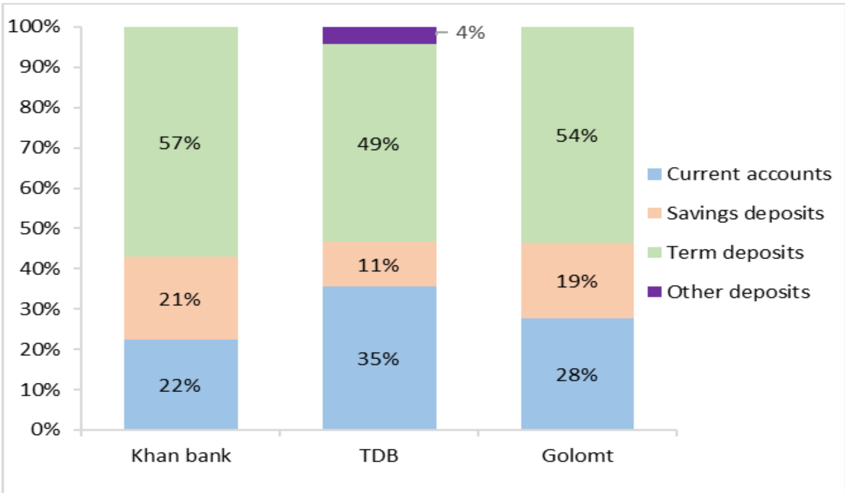
Source: Bank of Mongolia

Figure 9.2.1 Trend of Interest Rates of Mongolia

(2) A TSL on-lending loan is a long-term borrowing.

The term of TSL on-lending loan and sub-loan is from 3 to 10 years including up to 3-year grace period.

Deposits are major source of funding of PFIs. However, the share of time deposits is around 50% to 60% and the term of most of time deposits is up to 1 year. PFIs must find other sources of fund to finance long-term loans. TSL can be one of sources of fund for long-term loans as well as the government's and other donors' loan programs.



Note: As of the end of 2016
Source: Annual reports of individual PFIs

Figure 9.2.2 Composition of Deposits at Major PFIs

9.3 Financial Performance of PFIs

This chapter describes the financial performance of individual PFIs. The situation of the banking sector of Mongolia is evaluated in Chapter 2.

9.3.1 General

(1) Trend of Assets

The trend of total assets of PFIs is showed in the following Table. TDB, Khan Bank and Golomt Bank are the largest banks in Mongolia and account for 70% of total assets of the banking sector. During the period between 2012 and 2016, all PFIs steadily increased their total assets. Especially, State Bank and Capitron Bank achieved a high growth rate compared with three largest banks.

Table 9.3.1 Total Assets of PFIs

	Total Assets (Billion MNT)						Average Annual Growth Rate 2012/16 (%)
	2012	2013	2014	2015	2016	Share in Banking Sector in 2016 (%)	
TDB	2,701	5,124	5,415	5,523	6,645	26.2	25.2
Khan Bank	2,796	4,801	5,116	5,117	6,481	25.6	23.4
Golomt Bank	2,528	3,750	4,053	3,805	4,658	18.4	16.5
Xac Bank	1,078	1,812	2,073	1,936	2,257	8.9	20.3
State Bank	314	1,752	2,035	1,703	2,089	8.2	60.6
UB City Bank	532	1,214	1,472	1,445	1,474	5.8	29.0
Capital Bank	326	555	817	746	N.A.	N.A.	31.8*
Capitron Bank	121	204	184	191	411	1.6	35.8

Note: As of the end of year
* The figure is the average annual growth rate between 2012 and 2015.
Source: Annual reports of PFIs

Loans and advances of PFIs made steady increased during 2012 and 2016. The annual growth rates of smaller PFIs were higher those of large PFIs.

Table 9.3.2 Loans and Advances of PFIs

	Loans and Advances (Billion MNT)						Average Annual Growth Rate 2012/16 (%)
	2012	2013	2014	2015	2016	Share in Banking Sector in 2016 (%)	
TDB	1,533	2,531	2,777	2,645	2,835	23.0%	16.6%
Khan Bank	1,731	2,446	2,972	2,913	3,093	25.1%	15.6%
Golomt Bank	1,428	2,199	2,462	2,014	2,035	16.5%	9.3%
Xac Bank	631	1,030	1,314	1,171	1,157	9.4%	16.4%
State Bank	181	942	1,070	925	1,129	9.2%	58.0%
UB City Bank	287	544	646	612	572	4.6%	18.9%
Capital Bank	198	311	491	545	N.A.	N.A.	40.1%*
Capitron Bank	64	110	119	93	174	1.4%	28.6%

Note: As of the end of year. * The figure is the average annual growth rate between 2012 and 2015.
Source: Annual reports of PFIs

(2) Equity

PFIs increased their equity throughout the period 2012 - 2016. As for Capitron Bank, the size of equity fluctuated due to its loss from increased non-performing loans.

Table 9.3.3 Equity of PFIs

Unit: Billion MNT

PFI	2012	2013	2014	2015	2016	Annual Growth Rate 2012/16 (%)
TDB	240	369	548	647	759	33.4%
Khan	232	336	444	565	686	31.1%
Golomt	187	272	328	359	367	18.3%
Xac Bank	98	122	134	156	179	16.3%
State Bank	28	132	152	170	246	71.6%
UB City Bank	37	52	71	81	130	37.3%
Capital Bank	24	41	70	83	N.A.	51.6%*
Capitron Bank	121	204	184	170	411	35.8%

Note: As of the end of year. * The figure of 2015 is used for Capital Bank.
Source: Annual reports of PFIs

(3) Profit

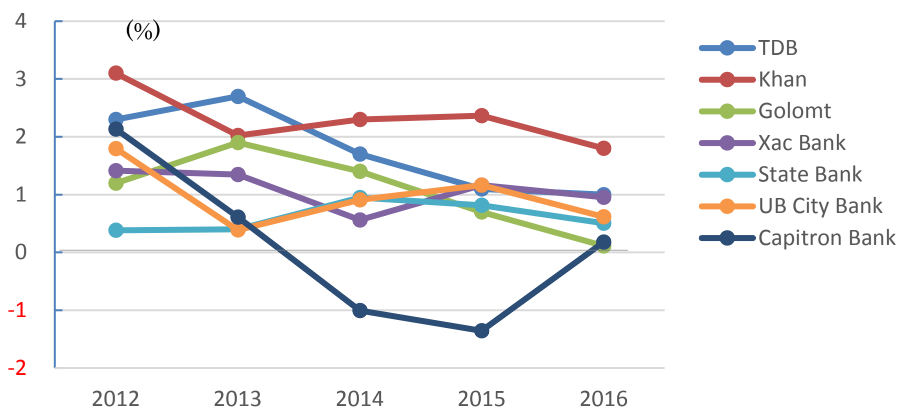
Capitron Bank recorded loss in 2014 and 2015. Capitron Bank ended in black in 2016; however, it recorded a loss of MNT 0.7 billion in the first half of 2017. Other PFIs continue to post a profit during 2012 - 2016. However, the return on asset (ROA) generally tended to decrease.

Table 9.3.4 Profit after Tax of PFIs

Unit: Billion MNT

	2012	2013	2014	2015	2016
TDB	63.1	139.3	89.3	50.1	56.1
Khan Bank	71.0	97.0	108.0	121.0	105.0
Golomt Bank	26.1	56.9	49.8	26.0	5.3
Xac Bank	15.2	24.4	11.6	22.5	21.5
State Bank	1.2	7.0	19.3	13.9	10.6
UB City Bank	9.6	4.7	13.4	16.8	9.1
Capital Bank	0.7	2.7	8.9	0.9	N.A.
Capitron Bank	2.6	1.3	-1.9	-2.6	0.7

Source: Annual reports of PFIs



Note: As for TDB, Khan Bank and Golomt Bank, the figures in their annual reports are used. For other banks, ROA is calculated using the figures of total assets as of the end of year.
Source: Annual reports of individual PFIs

Figure 9.3.1 Trend of ROA of PFIs

(4) Prudential Ratios

The liquidity ratio of PFIs have been much higher than BOM's minimum requirements due to liquidity injection programs by BOM and diversified sources of funding other than deposits. The level of capital adequacy ratio differs according to PFIs. TDB, Golomt Bank and Capitron Bank are at a tight situation to satisfy the BOM's requirement. The Asset Quality Review done in the late 2017 by PricewaterhouseCoopers Česká Republika company has affirmed that required capital of the banking system should be increased by equivalent to 1.9% of 2017's GDP (516 billion MNT) in order to meet capital adequacy ratio requirement.

Table 9.3.5 Prudential Ratios of PFIs

PFI	Ratio	2012	2013	2014	2015	2016
TDB	Tier 1 Capital Adequacy Ratio	10.0%	11.6%	13.0%	12.0%	10.6%
	Capital Adequacy Ratio	15.1%	15.1%	19.0%	16.3%	14.1%
	Liquidity ratio	37.2%	42.3%	41.5%	44.0%	46.0%
Khan Bank	Tier 1 Capital Adequacy Ratio	10.8%	11.1%	11.1%	15.6%	17.0%
	Capital Adequacy ratio	16.6%	16.6%	17.2%	22.6%	25.3%
	Liquidity ratio	39.3%	47.7%	43.5%	43.1%	44.4%
Golomt Bank	Capital Adequacy Ratio	13.3%	16.7%	17.1%	16.6%	14.8%
	Liquidity Ratio	41.1%	43.3%	38.2%	38.1%	44.8%
Xac Bank	Tier 1 Capital Adequacy Ratio	N.A.	N.A.	9.8%	13.7%	12.7%
	Capital Adequacy Ratio	16.2%	19.5%	17.0%	20.6%	19.2%
	Liquidity Ratio	42.3%	43.8%	37.2%	38.7%	42.5%
State Bank	Tier 1 Capital Adequacy Ratio	15.4%	12.9%	13.8%	15.7%	12.9%
	Capital Adequacy Ratio	15.6%	14.3%	15.1%	16.9%	19.3%
	Liquidity Ratio	41.3%	44.0%	42.3%	37.4%	38.1%
UB City Bank	Tier 1 Capital Adequacy Ratio	N.A.	N.A.	15.0%	13.5%	N.A.
	Capital Adequacy Ratio	N.A.	N.A.	18.8%	16.6%	N.A.
	Liquidity ratio	N.A.	N.A.	60.0%	49.2%	N.A.
Capital Bank	Tier 1 Capital Adequacy Ratio	13.4%	14.3%	N.A.	N.A.	N.A.
	Capital Adequacy Ratio	13.4%	14.3%	16.0%	N.A.	N.A.
	Liquidity Ratio	25.2%	35.1%	33.3%	N.A.	N.A.
Capitron Bank	Tier 1 Capital Adequacy Ratio	11.1%	12.9%	13.8%	13.4%	12.3%
	Capital Adequacy Ratio	17.2%	17.1%	15.9%	16.1%	13.5%
	Liquidity Ratio	34.8%	37.7%	31.8%	37.4%	49.0%

Note: The BOM's requirement of tier-1 capital adequacy ratio is over 9%, capital adequacy ratio is over 14%, and liquidity ratio is over 25% as of the end of 2016.
Source: Annual reports of individual PFIs

9.3.2 Trade and Development Bank of Mongolia

(1) Financial Situation

Assets

The Trade and Development Bank of Mongolia (TDB) significantly increased total assets from MNT 5.4 trillion at the end of 2014 to MNT 6.6 trillion in 2016. The size of "loans and advances to customers" was MNT 2.8 trillion, 43% in 2016. The share of "investment securities" accounts for 23% and that of "cash and cash equivalents" for 18%.

Table 9.3.6 Assets of TDB

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016	
	Group	Group	Group	Bank	Bank	Bank	Share
Cash and cash equivalents	475.0	444.8	1,090.2	1,053.8	695.0	1,188.8	18%
Investment securities	346.5	459.2	895.5	938.6	1412.5	1,525.5	23%
Investment in subsidiaries and associates	0.0	0.0	0.0	0.0	37.8	59.5	1%
Loans and advances (net)	1123.3	1533.3	2,530.6	2,777.2	2645.0	2,835.2	43%
Bills purchased under resale agreements	37.0	0.0	0.0	0.0	99.8	0.0	0%
Subordinated loans	7.0	7.0	7.0	4.0	4.0	4.0	0%
Property and equipment (net)	79.1	131.6	186.7	323.1	195.0	333.6	5%
Intangible assets (net)	0.4	0.6	4.3	1.4	1.2	5.0	0%
Investment property	0.0	0.0	0.0	0.0	99.8	88.9	1%
Foreclosed real properties (net)	0.6	0.2	6.1	1.0	1.4	2.2	0%
Current tax assets	0.0	0.0	0.0	0.0	0.0	0.0	0%
Other assets	51.8	123.9	403.7	315.8	331.9	602.5	9%
Total assets	2120.7	2700.5	5,124.1	5,414.9	5523.4	6,645.2	100%

Note: As for data before 2013, only consolidated figures of the group are available. Data after 2014 are figures of the bank.
Source: TDB Annual Report

Liabilities and Equity

The size of liabilities of TDB at the end of 2016 increased by 21% compared with 2015. Major increases occurred in Borrowing (37.6%), Debt securities issued (33.5%) and Deposits (26.7%). Customer deposits account for 41% of total liabilities as of 2016. The shares of borrowings and debt securities issued were 23.7% and 26.7% respectively.

Table 9.3.7 Liabilities and Equity of TDB

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016	
	Group	Group	Group	Bank	Bank	Bank	Share
Deposits from customers	1,277	1,402	2,140	2,545	2,212	2,416	41.0%
Deposits and placements by banks and other financial institutions	207	38	545	120	113	143	2.4%
Bills sold under repurchase agreements	-	-	373	0	100	130	2.2%
Borrowings	174	233	1,157	1,107	1,012	1,392	23.7%
Current tax liabilities	2	2	8	0	4	2	0.0%
Debt securities issued	207	601	461	741	1,176	1,569	26.7%
Subordinated debt securities issued	42	56	66	75	30	25	0.4%
Other liabilities	73	129	379	278	231	209	3.6%
Total liabilities	1,981	2,461	4,755	4,867	4,876	5,886	100.0%
Share capital	7	17	17	17	50	68	8.9%
Share premium	7	19	19	19	19	0	0.0%
Treasury shares	-6	-3	-3	-3	0	0	0.0%
Revaluation reserves	22	44	33	126	134	127	16.7%
Accumulated unrealised loss on available-for-sale financial assets	-	-	0	0	-24	30	4.0%
Accumulated unrealised gain on valuation of cash flow hedges	-	-	0	0	40	15	2.0%
Retained earnings	109	162	302	389	428	517	68.1%
Non-controlling interests	-	-	2	1.7	2	3	0.4%
Total equity	139	240	369	548	647	759	100.0%
Total liabilities and equity	2,121	2,700	5,124	5,415	5,523	6,645	

Note: As for data before 2013, only consolidated figures of the group are available. Data after 2014 are figures of the bank.
Source: TDB Annual Report

(2) Loan Portfolio

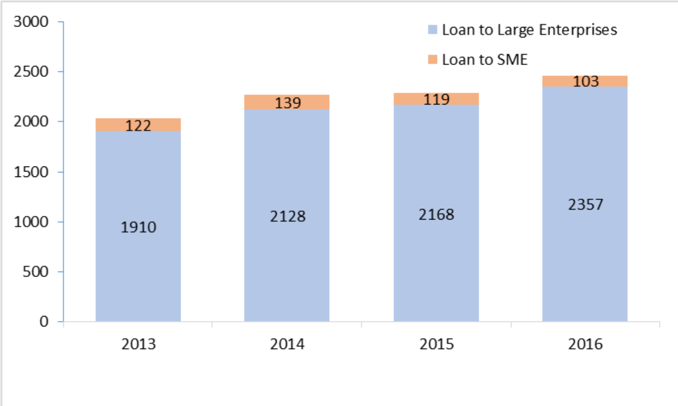
TDB defines it customer segments as follows:

Table 9.3.8 Customer Segment of TDB

Segment	Definition	
Corporate Banking	Loan amount: Borrower's sales amount:	Greater than MNT 3 billion , or Greater than MNT 6 billion
SME Banking	Loan amount: Borrower's sales amount:	Between MNT 350 million and MNT 3 billion, or Between MNT 1.5 billion to MNT 6.0 billion
Retail Banking	Loan amount: Borrower's sales amount:	Less than MNT 350 million, and Less than MNT 1.5 billion

Note: In addition, there are the investment and international banking segment and the treasury segment.
Source: TDB Annual Report

The characteristic of TDB's lending is a concentration to large enterprises. The size of loans to SMEs is approximately 4% of that of loans to large enterprises.



Source: TDB Annual Report

Figure 9.3.2 Breakdown of TDB's Loan by Size of Borrower

By sector, the construction, trading, mortgage and manufacturing loans account for 55% of total loans outstanding as of the end of 2016.

Table 9.3.9 Loan Outstanding of TDB by Sector

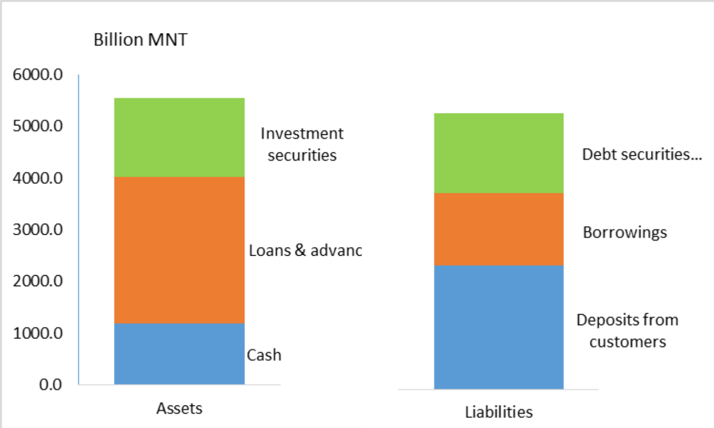
Sector	2015		2016	
	Amount (MNT Billion)	Share (%)	Amount (MNT Billion)	Share (%)
Construction	531.6	20.1%	456.4	16.1%
Trading	432.6	16.4%	494.2	17.4%
Mining and quarrying	357.4	13.5%	240.8	8.5%
Manufacturing	254.6	9.6%	274.2	9.7%
Mortgage	249.2	9.4%	343.1	12.1%
Hotel, restaurant and tourism	179.3	6.8%	221.7	7.8%
Financial services	166.8	6.3%	341.9	12.1%
Petrol import and trade	114.9	4.3%	91.1	3.2%
Payment card	96.8	3.7%	82.1	2.9%
Transportation	62.5	2.4%	42.6	1.5%
Health	21.0	0.8%	19.2	0.7%
Saving collateralized	20.8	0.8%	23.0	0.8%
Agriculture	15.0	0.6%	15.7	0.6%
Electricity and thermal energy	6.2	0.2%	67.7	2.4%
Education	3.2	0.1%	22.3	0.8%
Others	133.1	5.0%	99.2	3.5%
Total	2,645.0	100.0%	2,835.2	100.0%

Note: As of the end of year
Source: TDB Annual Report

TDB has provided a subordinated loan of MNT 4 billion to UB City Bank which bears a fixed interest of 8% per annum and is to be fully repaid in September 2017.

(3) Funding

The size of loans slightly exceeds that of deposits. TDB actively raises funds through borrowing and bond issuance.



Note: As of the end of 2016
Source: TDB Annual Report

Figure 9.3.3 Major Items of Assets and Liabilities of TDB

TDB borrows from domestic and international financial institutions. The borrowings from the Development Bank of Mongolia and BOM account for 21% of total borrowings. These borrowings are for the provision of program loans for price stabilization, housing development, SME development, etc.

Table 9.3.10 Borrowings of TDB

Source		2015		2016		Growth 2015/16 (%)
		Amount (MNT Billion)	Share (%)	Amount (MNT Billion)	Share (%)	
1	Cargill Financial Services International, Inc	170.2	17	252.2	18	48
2	Development Bank of Mongolia	168.2	17	293.8	21	75
3	Mortgage Financing Programme by BOM	132	13	217.6	16	65
4	TDB Syndicated Facility	78.7	8	57.5	4	-27
5	Commerzbank AG	62	6	104.0	7	68
6	Cargill TSF Asia Pte.Ltd	49.5	5	60.2	4	22
7	OPEC Fund for International Development	49.2	5	61.6	4	25
8	Bank of Mongolia	45.9	5	1.1	0	-98
9	Sumitomo Mitsui Banking Corporation	45.1	4	61.5	4	36
10	SME Fund, Ministry of Industry	39.8	4	9.6	1	-76
11	Japan International Cooperation Agency	24.1	2	27.0	2	12
12	Russian Agricultural Bank	24.0	2	0.0	0	-100
13	Netherlands Development Finance Company	16.6	2	12.5	1	-25
14	Export-Import Bank of Korea	14.2	1	1.7	0	-88
15	Banca Popolare Di Sondrio	13.4	1	55.2	4	312
	Other	79.4	8%	176.7	13%	123%
Total		1,012.4	100%	1,392.2	100%	38%

Note: As of the end of year
Source: TDB Annual Report

TDB issued debt notes on the international capital market in 2007, 2010, 2012 and 2014. Most recently, in May 2015, TDB issued senior unsecured noted of USD 500 million under the Global Medium Term Note Programme guaranteed by BOM at the Singapore Stock Exchange Market. In June 2016, TDB issued MNT 160 billion notes due to June 2021 at a price of 100% under Troubled Asset Refinance Program (TARP) by BOM.

9.3.3 Khan Bank

(1) Financial Situation

Assets

The size of total assets of Khan Bank represents 25.6% of total banking system assets. Khan Bank significantly increased total assets from MNT 2.8 trillion at the end of 2012 to MNT 4.8 trillion at the end of 2013. Since then, the increase has been slowed down and total assets were MNT 6.5 trillion in 2016.

Despite its increase in absolute term, the share of "loans and advances to customers" was 48% in 2016, decreased from 57% in 2015, due to the slowdown in the Mongolian economy. The share of "financial investments" increased from 8.7% in 2014 to 19% in 2016.

Table 9.3.11 Assets of Khan Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Cash and cash equivalents	541,457	646,628	1,385,864	1,131,550	679,590	1,124,976
Mandatory reserves with the Bank of Mongolia	172,471	209,088	346,380	293,847	335,260	453,245
Due from other banks	11,225	15,556	88,773	88,740	68,403	43,545
Loans and advances to customers	1,377,266	1,731,042	2,446,412	2,971,657	2,913,072	3,092,965
Investments in associates	513	513	513	513	552	552
Financial investments	66,111	99,931	396,895	444,537	844,891	1,254,484
Fixed assets	62,231	74,107	104,857	121,667	176,056	271,861
Other assets	4,470	19,216	31,262	63,563	99,343	237,999
Current income tax prepayment	-	389	-	-	-	1,205
Total Assets	2,235,743	2,796,470	4,800,956	5,116,075	5,117,165	6,480,832

Note: As of the end of year
Source: Khan Bank Annual Report

Liabilities and Equity

Customer accounts (deposits) account for 68.6% of total liabilities at the end of 2016. The breakdown of deposits is current account 22%, demand depots 21%, and term deposits 57%. The share of other borrowed funds has been gradually increasing and reached 27% at the end of 2016.

Total equity has shown a steady increasing trend due to favorable retained earnings. Total capital increased by 3.6 from MNT188.5 billion in 2011 to MNT685 billion in 2016.

Table 9.3.12 Liabilities and Equity of Khan Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Due to other banks	14,466	75,161	509,962	603,985	62,003	28,240
Customer accounts	1,812,333	2,073,817	2,773,725	2,744,750	3,005,377	3,975,189
Other borrowed funds	148,369	289,205	1,016,125	1,077,922	1,224,345	1,467,186
Other liabilities	12,259	18,761	25,324	25,397	28,729	41,871
Deferred income tax liability	1,130	4,339	4,342	7,193	6,052	-
Subordinated debt	58,648	103,410	135,885	213,211	225,957	282,632
Total Liabilities	2,047,205	2,564,693	4,465,364	4,672,458	4,552,462	5,795,117
Share capital	12,994	13,198	32,995	32,995	52,792	52,792
Share premium	13,866	14,141	14,141	14,141	-	-
Treasury stock	-	-28,614	-28,614	-28,614	-28,614	-28,614
Revaluation surplus	15,164	14,686	21,211	20,584	19,997	29,311
Other reserves	121	-	-	-	945	6,253
Retained earnings	146,394	218,367	295,859	404,511	519,583	625,973
Total Equity	188,539	231,778	335,593	443,617	564,703	685,715
Total Liabilities and Equity	2,235,743	2,796,470	4,800,956	5,116,075	5,117,165	6,480,832

Note: As of the end of year
Source: Khan Bank Annual Report

(2) Loan Portfolio

The breakdown of total gross loan is 41% for business lending, 59% for consumer lending and 3% for agricultural lending as of the end of 2016. By industrial sector, trade and commerce, construction, agriculture and real estate are major sectors of loans.

Table 9.3.13 Breakdown of Lending of Khan Bank by Sector

Unit: MNT Billion

Sectors	2014		2015		2016	
	Amount	Share	Amount	Share	Amount	Share
Individuals	1,570	52%	1,566	52%	1,937	59%
Trade and commerce	397	13%	415	14%	421	13%
Construction	269	9%	257	8%	220	7%
Mining	132	4%	128	4%	37	1%
Agriculture	118	4%	123	4%	97	3%
Real estate	82	3%	75	2%	87	3%
Food industry	47	1%	55	2%	61	2%
Chemical production	41	1%	34	1%	30	1%
Transportation	33	1%	24	1%	20	1%
Paper production	30	1%	25	1%	22	1%
Metal production	20	1%	20	1%	20	1%
Health and social organizations	17	1%	22	1%	23	1%
Other	278	9%	286	9%	289	9%
Total loans and advances to customers (before impairment)	3,034	100%	3,027	100%	3,263	100%

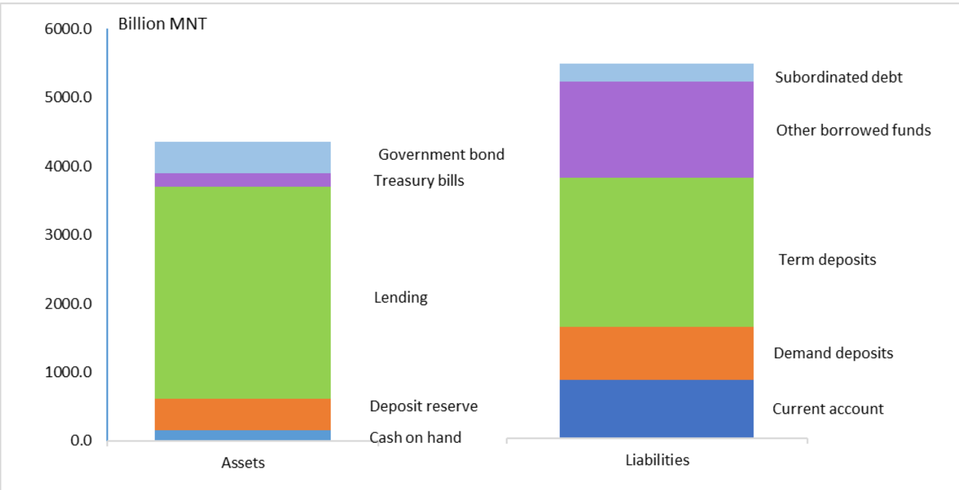
Note: As of the end of year.
Source: Khan Bank Annual Report

(3) Funding

In addition to deposits, borrowed funds have become an important source for lending. The size of borrowed funds was MNT1,467 billion at the end of 2016, an increase of 20% from the previous year.

The borrowed fund consists of borrowing from foreign financial institutions 69%, borrowing from government organization 23.6% and trade finance 7.4%.

The balance of borrowing from MOF for TSL was MNT 26,204.8 million at the end of 2016. This amount accounted for 7.5% of Khan Bank's borrowing from government organizations, or 1.8% of total borrowed funds.



Note: As of the end of 2016
Source: Khan Bank Annual Report

Figure 9.3.4 Major Items of Assets and Liabilities

Khan Bank borrows from development financial institutions such as EBRD, FMO, ADB, IFC, OFID and IIB and from IFI and MFIs such as BlueOrchard, Sawada Holdings, Credit Suisse Microfinance Fund Management Company, Symbiotics, etc.

Khan Bank also borrows funds from the government organizations to provide policy loans as follows:

Bank of Mongolia loans

i) Strategic Import Financing Schema (SIFS), Food Price Stabilization (FPS), and Construction sector support and apartment price stabilization, and mortgage programs

ii) Bank of Mongolia, Term Loan III

Ministry of Food, Agriculture and Light Industry

i) Small Medium Enterprise Investment Fund

ii) Small Medium Enterprise Development Fund /Wool & Cashmere loan/

Ministry of Finance

i) Two Step Loan Project for SME development and environmental protection financed (JICA)

ii) Good Herder project

iii) Agriculture and Rural Development Project (ADB)

iv) Rural Poverty Reduction Program (International Federations Agricultural Development)

Government Organizations of Aimags (provincial centers)

i) A loan obtained from the Local Government Office of Orkhon aimag to support local small and middle sized businesses

ii) Lending to Khuvsgul province local SMEs based on cooperation agreement with Khuvsgul province governors' office.

Others

i) Development Bank of Mongolia - Program of supporting export

ii) Development Bank of Mongolia - SME investment Fund

iii) Private Enterprise Development Fund

iv) Development Bank of Mongolia - Cashmere production

v) Development Bank of Mongolia - Industrial support

vi) Microfinance Development Fund

vii) Agricultural industry stabilization' short-term project

viii) Project loan of Asia-Europe 11th summit participation representative's accommodation

9.3.4 Golomt Bank

(1) Financial Situation

Assets

Golomt's assets at year-end of 2016 totaled MNT 4.7 trillion, and representing 18.6% of aggregate banking sector assets. Between 2011 and 2016, total assets grown by 2.2 times.

Table 9.3.14 Assets of Golomt Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Cash and cash equiv.	289.9	426.1	570.7	835.8	687	632.4
Short-term liquid assets	555.0	620.7	896.6	268.1	354.6	1197.5
Loans and advances (net)	1,249.30	1,428.00	2,199.20	2461.9	2013.6	2034.9
Other assets	40.5	52.8	83.1	487.4	749.9	793.5
Total assets	2,134.70	2,527.50	3,749.60	4053.2	3805.1	4658.3

Source: Golomt Bank Annual Reports

In terms of asset composition, loans and advances (net) accounted the biggest portion of 44% of total assets, followed by short-term liquid assets (26%) and other assets (17%). In 2013, loans increased by 54% and then 12% growth in 2014 reaching the highest amount. However, both loans and cash decreased by 18% in 2015 and thus resulted 6% decrease in total assets mainly due to the economic downturn. The situation eased in 2016 with 22% growth in total assets. All composition of total assets, except Cash and cash equivalents (-6%), increased. The highest growth occurred for Short-term liquid assets (238%).

Liabilities and Equity

Deposits from customers have been steadily increasing and comprised 65% of total liabilities at the end of 2016. Year 2016 had the highest deposit, liabilities and equity. Almost all categories increased in 2016 except retained earnings (-3%).

Table 9.3.15 Liabilities and Equity of Golomt Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Deposit from customers	1,839.3	2,056.6	2161.4	2232.1	2079.8	2803.3
Due to banks & Fis	9.5	47.0	26.5	133.3	90,0	121.9
Other liabilities	146.8	236.6	1289.8	1359.9	1276.8	1366.6
Total liabilities	1,995.60	2,340.20	3477.7	3725.3	3446.6	4291.8
Share capital	46.9	68.2	84.6	96.7	98.8	98.8
Other reserves	5.7	2.1	13.8	8.4	12	27.3
Retained earnings	86.4	117	173.5	222.8	247.8	240.4
Total equity	139	187.3	271.9	327.9	358.6	366.5
Total liabilities. & equity	2,134.60	2,527.5	3749.6	4053.2	3805.2	4658.3

Note: As of the end of year
Source: Golomt Bank Annual Reportszzz

(2) Loan Portfolio

In terms of sectoral distribution, consumer loans accounted for 29%, manufacturing 18%, followed by mining, construction and whole trade 11% each in 2016. Compared with 2015, the biggest increase occurred in consumer loans (37%) followed by other loans (4%). However, loans to agriculture sector decreased by 43%, mining sector loans by 24% and construction sector loan reduced by 10%.

Table 9.3.16 Breakdown of Loan by Sector of Golomt Bank

Unit: MNT thousand

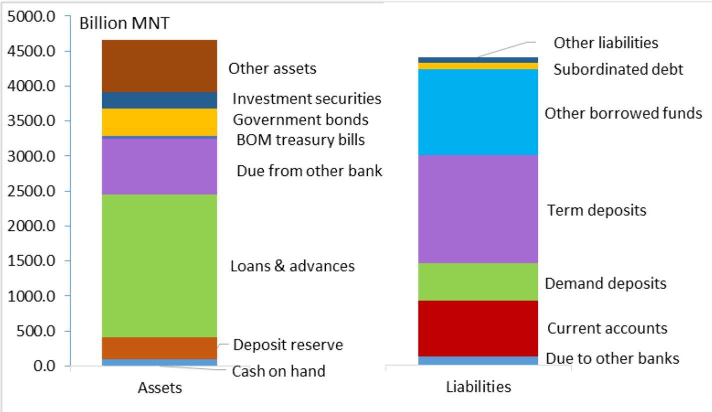
Sectors	2015		2016	
	Amount	Share	Amount	Share
Consumer loans	442,315,383	21%	606,678,776	29%
Manufacturing	405,779,805	19%	386,262,185	18%
Mining & Exploration	317,435,450	15%	242,130,121	11%
Construction	252,836,499	12%	227,687,785	11%
Trade - Whole & Retail	226,603,476	11%	231,047,086	11%
Real estate	84,369,105	4%	82,144,387	4%
Agriculture	63,806,431	3%	36,271,143	2%
Healthcare, education and social service	41,995,462	2%	28,120,885	1%
Other	273,563,630	13%	285,233,597	13%
Total loans and advances to customers (before impairment)	2,108,705,241	100%	2,125,575,965	100%

Note: As of the end of year
Source: Golomt Bank Annual Reports

(3) Funding

Current account and deposits are main part of liabilities accounting for 65% of total liabilities. Among them, term deposits hold % of total liabilities in 2016. Compared with 2015, current account increased by 52%, whereas demand deposits grew by 43% and time deposits by 24%. In addition to deposits, borrowed funds have become an important source for lending with size of MNT 1.2 billion (28% of total liabilities).

The borrowed fund consists of borrowed funds under projects 49.8% and borrowing from foreign financial institutions 50.2%. Borrowing from MOF for JICA's TSL account for 3.1% of Golomt Bank's borrowed funds under projects.



Note: As of the end of 2016
Source: Golomt Bank Annual Report

Figure 9.3.5 Major Items of Assets and Liabilities of Golomt Bank

Borrowings from other foreign banks of MNT 497.8 billion, increased 2.5 times compared with 2015, represented loans obtained in 2016 from a foreign bank in total amount of USD 200 million on 21 December 2015 with maturity of 18 months and on 15 July 2016 with maturity of 24 months. The borrowings are collateralized by the Bank's current account at these banks. The Bank obtained uncommitted revolving trade credit lines from international banks and financial institutions to fund its trade loans to customers. As of 31 December 2016, Golomt Bank utilized MNT 102.2 billion of related credit lines and issued loans for the same amount.

Golomt Bank borrows funds from the government organizations to provide policy loans as follows:

<u>Bank of Mongolia loans</u>

i) Strategic Import Financing Schema, Fuel Pricing Stabilization, Food Price Stabilization, and Construction Sector Support and Apartment Price Stabilization, and mortgage programs.

ii) Bank of Mongolia, Project loan of KFB bank

<u>Ministry of Food, Agriculture and Light Industry</u>

i) Small Medium Enterprise Investment Fund

ii) Small Medium Enterprise Development Fund /Wool & Cashmere loan

<u>Ministry of Finance</u>

i) Two step loan project for SME development and environmental protection financed by JICA

ii) Agriculture and Rural Development Project (ADB)

iii) Private Enterprise Development Project Loan (World Bank)

Government Organizations of Aimags (provincial centers)

i) The Labor and Welfare Service offices at 13 aimags and 1 district provided this fund for the purpose of supporting job creation.

ii) A loan obtained from the Local Government Office of Orkhon aimag to support local small and middle sized businesses

iii) Lending to Khuvsgul province local SMEs based on cooperation agreement with Khuvsgul province governors' office.

Other

i) Development Bank of Mongolia - Program of supporting export

ii) Development Bank of Mongolia - Manufacturing and Processing of Leather Products

iii) Development Bank of Mongolia - SME investment Fund

iv) Development Bank of Mongolia - Cashmere production

v) Development Bank of Mongolia - Industrial support

vi) Development Bank of Mongolia – Milk and dairy products

vii) Development Bank of Mongolia – Green house farming

viii) Development Bank of Mongolia – Funding for Asia-Europe meeting

ix) Development Bank of Mongolia – Agriculture 2016 program

x) Development Bank of Mongolia – Meat production

xi) Development Bank of Mongolia – Sewing industry

9.3.5 Xac Bank

(1) Financial Situation

Assets

The size of total assets of Xac Bank represents 8.2% of total banking system assets. The bank significantly increased (2.7 times) total assets from MNT 0.8 trillion at the end of 2011 to MNT 2.3 trillion at the end of 2016. In 2015, the bank experienced slight decrease in total assets amounting MNT 1.9 trillion. However, it recovered in 2016 and showed 17% of growth.

The share of “loans and advances to customers” was 51.3% in 2016, significantly decreased from 63.4% in 2014, due to the slowdown in the Mongolian economy. The share of “financial investments” increased from 10.6% in 2014 to 22.5% in 2016. “Cash and balances with central bank” and “Due from banks” had highest growths of 78% and 60% respectively.

Table 9.3.17 Assets of Xac Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Cash and balances with central bank	114.3	174.5	238.6	187.8	183.9	326.8
Due from banks	39.5	142.6	121.8	138.4	99.1	158.6
Reverse repurchase agreements	-	3.5	30	152.8	10	-
Financial investment	99.3	88.7	345.7	220.8	395.4	508.3
Loans and advances to customers	535.9	630.9	1,029.5	1,313.7	1,171.3	1,157.2
Fixed assets	19.1	25	29.6	31.2	34.8	36.6
Other assets	9.4	11.8	15.3	25.8	38.2	68.5
Current income tax prepayment	-	0.7	1	2.3	3.4	1.3
Total Assets	817.5	1,077.7	1,811.5	2,072.8	1,936.1	2,257.3

Note: As of the end of year
Source: Xac Bank Annual Reports

Liabilities and Equity

Customer accounts (deposits) account for 47% of total liabilities at the end of 2016, and the size increased by 11% from 2015. The size of customer accounts has constantly increased and has grown by 2.7 times since 2011. The share of other borrowed funds dramatically increased in 2013 and was same sizes in 2013 and 2014 with customer accounts. But the size lowered in 2015 and recovered again in 2016 as shown in the next table.

Total equity has shown a steady increasing trend due to favorable retained earnings. Total equity increased from MNT133.9 billion in 2014 to MNT179 billion in 2016.

Table 9.3.18 Liabilities and Equity of Xac Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Due to banks	62.5	55.9	141.7	34.3	20.7	0.7
Repurchase agreements	48.8	63	162.4	179.7	100.3	-
Customer accounts	365.3	516	644.5	797.7	886.3	985.5
Borrowed funds	217.1	286.1	664.4	803.6	643.2	936.1
Subordinated loans	37	48.9	58.6	97.8	104.2	123.4
Other liabilities	4.3	10	17.7	25.8	25.1	32.5
Total liabilities	735	979.9	1,689.3	1,938.9	1,779.8	2,078.2
Ordinary shares	20.4	20.4	20.4	20.4	55.3	55.3
Share premium	35	35	35	35	-	-
Other reserves	10.5	10.5	10.5	10.5	10.5	20
Retained profits	16.7	32	56.3	68	90.5	103.8
Total equity	82.6	97.8	122.2	133.9	156.3	179.1
Total liabilities and equity	817.6	1,077.7	1,811.5	2,072.8	1,936.1	2,257.3

Note: As of the end of year
Source: Xac Bank Annual Report

(2) Loan Portfolio

In terms of sectoral distribution, trade loans accounted for 24%, manufacturing 18%, mortgage 14% followed by service sector loans 12% in 2015. Compared with 2014, major growths occurred for manufacturing loans (6%), agricultural loans (39%), loans to staff (64%) and deposit backed (19%). All other sectoral loans declined: construction, loans to key management and other loans decreased by 36%; mortgage by 19%; mining by 17%; and consumption by 16%. Consequently, total loans reduced by 9% in 2015.

Table 9.3.19 Breakdown of Loan by Sector of Xac Bank

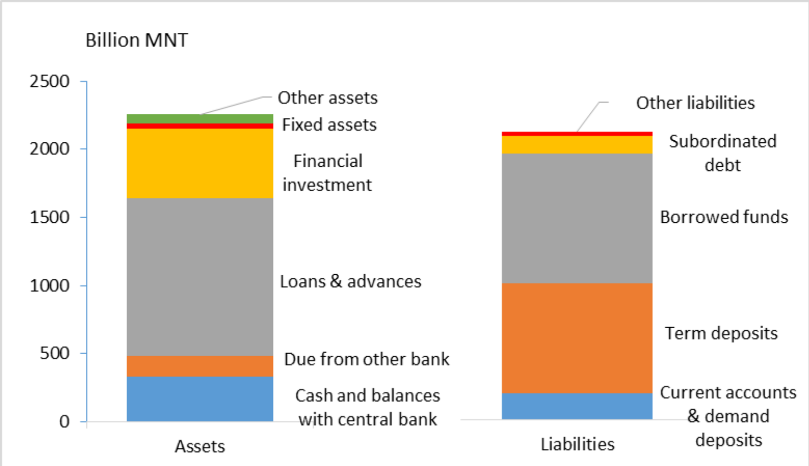
Sectors	2014		2015	
	Amount (Thousand MNT)	Share (%)	Amount (Thousand MNT)	Share (%)
Manufacturing	215,311,310	16	227,271,619	18
Mining & Exploration	17,134,711	1	14,285,039	1
Construction	99,753,180	7	63,909,196	5
Trade - Whole & Retail	312,112,759	23	297,764,750	24
Deposit backed	82,380,202	6	100,426,394	8
Mortgage	220,233,804	16	177,307,450	14
Agriculture	21,831,129	2	30,358,547	2
Consumption	134,270,861	10	112,569,112	9
Loan to staff	12,989,060	1	21,331,556	2
Loans to key management	2,018,373	0	1,298,699	0
Service	174,132,449	13	148,466,128	12
Other	69,651,066	5	44,472,092	4
Total loans	1,361,818,904	100	1,239,460,582	100

Note: As of the end of year
Source: Xac Bank Annual Report

(3) Funding

Current account and deposits accounted for 47.4%, including current accounts of 6%, demand deposits of 6% and term deposits of 38%. In addition to current accounts and deposits, borrowed funds have become an important source for lending. The size of borrowed funds was MNT 936.1 billion (45%) at the end of 2016, an increase of 46% from the previous year.

The borrowed fund consists of borrowing from foreign financial institutions 69.2%, borrowing from government organization 30.1% and other company 7.1%.



Note: As of the end of 2016
Source: Xac Bank Annual Report

Figure 9.3.6 Major Items of Assets and Liabilities of Xac Bank

Xac Bank borrows from development financial institutions such as EBRD, FMO, ADB, OFID, Microfinance Enhance Facility S.A., SICAV-SIF, Global Climate Partnership Fund, Development Bank of Austria, Micro, Small and Medium Enterprises Bonds SA and others.

Xac Bank also borrows funds from the government organizations to provide policy loans as follows:

<u>Bank of Mongolia loans</u>

i) Strategic Import Financing Schema (SIFS), Food Price Stabilization (FPS), and Construction sector support and apartment price stabilization, and mortgage programs.

ii) Bank of Mongolia, Term Loan III

<u>Ministry of Food, Agriculture and Light Industry</u>

i) Small Medium Enterprise Investment Fund

ii) Small Medium Enterprise Development Fund /Wool & Cashmere loan

<u>Ministry of Finance and others</u>

i) Two step loan project for SME development and environmental protection financed by JICA

ii) Agriculture and Rural Development Project (ADB)

iii) Employment Creation Support Fund

iv) Rural Poverty Reduction Program (International Federations Agricultural Development)

v) Micro Finance Development Fund

9.3.6 State Bank

(1) Financial Situation

Assets

The size of total assets of State Bank represents 7.6% of total banking system assets. State Bank significantly increased total assets from MNT 313.8 billion at the end of 2012 to MNT 2,088.7 billion at the end of 2016.

The share of "loans and advances to customers" was 54% in 2016. It reduced by 14% of 2014 due to the slowdown in the Mongolian economy. The share of "financial investments" increased by 56% and reached MNT 435 billion in 2016. Its share in total assets increased to 21% in 2016 compared with 16% of 2015. Unlike 2015 when had severe decreases in most asset components, assets in 2016 had increases except Cash & cash equivalents. The biggest increase occurred in financial investments (56%), due from other banks (34%) and loans (22%). These increases resulted in 22.6% increase in total assets.

Table 9.3.20 Assets of State Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Cash and cash equiv.	28.6	57.6	331.9	465.7	298.1	288.4
Due from other banks	16.7	10.9	36.5	143.5	106.0	142.2
Other short-term liquid assets	56.2	0.1	0.6	0.1	0.4	0.0
Loans and advances (net)	102.2	181.0	942.2	1,070.0	924.5	1,129.0
Financial investments	14.9	49.4	355.0	261.9	279.9	435.4
Fixed assets	11.3	11.2	60.0	74.6	79.2	78.9
Other assets	1.7	3.6	26.1	19.0	14.9	14.8
Total assets	231.6	313.8	1,752.3	2,034.8	1,703.0	2,088.7

Note: As of the end of year
Source: State Bank Annual Reports

Liabilities and Equity

State Bank highly depends on deposit for fund raising. Deposit from customers comprised 73% of total liabilities at the end of 2016. Deposit increased by 20% in 2016 from the previous year. In terms of equity, other reserves increased by 3.9 times in 2016 mainly caused by subordinated loan of MNT 65 billion. Retained earnings increased by 28% and these increases generated 45% of growth in equity.

Table 9.3.21 Liabilities and Equity of State Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Deposit from customers	160.4	193.9	1,034.2	1,167.2	1,149.5	1,351.6
Due to banks & FIs	10	17.1	144.1	303	184.4	127.1
Other liabilities	28.6	74.5	441.6	413	199.6	367.4
Total liabilities	199	285.5	1,619.9	1,883.2	1,533.5	1,846.1
Share capital	28	28	113	113	113	113
Other reserves	0.2	1.1	13.8	24.8	16.7	81.7
Retained earnings	4.5	-0.8	5.4	13.8	39.8	50.9
Total equity	32.7	28.3	132.2	151.6	169.5	245.6
Total liabilities. & equity	231.7	313.8	1,752.1	2,034.8	1,703.0	2,091.7

Note: As of the end of 2016
Source: State Bank Annual Reports

(2) Loan Portfolio

In terms of sectoral distribution as of the end of 2016, consumer loans accounted for 67% followed by agricultural loan of 14%. Other sectors accounts for very small shares. Compared with 2015, the biggest reduction occurred in electricity and oil (-49%) followed by healthcare, education and social service (-48%) and tourism (-24%). Loans to other sectors increased in 2016. The biggest increases occurred in other loans (609%), trade (273%), mining (259%), agriculture (216%), and transport (86%).

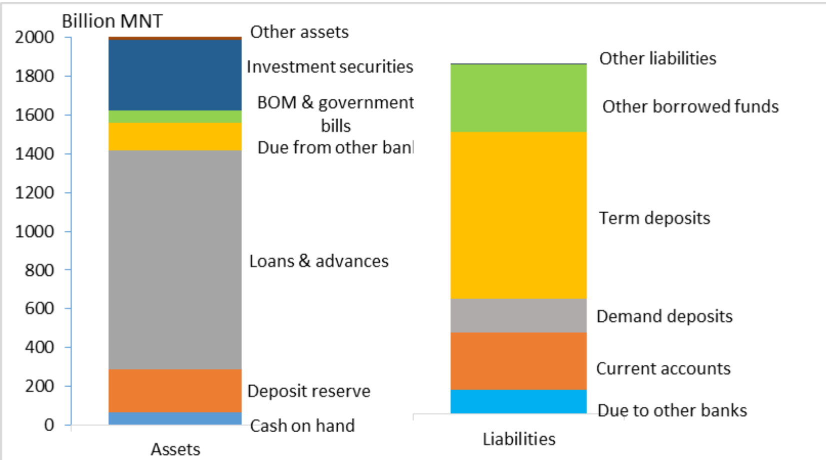
Table 9.3.22 Breakdown of Loan by Sector of State Bank

Sectors	2014		2015		2016		Increase 2015/16 (%)
	Amount (Million MNT)	Share (%)	Amount (Million MNT)	Share (%)	Amount (Million MNT)	Share (%)	
Consumer loans	856,785.200	79	772,023.4	82	778,887.7	67	1
Manufacturing	29,795.700	3	27,585.7	3	48,588.0	4	76
Mining & Exploration	2,596.900	0	1,671.7	0	5,995.0	1	259
Construction	62,622.300	6	45,105.7	5	61,859.5	5	37
Trade - Whole & Retail	14,432.600	1	8,022.6	1	29,934.1	3	273
Electricity & Oil	5,514.900	1	3,162.6	0	1,610.7	0	-49
Real estate	7,159.100	1	6,266.0	1	6,633.5	1	6
Finance	4,535.100	0	2,219.6	0	2,789.5	0	26
Agriculture	67,411.800	6	53,048.6	6	167,511.6	14	216
Transport & Communication	8,717.500	1	2,891.3	0	5,370.3	0	86
Tourism	3,547.800	0	3,359.6	0	2,541.4	0	-24
Healthcare, education and social service	12,709.800	1	11,831.5	1	6,113.4	1	-48
Other	3,585.900	0	6,396.9	1	44,816.2	4	601
Total loans and advances to customers (before impairment)	1,079,414.60	100	943,585.20	100	1,162,650.9	100	23

Note: As of the end of 2016
Source: State Bank Annual Reports

(3) Funding

Current account and deposits are main part of liabilities accounting for 73% of total liabilities. Among them, term deposits hold 47% of total liabilities in 2016. In addition to deposits, borrowed funds have become an important source for lending with size of MNT 352 billion (19% of total liabilities).



Note: As of the end of 2016
Source: State Bank Annual Report

Figure 9.3.7 Major Items of Assets and Liabilities of State Bank

State Bank borrows from development financial institutions such as ADB and Mortgage Financing Corporation.

State Bank also borrows funds from the government organizations to provide policy loans such as BOM, Ministry of Finance, TSL, SME Development Fund, Mongolian Ipotek Corporation and Development Bank of Mongolia.

9.3.7 Ulaanbaatar City Bank

(1) Financial Situation

Assets

The total assets of the Ulaanbaatar City Bank (UB City Bank) increased by 2% and reached MNT1.5 billion in 2016. The typical changes in recent years are an increase in "balances with BOM" and decreases in "loans and advances" since 2014. In 2016, the loans and advances account for only 39%, which was 61% in 2011 and had continuous decrease since then.

Table 9.3.23 Assets of UB City Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Cash on hand	3.4	6.7	9.1	8.8	8.7	19.9
Balances with BOM	64.5	42.4	140.5	215.6	255.6	244.7
Demand and time deposits with other bank and financial institutions	25	37.2	177.8	67.5	57.9	131.1
Bills and Securities	60.5	27.8	-	230	133	216.4
Loans and advances	280.9	286.5	543.7	645.8	612.0	571.7
Other real estate owned	-	-	-	-	-	0.04
Fixed Assets	7.8	14.4	33.8	39.8	46.6	96.5
Intangible assets	0.4	0.6	0.6	0.7	0.7	0.9
Long term investment	9.7	58.2	288.5	244.6	173.2	0.0
Other assets	4.7	58.6	20.1	19	156.9	192.4
Total assets	456.9	532.3	1,214.10	1,471.80	1,444.60	1,473.6

Note: As of the end of year
Source: UB City Bank Annual Report

Liabilities and Equity

In 2016, customer deposits account for 49% of total liabilities and increased by 0.5% compared with 2015. On the contrary, liabilities to other banks and bills sold under repurchase agreements decreased by 20% and 52.5% respectively in the same period.

Table 9.3.24 Liabilities and Equity of UB City Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Current/Deposit accounts from customers	257.9	206.5	477.8	701.5	657.4	660.6
Liabilities to other bank and financial institutions	-	-	568.2	186.6	343.8	275.2
Bills sold under repurchase agreements	-	-	54	152.5	130.6	62.1
Other sources payable	49.7	44.6	40.7	333.6	70.1	163.1
Subordinated debt	-	4	4	4	4	4
Other liabilities	7.8	66.2	17.2	22.9	157.9	178.7
Total liabilities	422.2	495.7	1,161.80	1,401.10	1,364.10	1,343.7
Share capital	8	8	16	16	40	50
Revaluation surplus	6.2	7.3	9.7	11.3	12.0	41.1
Retained earnings	16.5	21.4	26.6	43.4	28.4	38.8
Social development fund	0	0	0	0	0	0
Subordinated debt securities issued	4.0	-	-	-	4.0	0
Total equity	34.7	36.6	52.3	70.8	80.5	129.9
Total liabilities and equity	456.9	532.3	1,214.10	1,471.80	1,444.60	1,473.6

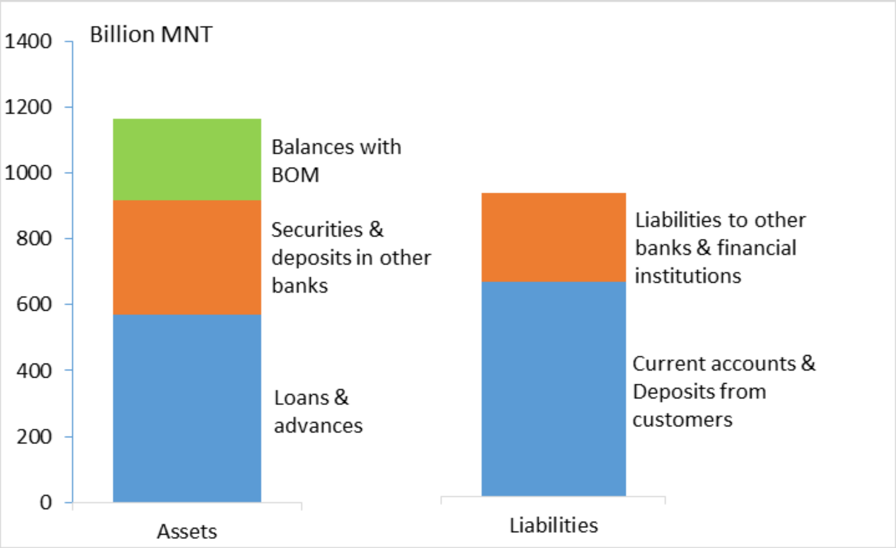
Note: As of the end of year
Source: UB City Bank Annual Report

(2) Loan Portfolio

The loan portfolio of UB City Bank decreased to MNT517.1 billion in 2016. The portfolio is 31% for business loan, 40% for mortgages loan, and 29% for consumer loan as of the end of 2015.

(3) Funding

The major source of funding for loans is deposits from customers at UB City Bank. As shown in the following figure, the size of deposits exceeds that of loans and advances.



Note: As of the end of 2016
Source: UB City Bank Annual Report

Figure 9.3.8 Major Items of Assets and Liabilities of UB City Bank

9.3.8 Capital Bank

(1) Financial Situation

<u>Assets</u>

Capital Bank decreased total assets from MNT 817 billion at the end of 2014 to MNT 746 billion in 2015. Capital Bank significantly increased the outstanding of loans and advances; on the contrary, it decreased cash/balances with the central bank and financial investments.

Table 9.3.25 Assets of Capital Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Cash and balances with the central bank	39.8	34.3	77.7	78.0	29.6
Due from banks	7.4	23.7	33.7	67.1	4.0
Derivative financial instrument		35.7	12.8	16.6	
Financial investments – available-for-sale	0.8	0.8	18.6	9.7	26.8
Financial investments – held-to-maturity	27.3	8.1	57.9	99.1	22.8
Investment in an associate	0.0	0.0	-	0.5	0.5
Loans and advances to customers	124.4	198.1	311.0	490.8	544.8
Property, plant and equipment	9.3	18.9	31.8	49.4	64.8
Intangible assets	3.3	3.1	2.4	2.0	7.6
Other assets	2.5	2.8	2.8	2.5	30.7
Assets held for sale	5.7	-	6.3	1.7	14.2
Prepaid tax	0.0	0.1	0.1	0.0	0.0
Deferred tax asset	-	0.1	0.0	0.0	0.0
Total assets	220.5	325.6	554.9	817.4	745.6

Note: As of the end of year
Source: Capital Bank Annual Report

Liabilities and Equity

Total equity has been steadily increasing because of generation of profit every year. Total liabilities decreased by 11% to MNT 662 billion in 2015. Deposits and borrowing stayed stable. Customer deposits account for 52% of total liabilities and borrowing for 40% as of the end of 2015.

Table 9.3.26 Liabilities and Equity of Capital Bank

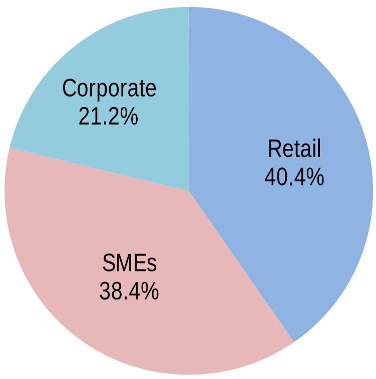
Unit: MNT Billion

	2011	2012	2013	2014	2015
Due to banks	11.4	50.9	74.6	130.8	31.9
Repurchase agreements	12.9	7.6	-	39.3	8.8
Due to customers	112.7	114.4	226.2	325.0	346.6
Borrowed funds	64.0	92.3	208.7	250.0	262.5
Derivative financial instrument	-	34.3	2.3	-	0.0
Other liabilities	2.1	2.2	1.7	1.4	10.8
Corporate income tax payable	0.0	0.0	0.0	0.5	0.1
Deferred tax liability	0.0	-	0.4	0.9	1.6
Total Liabilities	203.2	301.7	513.9	747.9	662.3
Ordinary shares	16.0	22.0	33.0	33.0	53.0
Other components of equity	0.1	0.4	4.4	23.1	15.9
Retained profits	1.2	1.6	3.7	13.5	14.4
Total Equity	17.2	23.9	41.0	69.6	83.3
Total Liabilities and Equity	220.5	325.6	554.9	817.4	745.6

Note: As of the end of year
Source: Capital Bank Annual Report

(2) Loan Portfolio

Total loan portfolio of Capital Bank is comprised of 40.4% to retail, 38.43% to SMEs, 31.2% to corporate bank customers, 21.2%.

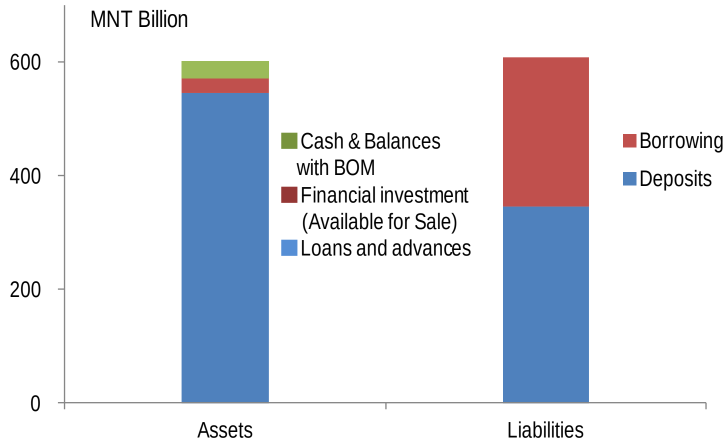


Note: As of the end of 2015
Source: Capital Bank Annual Report

Figure 9.3.9 Loan Portfolio of Capital Bank

(3) Funding

As the following figure shows, both deposits and borrowings are loans and advances are important source of loans and advances of Captital Bank



Note: As of the end of 2015
Source: Capital Bank Annual Report

Figure 9.3.10 Major Items of Assets and Liabilities of Capital Bank

Capital Bank provides various loans with the funds from the government through SME Development Fund, the Development Bank of Mongolia and other funds, and international financial institutions such as World Bank, JICA, IFAD, etc.

9.3.9 Capitron Bank

(1) Financial Situation

Assets

The bank's assets as of the end of 2016 totaled MNT 411.3 billion, representing 1.5 percent of total banking sector assets. Between 2011 and 2016, total assets grown by 232%.

Table 9.3.27 Assets of Capitron Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Cash and cash equiv.	16.5	18.1	41.2	36	31.7	151.9
Short-term liquid assets	11	18.8	30.3	7.9	28	27.6
Loans and advances (net)	69.7	63.6	109.9	118.9	93.1	173.9
Other assets	26.7	20.4	23	21.3	38.3	57.9
Total assets	123.9	120.9	204.4	184.1	191.1	411.3

Note: As of the end of year
Source: Capitron Bank Annual Reports

In terms of asset composition, Loans and advances (net) accounted the biggest portion of 42.3% of total assets, followed by Cash and cash equivalent (37%). Other assets accounted for 14%, whereas Short-term liquid assets accounted for 6.7% of total assets. In 2015, loans decreased by 22% due to the economic downturn, but recovered quickly. In 2016, loans had the highest increase in 6 years and grown by 87%.

Liabilities and Equity

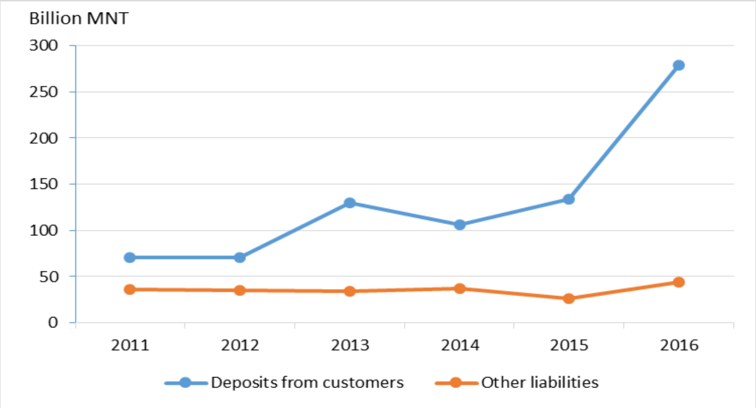
Deposit from customers comprised 73% of total liabilities at the end of 2016. Although both liabilities and equity increased in 2016, the retained earnings in capital has continued to be negative.

Table 9.3.28 Liabilities and Equity of Capitron Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016
Deposit from customers	70.9	70.3	129.7	105.8	134.1	278.6
Due to banks & financial institutions	4.5	0.5	19	19.3	9.3	56.9
Other liabilities	36.6	35.4	34.6	37.6	26.6	43.9
Total liabilities	112	106.2	183.3	162.7	170	379.4
Share capital	8	8	16	20.5	37.8	40
Other reserves	3.3	5.2	5.2	2.8	-5	2.8
Retained earnings	0.6	1.5	-0.1	-2	-11.7	-10.9
Total equity	11.9	14.7	21.1	21.3	21.1	31.9
Total liabilities & equity	123.9	120.9	204.4	184	170	411.3

Note: As of the end of year
Source: Capitron Bank Annual Reports



Note: As of the end of year
Source: Capitron Bank Annual Reports

Figure 9.3.11 Composition of Total Liabilities of Capitron Bank

(2) Loan Portfolio

In terms of sectoral distribution, real estate accounted for 25%, manufacturing 12%, consumption 12% followed by construction sector loans 10% in 2016. Compared with 2015, major growths occurred for health and education (289%), mining (282%), mortgage (189%) and real estate loans (149%), while decreases were recorded in agriculture (-14%) and electricity and water supply (-6%). Consequently, total loans outstanding increased by 71% in 2016.

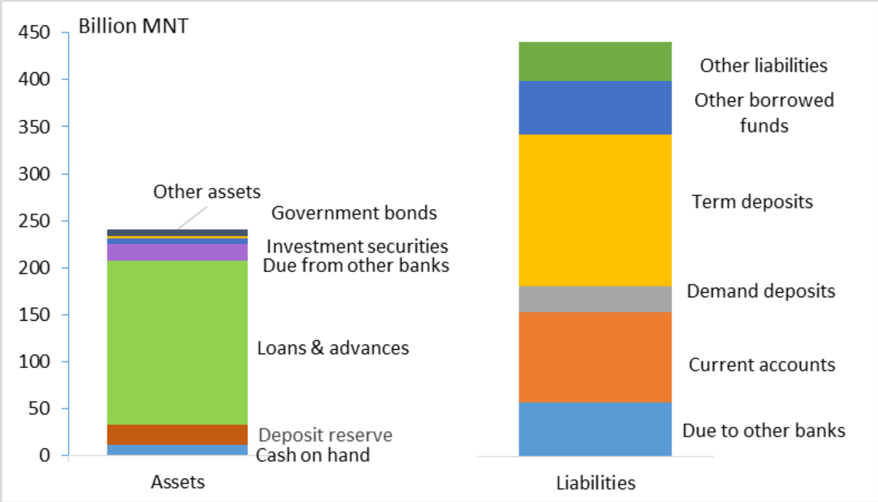
Table 9.3.29 Breakdown of Loan by Sector of Capitron Bank

	2014		2015		2016		Increase 2015/16 (%)
	Amount (Million MNT)	Share (%)	Amount (Million MNT)	Share (%)	Amount (Million MNT)	Share (%)	
Manufacturing	28,259	22	17,247	16	21,394	12	24
Mining & Exploration	8,263	6	3,224	3	12,315	7	282
Construction	9,325	7	14,748	14	18,246	10	24
Electricity & water supply	3,518	3	3,678	3	3,440	2	-6
Trade - Whole & Retail	18,081	14	13,300	12	22,771	12	71
Real estate	19,424	15	18,509	17	46,177	25	149
Agriculture	11,046	9	8,320	8	7,179	4	-14
Transport	2,620	2	2,586	2	6,619	4	156
Health, education	1,739	1	2,157	2	8,390	5	289
Mortgage	2,665	2	2,338	2	6,763	4	189
Consumption	16,821	13	16,624	15	22,500	12	35
Service	4,959	4	4,032	4	7,962	4	97
Other	1,641	1	1,450	1	1,457	1	0
Total loans	128,361	100	108,213	100	185,212	100	71

Note: As of the end of year
Source: Capitron Bank Annual Reports

(3) Funding

In 2016, current account and deposits are main part of liabilities accounting for 74% of total liabilities. Among them, term deposits hold 42% of total liabilities. In addition to deposits, borrowed funds have become an important source for lending with size of MNT 41.1 billion (11% of total liabilities).



Note: As of the end of 2016
Source: Capitron Bank Annual Report

Figure 9.3.12 Major Items of Assets and Liabilities of Capitron Bank

Capitron bank borrows funds from the government organizations to provide policy loans such as BOM, Ministry of Finance, TSL, SME Development Fund, Development Bank of Mongolia and others.

Chapter 10 Performance of SME Clients

10.1 Impacts and Benefits on the Small and Medium Enterprise (SME) Sector in Mongolia

A survey was conducted with the purpose of evaluating the impacts on the SME sub-borrowers of JICA-TSL.

The primary benefits on the SME side are i) business expansion, ii) quality improvement of products/services, and to some extent, iii) managerial capacity building through an access to long-term finance for capital investment.

At the national economy level, JICA-TSL had good impacts such as job opportunity creation, tax revenues, etc. through expanded domestic production for import-substitution and export promotion.

10.1.1 Outline of Survey

The survey was conducted as follows:

(1) Main Principle

The main principle of the survey was to be as simple as possible in order to avoid misunderstanding of respondents as well as to save efforts and time of respondents. But the questionnaire includes necessary questions for evaluating fundamental impacts of the JICA TSL on both micro level and macro level.

Micro impacts on the level of company performances included an increase in profitability, production volumes, sales, introduction of new products and services, better business diversification, advance in product/service quality, productivity, technology, marketing aspects, competitiveness, better management, human resource, and working conditions.

Macro level impacts were generally focused on the contribution to the state taxation income, increase of GDP, import substitution effects and contribution to the positive trade balance, and last but at least, the creation of jobs and contribution to the poverty alleviation.

(2) Period

The survey period was December 2016 - January 2017.

(3) Methodology

A questionnaire was sent to the SMEs through e-mail. The survey utilized Google Analytics for compiling answers from the respondents.

(4) Target of Sample Collection

The survey targeted to collect 350 responses.

Total 363 respondents were surveyed, which represents not less than 50% of the total number sub-loans disbursed by the JICA Two-Step-Loan Project within time frame 2006 - 2016.

(5) Result

The questionnaires from 363 companies were collected. In terms of geographical distribution of the responded companies, 235 companies (64.7%) operate in Ulaanbaatar city, and the rest 128 companies (35.3%) in the rural areas.

10.1.2 Evaluation of Direct Impacts on SMEs

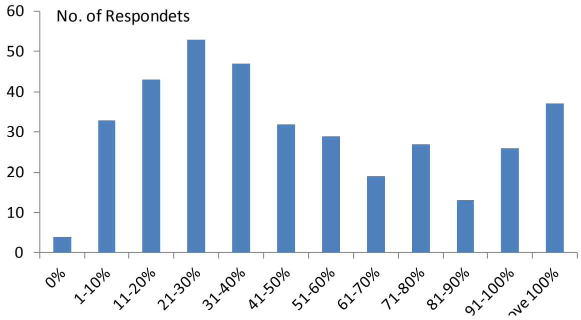
Sales

Almost all respondents increased its sales after TSL projects. More than half (57%) of respondents range between 21% to 80% of increase. About 10% of respondents increased sales more than double.

Table 10.1.1 Increase in Sales

Answers	No. Respondents	Share
0%	4	1.1%
1-20%	76	20.9%
21-40%	100	27.5%
41-60%	61	16.8%
61-80%	46	12.7%
81-100%	39	10.7%
Above 100%	37	10.2%
Total	363	100.0%

Source: JICA Expert Team



Source: JICA Expert Team

Figure 10.1.1 Increase in Sales

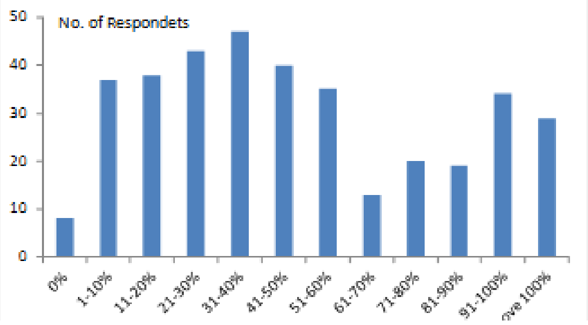
Production

Among the respondents, a quarter of the respondents answered growth of production by 21 - 40% followed by answers between 1 - 20% growth and those between 41 - 61%. On the other hand, 23% of respondents increased their sales by more than 80%.

Table 10.1.2 Increase in Production

Answers	No. Respondents	Share
0%	8	2.2%
1-20%	75	20.7%
21-40%	90	24.8%
41-60%	75	20.7%
61-80%	33	9.1%
81-100%	53	14.6%
Above 100%	29	8.0%
Total	363	100.0%

Source: JICA Expert Team



Source: JICA Expert Team

Figure 10.1.2 Increase in Production

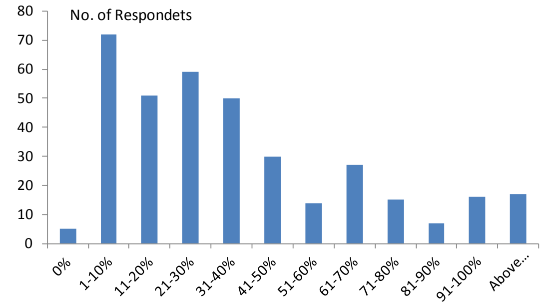
Profit before Tax

Total 64% of respondents have experienced an increase of profit before tax less than 40%. On the contrary, approximately 11% of respondents increased their profit by more than 80%.

Table 10.1.3 Increase in Profit before Tax

Answers	No. Respondents	Share
0%	5	1.4%
1-20%	123	33.9%
21-40%	109	30.0%
41-60%	44	12.1%
61-80%	42	11.6%
81-100%	23	6.3%
Above 100%	17	4.7%
Total	363	100.0%

Source: JICA Expert Team



Source: JICA Expert Team

Figure 10.1.3 Increase in Profit before Tax

Employment

The number of employment increased from 5,909 persons before the sub-loan projects to 9,486 persons after the projects. TSL projects have created net additional 3,577.

Other Impacts

As for the questions regarding technology, management and marketing, more than 90% of respondents answered that they have experienced positive impacts.

Table 10.1.4 Answers to Questions regarding Qualitative Impacts

Item		Yes		No		Total
		No. of Respondents	Share	No. of Respondents	Share	
1	Introduction of new product & service	334	92.0%	29	8.0%	363
2	Improvement of product quality	361	99.4%	2	0.6%	363
3	Introduction of advanced technology	338	93.1%	25	6.9%	363
4	Improvement of marketing	332	91.5%	31	8.5%	363
5	Acquisition of competitive advantage	348	95.9%	15	4.1%	363
6	Improvement of management capability	349	96.1%	14	3.9%	363
7	Development of human resource	341	93.9%	22	6.1%	363
8	Improvement of working condition	353	97.2%	10	2.8%	363
9	Adoption of industry best practice	283	78.0%	80	22.0%	363

Source: JICA Expert Team

10.1.3 Evaluation of Impacts on Macro Economy

Impact on Poverty Alleviation

Totally net 3,577 jobs have been added to the original 5,909 jobs by the TSL projects at 363 companies. From this figure, the impact on poverty alleviation is estimated as follows:

- The average salary in Mongolia is about MNT 800,000 per month

<u>Situation before the projects</u>

- The average salary in Mongolia is about MNT 800,000 per month.
- Annual income of 5,909 persons in amount of MNT 56.7 billion (equivalent to USD 22.7 million) was created (5,909 jobs x MNT 800,000 per month x 12 months = MNT 56.7 billion / MNT 2,500 = USD 22.7 million).
- Considering and the average family in Mongolia has 4 persons, livelihood of 35,454 persons was maintained by 5,909 jobs (5,909 jobs x 4 persons = 35,454 persons).

<u>Contribution of the projects</u>

- 3,577 new jobs were created within 363 surveyed companies. With the same logic as above, we conclude that:
- 3,577 new jobs created annual income of MNT 34.3 billion, equivalent to USD 13.7 million (3,577 jobs x MNT 800,000 per month x 12 months = MNT 34.3 billion / MNT 2,500 = USD 13.7 million).
- Livelihood of 14,308 persons was supported by creating 3,577 new jobs (3,577 jobs x 4 persons = 14,308 persons).

Impact on Increase in State Revenue

The impact on increase in personal income tax (10% of wages) payment by employees within the 363 surveyed companies is evaluated.

- The original 5,909 jobs generated personal income of MNT 56.7 billion; thus, created personal income tax of 5.67 billion per annum, equivalent to USD 2.2 million.
- 3,577 newly-created jobs generate the personal income of MNT 34.3 billion; thus created additional personal income tax of 3.43 billion per annum, equivalent to USD 1.4 million.

The impact on an increase in the social insurance payment (21% of wages) within the 363 surveyed companies is as follows:

- The original 5,909 jobs generated personal income of MNT 56.7 billion; thus, created the social insurance payment of MNT 11.9 billion per annum, equivalent to USD 4.7 million.
- 3,577 newly-created jobs generate the personal income of MNT 34.3 billion; thus, created additional social insurance payment of 7.2 billion per annum, equivalent to USD 2.9 million.

Combined state revenue from the personal income taxes and social insurance payments is MNT 10.6 billion per annum, equivalent to USD 4.3 million.

The 98.6% of the surveyed companies have increased their profit. From this figure, it is estimated that at state revenue from company income taxes has increased proportionally.

Impact on Import Substitution

Among the 363 surveyed companies, 251 companies or 69.1% have implemented import substitution projects. It is concluded that TSL projects had a significant impact on import substitution.

Impact on Domestic Production

Among the 363 surveyed companies, 98.9% of companies have increased its sales and 97.8% have increased its production.

10.2 Impacts of TSL on Environmental Protection

The EPL projects' impacts and benefits on environment could be observed in the EPL operational results. In Phase I, its impacts and benefits were evaluated with rather qualitative analysis because there were various types of projects, and some of them were difficult to prove in terms of the actual impacts on the environment in short term. In Phase II, EPL intentionally focused on the projects aiming for renewable energy, energy efficiency, and Heat Only Boiler (HOB), which are identified as one of the most needed projects and able to provide statistical indicators to evaluate their environmental impact. This section, thus, focuses on the results of Phase II to demonstrate the EPL projects' impacts on the environment.

The EPL's environmental impacts were measured with four indicators: namely, i) coal consumption, ii) energy consumption, iii) dust, and iv) emission of air pollutants (nitrogen oxide (NO_X), sulphur dioxide (SO_2), carbon monoxide (CO), and carbon dioxide (CO_2)), following the Phase II EPL guideline. Those indicators were carefully estimated and evaluated by the environmental experts at the TSL Project Office, before and after each project for all the 46 EPL projects in Phase II.

It was observed that the EPL subprojects have a positive impact on the environment in terms of air pollution control and carbon emission reduction. The EPL projects succeeded in saving 36.8 million kWh of energy, 55,500 tons of raw coal, and capturing 134,000 tons of carbon per year as a total positive impact of the projects.

Table 10.2.1 Evaluation of Impacts of EPL Subprojects on Total Emission

Monitoring Indicators	Before Project (ton/year)	After Project (ton/year)	Reduction Rate	Emission Reduction (ton/year)
Energy Consumption (kWh/year)	67,740,351.36	30,960,338.90	54.3%	36,780,012.46
Coal Consumption (ton/year)	166,417.90	110,933.82	33.3%	55,484.07
Dust	67,709.5	32,443.4	52.1%	35,266.13
Air Pollution				
Sulfur dioxide (SO2)	571.51	407.22	28.7%	164.30
Nitrogen oxide (NOx)	1,044.36	746.53	28.5%	297.83
Carbon monoxide (CO)	66,370.40	54,164.82	18.4%	12,205.58
Carbon dioxide (CO2)	454,673.08	320,077.42	29.6%	134,595.66

* Details are shown in Appendix 3.
Source: TSL Project Office

10.2.1 Energy Consumption

Energy consumption is monitored mainly with energy-efficiency and renewable energy projects. There are two renewable energy projects (solar panel and geothermal energy system) and nine energy efficiency projects (heat-insulation construction materials[1]). Energy consumption was approximately 68 million kWh per year before the implementation of the projects, which was reduced to 31 million kWh after the implementation. This indicates the positive impact of the projects, reducing energy consumption amounting to 37 million kWh by 33% reduction rate.

10.2.2 Coal Consumption

Coal consumption indicator is calculated from all the EPL projects except a tree nursery-carbon capture project. Before the implementation of the projects, the amount of coal burned each year was 166,000 tons. This amount was reduced to 111,000 tons after implementation of those EPL projects with 33% reduction rate.

Renewable energy[2] and energy efficiency projects contribute most to the reduction of coal consumption. Those projects generally achieve 50%-100 % of coal usage reduction. HOB is another contributor, but its reduction rate is as low as 12%-43 % since ger-stove and fuel manufacturing projects still require coal to certain extent.

10.2.3 Dust Emission

Dust emission is monitored in all ten HOB renovation projects and one tree-nursery establishment project. Those projects succeeded in decreasing dust emission from 67.7 thousand tons to 32.4 thousand tons or 35.3 thousand tons of reduced dust emission with 52.1% reduction rate. Mostly dust emission reduction comes from the HOB renovation projects, the majority of which were implemented in Ulaanbaatar and Uvurkhangai.

10.2.4 CO_2 Emission

Deduction of carbon dioxide emission is evaluated with all the EPL projects except for the dust recycling project. It was 454,600 tons of carbon emission before the projects, which is estimated to decrease to 320,000, reduction of 29.6 % or 134,600 tons of carbon every year.

[1] Examples for the projects of heat-insulation construction materials include Canadian woodworks, eco-panel, insulated wooden panel, polystyrene concrete, ICF, felt cover, and foam panel.
[2] Renewable energy projects here indicate solar panel and geothermal energy.

Carbon emission reduction largely relies on the renewable and energy efficiency projects, the same with coal consumption. This resulted in geothermal energy and solar panel projects, reducing carbon emission by 83% and 50%, respectively. Projects for HOB, ger-stove, and fuel manufacturing reduce carbon emission by 17.9%-43.3%. Manufacturing projects for heat insulation construction materials can also reduce 10%-100%, depending on their project capacity and scales.

10.2.5 Emission of Other Pollutants (SO_2, NOx, CO)

Other pollutants are monitored on all eight HOB renovations projects. It was 571 tons of SO_2, 1,044 tons of NO_x, and 66,370 tons of CO being emitted before the implementation of the projects. Those pollutants were reduced by 28.7%, 28.5%, and 18.4%, respectively.

The details of environmental impacts by all 46 EPL projects are compiled in Appendix 3.

10.3 Lessons from Best Practices of SME Clients

10.3.1 Factors contributing to success of sub-loan projects

Adequate business plan

All surveyed companies emphasized an importance of a good business plan. An attractive and realistic business model should be proposed in the business plan.

Personal discipline, commitment and enthusiasm of the owner/top management to reach the goals

Hard work and commitment of the company's founder is one huge part of success. A success or failure of a project mostly depends on the capability of a founder. Important factors required for management are vision, aspiration, executive ability, consistency, sense of responsibility, etc. The success of all interviewed companies depended largely on the capabilities of founders. In all surveyed companies the founders worked as general directors of their companies.

Choosing the product with unique characteristics

Success of overwhelming majority of surveyed companies depended on unique characteristics of their products that had been firstly introduced to Mongolian market.

Choosing right momentum for the investment

Invest in the right business at the right time is a key point of success. There are statistics that 80% of start-ups fail. The overwhelming majority of surveyed company is in the successful minority that survived, and even thrived in its business. Successful projects were conducted at the right timing. Provision of sufficient investment at right time to catch a momentum can enable noteworthy growth.

Best product quality and growing reputation

All surveyed companies expressed that improved product quality was appreciated by the customers and strengthened their reputation, which contributed much to their business success.

Proper studies and research of the product and technology

A project is not able to produce a high standard of product without proper technological expertise. Successful projects studied and introduced advanced and adequate overseas technologies to realize high production technology. All surveyed companies emphasized that advanced technology and modern equipment improved their product quality.

Successful transfer of know-how and advanced technology

Technical transfer is necessary to ensure product quality. The success of four companies out of interviewed 15 has been enabled with participation of foreign experienced experts who help the establishment of production line, efficient and proper use of equipment, and the achievement of quality products.

Sufficient production capacity

All surveyed companies expressed that increased production capacity has drastically increased their income and market shares, positioning them in a market leader level.

Qualified and motivated personnel

Educating and human resource development are crucial for success in modern business. Motivated personnel were pointed out as the most valuable asset for quality and productivity.

Understanding of existing market demand and market development trends

All surveyed companies reported that the key in their success is the right selection of business and understanding of market demand. Close cooperation with customers and consistent effort for customer satisfaction are the basis of successful business operations. All the surveyed companies pay much attention to changing customer needs for product improvements, elimination of defects of products, and after-sale services.

Export access

One of the key to success is seeking for export markets. Success of eight companies out of interviewed 15 depended on available access to export markets, which significantly contributed to their successful operations. Since the domestic market of Mongolia is small (Mongolia has only population of 3 million people), producers often come to face saturation of the local market. Exploration of overseas markets such as China and Russia is an option for growth. Overseas markets are also a buffer for a downturn of domestic economy. However, for export activities companies should comply with international quality standards. This is the main challenge for Mongolian producers today, and technical assistance/support of international development organizations is much needed for the fulfillment of quality requirement for export market access.

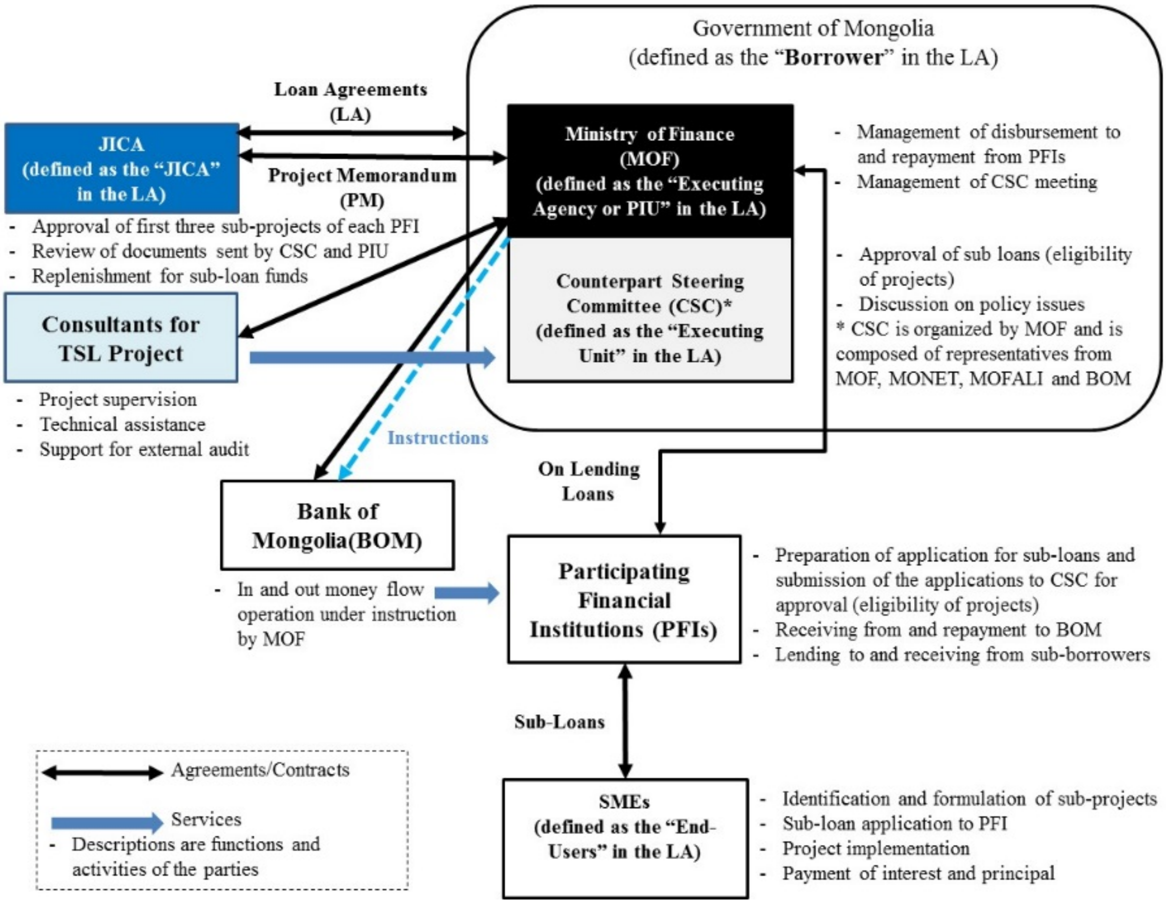
Multi-beneficial cooperation with production-supporting community, industry players and state authorities

A close cooperation with stakeholders is pointed out important. Cooperative relationship with suppliers, local municipalities and the industry are important to create favorable business environment. Support to local community such as farmers, agroindustry, technical workforce, construction workers, etc. bring multiple benefits, especially in remote rural areas. This fact was pointed out by all six companies surveyed in countryside, as well as for some respondents in Ulaanbaatar city.

Chapter 11 Review of Implementation Organization of TSL

11.1 Overall Implementation Structure

The Japan International Cooperation Agency's Two-Step Loan Project (JICA-TSL Project) Phases I and II implementation structure has been organized based on the loan agreements for Phase I and Phase II and its Project Memorandum as shown in the Figure 11.1.1 below. In this chapter, organizations, namely, Ministry of Finance (MOF), the Counterpart Steering Committee (CSC), Bank of Mongolia (BOM), JICA (formerly the Japan Bank for International Cooperation (JBIC)) and Consultants for JICA-TSL, were reviewed, thus implications obtained led for the revision of JICA-TSL of Phases I and II. As for the review of Participating Financial Institutions (PFIs) and small and medium enterprises (SMEs), refer to Chapters 9 and 10, respectively.



Source: JICA Expert Team

Figure 11.1.1 Overall Implementation Structure of JICA-TSL

11.2 JICA

JICA (formerly JBIC) has extended its non-objection basis approval for the application of the first three projects of each PFI. For the fourth project and onwards, JICA has been informed by receiving the applications for approved Sub-Loans, together with the minutes of discussion of CSC meetings. While JICA Headquarters had been in charge of these tasks in JICA TSL Phase I, the JICA Mongolia Office took over these tasks in JICA TSL Phase II. JICA has been consulted from time to time on the issues related to implementation of JICA TSL.

Not only in JICA TSL Phase I but also in JICA TSL Phase II, quite a long time was required to obtain the approval of JICA for the first three applications of Sub-Loans. Most of these times was caused by insufficient preparation of applications by PFIs who had not necessarily been accustomed to long-term financing.

11.3 Ministry of Finance (MOF)

According to the L/As for JICA-TSL Phase I and Phase II, the expected function of MOF is to implement the TSL project as "the Executing Agency". MOF organized Counterpart Steering Committee (CSC) as the "Executing Unit" for JICA-TSL based on the conditions of the L/As.

MOF's main tasks in JICA-TSL are as follows: (i) to manage disbursement to and repayment from PFIs and (ii) to manage CSC by holding its chairmanship of CSC Meetings.

11.3.1 Management of Disbursement to and Repayment from PFIs

MOF, as the Executing Agency, is responsible for managing the ODA loan through its Special Account (S/A) and RF/A (revolving fund accounts) set up with Bank of Mongolia (BOM), in accordance with the L/A concluded between GOM and JICA. Project seed fund was replenished from JICA into S/A, out of which sub-projects had been financed through selected PFIs. The principal repayments as well as interest payments of those sub-projects have been paid to RF/A. Funds accumulated in the RF/A are further being utilized to finance more sub-loans, and thus creating more funds to be accumulated.

MOF maintained eight RF/A, in tugrik and in US dollars for each of four categories: i) Phase I SME development TSL, ii) Phase I environmental protection TSL, iii) Phase II SME development TSL, and iv) Phase II environmental protection TSL, which created complications in operation. In fact, there were a few cases of different amount of interest being received from Project Office's calculation. Most of these miscalculations were caused by misunderstanding between TSL Phases I and II. As such, SAPI-2 team provided strong recommendation that the RF/A in TSL Phases I and II be merged together and used for the common purpose, the SME development or environmental protection.

CSC took SAPI-2 as well as Audit Recommendations into close consideration, and by the decision of CSC meeting dated 8 July 2015, the accounts for TSL Project Phase I and II were merged. Indeed, since the merging of RF/A, cases of mistaken transfers and/or miscalculations have been reduced to great extent. However, it needs to be noted that distinction between fund usage of Phase I PFIs and Phase II PFIs becomes a bit complicated, and hence, it was decided by CSC that only Capitron and State Banks are considered as Phase I PFIs and all the other 6 PFIs are as Phase II PFIs. Although the accounts have been merged, all the transactions are required to be recorded distinctively for the purpose of separation of fund usage and reporting.

11.3.2 Management of CSC

MOF has organized CSC as the Executing Agency for JICA-TSL and is responsible for the management of CSC meetings by holding its chairpersonship. For the smooth operation of CSC, MOF concluded the consultant service agreement with appropriate consultants (the Consultants for TSL Project) based on the L/A and its Project Memorandum. The Consultants have been engaged in the services to assist MOF to undertake implementation of JICA-TSL under the contract with MOF. The performance of CSC is mentioned below. From the view of the management of CSC, MOF has contributed to the smooth implementation of the Project through the approval of Sub-Loans (sub projects) and discussion on policy issues though CSC meetings.

11.4 Counterpart Steering Committee (CSC)

11.4.1 Structure of CSC

The Counterpart Steering Committee (CSC) for JICA-TSL Phase II was organized by the Ministry of

Finance (MOF) as the "Executing Unit" for JICA-TSL Phase II in accordance with the Loan Agreement (L/A) made between Mongolia and JICA. The Project Memorandum signed between JICA and MOF in 2011 stipules the function and structure of the Counterpart Steering Committee (CSC). CSC is composed of the members from MOF (head), Ministry of Nature, Environment and Tourism (MONET), Ministry of Food, Agriculture and Light Industry (MOFALI) (including representative from the department in charge of SMEs policy), BOM and MNCCI. The Director General of the Department of Policy Coordination for Finance of MOF was assigned to be the chairperson. On 14 September 2007, this chairperson of CSC was succeeded by the Directors or the Deputy Director of the appropriate Department in MOF thereafter. The members of CSC are recommended by the appropriate department of each Ministry and selected by MOF. If there are any changes in the members of CSC due to personnel change, it will be reported to JICA in the progress report. JICA and MOF confirmed that CSC will meet regularly so that smooth implementation of the Project is made. If the member is not available to attend CSC meeting, each ministry delegates an appropriate person to attend the meeting.

CSC members have been basically representatives of GOM's related ministries and thus each sub-loan has been screened from each ministry's policy perspective. For instance: Representatives from Ministry of Industry and Agriculture review sub-project eligibility from the ministry's policy guideline (intensified cow farm, meat and milk production etc.), check duplication of soft loan (whether or not received loan from Agriculture fund etc.), evaluate the current situation of each sector and so on. In addition, representative of Ministry of Environment conducts sub-project screening mainly from the point of hazardous impact on environment (whether or not waste water treatment plant operates in line with standard), and legal inspection (whether or not certain business operation is in line with food security law etc.). Table 11.4.1 is the recent member list of CSC.

Table 11.4.1 Member list of CSC

December 2013	March 2015	October 2016 ~
Chairman of CSC		
B.Nyamaa, Director General, Financial Policy and Debt Management Department, MOF	**- ditto -**	**I.BATKHUU , Director General, Development Financing Department (From April 2018)**
Members of CSC		
	D.Dorjsembed, Director General, Development Finance and Debt Management Department, MOF	T. Zorigtbat , Director, Financial Asset Management Division, Financial Policy Department, MOF (From September 2017)
N.Narangerel, Head of Debt Management Department, MOF	**- ditto -**	**- ditto -**
D.Ganbat, Director, Supervision Department, Bank of Mongolia	**- ditto -**	N. Batsaikhan, Director, Supervision Department, Bank of Mongolia
L.Choi-Ish, Director General, Strategic Policy and Planning Department, Ministry of Food, Agriculture and Light Industry	**- ditto -**	M.Dondogdorj, Director General, SME Policy Coordination Department, Ministry of Food, Agriculture and Light Industry
S.Regzedmaa, Senior officer, Manufacture and technological parking issue, Policy Implementation Management Department, MOLI	D.Battogtokh, Director General, Strategic Policy and Planning Department, Ministry of Industry	S.Regzedmaa, Senior officer, Light Industrial Policy Coordination Department, Ministry of Food, Agriculture and Light Industry
G.Batkhurel, Director General, Development Policy and Strategic Planning Department, Ministry of Economic Development	G.Bilguun, Director General, Small and Medium Enterprise Policy Implementation Department, Ministry of Industry	
B.Bat-Amgalan, Director, Small and Medium Scaled Enterprises Development Department, Ministry of Labor		
A.Enkhbat, Director, Clean Ecology and Science Department, Ministry of Environment and Green Development	G.Khorolmaa, Officer, Green Development Policy and Strategic Planning Department, Ministry of Environment, Green Development and Tourism	**- ditto -**
Ch.Nergui, Head of Policy Planning and Coordination Department,	**- ditto -**	N.Dolgormaa, Head of SME and Investment Promotion Department,

Mongolian National Chamber of Commerce and Industry		Mongolian National Chamber of Commerce and Industry
		J.Unenbat, CEO, Mongolian Bankers Association
Secretary of CSC		
Secretary: Yo. Amarbat, Senior officer, Financial Policy and Debt Management Department, MOF	**- ditto -**	**- ditto -**

Source: JICA Expert Team

In future, it would be concrete basis to accelerate the SPE establishment process if CSC composition is to be revised with inclusion of representatives from private sector (MBA, MNCCI and others) and from the independent third party.

11.4.2 Function of CSC

CSC has critical functions to ensure the smooth operation of the project. CSC is responsible for:

i) Concluding an on-lending loan agreement with PFIs in line with the sub-loan conditions under the Project, including the eligibility criteria, due management by BOM of special accounts established for the Project at BOM, due monitoring of each sub-loan by PFI and reporting to CSC.

ii) Sub-loan approval ONLY in line with the eligibility criteria of the Project and in reference to recommendations by project supervisor (consulting services), including a judgment of applicability of sub-loans to the environmental protection TSL.

iii) Request for concurrence to JICA as necessary, including for employment of the consultants and sub-loan approval.

iv) Instruction to BOM of disbursements of sub-loan funds to PFIs and due maintenance of special accounts established for the Project.

v) Production of quarterly P/R and PCR and their submission to JICA in the format of PSR in line with L/A and P/M.

vi) Request for disbursements from JICA and payment of interest and principal on time.

vii) Full cooperation to external audit of the special accounts and submission to JICA of unqualified annual external audit report.

viii) Selection of PFls, in consultation with JICA, under the same selection criteria as the first selection under open entry and exit policy.

ix) Daily monitoring and supervision of the Project.

Up until 2012, PFIs' loan officers in charge of particular sub-project used to attend CSC meeting for the purposes of providing detailed description of sub-project and responses for CSC members' inquiries. However, since 2012 loan officers are no longer able to physically attend, but send the necessary documents for CSC meeting, due to differentiation of CSC screening from PFIs' Credit committee screening, to be done from a policy perspective.

11.4.3 CSC Meetings

During Phase I project implementation, CSC had given much importance on employment creation whilst in Phase II project, those sub-projects that have more socio-economic benefit, better productivity and that utilize advanced technology have been prioritized. In both phases, export-oriented and import-substitute production and service have been the target for promotion. However, initial screening is being conducted by PFIs and project creditability and feasibility analysis is being done by the TSL Project Office.

In accordance with functions as stipulated in Project Memorandum, CSC reviewed PFI selection result, audit report on PIU's financial statements; approved/disapproved the sub-projects, set up on-lending and sub-loan interest rates, changed the loan conditions (extension of sub-loan tenure and grace period, conversion of USD sub-loan into MNT), approved bridge loan requests. But disbursement procedure of sub-loans from BOM accounts to PFIs has been regulated by MOF's internal regulation.

Each CSC meeting starts with project update, brief information on TSL project implementation, points to consider by TSL Office. This part includes general outline of overall project implementation, status of financial resources (SA and RF/A), reports on training and seminars conducted to PFIs and SMEs, and preparation of project guideline, operational manual and brochure. In addition, extension of Consultant's service agreement, internal audit report on project operation by MOF audit has been reported and reviewed and as a result, certain recommendations such as merging of RF/A of Phase I and II projects have been provided.

Requests for change of loan conditions are transferred to CSC screening only after PFIs' approval. Such requests have been submitted with main reason of economic and financial difficulties. For instance: During 2008-2009, as a result of so-called Lehman shock, many requests had been submitted from PFIs to change the loan conditions, mainly for extension of loan tenure and grace period. Such requests had been approved after profound screening and discussion at CSC meetings. During that time, mainly business operations related to construction sector (construction materials production etc.) faced hard times and requested for remedy. After 2011, due to upward trend of economic and financial situation, the business operations of above-mentioned sub-projects went back to normal. Same circumstance is recently being repeated during 2015-2016. In 2015 only, CSC received 7 requests and all were approved. Recent requests for change of loan conditions are mainly related to fall in sales income due to fluctuation of macroeconomic situation. However, during recent CSC meeting, it was decided that such requests are no longer to be transferred to CSC (no approval at all) as many may follow once approved, hence such requests are to be decided only at the PFI level.

Also, the bulk of initial requests for TSL loan has been gathered at PFIs due to limited funding available in the revolving fund accounts (RF/A). As a result, possibility of providing Bridge loan in relation to the business cycle of the sub-borrowers has been considered and discussed at CSC meeting. Requests for bridge loan have been submitted from TDB and transferred to CSC screening in July 2015. CSC members considered such requests as one form of re-financing, and thus disapproved.

In both phases, total of 37 sub-loans were extended in USD, which constitutes 5% of total number of sub-loans. Although it is up to sub-borrowers' discretion to choose which currency, the TSL Project office advises the sub-loan currency to be in line with sales income. During the project implementation period, altogether 4 requests for change of sub-loan currency have been transferred to CSC screening and all were approved.

Since the beginning of the implementation of the project, a total of 51 CSC meetings were held as of November 2016 as shown in the Table below.

Table 11.4.2 Brief overview of CSC meetings

as of 30 September 2016

Year	Number of CSC meetings held	Number of policy issues discussed	Number of projects screened	Number of projects approved	Number of projects Postponed	Number of projects rejected
2011	6	4	30	28	2	0
2012	14	1	154	148	4	2
2013	9	3	77	69	5	3
2014	7	8	85	74	6	5
2015	8	9	44	30	3	11
2016	7	5	56	48	2	6
Total	**51**	**30**	**446**	**397**	**22**	**27**

Source: JICA-TSL Project, Phase II

11.4.4 Policy issues discussed in CSC Meetings

During the implementation process of the TSL Project, several policy issues on JICA TSL have been identified and discussed at CSC meetings. MOF has initiated to take actions to resolve the issues with assistance of the TSL consultants. On these issues, MOF has informed CSC and asked for their views. Some of them are the following:

(1) Anod Bank issue

After BOM took administrative control of Anod Bank, CSC members asked the TSL consultants to a) discuss with the Anod bank sub-borrowers, b) research the opportunities to transfer the subprojects to other banks, and c) report it to CSC meeting. Through this action initiated by CSC members with assistance of the consultants, the transfer of Anod Bank subprojects to the other PFIs was successfully completed, and the negative impact of Anod Bank issue on JICA TSL was limited.

(2) PFIs selection

According to the PFIs selection method stipulated in the Minutes of Discussion between JICA and MOF dated 31 August 2011, CSC reviews and approves the report on assessment for PFIs selection for additionally applying banks. In the 3rd CSC meeting, CSC approved the report on the assessment for PFI selection for Phase II on the four additional banks, namely Golomt Bank, State Bank, Ulaanbaatar City Bank, and Capital Bank, in which Golomt Bank and Capital Bank finally obtained JICA's concurrence at this time. In the 14th CSC meeting, only Ulaanbaatar City Bank, out of the four banks, was approved by CSC as PFI for JICA TSL Phase II, and obtained the concurrence of JICA (please refer Chapter 9 for detailed PFIs selection).

(3) Utilization of RF/A Fund

In the 23rd CSC meeting for JICA TSL Phase I, the international consultant introduced the Operational Policy for Sub-Loans to be financed by RF/A as follows:

- Additional loan for ongoing projects - Ongoing projects should have more priority to be financed from RF/A and whenever there is additional loan request, project application should be submitted again.
- Loan for new projects - Maximum amount to finance newly proposed projects should not exceed USD 200,000 or equivalent MNT.
- The priority order of PFIs to receive loans shall be listed according to alphabetical order of the banks' names or any other order.

For this policy, one of CSC members commented that he agreed with the first and third requirements, but the second requirement could be adjustable according to the amount available in the RF/A. In fact, due to the increased accumulation in RF/A, CSC decided in the 33rd CSC meeting for JICA-TSL Phase I to increase the maximum amount to be financed from RF/A to USD 300,000 or equivalent MNT. Furthermore, CSC decided to increase the maximum amount to be financed from RF/A for Phase I to USD 400,000 or equivalent MNT in the 24th CSC meeting for Phase II. CSC also decided to increase the maximum amount to be financed from RF/A for JICA-TSL Phase II to USD 300,000 or equivalent MNT in the 22nd CSC meeting for Phase II, and to USD 400,000 or equivalent MNT in the 27th CSC meeting for Phase II.

The discussed policy issues above seem to contribute in the smooth implementation of the project (e.g., Anod Bank issue was well discussed in CSC meetings and the negative influence on the project was limited). Considering that some meetings were held with attendance of MOF members only, the attendance of all CSC members is necessary in order to achieve more productive discussions on broader policy issues at CSC meeting.

(4) Lending rate of the Sub-Loans

The lending rate of the Sub-Loans is defined to be reviewed every 6 months based on the market rate, while the Government has kept its policy for SMEs lending at less than 10% by the time of establishment of the Government in June 2016. CSC decided in CSC Meeting to keep the rending rate of the Sub-Loans at 7% (same as SME Development Fund) by the end of 2016.

However, in CSC Meeting in November, the increase in the lending rate of the Sub-Loans at 8% and the increase of the service charge are agreed.

11.4.5 Project loan discussed in CSC Meetings

Since the beginning of the implementation of the project, a total of 51 CSC meetings were held as of November 2016 and 446 projects were screened for CSC meetings and 397 projects were approved for loans by CSC decisions. 22 projects were postponed due to inadequate information provided to CSC or subject to revision on the loan amount, maturity and grace period. 27 projects were rejected (between November 2017 and April 2018, and CSC meeting has not been held).

446 projects were screened for CSC meetings and 397 projects were approved for loans by CSC decisions. 22 projects were postponed due to inadequate information provided to CSC or subject to revision on the loan amount, maturity and grace period. 27 projects were rejected because of one of the following reasons: the company has inadequate capacity to compete in the market and generate enough revenue to pay back the loans; the company lacks experience in the field, the number of newly created jobs is too few, the company is able to use internal financial sources to run the project and the company is not in line with the loan policies.

Selection of eligible sub-projects is being conducted by PFIs first, mainly from risk management point of view: financial resources for repayment, side business, collateral etc. The TSL Project Office conducts credit analysis mainly from sub-project feasibility point of view and plus due diligence analysis by visiting each sub-project site. CSC, on the other hand, screens each sub-project from policy point of view, by checking whether the sub-project is in line with Government and related agencies' policies. In parallel with policy perspective, CSC reviews each sub-project with consideration of the following criteria:

i) Sector Eligibility
ii) Eligible criteria DSCR, IRR
iii) Market situation and competitiveness
iv) Collateral issue
v) Loan maturity
vi) Raw materials
vii) Seasonal factorEnvironmental evolution
viii) Food safety
ix) Profitability

The results of the discussions for project loans in CSC Meetings are summarized in the next Table.

Table 11.4.3 Brief overview of CSC Meetings

Bank	Screened	Approved	Rejected	Postponed
Golomt	94	82	10	2
Khan	107	102	2	3
TDB	109	90	8	11
Xac	72	65	5	2
UB city	9	7	1	1
Capital	55	51	1	3
Total	**446**	**397**	**27**	**22**

Source: JICA TSL Project Office, Phase II

11.5 Bank of Mongolia (BOM)

BOM holds the S/A and RF/A, and smoothly performs daily in and out cash flow operations under the instruction of MOF. No operational problems are identified so far. Also, information on accounts such as statements or details of transaction is satisfactorily provided. Therefore, BOM has performed in satisfactory manner as the financial institution responsible in keeping the accounts.

11.6 Consultants for TSL Project

The Consultants for TSL Project have been engaged in the services to assist MOF to undertake implementation of JICA-TSL under the contract with MOF. While the consultants team for TSL Project for JICA-TSL Phase I composed of three international and three national consultants, the consultants team for JICA-TSL Phase II is composed of five international and five national consultants. The performance of the consultants is summarized below according to the relevant contract for the consultant services

11.6.1 Assistance for the Project

(1) Preparation of a manual for PFIs on the usage of the project

The Operational Manual was originally drafted in December 2006 just after the establishment of the TSL Project Office in November and was delivered to PFIs in January 2007. When TSL Phase II started, the Operational Manual was thoroughly revised in August 2011. Also, new annex formats were distributed based on the request from PFIs in November 2011. The Operational Manual has been fully utilized by PFIs' staff in-charge since then. The submission of the PFI manual were followed by individual trainings and seminars at staff-level at each PFI, for some the same trainings were provided repeatedly and at executive-level as well.

The manual has not been revised since Phase II commencement, as the PFIs are already used to do the credit analysis and due diligence reviews as a result of utilization of the manual as well as previous experiences. The PFI manual definitely requires a thorough revision, in accordance with revisions of practices proposed to be exercised in Phase III. Details of the revision is to be thoroughly discussed and decided when Phase III project starts.

(2) Preparation of the Sub-Loan Applications in line with the eligibility criteria as well as JICA guideline for environmental and social impact consideration, and assistance for CSC

The Consultants for TSL Project have provided technical and advisory assistance for PFIs on the preparation of the Sub-Loan Applications to CSC. Since the national consultants have enhanced their advisory abilities on financial aspect, they can assist PFIs to prepare the Sub-Loan Applications and recommend the review results for CSC without problems. As some of the Sub-Loan Applications have contained mistakes in the projection of financial statement, the international consultants sometimes checked the figures, and informed the same sort of mistakes and its measures to the PFIs at the training.

(3) Support to CSC for JICA concurrence of Sub-Loans as necessary

JICA has extended its non-objection basis approval for the application of the first three projects of each PFI. As PFIs were not necessarily accustomed to long-term financing, the national and international consultants targeted the capacity building of PFIs' staff through a close on-the-job training rather than simply support CSC to obtain JICA's concurrence.

(4) Support to CSC for instruction to BOM of the disbursement of Sub-Loans to PFIs

The Consultants for TSL Project under the control of MOF, manage the daily operation. The national consultants have prepared all the documents required for the disbursement of Sub-Loans funds from BOM to PFIs, obtained the signature required according to government procedures, and instructed BOM to make disbursements to PFIs. At the initial stage, there were several cases of delay in disbursement due to the absence of signatories. To tackle this issue, the signatories in MOF were integrated to the Director General of the department-in-charge at MOF during the implementation of JICA-TSL Phase I. After the integration of the signatories, there is no delay in disbursement. Even during the implementation of Phase II Project, the obtaining of signatures for disbursement papers have not caused a major issue of delay, the procedures are undergoing normally in line with respected regulations of MOF.

(5) Support to CSC for production of necessary reports and external audit report

As for JICA-TSL Phase I, the L/A requires that in order to provide JICA with the basis for supervision and monitoring of JICA-TSL, CSC furnishes the Project Status Report every quarter during the implementation of the project. In regard to JICA-TSL Phase I, CSC started to furnish the quarterly reports from the first quarter of 2008, and furnished the Project Completion Report with assistance of the consultants. CSC did not furnish the quarterly reports before the first quarter of 2008 though they have prepared monthly reports. As for JICA-TSL Phase II, PIU (CSC) succeeded the reporting task to JICA and has furnished the reports every quarter so far.

(6) Support to CSC for request for disbursements from JICA

Disbursements to the Government of Mongolia from JICA are based on a request for initial disbursement and replenishment with summary sheets of payments for each category of the TSL component presented. Disbursement application for expenditures on Sub-Loans above the threshold needs to be supported by related documents on the end users (SMEs) and the purpose of the Sub-Loans. The national consultants, with advice and assistance of the international consultants, have set up the internal procedures of the Consultants for TSL Project for disbursement, and have prepared all the documents required for disbursements from JICA. No operational problem is identified in this procedure so far.

(7) Support for the Public Relations (PR) activity (including brochure to SMEs)

In order to reach SMEs which are widely spread in the country, promotional activities, namely, preparing PR materials and holding promotional seminars, have been implemented. The Project Office prepared the PR materials listed in the next table.

Table 11.6.1 PR Materials Prepared by the Consultant Team

PR Material	Contents
TSL brochure	Project introduction, eligibility criteria, pre-condition of Sub-Loans, ineligible sectors, SME loan and EPL brief introduction, list of documents needed for application, contact details of the PFIs and the TSL project office
EPL pamphlet	Detailed information on EPLs, eligibility criteria, expected outcome of EPLs, some examples of EPLs, contact details of the PFIs and the TSL project office
Manual for SMEs	Project introduction, eligibility criteria, pre-condition of Sub-Loans, list of documentations, explanation of lending process, and detailed explanation on important points for writing a business proposal

Source: JICA – TSL Project, Phase II

There are no other PR materials provided in addition to the three materials mentioned above.

These PR materials have been distributed through promotional seminars and other events for SMEs, the JICA Mongolia Office, and PFIs. In addition, the EPL pamphlets have been distributed to the Clean Air Foundation, city government, and other projects and entities working with the purpose of environmental protection.

The Consultants for TSL Project have extended the promotional activities not only in Ulaanbaatar and other major cities but also in regional provinces such as Bayan-Ulgii, Umnegobi. Most of them were conducted jointly with PFIs after the training for PFIs loan officers in the regional branches and have introduced the TSL Project to more than 1,000 PFIs' customers.

Apart from that, the national consultants have continuously organized promotional seminars for SMEs by using the seminar facilities at the Mongolia-Japan Center for Human Resources Development (MOJC) since January 2012. At the seminars, the Consultants for TSL Project introduced the outline of the project and procedure on how to use and apply the TSL. As of the end of September 2016, 92 seminars had been conducted, and 2,115 people in total attended this event as interested SMEs.

(8) Monitoring of the Performance

The Consultants for TSL Project comprise the consultants which not only conduct monitoring of projects but actually managing its daily operation. The monitoring has been summarized in a TSL project status table twice a month and reported to CSC. The Consultants for TSL Project also collect valuable information on the implementation of sub-projects from PFIs officials for their prompt action.

11.6.2 Technical Assistance

(1) Training and advice to CSC on yen loan procedure

At the initial stage, internal office procedures for ODA yen loan were set up with advice of the Consultants for TSL Project. In addition, training and advices to CSC on ODA yen loan procedures have been done from time to time, as needed. As CSC got accustomed to the ODA yen loan procedure through JICA-TSL Phase I, the training and advice to CSC on the procedure are not needed in Phase II so far.

(2) Training and advice to PFIs on the usage of TSL /term loan operation

In addition to the preparation of the PFI Manual, seminars on the TSL Project introduction and Sub-Loans Application have been held for PFIs. These seminars for PFIs have been conducted in all 21 aimags, and over 4,000 bank staff including the loan officers in the regional branches have attended the seminars since the beginning of JICA-TSL Phase II (as of the end of September 2016). At the seminars, the Consultants for TSL Project introduce the TSL Project and give advice on Sub-Loans Applications and financial projection using a spreadsheet. In addition, the results of the review of Sub-Loans Applications by the Consultants for TSL Project served as a feedback to loan officers in these seminars.

According to the interviews with PFIs' directors, high demand for these seminars is identified as they rated the seminars highly and expressed their needs to provide the seminars to more bank staff. In addition, some PFIs' directors requested the Consultants for TSL Project to provide advanced-level trainings as they currently lack experienced loan officers. Hence, some PFIs requested for the trainings to be conducted not only 1-time, but repeatedly, with certain time intervals, as the bank's officers rotate very often. In addition, it needs to be noted that there were a few inquiries from some PFIs about the possibility to send or dispatch group of loan officers to study best practices from Japan.

(3) Training of SMEs on the usage of TSL such as application and project formulation

Technical and advisory assistance on the usage of TSL for the end users (SMEs) has been provided in the form of preparation of applications for Sub-Loans through PFIs, and of on-the-spot consultation when the Consultants for TSL Project the end users (SMEs). As PFIs are in the position to: a) find the borrowers, b) formulate the projects, c) disburse the loans, and d) conduct monitoring, the Consultants for TSL Project is focusing on PFIs training as mentioned above. The national consultants have been providing on-the-spot consultation for most end users (SMEs) basically before the disbursement and after the completion of sub projects. In addition, the Consultants for TSL Project conduct the monitoring through review of the quarterly monitoring reports on all subprojects submitted by PFIs and provide on-the-spot monitoring and consultation to end users (SMEs) based on the results of the reports.

11.6.3 Studies

The following studies were conducted:

(a) The Necessity for Long-term Financing in Mongolia: Study on the development of domestic term finance market strategy was completed in November 2013.

(b) The Challenges Faced by SMEs to Access Financial Support in Mongolia: Study on the development of the private sector and the SME promotion strategy was completed in March 2015.

No other studies were carried out since then.

11.6.4 External Audit: Support for TSL auditing by outsourcing internationally reputable auditor

Every year, the Consultants for TSL Project for the selection procedure of auditing for the TSL accounts, terms of reference for auditing, tender notice for auditor, and audit report to be submitted to MOF.

11.7 Major Implications

The following are the identified implications with regard to implementation organizations for JICA-TSL Phases I and II:

- Regarding implementation scheme, as there were some problems in TSL Phase I, e.g., the delay in disbursement to PFIs from BOM, some improvement was made i.e., the Consultants for TSL Project advised and supported to transfer the asset of the failed bank (Anod Bank) to the other banks quickly. As a result, no problem was identified in the overall implementation structure in TSL Phase II. If the RF/A were added in TSL Phase III, some improvement plan would be required such as the establishment of Loan Administration Unit to deal with the merging of the RF/A of Phases I, II, and III.
- There is a need to explore the possibility of having more frequent or efficient CSC meetings. Some PFIs request that CSC meetings should be held more frequently because their sub-loan borrowers are waiting for the approval of CSC in many cases.
- High demand for seminars of PFIs is identified as they rated the seminars highly and expressed their needs to provide the seminars to more bank staff. In addition, the demand for setting advanced courses for experienced loan officers is identified.

Chapter 12 Issues for TSL Project Phase III

12.1 TSL Operation

12.1.1 TSL Implementation Structure

With the review of the JICA-TSL Phase I and Phase II, the following recommendations are made for the TSL Implementation Structure for Phase III.

First, the Ministry of Finance (MOF) as the Borrower in Phases I and II, would be the Executing Agency (E/A) and responsible for the implementation, administration, and operation of TSL Project with the following main functions: namely, i) receive proceeds from JICA, ii) provide on-lending to PFIs, and iii) play a secretariat role for the Counterpart Steering Committee (CSC).

CSC is expected to enhance its operation capacity continuously in i) making decisions on the government development policies with regard to the SME development and environmental protection in Mongolia, ii) coordinating inter-government relations, iii) coordinating government - PFIs relations, and iv) being responsible vis-à-vis JICA for TSL Project operation.

Over the two phases of the TSL Project implementation, it has been observed that the priority policies on SME development and environmental protection at the CSC meetings tend to change whenever there was a change in CSC membership/chairmanship. This case points out to the necessity of preparing an operational guideline for CSC to adhere to, which should be approved by a higher authority such as the State Secretary of MOF.

As it has been with both phases, MOF should maintain the TSL project funds in the Special Accounts (S/As) and the Revolving Fund Accounts (RF/As) with BOM and perform daily project related disbursements under its supervision. Regarding these accounts, it would be worthwhile reconsidering whether the same system is to be kept when Phase III is officially provided.

As for the technical assistance for the TSL project implementation, a similar approach should be taken by hiring a consultant team consisting of national and international experts with sufficient knowledge and expertise according to the necessity.

To increase the effectiveness and efficiencies with the sub-loan administration, as well as to meet the reporting and monitoring requirements, it has become inevitable for the consultants' team to introduce a comprehensive financial software system.

12.1.2 Simplified Processing of Sub-loan Applications

The processing of sub-loan applications with smaller loan amount may better be simplified as pointed out by one of the PFIs. It is recommended that those applications with the sub-loan amount under USD 80,000 or MNT 200 million equivalents should be screened and processed by TSL Project Office in line with the above mentioned Operational Guideline to be set up. This sort of applications may not need the detailed feasibility analysis as the requested sub-loans are used for simple capacity expansion. This approach is likely to reduce the application processing time and increase the operational efficiencies of the TSL project.

12.1.3 Merger of Revolving Fund Accounts

As pointed out in Chapter 7, MOF maintained eight RF/As, in tugrik and in US dollar each for four categories: i) Phase I SME development TSL, ii) Phase I environmental protection TSL, iii) Phase II SME development TSL, and iv) Phase II environmental protection TSL, which creates some complications related to the TSL office accounting and repayment from PFIs. Hence, the SAPI-2 Study recommended that the RF/As in TSL Phases I and II should be merged and the number of accounts to be reduced to the extent possible.

Reflecting the recommendations made by SAPI-2 and the National Audit Office of Mongolia, the RF/Accounts for TSL Project Phase I and II were merged by the decision of the CSC meeting dated 8 July 2015. Indeed, with this action taken, the mistakes and human errors made during the invoicing and repayments by PFIs have been reduced substantially.

At the start of Phase 3, it will be necessary to examine efficient account management for funds of three phases.

12.2 SME Development Loans

12.2.1 Eligibility of Project

The priority policy reflected in the eligibility criteria for the TSL Project loan in the SME Development category should be further reconsidered, in order to make the TSL project more suitable to the existing economic situations of Mongolia. Through discussion with the concerned parties, the following areas are needed to be addressed:

First, the definition of SME should be reconsidered. In Phase II, the number of employees and the annual turnover amount were mainly used as the criteria to define the SME, following the legal definition. Currently available “SME Law” was ratified in 2007 and since then the economy has expanded greatly causing the definition of SME to become outdated. Despite the efforts by the present Government to amend the SME Law, it is still not certain when the amendment will be made by the Parliament of Mongolia.

Second, the priority sectors should be reconsidered for more efficient usage of the TSL Project Loan. During the two phases of TSL operations, the majority of sub-loans have been provided mainly to the manufacturing and agricultural sectors, followed by service industries, which included hospitality businesses and various social services. For the next phase of TSL, the main focus should be placed on value-added, technologically advanced domestic productions with the import-substitution and export-promotion emphasis.

Third, there exists a strong need of sub-loan for inventories for production purpose. It should be reconsidered a mechanism to be able to make longer term finance for inventory responding this need to stimulate wider economic activities in the country.

Fourth, further discussion is needed on whether the creation of employment opportunities could be in the priority policy list for the TSL Project financing. The dilemma is the labor-intensive production is likely to favor traditional businesses with less advanced technologies. Hence, this issue has to be well considered and the possible solution could be the case-to-case approach to decide the fate of such applications.

Fifth, more promotional activities on TSL Project loan need to be taken in order to reach out more SMEs in rural areas. In this regard, the training for PFIs staff working in rural branches will be quite important.

12.2.2 Sub-loan Condition

The review of the phase I and II operations has revealed certain areas of sub-loan conditions to be reconsidered, which are:

Firstly, the minimum and maximum amount of sub-loan should be revised to reflect the country’s economic capacity and inflation level. Moreover, in order to promote the introduction of advanced technologies, the ceiling amount per sub-loan might be better to be increased to the appropriate level.

Secondly, the sub-loan and/or on-lending loan interest rate and its calculation methodology need to be reconsidered. Main reason is that ODA loan’s interest rate would be higher reflecting Mongolia would become a middle-income country. Another reason is SPE would be an implementation agency so that its margin should be considered. At present, interest rate of sub-loan could be 11-12% annually which is considered affordable for SME

Thirdly, the review of loan tenure and grace period is also seen as necessary. Longer tenure would be applicable to certain EPL projects, as their investment pay-back period is likely to be much longer than the SME development sub-loans. The grace period might be shortened reflecting the outcome of the survey by the TSL office that average period of grace period is shorter than the anticipated period.

Fourthly, in order to help SME with the shortage of collateral to access TSL project financing, it is advised that the services of the credit guarantee fund should be more used. The sub-loan borrowers are currently obliged to provide collateral on average 159% of the sub-loan amount, after strict evaluation of its recoverable value by PFIs. With this approach taken by PFI, it is obvious for the applicant SMEs to fall short of collateral to secure the loan.

12.3 Environmental Protection Loan (EPL)

12.3.1 Preferential Treatment for EPL

During the operations of both phases, the terms and conditions for the sub-loans in EPL category were the same as with the sub-loans in SME development category, except for the ceiling amount per EPL sub-loan. For the next phase of TSL, if the government continues to place high priority on environmental protection agenda, it would be proposed to have a preferential treatment for the EPL sub-loans, in the form of longer grace period and lower sub-loan interest rate as well.

12.3.2 Promotion of the HOB Projects in Rural Areas

Most of the privately-owned HOBs in Ulaanbaatar have been replaced by high heat efficiency boilers in the last three years, thus the demand for HOBs replacement in Ulaanbaatar has been significantly reduced. In contrast, the demand for HOBs replacement still remain high in rural areas, particularly in the soum/sub-province centers. Therefore, Phase III could aim for the promotion of these HOB sub-loan projects in the rural areas.

12.3.3 Capacity Building of PFIs and Borrowers on Environmental Impacts Assessment

The capacity building of PFIs and sub-loan borrowers on environmental impact assessment and monitoring is highly expected for the next phase of TSL. During the previous phases of operations, PFIs and sub-loan borrowers have been required to estimate the project’s impact on environment and prepare monitoring indicators. Despite the EPL guideline was formulated for the Phase II, it was quite difficult for them undertake this task, due to the lack of knowledge, experience and financial resources.

12.3.4 Promotion of Technology Transfer for Renewable Energy and Energy-Saving

The transfer of advanced technologies in the renewable energy and the energy-saving fields should be promoted as they have huge potentials in Mongolia to mitigate the negative impact on the environment. A mission of Japanese experts on environmentally-advanced technologies could be dispatched in order to introduce the environmental protection technologies into Mongolia. The facilities of the Mongolia-Japan Centre for Human Resource Development (MOJC) could be used to promote these types of initiatives.

12.4 Participating Financial Institutions (PFIs)

The PFI selection for Phase II has been made appropriately in accordance with the selection criteria stipulated by the Minutes of Discussion (M/D). Applicants were carefully assessed based on the CAMELS method. As a result of severe examination, Capitron Bank and State Bank were not approved as PFI of Phase 2 even though they were PFIs of Phase 1.

The last revision of PFI selection methodology was made in 2010 before the start of Phase 2. Any view recommending to revise selection methodology has not been expressed by stakeholders, therefore it is anticipated. It is assumed that the existing selection methodology will be applied for Phase 3 as before. It is appropriate to review the selection methodology in accordance with BOM’s policies of strengthening and monitoring the banking sector.

Regarding risk management, it is necessary to strengthen periodical review and monitoring of PFIs on an annual basis to check whether they satisfy the eligibility criteria including prudential requirements.

Since the beginning of Phase II, the TSL project has been implemented with participations of 8 PFIs, up until recently. Three banks, namely Chinggis Khan Bank, Arig Bank and National Investment Bank, have expressed their interest to be a PFI. The assessment of these banks should not wait for the selection of PFIs for Phase 3 because the assessment as a PFI for the existing RV/F can be applied to them.

Part 3:

Establishment of SPE

Chapter 13 Case Studies of Similar Public Finance Institutions

13.1 Domestic Cases

13.1.1 Development Bank of Mongolia (DBM)

The Mongolian government has reached an agreement with the International Monetary Fund (IMF) team on the financing of a 3-year extended fund facility (EFF) program for USD 440 million in February 2017. One of the biggest conditions of the EFF is the restructuring of DBM. IMF strongly requested the Government of Mongolia (GOM) to change the authority, capability, and operations of DBM under the EFF agreement. In accordance with the agreement, GOM made amendments to the DBM law in February 2017 and the amended law came into force in April 2017. The restructuring of DBM based on the new DBM law has been conducted and finished in late August 2017. The key points of the new DBM law and its restructuring are summarized in clause (5) below.

(1) Background of Establishment

Mongolia has experienced rapid economic growth in the past ten years. For further development, there is an urgent need to develop the necessary infrastructure particularly the transport system involving the road network, city transportation, and energy. However, financial environment in Mongolia is not well established to host large project investments yet. The capacity of the commercial banks is too small to finance large-scale infrastructure investments. Moreover, loan conditions of commercial banks such as short-term maturity and high interest rates, are also a hurdle for such investment. Furthermore, with limited experience of financing large projects, commercial banks do not seem to have sufficient capacity in credit analysis and risk management of projects. Considering these issues, GOM studied the practice of other countries, and decided to create a public institution with high financial capacity and specialization which can provide long-term loans at low interest rates for infrastructure investments necessary for the country's economic growth. Thus, GOM established DBM in 2011.

(2) Legal Background and its Structure (Under the DBM law 2011)

DBM was established under the DBM law in 2011. The DBM law stipulates that DBM is government-owned and the only policy-oriented bank in the country. At the same time, DBM is registered as a limited liability company. Financial activities performed by legal entities in the banking and financial sectors are subject to licensing requirements and close scrutiny by either the Bank of Mongolia (BOM) or the Financial Regulatory Committee (FRC) in Mongolia. However, The DBM law enables DBM to conduct its activities beyond the control of BOM or FRC through legalizing a system in which DBM operates without supervision of such authorities. DBM is supervised by the Ministry of Finance (MOF).

The DBM law is comprised of 7 chapters and 29 articles including "General provisions", "Activities of DBM", "Management and organizational structure of DBM", "State authority on DBM", "Limitation and supervision system of DBM's activities", "Accounting", "Auditing, Financial statement", and "Responsibility".

The major relations with the Government (the Cabinet) and the Parliament of Mongolia on DBM's finance in the DBM law are summarized below.

Table 13.1.1 The Relations with the Government on DBM's finance in the DBM law (2011)

Criteria for projects and programs funded by DBM	Significant development projects and programs approved by the Parliament of Mongolia will be funded. - Must be involved in development priority and strategically significant sectors of Mongolia approved by the Government (Cabinet). - Design and drawings, budget, feasibility study of the projects and programs must have prepared. - Must have aim to produce goods and products that support economic growth, or value-added goods and products that replace export and import products that meet the international standards and European Committee standards. - Credit risk assessment, grounds for loan, economic and social benefits of the projects and programs must be evaluated and assessed in accordance with professional analysis methods and techniques accepted in international context. - Assets originated from the projects and programs must be counted as pledge of the loan until the loan is repaid in full. (Article 10.1 of the Law)
Management	The Board shall be comprised of 9 directors. - The Board shall be appointed by the Government. Three of them shall be independent members. BOM, Mongolian National Chamber of Commerce and Industry (MNCCI) and MBA shall nominate the independent directors and the Government shall appoint them. Management shall be selected in accordance with open tender bid, and the Board shall appoint and dismiss the management as approved by the Government.
Liaison with state organizations	**Parliament:** - Determine the funding source of the Government for its contribution to the share capital of DBM, and to approve such funding amount - Approve a list of significant development projects and programs of Mongolia to be funded by DBM **Government (Cabinet):** - Provide credit guarantee for Development bank - Express its position with respect to credit policy and its implementation - Purchase and invest for long-term securities with call option - Discuss and approve the Board's report on DBM's activities - Discuss and approve the Board's report on financial statements - **Appoint and dismiss the Board directors** - Establish operating procedure, powers, responsibility and liability, salary and incentive of the Board **Ministry of Finance:** - Review the estimation in connection with funding provided by state budget in order to collect share capital of DBM and the credit guarantees to be provided by the Government, and submit for Government discussion its proposal on medium-term budget framework statement - Establish financial criterion to be applied by DBM

Source: JICA Expert Team

(3) Operation of DBM

The DBM law regulates DBM's operation (Article 7). The DBM law allows DBM to do loan disbursement, foreign/domestic payment and settlement services, guarantee issuance, securities issuance and purchase, dealing of foreign currencies, and other asset or liability management within the limitation regulated by law. Article 10 of the DBM law stipulates that the eligible projects and programs for DBM loan should:

- Be under the sectors that the government recognized as leading or important for economic development.
- Have a complete feasibility study and is included in the budget.
- Contribute to either export promotion and/or import substitution and meet international and European Union (EU) standards.
- Have been analyzed its risks, and economic and social impacts in accordance with internationally accepted methodology and standards.

DBM has two types of borrowers, namely, ministries (for projects selected by ministries) and corporations. Loans for ministries cover the target sectors such as road, railway, and energy. The loans are guaranteed by the government to the extent necessary. Loans to corporations are provided for industries which the government has prioritized for further development. Small and medium enterprises (SMEs) in the manufacturing sector and mining sector are also eligible. The repayment is expected to be done from the project's revenue.

Operational Results

The initial capital of DBM was MNT 16.7 billion funded by GOM. The asset size was increased to MNT 6,070 billion at the end of 2015 through GOM's continuous financial support, and DBM's large-scale bond issuance. A majority of the Chinggis Bonds, which GOM issued and amounted to USD 1.5 billion was also converted to DBM's financial source. DBM itself can also issue bonds, and it has issued a Euro Medium-Term Note (EMTN) of USD 580 million and a Samurai bond of JPY 30 billion. Details of the bonds are shown below.

Table 13.1.2 DBM Bond and Chinggis Bonds

(USD Million)

№	Bond name	Amount (mln USD)	Date of issuance	Payment date	Year	Interest rate	Issued exchange	Purpose
1	Development Bank bond	580	21.03.2012	21.03.2017[1]	5	5.75	Singapore Exchange	Industrial development, infrastructure, economically efficient project financing
2	Chinggis Bond (Government)	500	05.01.2013	05.01.2018	5	4.125	Singapore Exchange	Industrial development, infrastructure, economically efficient project financing
3	Chinggis Bond (Government)	1,000	05.12.2012	05.12.2022	10	5.125	Singapore Exchange	Industrial development, infrastructure, economically efficient project financing
4	Samurai Bond	292	16.12.2013	16.12.2023	10	1.52	Closed deal	Big projects: 5th power station, airport, etc.
	Total	**2,372**						

Source: JICA Expert Team

It should be noted that the asset increase mostly relies on liabilities such as bond issuance and the amount of equity capital was still around 300 billion MNT.

In terms of loan operation, the outstanding loan in 2015 was MNT 4,781 billion (see Table below). By sector, the loans were provided to the road sector (24%), mining sector (11%), refinery (25%) and energy sector and railway (7%).

Table 13.1.3 DBM loan disbursement, as of December 2015

(MNT million)

№	Industry & projects	Amount (MNT million)	No of projects	Interest rate (%)
1	Auto roads	1,157,083.2		
	Local auto roads	844,168.0	88	6.125
	Capital city auto road	107,918.5	56	7.34
	Financed roads according to 2015 budget law	34,401.2	13	4.791
	Tavan Tolgoi - Gashuun Sukhait auto road	170,595.5	1	4.25
2	Street project	129,335.0	94	6.125
3	Engineering infrastructure	408,768.6	108	6.125
4	Railway	347,079.7	2	6.125
5	Energy, power & thermal stations	333,672.7	5	5 - 8.06
6	Refinery	1,202,562.5	72	5 - 8.79

[1] It is said in the financial market that the bond holders agreed to exchange into new sovereign seven-year notes at par based on the agreements on EFF between IMF and GOM. The yield for the new notes was set at 8.75%, the minimum shown in the Feb. 24, 2017 guidance by GOM.

7	Mining	536,127.4	7	7.35 - 10
8	Construction	362,717.8	9	4.5 - 12
9	Transportation - Boeing airplane	152,594.7	5	5.12 - 6.62
10	Real estate - 6% mortgage	80,000.0	2	6.75
11	Financial activity - MSE	2,726.9	1	-
12	Hotel, hospitality services - ACEM	36,351.8	1	4.5
13	Other	31,868.4	4	4.792
	Total	**4,780,888.7**	**468**	

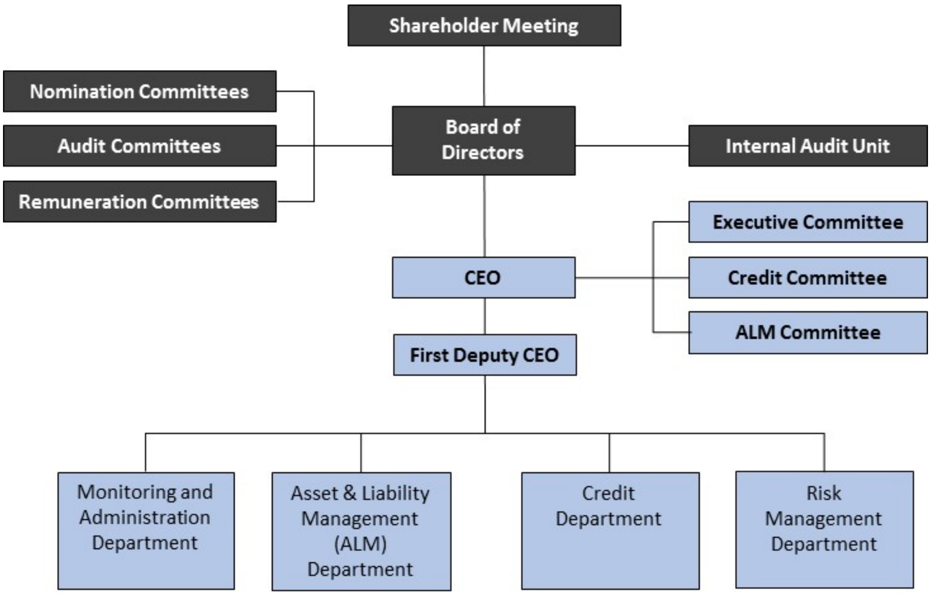
Source: DBM website

DBM had profit of MNT 101.5 billion in 2014 but reduced by 67% and reached MNT 33.3 billion in 2015. As a result, the profit levels of DBM became lower than 2014: return on equity (ROE) was 11.6% and return on assets (ROA) was 0.5%.

The international rating company Moody's stated that DBM's standalone credit profile is weak, pressured by its policy role, and its performance moderately worse than that of the Mongolian commercial banks. In terms of loan profitability, DBM's net interest margin registered only 2.66% in 2014, far lower than the 4.11% average for the five commercial banks that Moody's rates in Mongolia (Moody’s, 2015).

Organization and Staff

The released organization of DBM was as shown below. The structure of the organization seems to be a standard one. However, the effectiveness of the functions and responsibilities of the committees and departments was practically limited due to the relations with the Government on DBM’s finance in the DBM law (2011) as specified in the above section.



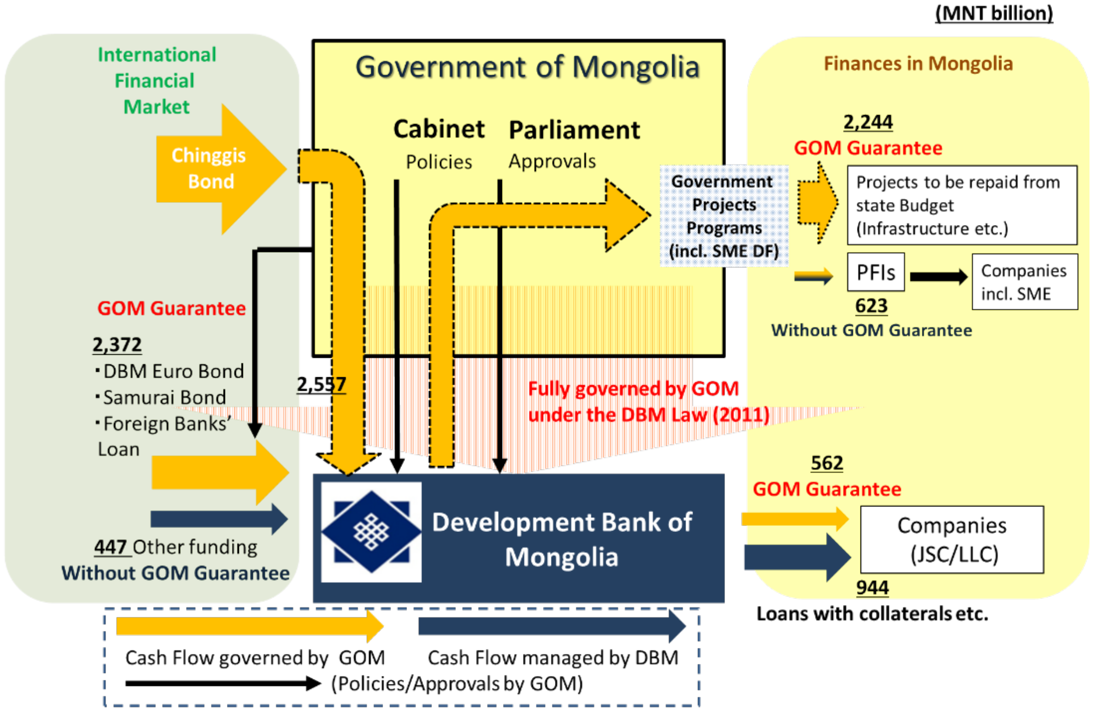
Source: JICA Expert Team

Figure 13.1.1 Organization of DBM

The number of staff in DBM at the establishment of DBM in 2011 was less than 50, and the number of employees of DMB has increased to between 50 to 100 people thereafter.

(4) Lesson from case study on DBM

Through our study on the structure and operation of DBM before its restructuring, it is clear that the activities of DBM were deeply influenced by GOM. More than 90% of the total amount of funding at DBM was guaranteed by the Government, and approx. 65% of the total amount of the DBM loans was guaranteed by the Government (the 15% was provided as two-step loans under the Government's policy) as summarized in the following Figure.



Note: The above figures of cash flow are at June 2015 based on the MONGOLIA ECONOMIC UPDATE by the World Bank Group in November 2015

Source: JICA Expert Team

Figure 13.1.2 Financial Structure of DBM

We understand that deep political influence is the major reason for the current financial difficulties of DBM and Mongolian Government.

The following issues to be considered for the structure of SPE.

- The DBM's independent activities from GOM have been limited.
- DBM has not been governed and audited as a financial institution under the DBM law (with control by either BOM or FRC). IMF and the World Bank requested GOM strongly to restructure DBM as a development financial institution with independence.
- DBM has been utilized by GOM for its politics and policies. This has prevented DBM from sound operation as a financial institution.
- The transparency of the operation of DBM has been limited under the DBM law.
- The capacity of DBM for credit analysis and asset liability management was not sufficient. The special knowledge and experience related to assessment of project risk and loan collateral were inadequate in DBM.

The lessons from the case study on DBM are as follows.

- Although SPE is the executing agency for government development assistance, it should be operated as a financial institution based on a transparent and high-quality governance.

- SPE should be governed and audited as an independent financial institution under the Company Law and Banking Law/Non-Bank Financial Institution Law (NBFI Law).[2]
- SPE must be established with the structure and organization that can eliminate political influence.
- The transparency of SPE needs to be secured by compliance with related laws and regulations, inspection / audit by regulatory agencies (FRC)[3], the articles of the internal audit and information disclosure to be specified in the company's charter.
- Although SPE would provide PFIs with wholesale lending, SPE has to be enhanced its capacity for credit analysis and asset liability management also. The capacity building of SPE should be secured by the technical assistance and trainings by international experienced experts for the initial period of its operation.

(5) New DBM law and DBM Restructuring

The new DBM law established in February 2017 (effective in April 2017) was greatly changed compared to the former DBM law in 2011, since IMF requested GOM to change DBM as an independent financial institution.

The new DBM law established in February 2017 (becoming effective from in April 2017) was greatly changed compared to the former DBM law in 2011. The biggest feature is that loans to government enterprises and government projects with government funds as repayment funds / government guarantees are excluded from the DBM lending operation (the relevant provisions are Article 8 of the new law and 7.8 and 9 of the former). The adjustment of the balance sheet was completed by the end of January 2017 (transfer of credit/liability to the government account). Although it is a policy loan, DBM’s two step loans related to SME Development Fund still remain in DBM's balance sheet because debtors are PFIs.

1) **Points of the new DBM law (2017)**

The following are thee points of the new DBM law:

<u>Funding</u>

The regulation concerning funding for DBM is not specifically stated in the new DBM law other than regulation of funding under the government guarantee. Although it can be understood that it is legally possible as a financial institution to procure its own funds from the financial market, it is considered impossible to procure new funding from the financial market for the time being.[4]

<u>Legal status of DBM</u>

The legal status of DBM and the rights (authorities) of the Mongolian parliament, cabinet and the ministry concerned (MOF) were clarified by the new DBM law. In the former DBM law, DBM was specified as "a state-owned corporation with a special policy" based on the DBM law, but in the new DBM law, DBM is defined as “a for-profit legal entity” to be governed by the new DBM law, Company law and related laws such as the banking law. In the new DBM law, the rights of the government are basically included in the rights of shareholders under the Mongolian Company law.

In the new DBM law, the involvement of BOM is clearly stated in the credit control and setting / inspection of business indicators as financial institutions.

The following is the Comparison of DBM lows for Government Lights and Capacities.

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[2] In accordance with the considerations on the financing scheme for TSL and the characteristics of SPE, it is recommended to establish SPE as a limited liability company (LLC) with a license for NBFI under the Company Law and NBFI Law in Mongolia. The details are specified in the following Chapter 2 and 3 of this report.

[3] The financial institutions with licenses under NBFI Law in Mongolia are inspected and audited by the Financial Regulatory Committee of Mongolia (FRC).

[4] November 21, 2016, Moody's Investors Service has downgraded the foreign currency issuer rating of Development Bank of Mongolia LLC (DBM) to Caa1 from B3. At the same time the backed senior unsecured debt and MTN program rating are downgraded to Caa1/(P)Caa1 from B3/(P)B3. Also, BCA/adjusted BCA are downgraded to ca from caa1.

Table 13.1.4 Comparison of DBM lows for Government Lights and Capacities

	Former DBM Law 2011	New DBM Law 2017
Parliament	1) To confirm the amount of equity contribution by the government and source of the funding 2) To determine the upper limit of the guaranteed amount for DBM's funding by the government 3) To review the audit report	1) To be reported on the DBM's reorganization and decisions on abolition 2) To receive the DBM's activity report, financial report and audit report. **Not to be involved in the decisions for DBM's operation basically.**
Cabinet	1) To establish DBM and the articles of incorporation 2) To establish the plan and modification of the organization of DBM 3) To decide the amount of equity contribution by the government and source of the funding 4) To draft the project list to be financed by DBM 5) To prepare the government guarantees for DBM's funding 6) To make representation of the government's position for negotiations between DBM and the related organizations/institutions. 7) To decide on purchases for the bonds issued by DBM and investment of securities 8) To review and approve the annual report / auditing report prepared by the Board of Directors (BOD) of DBM 9) To decide the purchase of securities 10) To appoint and dismiss of the members of BOD 11) To set the full rights of the Chairman and BOD members	**The rights of the government in DBM shall be the shareholder rights under the Company law plus the following:** 1) To purchase (investment) of long-term bonds with put option issued by DBM 2) To review and approve DBM's financial report and audit report, and to submit them to the Parliament along with DBM's activity report 3) To establish and implement the integrated plan/ countermeasure for the stabilization of DBM's financial and payment capacity 4) To approve the articles of association (Charter) of DBM 5) To decide changes the structure and amount of the DBM's paid-in capital 6) To conduct regular inspection on operation of DBM for its compliance with the related laws every two years, and irregular inspection, if necessary 7) To approve the rule for selecting the members of BOD in DBM **8) To decide issuance of the Government Guarantee for DBM (the Government may issue guarantee for DBM, it shall be regulated in accordance with the Debt Management law)**
Ministry in charge (Ministry of Finance)	1) To prepare the proposal to the Cabinet for the equity contribution/budgeting and the guarantee by the Government for DBM 2) To prepare the proposal to the Cabinet for DBM's structural reform and organizational change	1) To prepare the proposal to the Cabinet for DBM's structural reform and organizational change 2) To obtain information from DBM necessary for the implementation of the DBM's objective as specified in the article 5.1 of the DBM law
Central Bank (The Bank of Mongolia)	**BOM was not involved basically**	1) In the former law, the Ministry of Finance decided the financial inspection index to be respected, but changed to "the criteria of the prudential ratio, etc. are decided by the BOM in consideration of the opinion of the Minister of Finance". 2) To monitor the limitation of the total and large exposures of DBM

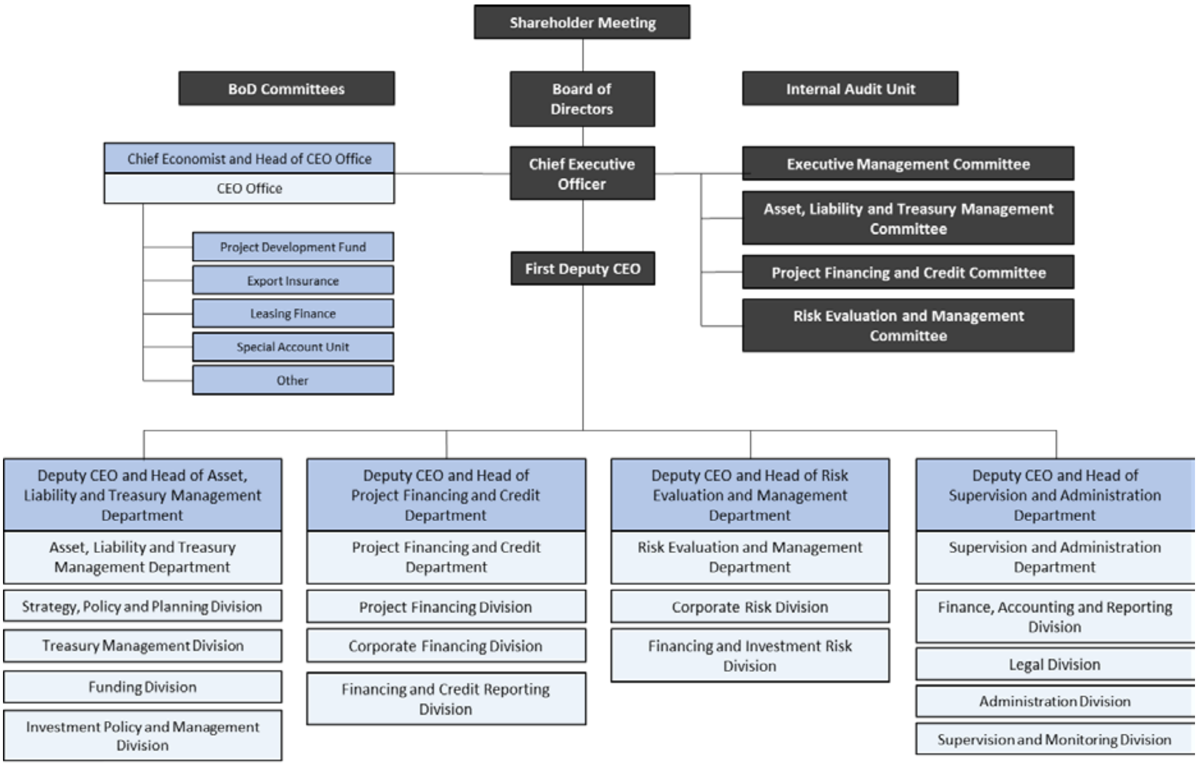
Source: JICA Expert Team

Governance

Details of the responsibilities and roles of the general shareholders meeting, the Board of Directors (BOD) and the business executives are specified in the new DBM law. It basically complied with the provisions of the Mongolian Company law. The eligibility requirements for BOD members and executive officers are fairly detailed in the new DBM law.

2) Organization

In accordance with the new DBM law, the restructuring of DBM organization is ongoing. The following is the planned organization.



Source: DBM

Figure 13.1.3 New Organization of DBM

(6) Recent movement for DBM

DBM and Government of Mongolia jointly implemented actions of refinancing investment resource of USD 580 million attracted from international market in the first quarter of 2017. On December 26, 2017, DBM held its annual general meeting. In the meeting it was expressed that DBM has taken measures for financial stabilization, specifically, planning of refinancing external debt and improving legal environment related to the bank operation. DBM management also said that the investment resource increase could build trust of investors on the DBM’s capability to ensure its financial stability, and the repayment of loans worth of USD 260 million would be made in the first half of 2018 without any difficulties.

It is announced that DBM decided to introduce ISO 37001 standard for the better compliance of the operation. The ISO system is expected to improve its corporate governance.

The international financial market for DBM has gradually be improved. In January 2018, Moody’s upgraded the credit rating of DBM from Caa1 to B3 and in March 2018 Russia’s International Investment Bank (IIB) reported that an agreement was made with DBM to allocating additional loan financing.

According to the agreement, IIB will increase DBM's available loan financing to a maximum of 50 million EUR for up to seven years.

13.1.2 SME Development Fund

(1) Background of Establishment

The SME Development Fund is traced back to the SME Fund initially established by the former Ministry of Industry and Trade (MOIT) in 1992 in compliance with the agreement on "Help for Agricultural Products" between GOM and the US government. In 2000, the SME Fund was restructured as the SME Support Fund for agriculture and industry by the Ministry of Food, Agriculture and Light Industry (MOFALI). In 2009, the SME Support Fund was again restructured as the SME Development Fund under MOFALI, and then transferred to the Ministry of Labor (MOL) since August 2012. In 2014, the responsibility for the SME Development Fund in the Government was transferred to the Ministry of Industry (MOI), and it was returned to MOFALI in July 2016 by the restructuring of ministries.

The primary purpose of the SME Development Fund is to retain existing employment and create new employment for SMEs in both rural and urban areas.

(2) Legal Background

SME Development Fund is governed by the laws and regulations comprised of :

- Law on Government Special Funds
- Law on Small and Medium Enterprises
- Small and medium enterprise development program (Government resolution)

An overview of the SME fund is shown in the following table.

Table 13.1.5 Legal Background of SME Development Fund

Laws and regulations	Legislation on SME Fund is comprised of the following: - Law on Government Special Funds - Law on Small and Medium Enterprises - Small and medium enterprise development program (Government resolution)
Purpose	To build up funds required for small and medium enterprise development activities (Law on SME Fund, 22)
Legal status	Government Special Fund is a part of income of the state central budget, donations, and grant aid accumulated into a special account with the purpose of implementing particular functions and objectives of the Government. (the Law on Government Special Funds, 5.1) Not legal entity.
Funding source	SME Fund is classified as the fund most part of whose sources are built up from budget and consists of the following sources: 1. State central budget 2. Grant aid and donations by international organizations, donor country, foreign and domestic organizations and citizens 3. Credit given by foreign countries and international organizations through the government (6.1.3, 6.4, 6.4.4, 7.1) 4. Income earned from the fund-managed activities 5. Income earned from the loan repayments 6. Other income The allocation from the state central budget to form the SME Development Fund shall be equal to at least 10% of the public investment program of the central budget. (14.2) Local government can allocate sources to SME Fund and the amount shall be determined in the local budget and approved by aimag, capital city, soum and district Citizens Representative Khural.
Activities	- Job creation - Long-term concessional loans for SME operations - Loan guarantees and warranties, investment to the credit guarantee institutions, dual guarantee for the credit guarantee - Professional advice and provision of information - Training and re-training - Purchase of some types of insurance

	- Other activities specified in the law
Management	As specified in Article 26.3 of the law on Government Special Funds, the decision disburse the resources in the SME Fund shall be made by the Cabinet member or the Minister of the responsible ministry (MOFALI). Under this Article, it is prohibited to establish working group for this type of special funds.
Liaison with state organizations	Ministry of Finance: - Control over the disbursement of the resources in the Fund State Fund Department: - Resources of SME Funds shall be places in special accounts at the state funds, and interest shall be paid on balance funds on the accounts - Based on the decision of the Minister of responsible ministry, State Fund Department shall finance from the special funds resources. Parliament, relevant standing committee: - If necessary, it can discuss the disbursement of the resources in the Funds Minister of the responsible mnistry (MOFALI) : - Disburse the resources in the Funds
Limitations on activities	It is prohibited to use and disburse the resources in the Funds for the purpose not described in laws, and to exceed from the approved budget.
Internal audit	Disbursement report of special funds shall be audited in accordance with the Law on Public audit and be given an audit opinion. Internal audit department/auditor of relevant ministry shall conduct monitoring on special funds disbursement in accordance with Article 69 of the Law of Mongolia on Budget.

Source: JICA Expert Team

In the discussion with SME Development Fund in March 2018, the Director General of the fund explained that the discussion for the revision of the legal framework for the fund was started but there is no progress yet.

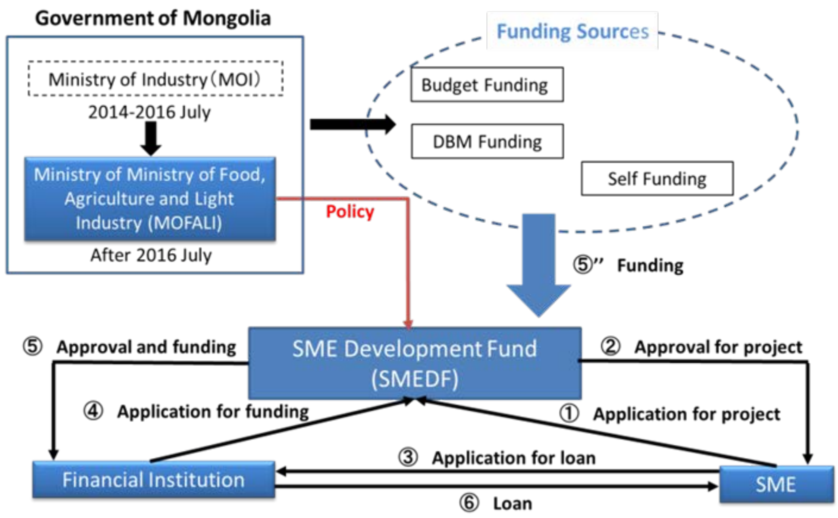
(3) Operation of SME Development Fund

<u>Operation Scheme</u>

Figure 13.1.4 below shows the operation scheme of the Two Step Loan at SME Development Fund.

The major charactaristics of the operation are as follows:

- The policies and governance for the operation are instructed by the responsible Ministry of GOM (MOFALI).
- The original funding source was budged. During the period of 2012 to 2014, DBM loans were major funding source. From 2015, the new lending activities at SME Development Fund has been very limited due to the difficulty of funding from DBM.
- First the application for SME loan is submitted directly to SME Development Fund by the potential borower (SME) not through the financial institutions (PFIs) as illustrated in the following figure.



Source: JICA Expert Team

Figure 13.1.4 Operation Scheme of SME Development Fund

In addition to the above scheme of the two-step loan, SME Development Fund has a direct lending scheme to SME based on the budget funding.

Operation Records

As of December 2016, the outstanding sub-loan portfolio of the SME Development funds was MNT291.8 billion to 3,160 SME borrowers, of which MNT 8 billion classified as non-performing loans. SME Development fund disburses its funds through two main channels: (i) SME Development fund may disburse its own resources directly to SME clients. The interest rate for the own funding is 3% p.a.; (ii) Fund mobilized from DBM and other GOM funded programs are disbursed through 11 participating financial institutions (Golomt, Khan, Xac, Capitron, Capital, State, Arig, Trade and Development, Ulaanbaatar city, Chinggis khan, National investment banks-PFIs). The credit risks of those loans are borne by the PFIs.

Between 2009-2016, SME development fund granted concessionary SME loans of MNT 775.4 billion to 7,174 SMEs resulting in creation of 39,947 new jobs while retaining 31,143 existing jobs.

The following Table shows the number of projects, disbursed loan amounts and the number of job newly created and retained by SME Development Fund.

Table 13.1.6 Operation Records of SME Development Fund

(MNT billion)

No.	Province	Number of projects	Disbursed loan amount (billion MNT)	Jobs	
				Newly created	Retained
1	Arkhangai	263	7.34	914	558
2	Bayan-Ulgyi	423	6.56	1553	935
3	Bayankhongor	227	8.40	834	579
4	Bulgan	210	7.06	1217	339
5	Govi-Altai	230	4.13	744	331
6	Govi-Sumber	154	3.08	343	127
7	Darkhan-Uul	319	29.39	2013	1118
8	Dornod	300	12.01	1075	500
9	Dornogovi	178	5.29	485	344
10	Dundgovi	184	4.59	548	371
11	Zavkhan	334	9.64	908	564
12	Orkhon	178	11.73	793	609
13	Umnugovi	165	7.57	460	239
14	Uvurkhangai	288	9.08	1130	755

15	Uvs	303	14.63	708	632
16	Sukhbaatar	169	4.76	607	253
17	Selenge	259	23.35	1716	837
18	Tuv	284	16.33	1277	853
19	Khovd	298	6.52	900	677
20	Khuvsgul	304	6.05	1457	565
21	Khentii	161	5.59	602	320
22	Ulaanbaatar	1943	572.31	19663	19637
	TOTAL	**7174**	**775.41**	**39,947**	**31,143**

Source: SME, cooperatives policy coordination department, MOFALI

The terms and conditions of loans from the SME Development Fund are shown in the Table below. The maximum loan amount varies between urban and rural areas.

Table 13.1.7 Terms and Conditions of Loans of SME Development Fund

Category	Ulaanbaatar	Provinces	Regions	Leasing
Maximum Loan Amount	MNT 200 million	MNT 100 million	Over MNT 200million	Over MNT 200 million
Loan Tenure	5 years	5 years	5 years	5 years
Grace Period	1 year	1 year	1 year	1 year
Recipient of Project Application	City and District Governor Office	MOFALI Department of the Local Government	MOFALI and SME Fund	MOFALI and SME Fund

Source: Website of the Ministry of Labour (MOL)

The current level of the interest rate and funding cost/margin for the two-step loans provided by SME Development Fund are shown in the following Table (for two step loan).

Table 13.1.8 Interest Rate and Funding Cost/Margin for Loans by SME Development Fund

Type of Loan	Type A	Type B	Type C
Cost of DBM Funding		3.8%	3.8%
SME Development Fund Cost/ Margin	1.8%	0%	-2.0%
PFIs' Margin	5.2%	5.2%	5.2%
Interest Rate of SME Loan	**7.0%**	**9.0%**	**7.0%**

Source: JICA Expert Team

In the discussion with the SME Development Fund in March 2018, the Director General of the fund explained that 154 transactions with the amount of approx. MNT 50 billion have been made in 2017 (all transactions were direct lending to SME). He explained that the interest rate of the SME direct lending is 3% per annum in 2017. After the restructuring of DBM in 2017, SME Development Fund could not be provided any funding for its two-step loan and it provided no two-step loan through PFI in 2017.

(4) Recent movement for the SME Development Fund

In 2017 through the Government, the SME Development Fund requested EBRD to consider its support for funding to the fund and the dialogue has started between EBRD and the fund. EBRD pointed out the necessity of the improvement of the governance of the fund. No progress in the negotiation for funding and specific technical assistance by EBRD as of March 2018.Lesson from case study on the SME Development Fund.

(5) Lesson Learned from case study on the SME Development Fund

Through our study on the structure and current operation of the SME Development Fund, it is clear that the SME Development Fund is not an independent financial institution but an implementation agency of the GOM.

The lesson learned from the study on the SME Development Fund is that it is quite important for financial institutions to establish sound management system based on international standards of corporate governance.

The following issues to be considered for the SPE.

- The management team of the SME Development Fund has frequently changed due to the changes of the responsible ministry for the fund.
- The first application for SME loan is submitted not through PFIs but directly to the SME Development Fund.
- The SME Development Fund has made deficits in some transactions, since the lending rate of SME loan is instructed by GOM regardless of funding costs.

The lessons learned from the study on the SME Development Fund are as follows.

- The operation and management of SPE should be governed by the company structure and its shareholders to maintain the continuity and consistency for its sustainable operation. The basic conditions for nomination of the board members and executives had better be defined in the Charter of SPE.
- SPE should maintain the current procedure (steps) for the application, appraisal and disbursement of JICA TSL from the viewpoints of the credit responsibility of PFIs.
- SPE should provide TSL based on its funding cost and its appropriate ALM (Asset and Liability Management).

13.1.3 Mongolian Mortgage Corporation HFC LLC

(1) Background

The 2004-2008 Action Plan of the coalition government included a promise to deliver 40,000 housing units. The Office of the Prime Minister requested assistance from USAID's Economic Policy Reform and Competitiveness project (EPRC) to assist it in developing and proposing alternatives to fulfill the promise.

In November 2005, based on international experience, especially from Latin America, countries such as Chile, Colombia, and Mexico moved to second-generation models to finance housing for low-income residents as state-controlled mortgage banks went bankrupt, the EPRC proposed a scheme of mortgage down payment subsidies run through commercial banks. However, during the assessment of alternatives to finance housing, the EPRC identified a nascent niche to establish a private sector-controlled initiative in the form of a second-tier mortgage finance institution. Consultations with local banks and BOM found support for the idea, and bankers and the BOM established a working group to develop the concept with project assistance.

At that time, the total value of the primary mortgage market was about US$5 million, and there was no standardization of mortgage loan documents and/or origination.

In March 2006, participating banks signed a memorandum of understanding (MoU) to establish a secondary mortgage institution, and by October 2006, shareholders, including BOM, Anod Bank, Golomt Bank, Zoos Bank, Capital Bank, Capitron Bank, Post Bank, Khaan Bank, Xac Bank, Trade and Development Bank signed the Mongolian Mortgage Corporation's (MIK) Founding Agreement.

(2) Objectives

Per the founding agreement, the objectives of MIK are to:

- Promote development of a secondary mortgage market.
- Raise medium- to long–term funds through sale of its securities and as a direct borrower.
- Collaborate with the government on legal, regulatory, and institutional issues necessary to promote development of primary and secondary mortgage markets.
- Help standardize underwriting policies and documentation for issuance of loans on the primary mortgage market.

- Conduct open-market activities to support its core activities.
- Provide services on securities.
- Effect foreclosure of mortgaged assets.

(3) Shareholding Structure & Capitalization

Per founding agreement of 2006, the ten founding members agreed to equal shareholding of 10% each, contributing MNT 100 million each.

In 2011 shareholders of MIK agreed to issue additional shares to enhance capitalization of the MIK. During the subsequent periods MIK issued additional shares subscribed by commercial banks and NBFIs building up its paid-in capitalization to MNT 6.0 billion in 2012, MNT 22 billion in 2013, and MNT 32 billion in 2014.

The initial equal shareholding structure shifted significantly during the period for various reasons, including (i) three of the founding members (Anod Bank, Zoos Bank, Post Bank) were liquidated, merged or taken under receivership of the central bank and their shares were transferred to either central bank or to subsequent asset holder (State bank); and (ii) differing subscription of shares issued by existing shareholders; (iii) new institutions joined subscribing new shares.

In December 2015, MIK successfully launched its first Initial Public Offering (IPO) in Mongolian Stock Exchange raising MNT 37.2 billion. Per public disclosure information of Mongolian Securities Clearing House and Central Depository, MIK is a public listed company, currently owned by over 100 shareholders. Currently 19.31% is held by state owned enterprises, 80.63% by private entities and banks and 0.6% by individuals.

(4) Impact and Achievements

Creation of the first secondary mortgage market institution in Mongolia, which is commercially operated and private-sector controlled brought significant impact on the development of the mortgage market as well as financial sector development, including:

- Raising development financing leveraging its resources: MIK borrowed 4.8 million euro liquidity facility provided by *Kreditanstalt für Wiederaufbau* (KfW).
- MIK played an important role in building legal and regulatory environment, which led to adoption of the Mortgage Collateral law and the Asset-Backed Securities Law.
- With assistance of KfW and support of BOM MIK led the initial development of the secondary mortgage market and standardization of primary mortgage documents.
- Deepening and broadening of the financial market by introducing new financial long term instruments.
- Provision of liquidity to banks for eventual improved term matching of their assets and liabilities
- Registered and issued the first mortgage-backed bonds in Mongolia.
- Directly sold mortgage-backed securities worth MNT 6.3 billion to four investors through swapped mortgage pools and cash settlements.
- Insured mortgage pools on life insurance and collateral insurance.

As the first and only Mongolian secondary mortgage market institution, MIK played a central role materialize opportunities in the rapidly expanding mortgage market. Today MIK developed into a professional financial institution and became a key instrument in implementing GOM's mortgage program taking the leading role for issuing Residential Mortgage Backed Securities and alternative long term financial instruments servicing financial sector.

(5) Lessons learned

Leadership in initial take off and subsequent progress: The leadership (sometimes strong arm) and consistent support of BOM and several forward-looking and respected bank CEOs were instrumental in rolling the project off the ground.

Consensus building and coordination through honest broker: Generating a working consensus among potential participants, leading to the formation of a working group and coordinating among stakeholders is cumbersome assignment that requires persistence, patience and time. Particularly the coordinator is to be respected neutral honest broker. USAID as the trusted partner of the most successful privatization of Khan Bank, formerly the state-owned Agricultural Bank of Mongolia, and the Trade and Development, co-founder of the Xac Bank and a flexible supporter to BOM was instrumental and necessary for the taking this role.

Continued support: USAID's project assisted not only for the formulation of the institution but also complemented its support through temporary secondment of key personnel, TA in developing and adopting necessary legislations, inviting other donors who share overlapping objectives. USAID's efforts are complemented by ADB, IFC, and KfW.

13.1.4 Credit Guarantee Fund (CGF)

(1) Background of Establishment and Legal Status of CGF

<u>The Law on Credit Guarantee Fund</u>

In order to solve the issue of the lack of collateral as one of the major hurdles for SMEs to access financing, the Law on Credit Guarantee Fund was established in 2012 with technical assistance by GIZ (Deutsche Gesellschaft für Internationale Zusammenarbeit).

For the establishment of the law, a working group was organized to draft a law on credit guarantee framework. The group was composed of related ministries and government agencies (MOF, Ministry of Food, Agriculture and Light Industry, and National Development and Innovation Committee), private industry representatives (MBA and MNCCI), and GIZ.

The main features of this law are as follows:

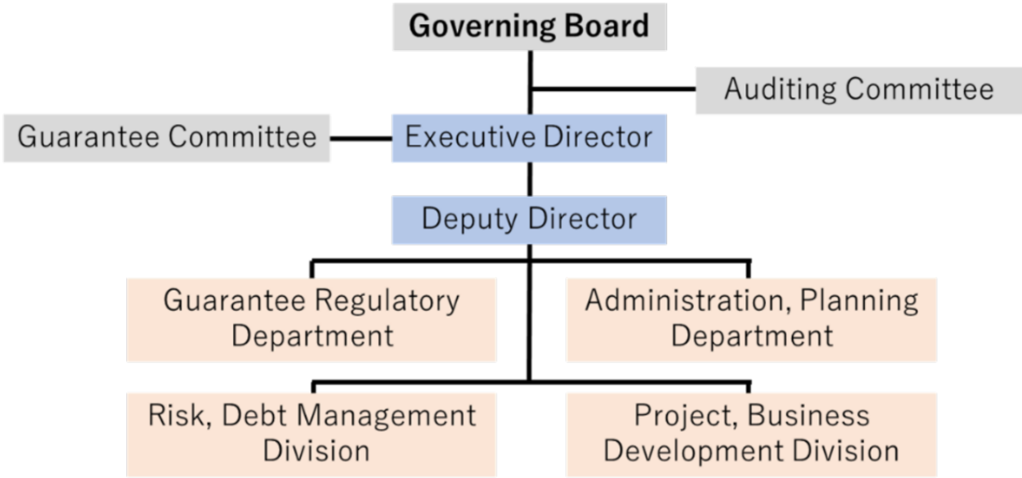
- Not only public but also private entities, individuals or international organizations can be a founder of a credit guarantee fund (Articles 7.5 and 7.6).
- The fund can guarantee up to 60% of a loan (Article 9.1.1).
- Total amount of guarantees issued by a fund shall not be more than 20% of its capital (Article 14.3).
- The SME Development fund shall counter-guarantee up to 60% of total obligations of the fund. (Article 13.2).
- FRC also approves and amends the Charter, as well as issues detailed regulations of a fund (Articles 8.2 and 14.2).

Based on the Law on Credit Guarantee Fund, the original credit guarantee fund was established as a public-private partnership in the form of a limited liability credit insurance entity in 2012 (CGF/PPP). However, there were several arguments between public sector and private sector, including the issues of securities (collaterals) for its guarantees.

<u>Establishment of Guarantee Fund by the Government</u>

After the arguments on CGF/PPP, the Government of Mongolia newly established the credit guarantee fund (CGF/GOM) on 6 November 2012 as a non-profit organization (NPO) with the capital of 5,040 million MNT.

The structure of the organization is shown in the following figure.



Source: CGF/GOM

Figure 13.1.5 Organization Structure of CGF/GOM

- The Governing Board of CGF includes members who are the representatives of GOM (MOFALI and MOF).
- The Guarantee Committee consists of five members, including the representative of MBA, the representative of SME Development Fund, the Executive Director and Deputy Director of CGF and the General Manager of Guarantee Regulatory Department of CGF. CGF has a Risk and Debt Management Division. This division was additionally created under the guidance of ADB, and it evaluates and manages the entire risk of organization management.
- CGF is audited by Non-Banking Department of FRC.
- The number of employees was 34 as of June 30, 2017.

(2) Operation of CGF/GOM

CGF/GOM started to operate in August 2013. The State Bank first signed as a participating bank, which expanded to 13 banks (including National Investment Bank) and eight NBFIs by the June of 2017.

The basic conditions for CGF/GOM services are described in the Table below.

Table 13.1.9 Conditions of Guarantee by CGF/GOM

Types of loans	Loans for working capital, loans for investment, and microcredit
Major funding sources for loans	Banks, SME Fund, Chinggis Bond and TSL[5],
Guarantee limits	Up to 60% of the loan, and maximum guarantee amount is MNT 250 million
Time required to issue guarantee	10 business days
Service fee	MNT 10,000 per application
Guarantee fee	Loans with maturity of up to 1 year – 1% of the guarantee amount Loans with maturity of 1-2 years – 2% of the guarantee amount Loans with maturity of more than 2 years – 3% of the guarantee amount

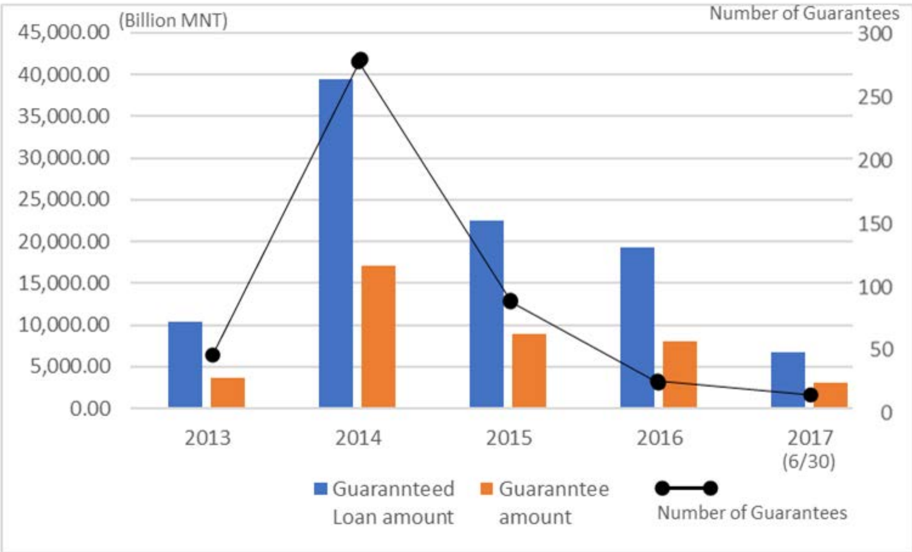
Source: CGF/GOM Procedure

[5] The guarantees for TSL Loans account for 8.0% in number and 13.6% for loan amount among the total (as of March 2016). Since the credit guarantees offered by CGF were to cover the collateral shortage of SMEs applying for the bank loans, it was likely for the commercial banks to ask for the guarantee services for the applicant SMEs requesting JICA-TSL Project funding. With the banks acting in-between and deciding the initial fate of the applications, there had been no direct contact or cooperation between CGF and JICA-TSL project.

In terms of guaranteed loan amount, the amount rapidly increased since its establishment. In 2014, loans with guarantee, guarantee amount and number of guarantee increased more than 4 times.

However, the number of guarantees and the guaranteed amount have decreased from 2015 to 2017 mainly due to the funding difficulties at banks and economy recession in Mongolia as shown in the following figure.

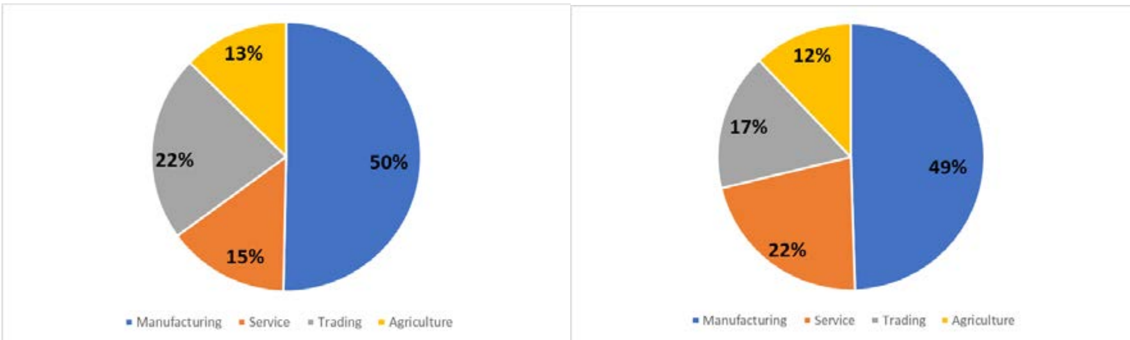
The outstanding guarantee amount was 23.5 billion MNT as of June 30, 2017.



Source: CGF/GOM

Figure 13.1.6 Guarantee amount and Number of guarantees issued by CGF/GOM

The following Figure shows the ratio of guarantees provided by sector; about 50% is provided to the manufacturing sector as of June 30, 2017.



Source: CGF/GOM

Figure 13.1.7 Guarantee amount and Number of guarantees issued by CGF/GOM

(3) Support from ADB

ADB concluded with GOM for its financial support to CGF. The total amount of the ADB loan was US$60 million (the annual loan amount was scheduled US$12 million) at for 5 years from 2016. The grace period of the loan is 12 years and the final maturity is 18 years (2034). ADB also agreed to provide its technical assistance amounting USD 800,000. It is planned that eleven consultants (including 4 international consultants to cover guarantee aspect, risk management aspect, fiscal management aspect and legal aspect). They are dispatched about once every two months for about 4 weeks. The consultant team is focusing on the following fields:

(i) Governance of CGF

(ii) Legal system and procedures of credit guarantee

(iii) Risk management

(iv) Accounting

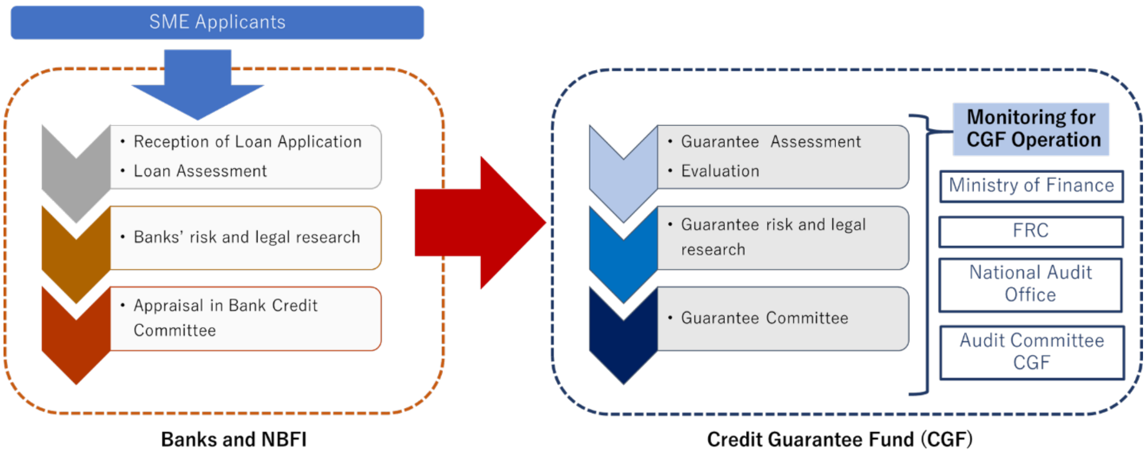
(v) Diversification of products

(4) Lesson from case study on CGF/GOM

Through our study on the structure and current operation of the Credit Guarantee Fund of by the Government (CGF/GOM), it is clear that the function of CGF/GOM is necessary to supplement collateral shortfalls at SMEs for their borrowing. Both TSL and the function of the credit guarantee can enhance the capacities of PFIs for their SME finance in Mongolia.

At the same time, the following issues at CGF/GOM are considered for the structure of SPE.

- From the view point of the management of the organization, NPO, as the form of organization like CGF/GOM, seems to be "not appropriate" for efficient commercial operation.
- From the viewpoints of the governance and monitoring for the operation, CGF/GOM, seems to be controlled by the government organization as shown in the following figure.



Source: CGF/GOM

Figure 13.1.8 Operation Flow and Monitoring of CGF/GOM

- For the stable operation of financial institution, adequate reserve and/or financial backup resources are very important. It is noteworthy that GOM and ADB concluded ADB's financial support for CGF/GOM.
- Capacity building for CGF/GOM by ADB is essential for stable and efficient operation of CGF/GOM.

The lessons learned from the case study on CGF/GOM are as follows.

- SPE should be established as a profit financial institution under the Company Law and NBFI Law.
- For the sustainable growth of SPE, further financial and technical support to SPE by the GOM and International Financial Institutions (IFIs) is necessary. After the establishment of SPE, JICA's technical assistant and capacity building for SPE is expected.

13.2 International best practices

The proposed SPE has been designed following the international best practices developed and tested by the World Bank and IFC (World Bank Group, WBG) in establishing and supporting Development Finance

Companies (DFCs) in more than 50 countries. Initially WBG even limited its financing only to privately owned development banks which financed productive enterprises in the private sector. This posture reflected a strong belief in the effectiveness of private, business-like management of DFCs in supporting industrial development through private entrepreneurship.

Two main reasons inspired the WBG approach, both with the objective of promoting private investment and private enterprise. From a practical point of view, channeling funds through a DFC allowed to entrust reliable intermediaries with the financing of SMEs, then constituting the bulk of emerging private industrial sectors. More importantly, from a strategic point of view the DFCs function was to demonstrate the merits of allocating finance through professional and pragmatic project evaluation, independent from political pressures. Because of that, WBG considered DFCs as a key component of the institution building needed for sustainable development.

The basic principle of the WBG DFC model is to ensure that realistic development objectives are implemented efficiently, i.e. in a business-like manner. The model is based on private sector management of broadly defined development objectives. In practical terms, that meant setting up financial institutions that are privately owned (fully or partially) and privately managed, and that would finance only those projects which are both consistent with the Government development priorities and having realistic business prospects as viewed from the private sector perspective and experience.

This mechanism is best supported through active involvement of a donor IFI, providing concessional financing and/or direct investment as well as active monitoring. IFIs share development objectives, offer solid governance and play a role of honest broker at the infant stage of the institution. This WBG DFC model has been generally very successful and appears to be well suited for SPE role in support of Mongolia's SMEs development program. The following paragraphs outline two case studies, analyze the principal issues facing a DFC, and how these have been addressed in the case of SPE.

13.2.1 The Private Development Corporation of the Philippines (PDCP)

(1) PDCP Inception

Starting operations in 1963 on the initiative and recommendation of WBG, PDCP was one of the earliest WBG supported DFCs. It was established as a corporation and not as a banking institution. Its initial equity capital was of PHP 25 million (about USD 6.4 million at that time) in common shares, of which 70% reserved for Philippine shareholders and 30% available for foreign shareholders. IFC took a participation of 3.2% (without a Board seat), which it sold in 1967. PDCP's Board comprised eleven Directors, including one Government representative (the Director General of the National Economic Development Authority: NEDA) and three representing foreign shareholders. PDCP shares were listed on the stock exchange and were relatively widely held for an institution of this kind. By 1974 paid in share capital had been increased to about PHP 40 million, held by over 1,000 Philippine shareholders (of which only four holding between 0.5% and 1%) and by over 100 foreign shareholders. Of these, 18 major international banks held about 27% of the capital, reflecting the common pattern for initial presence in emerging markets, as well as the high expectations as of that time for Philippine economic development. Through successive share offerings paid in capital eventually reached PHP 100 million.

PDCP initial capitalization included : (i) a concessional terms, local currency USAID subordinated loan, in the amount of PHP 27.5 million (USD 7 million equivalent), with a 30-year maturity and 0.5% interest rate; and, (ii) a WB foreign currency loan (channeled through the Philippine National Bank: PNB, a Government bank) in the amount of USD 15 million equivalent, with a 15-year maturity and interest of 5.5% to 6% plus a ¾% fee to PNB. Its resulting initial capital structure was therefore 47% in equity and quasi-equity, and 53% in long term debt.

This capital structure, fairly common for DFCs, was evidencing the importance of concessional quasi-equity financing to supplement the limited availability of equity financing so as to allow borrowing long term debt while maintaining a reasonable leverage. To ensure a correct balance between development objectives and the interests of private ownership and management, a WB-mandated Statement of Business

Policies had to be complied with. In addition, the USAID loan also included certain guidelines and restrictive clauses.

(2) Resource Mobilization

A priority role of a DFC is to mobilize incremental financial resources on its own credit, and PDCP performed reasonably well in that respect. Domestic resource mobilization between 1978 and 1981 totaled about USD 80 million equivalent, primarily from insurance companies with maturities of 3 to 7 years and interest ranging from 14% to 19%. Foreign exchange resource mobilization was more substantial, although almost exclusively from IFIs carrying a direct or indirect Government guarantee. The total USD 322 million equivalent raised between 1963 and 1981 included six WB loans (USD 176 million), five ADB loans (USD 100 million) and one IFC loan (USD 15 million, without Government guarantee). The only foreign exchange commercial terms financing obtained in the period was a syndicated loan of USD 10 million from Bank of Tokyo in 1978.

(3) Operations

In terms of its operations, for about two decades from 1963, PDCP efficiently fulfilled its mandate of financing economic priority and sound projects nationwide, mostly in industry and inter-island shipping. It helped narrow the gap between the borrowers need for long-term and mainly foreign exchange denominated funding and what the domestic financial system could provide (short-term in local currency). At the same time, as a private sector-led institution, it was able to achieve its objectives in terms of its (a) greater ability to avoid having to finance unprofitable, government–sponsored programs and (b) greater effectiveness in supporting private managerial and technical talents and financial resources.

Aside from WB, other partner institutions (ADB, USAID) gave positive reviews of PDCP's management, operations, profitability and economic impact during this period. Its wide ownership profile helped minimize conflicts of interest between shareholders and borrowers, although there has been initially some criticism of repeat financing to companies linked to Board members, which was subsequently corrected. Geographic diversification was a priority and PDCP set up and funded private development banks in the provinces, contributing to know-how transfer to these institutions. It also expanded its financing to SMEs.

(4) The Crisis

However, in the late 70s and early 80s PDCP was severely affected by an economic recession in the country and in particular by the sharp deterioration of the PHP exchange rate vis-à-vis major convertible currencies in which its borrowings and loans were denominated.

The situation was aggravated by the predominantly domestic market orientation of most of its clients, which were generally unable to benefit from an export revenues hedge. The effective cost to borrowers of WB-funded loans reached over 20% as compared to nominal rates ranging from 12.5% to 16%. As a result, its portfolio quality deteriorated, with many borrowers defaulting while some of the stronger ones made an effort to prepay their loans.

It was clear that greater access to local currency funding was vital. In 1981 through a share swap PDCP became an affiliate of Far East Bank and Trust Company (FEBTC), the sixth bank in the country which aimed at becoming a universal bank. With PDCP having access to FEB's local currency funds and becoming the medium term industrial lender of the group, the *de facto* merger benefited both institutions. In 1986 the Government agreed to converting PDCP outstanding foreign currency loans to PHP equivalent, in effect taking over any future foreign exchange risks. In 1992 PDCP obtained a banking license and started accepting deposits. Its business was subsequently acquired by Metro Pacific Corporation in 1994 (with minority participations from DEG[6] and from a US venture capital fund) and finally by Banco de Oro in 2002. By that time its original functions had faded away.

In balance, PDCP's performance as a DFC had been successful as long as stable exchange rates and a reasonably favorable country economic environment prevailed. But the model, foreign exchange on-

[6] Deutsche Investitions- und Entwicklungsgesellschaft (DEG) is a Development Finance Institution (DFI) and a subsidiary of KfW Group.

lending for importation of equipment to clients predominantly domestic market oriented, did not allow for flexibility and products diversification until it became too late.

13.2.2 The Korea Development Finance Corporation (KDFC)

(1) Economic Background

In the mid-60s Korean industrial development was just beginning to accelerate. Initial priorities were to restore physical infrastructure and build up a heavy industry base (in the public sector, given the heavy capital requirements, specifically in steel and petrochemicals) to provide inputs for private sector manufacturing. In manufacturing the strategy called for a balanced mix of import substitution and exports, with priority given to the latter (also as a stimulus for improving competitiveness), all supported by an elaborate network of incentives.

Lack of domestic savings meant that capital investments were mainly financed with foreign aid and Government borrowings, the bulk being allocated to public sector infrastructure programs. Commercial banks (all Government owned at that time) were lending at interest rates of 25% or higher and with maturities up to one year. Given this scenario and the general scarcity of foreign exchange, medium size private sector manufacturing companies (anyhow still quite small) had very limited access to the financing required for importation of production equipment, notwithstanding their recognized priority as the main engine of export growth.

(2) KDFC Inception

To overcome such constraints, the Federation of Korean Industries (FKI) with full support from the Government took the initiative in the mid-60s to promote the establishment of a new special purpose financial institution. FKI and the Government approached the World Bank and the IFC for institutional advice and eventual funding. By that time WBG had helped organize similar development finance institutions (DFCs) in over two dozen countries. DFCs were the ideal intermediary to retail WB funds in support of emerging private sector industrialization. The Korea Development Finance Corporation (KDFC) was incorporated in 1967 and in early 1968 received the very first WB loan to Korea (in the amount of USD 5 million) as well as a USD 700,000 equity investment from IFC, representing 14% of KDFC’s USD 5 million equivalent share capital. IFC was then by far the single largest shareholder and initially took an active role in overseeing operations.

KDFC’s primary purpose was to finance, with medium and long-term loans, the foreign exchange cost of equipment importation. The target market was strictly defined as productive private sector enterprises, with further priorities being export industries and expansion of companies with a proven track record. These somewhat restrictive parameters were designed to focus the new institution on the specific function for which it had been created, therefore making it a more effective financial intermediary than if those functions had been added to the broader scope of the existing Government development banks. In addition, specific guidelines were agreed and formalized in a Statement of Policies. The Statement addressed both institutional objectives and prudent operational parameters.

KDFC’s financial structure introduced several innovative elements, aimed at achieving specific objectives and worth analyzing in some detail. First and foremost, the predominantly private sector share capital composition: FKI members and private insurance companies holding a total of 46% stake, with only 15% held by public sector banks but no direct Government participation. Together with the operational focus mentioned above, it emphasized the importance of shared business experience between lender and industrialist. Government strategies and priorities were properly set on a global basis, and KDFC pledged to be guided accordingly, but individual lending decisions were to be taken on the basis of case-by-case sound business criteria. Such differentiation of roles, which the Government considered in the best long term national interest, was strengthened by the 25% equity participation held by nine foreign banks in addition to IFC’s 14%, with 4 directors in a Board of 13.

Government support for the role that KDFC was designed to carry out was evidenced also by the provision of a USD 7.5 million equivalent quasi-equity component. It consisted of a South Korean Won (KRW)-

denominated subordinated loan with a 40year maturity and interest of 4%, but ranking *pari-passu* with share capital in case of liquidation. Similar to a Trust Fund, or the equivalent in modern terms of non-voting preferred stock, it substantially strengthened the USD 5 million share capital without affecting the private sector character of the institution.

In addition, KDFC's initial foreign exchange resources consisted of two loans of USD 5 million each: (i) proceeds of a two-step USAID loan, carrying a 4 year maturity and 2% interest to the Government, on-lent to KDFC at 15 years and 6%; and, (ii) a WB loan with 15 years maturity and interest of 6.5%.

(3) Operations

From a slow initial start (11 loans by mid-1969), KDFC operations grew rapidly in the following years. This is best appreciated by some highlights of the first 10 years of operations. Its staff had increased from about 20 initially to about 190 and annual financing approvals were in the order of 60. By 1978, KDFC had provided financing to about 350 projects for a total amount of USD 330 million. About two thirds of its loans were for amounts below USD 600,000 and about one third of its clients were enterprises with less than 300 employees and/or less than USD 1 million in assets. This breakdown reflects the relatively small size of the average private enterprise at that time.

In terms of resource mobilization, by 1978 KDFC had received an additional USD 5 million equivalent capital increase (Germany's DEG had also become a shareholder); had obtained six WB loans for a total amount of USD 220 million (*), plus two ADB loans for a total of USD 70 million and the original USAID loan of USD 5 million, for a total of USD 295 million. It had also succeeded in raising several commercial terms syndicated loans on its own credit standing, without a Government guarantee.

The principal ones were: (a) in 1976, an IFC syndicated loan in the amount of USD 17.8 million (including 8 international banks and institutions) plus a "parallel" DEG loan of USD 2 million; and, (b) in 1977, a USD 20 million syndicated loan arranged by Asia Pacific Capital Corporation (APCO, an affiliate of FNCB of New York, now Citibank), with the participation of 8 international banks.

As it was consolidating in the 70's its role as the foreign exchange lender of reference to the medium/large private industries sector, KDFC launched two important initiatives, both being the first of its kind in Korea. In 1971 KDFC and IFC jointly established the Korea Investment and Finance Corporation (KIFC). Its primary purpose was to create a market in short term commercial paper of reliable quality standards; subsequently KIFC expanded its role into the underwriting of corporate securities. Next came the establishment in 1975 of the Korea Development Leasing Corporation (KDLC), together with IFC and the Orient Leasing Co. of Japan as technical partner. In addition, KDFC started a program of co-financing with regional commercial banks aimed specifically at SMEs.

By the end of the 70s, KDFC's role was well established, but the market was changing. Contrary to the case of PDCP in the Philippines, export-led growth was high, foreign exchange was no scarcer, most borrowers being also exporters were able to manage the KRW devaluation, and competition from commercial banks was becoming a factor. The single product model (foreign exchange term loans) had become too restrictive, particularly since under its charter KDFC (also originally established as a corporation and not as a financial institution) had no means to access local currency funding.

In collaboration with the WB and IFC and with the full support of the Government, KDFC then initiated a strategic review of its functions which eventually resulted in new legislation (the Long-Term Credit Bank Act) under which in 1980 it transformed in a bank. The main purpose in becoming Korea Long Term Credit Bank (KLB) was to gain access to local currency funding by issuing medium to long term debentures and by being authorized to accept deposits from its corporate borrowers, though not from the public. Over time, KLB continued to grow and diversify its business, including its 1998 merger with the Kookmin Bank (a commercial bank), which created the largest banking group in Korea at the time.

13.2.3 Principal Risks and Issues facing a DFC

Government Involvement in Operations

As noted above, the propensity to directly influence the allocation of industrial financing is inherent in Government's development policies. However, and particularly when dealing with a large number of fairly small and diverse cases, in the long run a clear distinction of roles is more effective. Government would set a policy strategy and implementation framework, leaving individual credit decisions to be taken by independent institutions on the basis of specific project and borrower merits. Testing pragmatically the viability (or lack thereof) of individual projects could also help fine-tuning the overall policy. Once such a policy decision has been made, a respected professional management would have the credibility to uphold this approach when needed. This has been the case for both PDCP and KDFC. A direct or even indirect involvement by an international development agency would help to maintain a consistent adherence to the above principles.

Conflicts of Interest

Raising share capital from private investors in a developing country still lacking a genuine stock market, inevitably implies reliance on corporate investors. However, these are also the prospective clients of the financial institution they are supporting, which creates a potential conflict of interest. Both PDCP and KDFC managed to avoid that problem primarily because of two reasons. First, corporate shareholders were many, each with a very small stake. The second key factor, and possibly the most important, was the integrity of management and the continuing adherence to the Statement of Policies.

Other DFCs in other countries were less successful in that respect, as they were unable to avoid a significant concentration of influence in a few major shareholders. On balance, a preferable approach would be to rely for the private sector stake on institutional entities such as an FKI or a banking sector equivalent as in the case of the proposed MDFC.

Scarcity of Domestic Equity and Role of ODA Funding

Domestic equity is an essential component of a successful initial capitalization. When local private sector cannot be expected to mobilize an adequate equity base, IFI concessional funding is appropriately relied to strengthen a DFC's initial capitalization, with the dual purpose to provide resources for direct operations, as well as to provide a basis for incremental borrowings. Both PDCP and KDFC benefited from such funding on their initial small scale. The unique and innovative capitalization recommended for MDFC will maximize the benefits of ODA funding. The multiplier effect of the substantial redeemable preferred shares capital provided by GOM will enable it to mobilize additional funding at a very early stage.

Long Term Funding

Industrial equipment financing would require fairly long maturities (typically 7 to 10 years) including adequate grace periods (no less than 2 to 3 years). In a national environment characterized by scarcity of foreign exchange, these resources had to be obtained from foreign sources, which means primarily multilateral and bilateral development agencies. This is particularly true in the early phases of development and for "new" borrowers, whether financial institutions or industrial.

While entirely appropriate in the early phases, indeed that is precisely the role of development agencies, in the long run continuing dependence on one funding source is imprudent besides being a limiting factor. For this reason, WB/IFC have consistently urged DFCs to diversify their funding sources, with generally limited success due to other priorities in international financial markets as well as countries' and DFCs own credit standing. PDCP was not successful in diversifying its foreign exchange funding, primarily (but not only) for country reasons. That KDFC was able to start doing that already by the late 70s confirms that a strongly capitalized and well managed institution could overcome market reluctance. Its credibility was of course enhanced by the growing recognition of Korea's remarkable development achievements, as well as by the involvement of WBG.

Foreign Exchange Exposure

Most DFCs that came into existence through the 60s relied for their foreign exchange funding primarily on borrowings from the WB, carrying a Government guarantee as to repayment but no foreign exchange risk protection. While nominally expressed in USD equivalent, WB loans and disbursements were in fact denominated in the same mix of currencies in which WB's own bond issues were denominated (at that time mainly USD, CHF and other European currencies). That was perceived as an unproblematic accounting feature in the fixed exchange rates world then prevailing. But when in the 70s that system collapsed, the sharp rate adjustments between major currencies resulted in major and unexpected increases in DFCs sub-borrower's debt service burden expressed in their respective local currencies.

It became then obvious that the conventional wisdom of borrowers assuming the foreign exchange risk would not protect lenders in case of a crisis affecting to a major extent the whole portfolio. Given the magnitude of their clients' difficulties, most DFCs ran into serious liquidity problems themselves, necessitating Governments' and to some extent WB support measures. A major reason for such chain of problems was that foreign exchange borrowings were needed for equipment importation, even when production (and resulting cash flows) were for the domestic market. This was the main problem leading to PDCP's decline. KDFC instead was substantially sheltered from this adversity, mainly because of the heavy export orientation of most of its clients, which helped *de facto* hedging their cash flows. MDFC, dealing mainly with local market-oriented SMEs, will need to continue relying on the current GOM policy of sheltering its operations from foreign exchange risks.

13.2.4 Key Elements of Success

The history of both PDCP and KDFC evidences some crucial and replicable components of success. On the institutional set-up level, the convergence of two major factors: (a) a long-term Government policy choice, that an independent and private sector driven institution was in the long term national interest; and, (b) the support, through technical assistance, funding and ongoing operational monitoring, by an international development agency, in their case WB together with the IFC.

On the operational level, a strong top management and a highly professional staff. Both institutions benefited from the continuity in office of competent and committed CEOs and top management. Demanding standards were set for staff recruitment and behavior: to be highly qualified, and with salary levels at a premium compared to the market. The key guidelines embodied in the Statement of Policies agreed with IFC provided a further helpful operational framework.

Particularly in the case of KDFC, notwithstanding initial criticism of being too rigorous in project evaluation, over time that approach won the respect of clients, who came to appreciate the merits of an independent project analysis, more thorough and systematic than typically done. This had a useful and lasting demonstration effect, indirectly providing project and corporate finance training to both clients and associated banks.

Finally, and specifically in the case of KDFC, its evolution shows that a focused and motivated institution can expand and diversify beyond its original scope and modest initial resources. In that way its role in support of its client base managed to evolve in tune with market requirements. This is indeed the ultimate test of the validity of the model.

Chapter 14 Identification of Optimal Form of New Finance Scheme for SMEs

The concept of new SME development finance scheme of TSL lending was first discussed in the SAPI-2 study conducted by JICA in 2014. The report confirmed continued development support needs for SMEs with long-term lending facility, and recommended establishment of a special purpose entity (SPE) for TSL-based affordable long-term financing for SMEs on a sustained basis. This Chapter is to present the recommended form of the SPE, based on the study and evaluation done in collaboration between MOF and JICA technical assistance team.

14.1 Rationale for Establishment of SPE (Special Purpose Entity)

As a starting point of the study, below are the reasons why a new vehicle for TSL lending operation is needed, i.e., the rationale for establishment of SPE.

(1) Need for continuation of operation for expanded reach of TSL Project activity

The TSL Project through Phase I and Phase II has outperformed the expectations in the initial out-turn in terms of: long-term SME project finance provided to over 700 borrowers to help achieve their growth; a business process of TSL lending through PFIs established; Creation of employment; and a loan portfolio of low level of non-performing sub-loan assets. In view of the successful results so far, GOM and JICA share the common understanding that, in order to further pursue the project's development goals, it is critical to continue the TSL operation in a sustainable manner to expand its reach beyond Phase I and II. In order to sustain and expand the TSL Project activities, a permanent specialized entity is needed.
In a more immediate time-frame, a framework of continuation is needed with respect to the TSL Phase III which GOM requested after the SAPI-2 study., , In this context, MOF was to define an exit policy which establishes sustainable operational framework of TSL Project for the duration of the TSL Loan, thus ensuring continuation of the operation beyond the Project assistance.

(2) Need for long-term sustainability from SME development policy perspective of GOM

Serving GOM policy objectives of SME development financing with meaningful impact requires a very long-term execution framework rather than an arrangement of short-term intervention for a few years. In promoting economic development through industry diversification, GOM implements diverse programs to support SME sector. In the area of financial support for SMEs, however, there remains a large portion of SMEs that are underserved and in need of assistance for longer term loans financing their business projects' needs. This necessitates a permanent framework of long-term financing for SMEs. The TSL Project's framework of continued operation should be made to serve GOM's long term policy goals of SME development. Establishment of an SPE, a specialized lending vehicle, which will efficiently channel development resources based on the business-focused principles successfully implemented through the TSL project, should meet the national policy demands in the pursuit of long-term policy goals. The SPE, with good management as a going concern, should be capable of growing the operation, mobilizing additional financing by leveraging its originally endowed resources.

(3) Need for an independent entity

In order to meet the objectives of expanding the reach of TSL Project operation, and of serving the national policy goals of SME sector development long term, there is a need for an SPE, a specialized lending vehicle, which must stay focused on its business mission, and sustain and grow the operation of long-term financing for SMEs. Based on the lessons drawn from the recent experiences in similar endeavors to support SME financing in Mongolia as reviewed in Chapter 13, the SPE needs to be insulated from interference in business execution management in relation to illegitimate political influences over uneconomical lending programs and individual borrower preferences. Such considerations call for an SPE that is independent of the government organization to reduce susceptibility to political interference.

14.2 Objectives of the SPE Operation

In responding to the needs identified in the preceding section, the objectives of the SPE operation are summarized below in the perspective of designing the SPE structure:

(1) Sustain and further build upon the current TSL lending operation and business model

The SPE's first priority objective is to sustain and further grow the TSL lending operation and its business model. In order to sustain the business and stay relevant in the market it serves, the SPE should continuously work toward strengthening and expanding the current TSL organizational structure and improving the processes of lending extended in collaboration with PFIs.

(2) Expand business by mobilizing additional financing resources

The SPE is to capitalize on the TSL project's business processes and well-performing RV/F assets that create a unique set of endowments for the SPE to mobilize additional financial resources in order to support further growth of operation. The first priority financing should be the Phase III of the TSL Project that should be channeled through the SPE. Further financing should be sought going forward to ensure sustainable and profitable operation to better serve the SME sector's financial needs in the long term.

(3) (In order to achieve the above business objectives) Establish and maintain corporate governance discipline of transparency and accountability

The SPE is to be managed with solid corporate government discipline ensuring transparency and accountability in conducting its business from top to bottom. The SPE is expected to follow the international best practice in corporate governance. This will keep the SPE on track avoiding deviation from the long term pursuit of the business objectives.

14.3 SPE's Functions and Required Capacities of the SPE

As the long-term lending vehicle that inherits the TSL Project operation, the SPE's main functions and required capabilities are summarized below.

(1) Assets - Wholesale lending capability inheriting the TSL Project scheme

The SPE will continue to provide affordable long-term financing to SMEs through PFIs on a wholesale basis. The continued lending function requires: the TSL Project's revolving fund (RV/F) loan assets (on-lending loans to PFIs) need to be transferred from the MOF to the SPE; the operational policies and procedures along with know-how for the operation need to be transferred to the SPE, and legal constraints, if any, need to be addressed properly.

(2) Funding – Capacity to fund initial loan portfolio

The SPE's Initial loan portfolio transferred from MOF out of the Project's RV/F needs to be funded by GOM/MOF with a special capital investment that should meet the demands for long-term funding as well as capital to support the lending operation. With respect to the GOM/MOF investment, the SPE operation is expected to be capable of providing financial returns to GOM/MOF sufficiently in support of GOM's financial needs for the TSL loan repayments to JICA. It should be noted that the transfer of the asset portfolio and its operation funded by the JICA loans does not provide guarantee over the value of the asset portfolio. It is expected to improve the future availability of funds to support GOM/MOF's repayments of the JICA loans due to SPE's enhanced long-term sustainability. But the SPE is not an insurance scheme for the funds to repay the ODA loans.

(3) Funding – Further development of financing capacity

In order to meet demands of SMEs to close their financing gap for long term project finance, the SPE will need to attract and mobilize additional financing from international financial institutions and other investor markets.

(4) Capacity building assistance for PFIs

The project financing approach associated with long-term lending is an essential element in assisting the

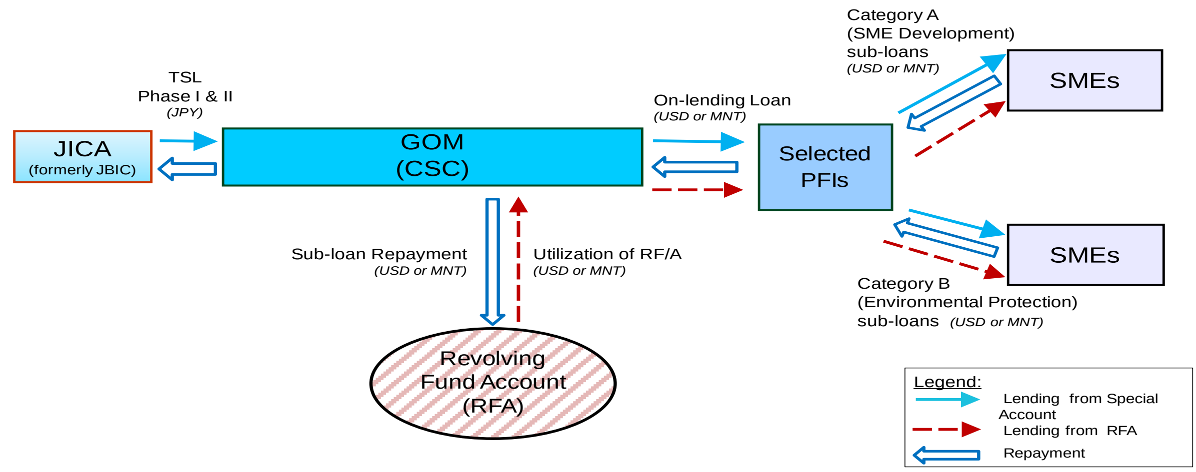
SMEs to grow as commercially viable business enterprises. The ability of SMEs to develop bankable projects and the proper evaluation of such proposals by PFIs are the core business interests of the SPE. Hence, it is the built-in function of the SPE to promote capacity building in this respect for the PFIs, the financiers, and also the project developers.

(5) Ancillary and new business capabilities

The SPE is expected over time to complement and contribute in introducing new (and enhancing existing) policy instruments to support SMEs. These will include collaboration with the Credit Guarantee Fund, provision of business focused project financing and expansion in leasing services. Co-financing with PFIs for SME borrowers is also a possible area of lending function of the SPE down the road.

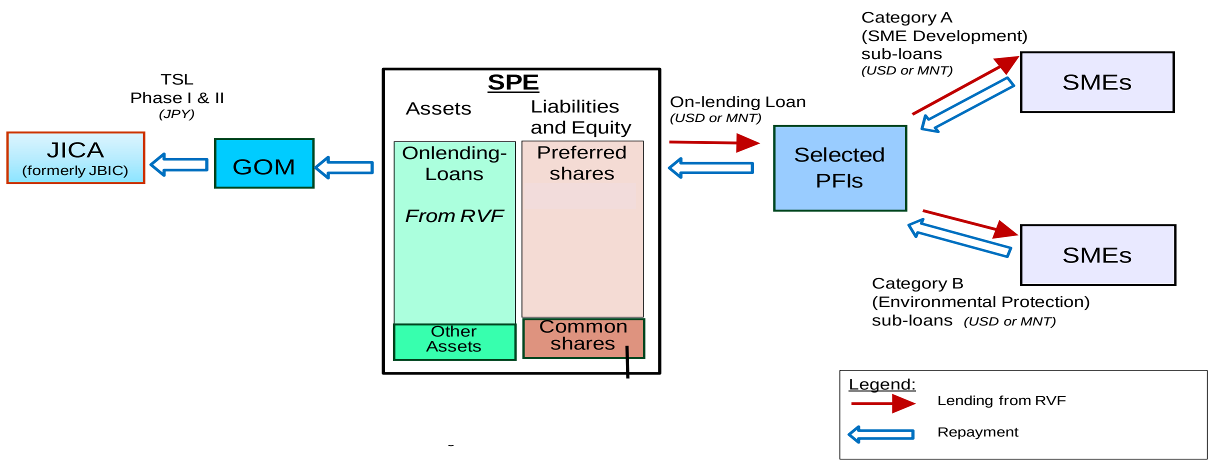
(6) Self-sustainable operation

The SPE's objectives can only be achieved meaningfully when TSL implementation is sustained for a long time and channeled efficiently to support viable SME projects. This requires the SPE to be a professionally managed institution with robust business model and operating policies and procedures. Please see the figures below for the comparison of the functions between the current TSL project scheme and the proposed SPE (as SME Finance Corporation: SME FC) scheme.



Source: JICA Expert Team

Figure 14.3.1 TSL Operation Function Scheme (Current)



Source: JICA Expert Team

Figure 14.3.2 TSL Operation Function Scheme (after establishment of SPE)

14.4 Legal Status of the SPE

There are several laws that are relevant to establishing an SPE as a financing vehicle. The following sub-sections 14.4.1 – 14.4.5 are a brief review of the main laws that are important for the formation of the SPE.

14.4.1 Company Law

The Company Law regulates the establishment, registration and reorganization of a company, capital securities (common shares & preferred shares), liquidation, governing bodies, and rights and obligations of shareholders. The company categories covered by the Company Law are Limited Liability Company (LLC), Open Public Company, and Closed Public Company.

The Company Law is applicable to all companies whether state-owned (SOE), or PPP or private investors only unless the company is established under a special law. Companies engaged in financial services are subject to the Company Law and subject to specific laws regulating those financial services industries. such as Banking Law and Law on Non-Bank Financial Activities.

In the Company Law's requirements on governing bodies, Public Companies are mandated to have a board of directors and are required to have 9 or more directors, of which one-third at minimum need to be independent. LLCs are not subjected to these requirements. An LLC may be governed and managed by one Executive Director, without having a board of directors, depending on the shareholders' determination. In the case of SOE, the Company Law applies the same requirements for Public Companies, i.e., a board of directors with minimum 9 members, of which at least 1/3 should be independent.

Open Public Companies are required, as part of the board of director structure, to have specialized board committees in the areas of audit, salary and bonus, and nomination. No less than two-thirds of the board committees need to be independent directors. Specifically, the audit committee should be chaired by an independent director. On the other hand, LLCs are not subjected to the requirement of board committees, even if they elect to have a board of directors.

For establishing the SPE which will have a small ownership structure, LLC, a company form for those with small number of shareholders (up to 50), is a good option as it allows flexibility in designing governing bodies.

14.4.2 Law on Non- Bank Financial Activities (LNBFA)

The Law on Non-Bank Financial Activities (LNBFA) regulates relations concerning the licensing and suspension or revocation of licenses of entities conducting non-bank financial activities. The law stipulates total of 11 activities such as lending, factoring, financial lease, guarantee, issuance of payment instruments, electronic payment and remittance service, foreign currency exchange, trust service, investment into short-term financial instruments and provision of investment and financial consultancy and/or information service that are subject to licenses.

NBFIs are in general incorporated under the Company Law, and are subject to specific requirements of LNBFA. For example, LNBFA specifically requires NBFIs to establish procedures of Internal Audit to be included in the Company Charter (Article 10).

LNBFA sets the limitations on single borrower (and the related party) transactions. Pursuant to Article 13 of LNBFA,

- the total amount of loans, assets equivalent to loans and guarantees issued to one borrower and related parties by a non-bank financial institution (NBFI) shall not exceed 30 percent of the total capital of the NBFI;
- the aggregate guarantees issued by a NBFI shall not exceed 70 percent of the total capital;

- the maximum amount of loans, assets equivalent to loans and guarantees issued to one shareholder and connected parties shall not exceed 10 percent of the NBFI's capital, and their aggregate sum shall not exceed 25 percent of the NBFI's total capital.

The definition of capital for the purpose of the lending limitations shall be calculated according to accounting regulations approved by the FRC (Article 14). The accounting regulations of Mongolia is now based on the International Financial Reporting Standards (IFRS) according to the Accounting Law since 2016. LNBFA mandates FRC to supervise the non-bank financial activities and to determine minimum capital requirements for conducting non-bank financial activities.

Where the SPE is formed under Company Law, the SPE will need to obtain NBFI license under LNBFA. Under this option, careful attention is called for in terms of the single borrower limitations, given the SPE's small number of borrowers.

14.4.3 Investment Law

Investment Law provides legal rights and obligations applicable fairly to both domestic and foreign investors, determines tax incentives for investors in corporate income tax, custom duties, value-added tax, etc., stabilizing the tax environment in order to promote foreign investment in Mongolia. In the SPE perspective, the Investment Law's incentives may be considered when international investors are invited to participate in the SPE.

The Investment law's tax incentives are offered in the form of tax stabilization certificates which give investors with qualifying projects up to 18 years depending on the amount of investment, the industry sector, and the geographic area. The incentive period can be 1.5 times longer for projects of production of goods of import substitution and those for export, etc., which have significant impact on the socio-economic development of Mongolia. The criteria of the investment amount is MNT 500 billion or more. In addition, the Investment Law provides investors protection in terms of Intellectual Property rights, right to transfer assets and revenues out of Mongolia and the currency conversion right, land tenancy period up to 60 years instead of normal 40-year limit. It provides also preferential treatment in the labor permits and requirements for foreign personnel of investors' projects.

14.4.4 Various by-laws adopted by the FRC

As the main regulatory and supervisory institution of the non-bank financial activities, FRC is entitled to issue various by-laws establishing ratios on matters such as prudential ratios on reserve fund, liquidity, capital adequacy, loan loss provisioning, foreign currency exposure under LNBFA. Non-conformities of these by-laws by NBFIs can be the material ground for termination of the licenses.

In addition, FRC put in place the Corporate Governance Code, which draws from the recommendations contained in the OECD Principles of Corporate Governance. The Code is primarily targeted to listed public companies (or joint stock companies), but FRC encourages private LLCs also to take into account the Code's recommended practice. It is noted the Code recommends companies to establish 3 Board Committees, i.e., Remuneration & Nomination Committee; Audit Committee; and Risk Management Committee.

14.4.5 Law on State and Local Properties

Law on State and Local Property regulates how government assets are to be managed. The Law stipulates requirements of State-owned enterprise management, and requirements in exercising ownership rights in business entity with state ownership participation. In relation to the SPE establishment, the Law's provision that the members of the representative governing board for the business entity with state ownership participation shall be appointed by the government (State Property Committee) in proportion to the state ownership deserves special attention. In terms of the SPE's initial loan assets transfer from MOF, it is noted that the Law also regulates the process of privatization of state assets.

14.5 Evaluation of SPE Structure Options

The evaluation results are presented below with respect to the possible options, i.e.,

i) Government Bank like the Development Bank of Mongolia (DBM) ;

ii) SME Fund like SME Development Fund;

iii) Limited Liability Company (LLC) with NBFI license.

(1) Government Bank under a special law

In forming the SPE, establishing it as a Government Bank under a special law is an option. The example of this is DMB.

The approach of a special law for a specific bank has the clear advantage in the flexibility in the legislation that can cater for the SPE's specific operational characteristics. However, based on the lessons discussed in Chapter 13, this approach is not recommended. As reviewed in that chapter, DBM's relationship with the Government and the Parliament tends to be very close and complicated making management of the bank difficult. In view of the need for the SPE that should be focused on the specialized business of TSL for SMEs and the need for independence from unwarranted political interference, the special law does not appear to be an appealing option. See 13.1.1 for detailed discussion and lessons learned.

(2) Government Fund under Law on Government Special Fund

The SME Development Fund is a type of Government special fund and is created to finance activities under Government's policy to support development of SMEs under the Law on Government Special Funds (the "Law on GSF"). It represents another possibility as the form of establishing the SPE. The Law on GSF provides options to form a special fund to implement TSL system. The most applicable option can be "fund regulated by separate law" classification. Setting up the SPE as a new fund under GSF does not serve the needs of the SPE for long-term sustainability supported by independence from uneconomical interference. The government special fund is defined as a part of income of the country's general budget, donations and grant aids accumulated into a special account with the purpose of implementing particular functions and objectives of the Government in accordance with Article 5.1 of the Law on GSF. As reviewed in Chapter 13 (13.1.2), the SME Development Fund provides long-term concessional loans for SME operations and loan guarantees. However, the GSF framework does not allow the funds as legally independent entities. It is not possible for the funds to have their working group or operating units. It is difficult for the funds to be managed as the operation that is economically viable and therefore sustainable going-concern. See 13.1.2 for more detailed discussion and lessons from the example of SME Development Fund.

(3) Limited Liability Company (LLC) with Non-Bank Financial Institution license (NBFI)

Incorporation as an LLC under the Company Law with the license of non-bank financial institution under the NBFI represents a strong candidate structure for establishing the SPE. The NBFI status generally suits the needs of the SPE's objectives and functions discussed in 14.2 and 14.3 above. With the specific scope of business in wholesale lending to PFIs without involvement in deposit-taking activities, the NBFI status will give the SPE more flexibility compared to banks under the Banking Law, e.g., in organizing the governance structure. Under the regulatory supervision of FRC under the Law on Non-Bank Financial Activities, the SPE conducts TSL lending and can add, where necessary, other financial services such as trust services subject to the FRC licensing.

However, operating as an NBFI requires a large capital base for the SPE due to LNBFA's single borrower limitations, including limits on shareholder borrowers require careful consideration for the structuring the SPE (see 14.4.2 above). It presents challenges where the PFIs (borrowers from the SPE) are to participate in the SPE as shareholders. An NBFI needs to observe various by-laws issued by the FRC which establishes prudential ratios and minimum capital requirements, and procedures supervision by the FRC as primary regulator.

Recommended Legal Structure

Based on the discussion above, the structure of Limited Liability Company (LLC) incorporated under Company Law and licensed as Non-Bank Financial Institution under Law on Non-Bank Financial Activities is recommended as the SPE's legal structure.

14.6 Funding Structure and Shareholder Structure of the SPE

In organizing the SPE based on the LLC structure, there are two areas that need careful consideration:
(1) Transfer of the TSL Project's loan assets from MOF to the SPE and the funding for the transferred loan assets to be provided by GOM/MOF (see 14.3 (Funding – Capacity to fund initial loan portfolio))
(2) Creation of appropriate structure of ownership of equity capital that promotes good governance of the SPE, supporting integrity of management and enhancing discipline to guard itself against corrupt interference. (see 14.1 and 14.2);

(1) Loan asset transfer (SPE's start-up assets) and preferred share funding (SPE's start-up funding)

As discussed in 14.3, the TSL Project's loan assets currently outstanding within the RV/F account will need to be transferred from MOF to the SPE, creating the SPE's initial loan assets on its balance sheet. In funding the transferred loan assets, MOF needs to also provide funding to the SPE. In consideration of the single borrower limitations of LNBFA (see 14.4.2), this initial funding from MOF is recommended to be a capital instrument. Given the large size involved which is close to the total assets, it is recommended that the funding from MOF should be preferred shares which allow SPE more flexibility in dividend and redemption than common shares. With the substantial amount of capital provided by the preferred shares, the SPE will have a strong capital base to support the TSL lending operation. The preferred shareholding is not associated with voting rights in the shareholders' meeting, but it gives the holder a priority status relative to the common shareholders in periodic dividend receipts asset allocation at the time of liquidation of the company. A major portion of the preferred shares, which corresponds to the sum of the original funding from JICA loans to GOM for the Project, should be structured to be redeemable by the SPE. With respect to this preferred share funding, the SPE operation, conducted under the TSL lending business model proven through the Project implementation, is expected to be capable of providing financial returns to GOM/MOF sufficiently in support of GOM's financial needs for the TSL loan repayments to JICA.

(2) Common shareholders – Ownership structure of PPP model

In view of the lessons in Chapter 13 from the recent history in Mongolia's development policy implementation, as discussed in 14.2, ownership structure of the SPE is critically important. It should be a structure to promote disciplined management, to guard against corruptive interference, and to foster long-term sustainability of the operation. Contribution to the long-term policy goal of SME development is only possible with sustained operation. The SPE structure should be a framework to guard itself against deviation from business management principles such as engaging in uneconomical lending programs and lending to borrowers of political favor.

In response to this need, it is recommended that the SPE's ownership structure be a Public-Private Partnership structure in terms of common share holdings. This structure allows the SPE to keep distance relative to politics, empowers the SPE to operate TSL business under clearly defined accountability, and best serves the SPE's needs for strong corporate governance.

For this shareholding structure, it is further recommended that the shareholding partners to be invited should include, in addition to GOM/MOF, Mongolia Banking Association (BMA) in association with the PFIs and international financial institutions (IFIs). Based on the deliberations of MOF with the assistance of the TA team, the proposed final target of distribution of the shareholding is 34% for GOM, 36% for MBA, and 30% for IFIs of the total amount of authorized shares of MNT 15 billion. In view of the fact that the participation of IFIs is not immediately achievable, the practical approach expected is to establish the SPE with the two shareholders, namely, GOM and MBA, reserving the remaining portion (30% of authorized shares) for IFIs for future participation.

The 34% share for GOM represents veto power for GOM with respect to major changes in the SPE governance, such as a change in the Company Charter, which require a super majority of two-thirds of shareholders. This is appropriate in consideration of GOM's responsibility in continued TSL operation and the SME development policy. It is also worth noting that GOM/MOF is a strong advocate for the IFI participation in the SPE as they see following merits: (i) Political Clout: The IFIs, if needed, are expected to ensure that the SPE operations are run free from the unwanted political interference; (ii) Honest Broker: The IFI can play a crucial role of an honest broker between the public and the private sector stakeholders. To date, there has not been a single case of successful PPP project in Mongolia; and (iii) Contribution to additional capital funding: Having an IFI as a shareholder can often result in successful capital funding with favorable investor view due to transparency and good corporate governance associated with IFI's presence.

In the deliberation process of MOF, a "GOM only" option for the initial stage of the SPE establishment was also discussed and evaluated. The "GOM only" option is a feasible option in terms of legal requirements and processes. It is assumed to have the merit of relative ease of TSL loan asset transfer compared to transfer to a PPP entity required in the Law of State and Local Property. On the other hand, the Company Law requires higher standards for corporate governance for "GOM only" company, i.e., State-Owned Entity. The Company Law demands SOEs the same level of transparency and accountability for listed joint stock companies. However, in view of the lessons learned from the recent experiences in the SME support efforts in the recent years, SOE is viewed as susceptible to illegitimate and corrupt interference. In conclusion of the deliberation, for the initial stage approach, the "GOM and MBA option" was determined as the option much preferable to the "GOM only" option. Given the strong governance needs, the SPE should pursue the governance practice of high standards, despite the lower legal requirements for private LLCs. Chapter 16 provides more discussion about corporate governance.

14.7 Selection Criteria / Priority for SPE Structure

This section summarizes the criteria for the selection of SPE structure that were used in the examination and evaluation process presented in the preceding sections.

Main areas of consideration for the SPE structure selection are:

i) Continuity of TSL Scheme (Wholesale lending to PFIs and disciplined partnership with PFIs as sub-lenders to SMEs);

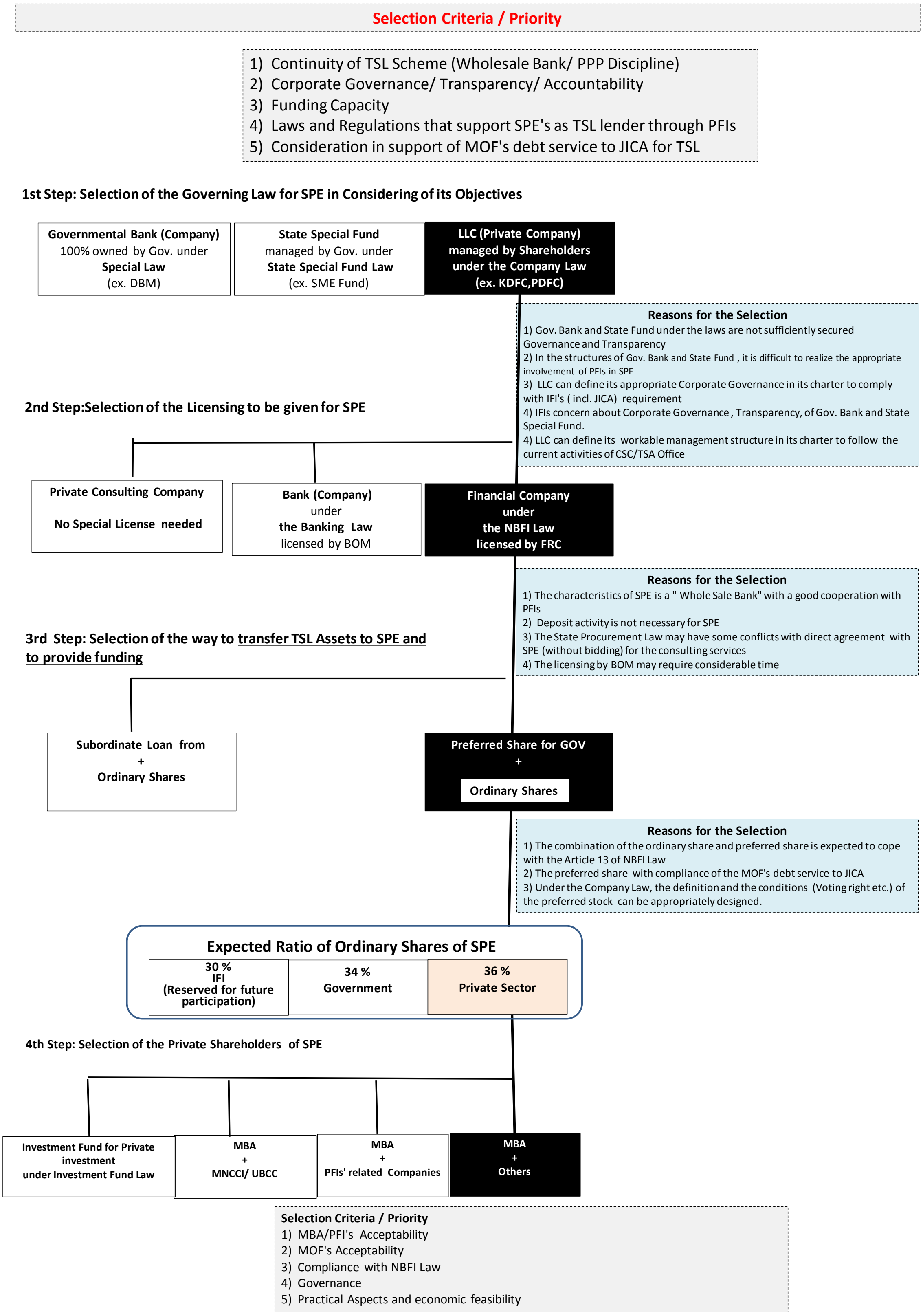
ii) Strong Corporate Governance ensuring Transparency and Accountability (Safeguarding the SPE from deviation from business integrity);

iii) Funding Capacity (supporting the wholesale lending operation further expanding going forward);

iv) Laws and regulations that support the SPE as SME TSL lender in partnership with PFIs

v) Consideration in support of MOF's debt service to JICA for the TSL Projects

Selection of SPE Structure



Source: JICA Expert Team

Figure 14.7.1 Process for the selection of SPE structure

Chapter 15 Establishment Plan of Special Purpose Entity (SPE)

This chapter presents detailed proposals with respect to the SPE's capitalization and ownership at the inception, based on the recommended structure of the SPE as an LLC with NBFI license. Financial projections are also presented to review viability of the SPE as proposed.

15.1 Capital / Operating Structure of the SPE

15.1.1 Capital base to support Lending Facility of the SPE – Preferred Shares

RV/F assets to be transferred as SPE's initial loan assets

The existing RV/F assets (the TSL project's on-lending asset portfolio) will be the SPE's starting loan portfolio on the asset side of its balance sheet. Upon incorporation of the SPE, the RV/F assets (mostly loans and residual cash balance) will be transferred from MOF to the SPE. This asset transfer will be handled in accordance with the Law of State and Local Property. While the exact amount will be determined at the time of SPE incorporation, the amount of the RV/F assets is estimated to reach about MNT 147.9 billion as of the end of 2017. The RV/F assets have been generated by two distinct components of funding: (i) appropriately MNT 116.3 billion being the MNT equivalent of the successive disbursements for sub-loans through PFIs from the JPY-denominated JICA ODA loans (TSL I and II) at the JPY/MNT historical exchange rates used for each disbursement (referred to as seed capital component); and, (ii) approximately MNT 26.5 billion being accumulated earned interest on loans to PFIs, which MOF has added to the RV/F for the purpose of providing additional PFIs/SME lending resources (referred to as accumulated interest component). In future after the transfer, the RV/F asset portfolio will continue to grow through the relending of the SPE net cash flow.

SPE's Preferred Shares subscribed by MOF in exchange for RV/F assets as in-kind payment

To continue performing its function of a wholesale lender (specifically, being a direct lender to only a few PFI borrowers) under the NBFI Law, the SPE needs a large equity base so as to avoid being constrained by the NBFI Law provisions related to single borrower restrictions. The most practical way to ensure adequate capital funding for the SPE's initial and future on-lending portfolio is for the SPE to issue Preferred Shares (PS) to MOF, in exchange for the transfer of RV/F assets to the SPE as in-kind payment for the equity investment in the Preferred Shares.

In recognition of the different characteristics of the two RV/F components, it is recommended that the Preferred Shares have two classes, A (PS-A) and B (PS-B):

(i) **PS-A**: Approximately MNT 116.3 billion, equating to seed capital component, i.e., the sum of all original disbursements from the JICA loans at the corresponding historical exchange rates. PS-A will be entitled to preferred dividends at a fixed rate around 4% p.a. PS-A will be redeemable by the SPE in due respect of GOM's JICA loan repayment schedule of the next 25-33 years.

(ii) **PS-B**: Approximately MNT26.5 billion equating to the accumulated interest component of the on-lending to PFIs. PS-B will be entitled to preferred dividends also at a fixed rate around 4% p.a. PS-B will not be redeemable.

The preferred share is a type of equity that gives the holder the benefit of priority rights with respect to dividends and assets recovery upon liquidation. For the SPE, it establishes a strong equity base in support of the SPE's lending facility for PFIs. The strong equity base can also facilitate future borrowings from investors.

15.1.2 Founders and Shareholder Composition - Ownership Structure of the SPE

The SPE's common share ownership structure as discussed in section 14.6 (2) aims at a PPP model in which GOM/MOF and MBA from the private sector are eventually joined by IFI(s). The balance between major shareholder groups, i.e. GOM/MOF, private sector and eventually IFI(s) needs to be carefully managed to mitigate potential conflict and ensure smooth collaboration for sustainable continuation of the TSL Project operations and development of a professional financial institution. By nature, the groups have differing objectives: (i) Government aims to achieve broad development objectives; (ii) private sector would seek a reasonably profitable operation, even though in this case MBA-member PFIs share a broader common interest in the purposes of the SPE; and, (iii) IFI(s) would aim to ensure a fair and effective combination of the two.

Ideally, the balance is achieved through equitably distributed shareholding structure: host government, IFI(s) and private sector, represented by MBA. Therefore, MOF has been approaching IFIs for equity participation in the SPE and will continue to do so going forward. In the case of Asian Development Bank (ADB), it was indicated that ADB is unable to make an equity investment in the SPE in the current circumstances. ADB, however, expressed willingness to appoint a Director on the SPE's Board if so requested, recognizing the importance of its institution building role.

As presented in section 14.6 (2), the SPE's authorized common share capital is expected to be MNT15 billion, of which initially 34% (or MNT5.1 billion) would be subscribed by GOM/MOF, 36% (MNT5.4 billion) would be subscribed by MBA, and the remaining 30% (MNT4.5 billion) would remain unpaid authorized capital reserved for IFIs / international private investors for participation at the next stage. This phased approach is considered appropriate as it enables the SPE's early start by the local founding parties which are ready to move, putting in place without delay a solid vehicle of MOF's exit strategy for sustained TSL operation. The recognition of the remaining authorized capital as reserved for IFIs would exhibit MOF's commitment to the ultimate objective of securing IFI investment when circumstances permit.

While it is broadly recognized that PPP structure is optimal for effective delivery of the development policy, MOF and JICA share the view that establishment of the SPE should not end up in a "privatization exercise" for the sake of privatization. It is important to keep prudent and effective collaboration among the initial public and private stakeholders and reduce the risk of diversion from the originally intended purposes of the SPE, particularly during the initial stages of operation.

Proposed shareholding structure is shown in the Table below.

Table 15.1.1 Proposed Target Capitalization structure of the SME DFC

Category	Capitalization	
	(in billion MNT)	(% of common shares)
Authorized shares	**157.9**	
Preferred shares	**142.9**	
Preferred A (GOM)	116.3	
Preferred B (GOM)	26.5	
Common shares	**15.0**	**100.0%**
GOM	5.1	34.0%
Private sector (MBA)	5.4	36.0%
International Institutions	4.5	30.0%

Source: JICA Expert Team

15.1.3 SPE's Shareholder Composition and Single-borrower lending limits

As discussed in section 15.1.1 above, the SPE's large capital base is designed in consideration of LNBFA's provisions of single-borrower lending limits (*Note). The preferred shares of about MNT 142 billion will form the major portion of the initial capital base, thus enabling lending operation to the limited number of PFIs. Among those limits, the limit on shareholder borrower (connected-party borrower) deserves special attention. Selection of MBA as shareholder (to represent private financial sector expertise and interests) is to avoid lending to shareholders. However, MBA's SPE capital investment arrangements should be carefully set up so that MBA as shareholder and the individual PFIs are appropriately separated. These lending limit issues were discussed in a meeting between FRC and the

JICA expert team in March 2018. It is recommended that MOF and MBA discuss with FRC further on the MBA's investment arrangements and obtain understanding of FRC.

* Note: Pursuant to Article 13 of LNBFA:

(1) Limit on lending (loans and guarantees total) to a single borrower including its related parties is up to 30% of the NBFI's total capital;
(2) Limit on lending (loans and guarantees total) to one shareholder borrower (the NBFI's shareholder) and one connected-party borrower (director, officer of the NBFI) is up to 10% of the NBFI's capital, and their aggregate sum shall not exceed 25% of the NBFI's total capital;
(3) Aggregate guarantees issued by a NBFI shall not exceed 70% of the total capital.

15.1.4 Board of Director Structure

The table below shows a recommended structure of the Board of Directors of the SPE. Under delegation of authority by the shareholders meeting for ongoing governance of the company, the board of directors: (i) provides guidance for the SPE (determines high level policies and high-level strategies of the SPE business), and (ii) provides oversight on the SPE management and overall operation (monitors the management team's execution of the policies and strategies and evaluates operating results). Under the board of directors' policies and strategies, the management team is responsible for making executive decisions and implementing the operation of the SPE in adherence to the professional business principles required for sustainable and successful business concerns.

Table 15.1.2 Board of Directors composition by nomination sources

Director nomination sources	Common share ownership		**Director seats to be nominated**			
	(in billion MNT)	(% of common shares)	**Director Seats**	**Non-Independent**	**Independent**	**CEO candidate**
	15.0	100.0%				
GOM*	5.1	34.0%	**2**	**1**	**1**	
Private sector (MBA)	5.4	36.0%	**2**	**1**	**1**	
IFIs / International private	4.5	30.0%				
Non-shareholder IFI (ADB)	-	-	**1*** **		**1*** **	
Shareholder-consensus nominees**			**2**		**1**	**1**
Total			**7**	**2**	**4**	**1**

* The number of directors that GOM should appoint is required by Law of State & Local Properties to be proportional to GOG's ownership share of common equity.

** Shareholder-consensus nominees are those selected directly in a collaborative process of search / selection among major shareholders. Nominees from this process are expected to be independent of GOM and MBA/PFIs. All director nominations should be finalized with the consensus among all the shareholders. Under this consensus nomination process, the number and names of GOM's appointments may be determined to comply with the proportional appointment requirement of the law.

*** Nomination from IFI sources may not materialized in the initial stage. In this case, the nomination attributed to IFIs above will be added to the shareholder-consensus nominees.

Source: JICA Expert Team

Based on examination of the nature of the SPE operation, a board of 7 directors is recommended as an appropriate size for effective and efficient governance.

Nomination sources of directors are recommended to be split among the shareholders and stakeholders as shown in the table above in order to create a board with diverse views conducive to constructive discussion. MBA, representing the private financial sector expertise and interests should be a source of professional talents for director nomination. IFIs supporting the SPE such as ADB even before equity participation can be a source of director candidates who can act as an honest broker within the board. The nomination by these source groups including GOM should include independent director candidates as shown in the table.

Independent Directors: The Board of Directors is recommended to include 4 independent directors. Chairperson of the Board shall be an independent director. This is more than the Company Law's requirements of minimum of three independent directors or 1/3 of all directors for listed joint stock companies and SOEs for which the law expects higher standard of accountability and transparency. The rationale for the four independent directors is:

(i) In view of the SPE's specific needs for strong discipline to protect itself from illegitimate interference, a strong structure of Board of Director that is similar to listed joint stock companies and SOEs is appropriate; and

(ii) with assignment of independent directors to chair the three Board Committees similar to those expected of listed companies and SOEs by the Company Law in addition to the Board chair, it is desirable to have 4 independent directors to make the Board of Directors function regularly and effectively.

"Independent director" is defined as a person who meets all of the criteria of independence below (in consistency with the Company Law Article 79):

a) Does not own 5% or more of the SPE common shares (Company Law Art. 79).

b) Does not hold an official position in the SPE in the last 3 years (ditto Art. 79).

c) Shall not be public servant other than public service officer (ditto Art. 79).

d) Shall not be related to the SPE's business in any way (ditto Art. 79).
As d) is applied to the SPE situation, independent director candidates shall not be related to the shareholders, PFIs (borrowers), sub-loan borrowers and providers of funding of the SPE. Candidates who are related to IFIs may be regarded as independent under shareholders consensus.

<u>Board Committees</u>

In order to promote appropriate corporate governance of the SPE, in particular, protecting the SPE operation from political pressures for uneconomical programs and political interference for individual sub-borrowers and projects, the SPE should adopt the following Board Committee structure from the initial stage. The structure here is in conformity with the best practice recommended in FRC's Corporate Governance Code of Mongolia, as well as international guidelines such as OECD Guidelines on Corporate Governance of SOEs, and G20 OECD principles of Corporate Governance.

The SPE's Board of Directors will have the following committees

(1) Nomination and Remuneration committee

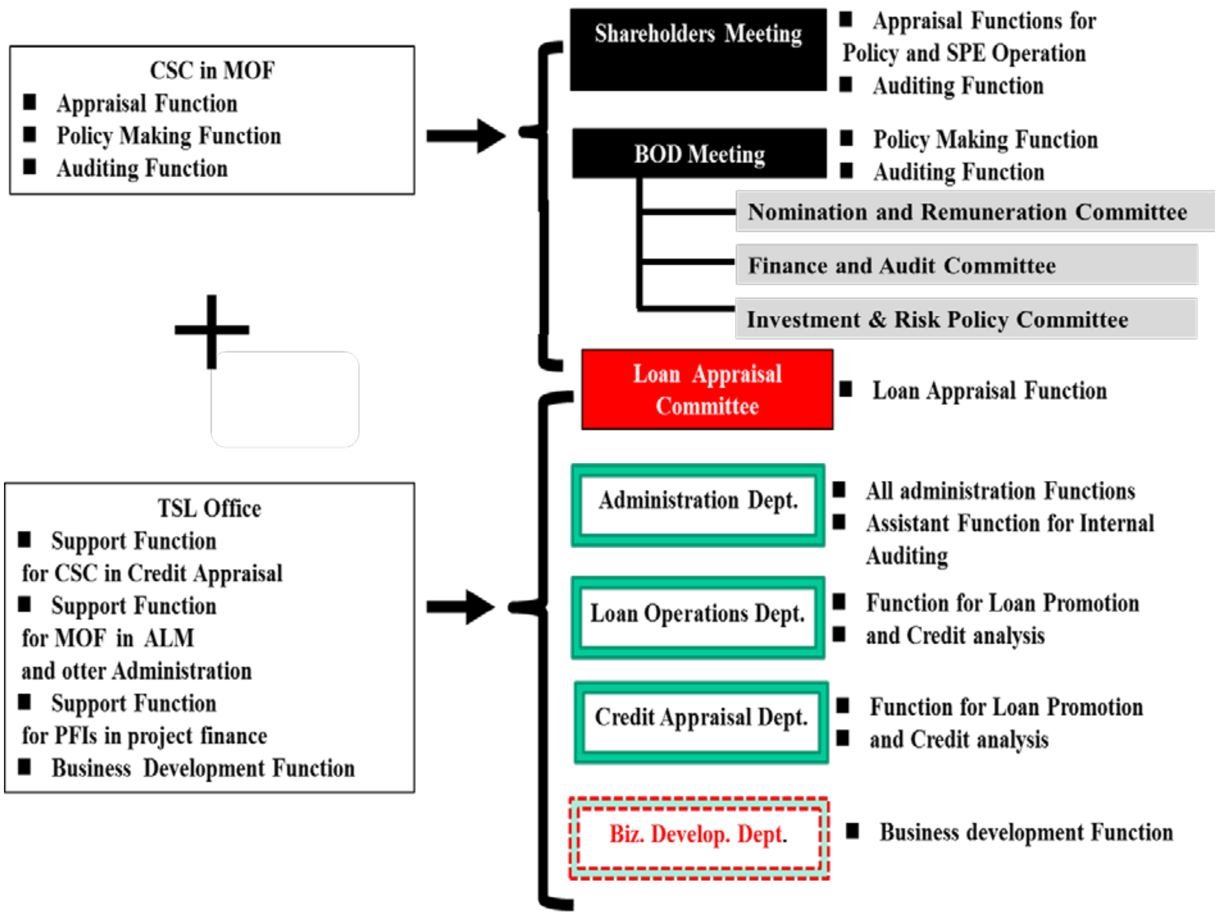
(2) Finance and Audit Committee

(3) Investment & Risk Policy Committee

The committee chairperson of the 3 Board Committees (see below) shall be an independent director.

More detailed discussion of the Corporate Governance structure is presented in Chapter 16.

The Figure 15.1.1 below compares the organizational functions between the current TSL scheme and the proposed SPE



Source: JICA Expert Team

Figure 15.1.1 From TSL Project Scheme to SPE Organization

15.2 Business Plan of the SPE

The SPE business plan is designed to achieve the crucial medium- and long-term objectives outlined in Sections 14.1 and 14.2, which have led MOF to promote its establishment. The successful establishment and operation of the SPE will achieve several important policy objectives, as highlighted below. Its organization and staffing, its financial structure and its operating policies are coordinated in support of those objectives.

To keep and expand lending activity in an innovative manner: The broadly recognized immediate priority is to ensure the continuation of the highly successful TSL Project in a sustainable and efficient manner. In particular, the TSL Project shall evolve into its second phase in terms of implementation mechanism by transitioning from the existing TSL structure into -sustainable and independent institution with reasonable profitability to ensure self-sustainability, which can expand beyond the original TSL Project outreach. The SPE is structured to take over responsibility for the program as well as for its further expansion both in terms of resource mobilization and diversification of support services. The SPE's strong equity base and the organization managed under business principles are consistent with these functions.

The SPE will continue its established policy of lending to SMEs through PFIs, therefore maintaining the existing wholesale lender model. The SME sub-borrowers credit risk analysis will be continued by the PFI's responsibility, with feasibility analysis of sub-borrower projects being actively monitored by the

SPE in collaboration with the PFIs through expanded TA activities of the SPE in the capacity-building support role.

In addition, new features will be introduced. Co-financing with PFIs in sub-loans to SMEs will be introduced to become a regular lending policy of the SPE going forward, with a standard minimum ratio to be set such as 20% for the PFI component, so as to leverage the RV/F resources by mobilizing incremental resources. The aggregate principal amortization schedule will provide for the PFIs shorter term component to be repaid first. Furthermore, since the interest rate on PFIs' own funding will be higher, the SPE will consider the possible introduction of time-averaging features to even out interest payments to the benefit of the SME borrowers.

TSL operation aligned with GOM policy objectives: The proposed capitalization of the SPE through issuance of the preferred shares matching the transferred TSL RVF assets, combined with issuance of the common shares, represents GOM's commitment to the TSL operation to support SME development. This means that: (i) funding made available by the JICA loans will continue to be utilized for the intended purposes, and therefore MOF policy implementation in providing financial and technical assistance to SMEs will be successfully sustained; and (ii) the SPE will have capacity to redeem the preferred shares with the sustained on-lending operation, supporting MOF's repayments of the JICA loans of TSL Phases I and II**.**

Enhanced SME support: In comparison to the current administrative costs of the TSL program (until now covered by Phase II), the SPE will need to cover incremental operating expenses of about MNT1.9 billion due to the buildup of an independent organization with expanded technical assistance capacity in addition to its project finance role. Indeed, as discussed in 14.3 (Functions and required capacities of the SPE), the SPE is specifically designed and capitalized to provide tangible support (in the form of long-term financing) as well as intangible forms of support (through TA for the improvement of business practices), both essential for SMEs development and growth. The SPE will thus be able to significantly expand the annual volume of financing mobilized, including the new co-financing policy, to an average of about MNT 60-80 billion in the early years, stabilizing over time at MNT 70 billion. The number of sub-loans per year is expected to stabilize at about 110, reflecting the gradual increase in the average size of loans, in itself a positive development indicating higher requirements from growing SMEs. The planned management and staffing organization will enable the SPE to expand its technical assistance in support of both PFIs and SMEs capacity building, particularly with respect to project analysis and business planning.

Interest Rate Policy Revision: As noted above, the SPE will need a stronger organization than the current TSL set-up to carry out such expanded range of activities. Its operating budget will be at least double that of the present TSL office, and will have to be covered by its own revenues, since the SPE will operate as an independent and creditworthy financial institution. In addition, consideration should be given to supporting the SPE's earning power so that the SPE maintains capacity for payouts on preferred share dividends and incremental redemptions to MOF. In the recent years, the lending rate to the ultimate SME borrowers was fixed at 8%, while the rate on on-lending to PFI was fixed at 4%. In consideration of the change in the TSL operation moving forward to the next stage, the interest policy is reviewed in consultation with MOF. The revised rates under consideration are: 12% for PFIs' loans to SMEs; 8% for SPE's on-lending to PFIs. The revision is based on the following considerations:

(i) After the establishment of the SPE, the TSL operation will transition from the project stage of introductory dissemination housed within the government, onto the nest growth and expansion stage with the self-sustaining institutional foundation

(ii) The new SPE is to take on expanded roles in technical assistance to PFIs and SME borrowers

(iii) With the JICA TSL loans to GOM aging past grace periods, MOF expects the SPE to maintain solid profitability which should generate investment returns to MOF in support of the repayments

Mobilizing Additional External Financing: Notwithstanding the enhanced program outlined above, demand from SMEs and PFIs remains well in excess of current resources, resulting in a significant applications backlog. It is undeniable that the potential for growth in lending operations has been constrained in recent years by limited availability of additional resources. The reason is that upon completion of the initial disbursements from TSL Phases I and II, new loans could only be funded through the RV/F cash balance, which is generated by repayments from previous loans and by the interest on outstanding loans. Additional funding is urgently needed and it is precisely for that purpose that the SME program is being transferred to an SPE, a self-sustaining financial institution structured to be a creditworthy and professional development finance institution that can raise financing on its own right. In the medium/long term, SPE's proposed strong capitalization based on the existing RV/F and its strengthened organization should be leveraged to mobilize additional funding in support of SMEs.

15.3 Financial Projections of the SPE

Financial projections have been prepared to show the base case for the possible financial outcome over the next 30 years. The projection incorporates an assumption of additional financing of the TSL Phase III in the amount of and on the terms of the potential Phase III loan under consideration. Assumptions used for Phase III are: Loan amount MNT225 billion or JPY10 billion; disbursement starting in 2020; loan duration 30 years with a 10-year grace period. The interest rate policy revision for the on-lending loans discussed in section 15.2 above is also incorporated in the projections, assuming the new rates apply to new loans after the SPE establishment. Other initiatives discussed in the Business Plan section are not reflected in this base case projection, such as mobilization of new external funding. The summary financial projections are shown in the Tables below.

The financial projections have been run through 2050, by which time MOF's repayment of JICA loans will be completed. The financial projection assumes the same treatment for the additional financing, that is, MOF's transfer of TSL Phase III loan proceeds to the SPE and concurrent subscription of Preferred Shares A3 issued by SPE. The preferred share redemption volume and timing were assumed to correspond to the MOF amortization schedules to JICA.

The projection results confirm that the SPE under the business plan based on the business model developed through Phases 1 and 2 will generate income and cash flows that are respectable as a viable wholesale financial institution. In the initial two years after starting the SPE operation till 2020, net annual income after tax(*Note) stays around MNT 6 billion, which may not allow growth in retained earnings after the first few PS-A redemptions. Subsequently in the latter half of 2020's, new PFI lending activities supported by the Phase III funding, coupled with the effect of the lending rate change, bolster the SPE's income growth, allowing net income after tax to exceed MNT 17 billion and to maintain stable growth further. The profitability projected is at a level that secures sufficient cash flows to enable the SPE to make payments of: PS A and B dividends; common share dividends; and PS-A redemptions in an expected pace.

*Note: As an independent and self-sustaining financial institution, SME FC will pay corporate income tax, estimated initially at MNT584.5 million in 2019 (the first year of operation) and reaching an average of about MNT2.0 billion from 2022 onwards.

The investment return cash flows to MOF paid from the SPE will reach about MNT 64.0 billion by 2023 (MNT 44.9 billon in PS dividends, MNT 3 billion in common share dividends, MNT 16.1 billion in PS-A redemptions). In the 20 years 2024 – 2043, annual net income after tax ranges around MNT 25 billion – MNT 34 billion, which compares to annual dividends and redemptions to MOF ranging MNT 10–25 billion. Till the end of 2050, a total of MNT 635.1 billion of payments, of which MNT 293.8 billion in dividends and MNT 341.3 billion redemptions, are projected to be made to MOF during the projection period.

The SPE's loan assets show a sharp increase in total on-lending portfolio which would grow by 2024, to MNT389.8 billion under the assumption of the Phase III funding. Without new additional funding initiatives incorporated in the projection, the loan portfolio balance is expected to plateau for a while, but resumes steady growth after 2026 reflecting improved profitability and cash flows. The ability to raise external funding is the fundamental medium-term objective of the SPE. The SPE can capitalize on the PPP structure of ownership and steady profitability in cultivating new source of funding.

While 30 year projections are subject to countless variables and uncertainties, they are nevertheless indicative of structural trends. In this case, they confirm the long-term validity of the SPE model as a sustainable and creditworthy institution capable of mobilizing additional financing in support of SMEs and in amounts substantially greater than the simple continuation of TSL project utilizing existing resources.

Table 15.3.1 Projected Summary of Cash Flows

(Unit: million MNT)

CASH FLOW SNAPSHOT								
		SPE RVF Beginning Balance	Onlending disbursed	Dividends paid	Redemption of Preferred shares	Loans repaid	Taxes paid	SPE RVF Ending Balance
Totals (by 2050)		**145,646,580,025**	**2,744,135,082,680**	**324,601,671,069**	**341,316,476,924**	**-**	**102,228,348,512**	**552,749,471,365**
Periods	**12/30/23**	290,502,467,484	332,633,203,885	49,308,401,465	16,143,291,078	-	7,058,863,841	317,446,308,139
	12/30/28	356,574,047,021	697,226,201,014	126,894,700,825	35,712,551,404	-	21,936,205,363	361,199,692,420
	12/30/33	376,028,892,979	1,093,483,036,871	197,220,273,120	100,281,811,729	-	38,210,990,011	375,899,129,693
	12/30/38	389,965,398,702	1,508,319,845,223	252,719,493,350	176,101,072,055	-	54,880,141,248	392,334,256,619
	12/30/43	425,162,420,663	1,960,688,219,059	293,054,861,515	251,920,332,381	-	72,729,230,154	430,369,117,581
	12/30/50	535,588,194,334	2,744,135,082,680	324,601,671,069	341,316,476,924	-	102,228,348,512	552,749,471,365

Source: JICA Expert Team

Table 15.3.2 Projected Summary of Balance Sheets

(Unit: million MNT)

BALANCE SHEET SNAPSHOT (MNT)							
	6/30/18	12/31/23	12/31/28	12/31/33	12/31/38	12/31/43	12/31/50
ASSETS							
Cash & cash equivalent	-	50,278,353,911	43,265,483,647	40,144,275,581	42,413,029,234	48,865,339,935	71,034,097,274
Deposits (common share & reserves)	12,000,000,000	16,000,000,000	16,000,000,000	16,000,000,000	16,000,000,000	16,000,000,000	16,000,000,000
Onlending portfolio	145,646,580,025	317,446,308,139	361,199,692,420	375,899,129,693	392,334,256,619	430,369,117,581	552,749,471,365
TOTAL ASSETS	**157,646,580,025**	**383,724,662,051**	**420,465,176,066**	**432,043,405,273**	**450,747,285,853**	**495,234,457,516**	**639,783,568,639**
LIABILITIES & EQUITY							
Liabilities							
Accounts payable	-	-	-	-	-	-	-
EQUITY							
Preferred A	116,316,476,924	325,173,185,846	305,603,925,520	241,034,665,195	165,215,404,869	89,396,144,543	0
Preferred B	29,330,103,101	29,330,103,101	29,330,103,101	29,330,103,101	29,330,103,101	29,330,103,101	29,330,103,101
Common shares	12,000,000,000	15,000,000,000	15,000,000,000	15,000,000,000	15,000,000,000	15,000,000,000	15,000,000,000
Retained earnings	**-**	**14,221,373,104**	**70,531,147,445**	**146,678,636,978**	**241,201,777,883**	**361,508,209,872**	**595,453,465,538**
TOTAL LIABILITIES & EQUITY	**157,646,580,025**	**383,724,662,051**	**420,465,176,066**	**432,043,405,273**	**450,747,285,853**	**495,234,457,516**	**639,783,568,639**

Source: JICA Expert Team

Table 15.3.3 Projected Summary Income Statements

(Unit: million MNT)

	6/30/18	12/31/23	12/31/28	12/31/33	12/31/38	12/31/43	12/31/50
REVENUE							
Onlending interest	-	24,265,847,039	31,806,219,619	33,198,042,874	34,443,825,827	37,645,920,204	137,031,738,847
Deposit(s) interest	-	1,440,000,000	1,440,000,000	1,440,000,000	1,440,000,000	1,440,000,000	4,320,000,000
TOTAL REVENUE	**-**	**25,705,847,039**	**33,246,219,619**	**34,638,042,874**	**35,883,825,827**	**39,085,920,204**	**141,351,738,847**
EXPENSES							
Salary & Office expenses	-	1,929,402,022	1,918,902,027	1,916,402,032	1,918,902,037	1,921,402,042	1,916,402,049
Interest expenses	-	196,875,000	-	-	-	-	-
TOTAL EXPENSES	**-**	**2,126,277,022**	**1,918,902,027**	**1,916,402,032**	**1,918,902,037**	**1,921,402,042**	**1,916,402,049**
Profit before tax	**-**	**23,579,570,018**	**31,327,317,592**	**32,721,640,843**	**33,964,923,791**	**37,164,518,163**	**139,435,336,799**
CIT	-	2,357,957,002	3,132,731,759	3,272,164,084	3,396,492,379	3,716,451,816	4,719,965,335
Profit after tax	**-**	**21,221,613,016**	**28,194,585,833**	**29,449,476,758**	**30,568,431,412**	**33,448,066,346**	**134,715,371,464**
Dividends	**-**	**12,244,422,120**	**13,514,776,707**	**11,269,506,294**	**8,236,735,881**	**5,203,965,468**	**1,253,947,553**
Preferred A	-	11,071,217,996	12,341,572,583	10,096,302,170	7,063,531,757	4,030,761,344	80,743,429
Preferred B	-	1,173,204,124	1,173,204,124	1,173,204,124	1,173,204,124	1,173,204,124	1,173,204,124
Common shares	-	1,650,000,000	1,650,000,000	1,650,000,000	1,650,000,000	1,650,000,000	1,650,000,000
RETAINED EARNINGS	**-**	**7,327,190,896**	**12,628,038,658**	**16,529,970,465**	**20,681,695,531**	**26,594,100,879**	**39,575,740,461**

Source: JICA Expert Team

Table 15.3.4 Projected Summary of Statements of Cash Flows

(Unit: million MNT)

STATEMENT OF CASH FLOW SNAPSHOT (MNT)							
	6/30/18	12/31/23	12/31/28	12/31/33	12/31/38	12/31/43	12/31/50
INFLOWS							
Onlending principal repayment(s)	-	37,378,756,134	77,381,755,810	78,023,053,964	78,795,995,144	85,616,471,642	103,563,724,025
Loans received	-	56,250,000,000	-	-	-	-	-
Retained earnings	-	7,327,190,896	13,029,809,126	16,529,970,465	20,681,695,531	26,594,100,879	39,575,740,461
TOTAL INFLOWS	**-**	**100,955,947,030**	**90,411,564,936**	**94,553,024,428**	**99,477,690,675**	**112,210,572,521**	**143,139,464,485**
OUTFLOWS							
Redemption of Preferred shares	-	3,913,852,065	3,913,852,065	15,163,852,065	15,163,852,065	15,163,852,065	2,691,447,640
Loan service	-	-	-	-	-	-	-
Onlending disbursed	-	91,578,429,606	84,145,536,135	77,303,326,752	83,820,746,823	95,702,790,591	131,745,407,220
Net cash flow	-	5,463,665,358	2,352,176,736	2,085,845,611	493,091,786	1,343,929,865	8,702,609,626
TOTAL OUTFLOWS	**-**	**100,955,947,030**	**90,411,564,936**	**94,553,024,428**	**99,477,690,675**	**112,210,572,521**	**143,139,464,485**

Source: JICA Expert Team

Chapter 16 Corporate Governance of the Special Purpose Entity

This Chapter elaborates further on the recommended corporate governance structure of the SPE presented in Chapter 15.

16.1 Why Corporate Governance is important for the SPE?

16.1.1 Corporate Governance Defined

Corporate governance is a set of processes and mechanisms that promotes a disciplined approach for a company to be effectively directed and controlled in order to achieve its strategic goals. Under the corporate governance discipline, rights and responsibilities are clearly identified for various actors involved in the company's operation, rules and procedures are clearly established for making decisions in corporate affairs, and processes for monitoring are put in place for the policy decisions, implementation actions and results.

This definition is very obvious and makes sense to everyone. However, corporate governance is not a system of knowledge, but it is a culture of discipline that is exercised by the top and the rest of the organization.

16.1.2 Special Needs for the SPE's Corporate Governance

In light of the lessons drawn from recent experiences in similar organizations reviewed in Chapter 13, the following aspects are of paramount importance in establishing the SPE's corporate governance structure:

1) Lending policies and programs of the SPE must not be taken advantage of by political interests in favor of special interests. This results in diversion of resources away from the objectives of SPE and GOM.
2) Individual lending decision must not be compromised by political interference (Corrupt lending).

As a lending institution for the private sector to serve the national development goals, the SPE needs to stay focused on the operating mission in the long term. This demands strong discipline to adhere to business principles in lending decisions and ongoing financial management. The corporate governance structure recommended here is designed to protect the SPE management against adversarial influences of diversion from the discipline of economically viable business operation.

In view of the role of the SPE as provider of concessional loans that are vulnerable to corrupt interference, the governance structure with a solid board of directors is chosen for the SPE, despite the fact that legal requirements of the board of directors is not applicable to private LLCs. The recommended governance structure stays relevant to the SPE irrespective of the variation of ownership whether it is formed with the government as 100% owner or as a minority owner.

16.2 Basic framework of the SPE's Corporate Governance

16.2.1 Basic Framework

Institutional actors in the corporate governance for the SPE are summarized below.

- SHAREHOLDERS' MEETING: The Shareholders Meeting is the supreme body of governing of the SPE. It meets annually, and it delegates much of ongoing governing authority to the board of directors.
- BOARD OF DIRECTORS: Responsible for guiding the management team and monitoring the management processes and execution results. The Board of Directors meets regularly

(typically monthly and where needed). Board Committees are formed to make guidance and oversight in high risk and important areas of management more effective.

- MANAGEMENT TEAM: Responsible for managing the execution of the SPE strategy to achieve its objectives.

Within this framework for effective corporate governance, the central focus is placed on the leading roles played by the BOARD OF DIRECTORs. The key to successful corporate governance is to have a solid BOARD OF DIRECTORS and a professional MANAGEMENT TEAM, and to maintain an interactive and constructive working relationship between the board of directors and the management team.

16.3 Board of Directors

16.3.1 Composition of the Board of Directors

(1) Number of Directors

The SPE is recommended to create a 7-member board as discussed in the previous Chapter (15.1.3). The 7 directors on the board should be appropriate in terms of hitting the balance of effectiveness and efficiency, given the relatively small size of the company and the strong need for corporate governance as summarized in 16.1.2 above.

(2) Nomination sources of directors and Independent Directors

The nomination sources of the SPE directors should be shared among the shareholders and non-shareholding stakeholder(s) as recommended also in 15.1.3. This is to create a strong board with members of diverse views. The nomination by these source groups should include independent director candidates. The chair of the Board should be an independent director. Criteria for independent directors are presented in 15.1.3.

(3) Chief Executive Officer and Directorship

It is recommended that the CEO should also be a director on the Board. The CEO candidate will be nominated with consensus of all shareholders. The CEO's directorship promotes effective functioning of the Board's strategic guidance and supervision of the Management under a constructive working relationship between the two bodies. See 16.6.3 *Notes on CEO and Board Membership* below for more discussion on CEO's appointment as director on the Board.

16.3.2 Board Committee structure

Three board committees are recommended for the SPE board (as stated in section 15.1.3).

1) Nomination and Remuneration committee
2) Finance and Audit Committee
3) Investment & Risk Policy Committee

Each of the 3 committees comprises 3 directors as voting members. For each of the 3 committees, the chair among the 3 members should be an independent director. The CEO, though a director of the board, will not be a member of the board committees. The CEO (and other management team officers) may actively participate in the committee meetings as presenter and resource personnel, but will not have voting rights in the committees' decision-making.

Responsibilities of the 3 Board Committees are as follows.

(1) Nomination & Remuneration Committee

- Nominates candidates for new directors to recommend to the board for onward recommendation to the shareholders' meeting.
- Nominates candidates for new Chief Executive Officer (CEO) to recommend to the board.
- Evaluates executive officers' performance and reviews compensation to recommend to the board for necessary actions.

(2) Finance and Audit Committee

- Provides guidance and oversight on Internal Control responsibilities
  - Establishment of Internal Control of the SPE and its implementation.
  - Integrity of financial statements (collaborating with External Auditor).
  - Effective enforcement of compliance policies in financial management, business operation and ethical standards.
- In discharging above responsibilities, the Committee works closely where necessary with the external auditor which the SPE contracts with under Board approval.

<Strategic Business Direction Responsibilities>

- Provides guidance and oversight on:
  - Business planning and budget of the SPE in terms of annual formulation, regular reviews and revisions.
  - Financial management of the SPE in terms of managing the balance sheet and income flows for financial sustainability.
- The Committee recommends board actions as needed, e.g., approval for or direction to revise on proposed policies (such as accounting policies, personnel policies) and strategic plans and decisions in financial management (annual business plan, budget, quarterly review and action plan, etc.).

(3) Investment & Risk Policy Committee

- Provides strategic guidance and oversight on:
  - Credit risk management policies – policy establishment and revisions.
  - Monitor and review management's execution results of the credit management policies, and integrity of credit management practice.
  - Monitor and review loan (and investment) portfolio status
- The Committee recommends board actions as needed, e.g., approval or rejection of new credit policy adoption/revision, direction to the Management for remedial actions on undue credit risk situation identified.

16.4 Management Team

16.4.1 Management Team Composition

In accordance with the Company Charter and the Statement of Management Policies, and under the guidance and direction of the board of directors, the management team is responsible for managing the execution of the SPE's operation.

The SPE's executive management will be led by Chief Executive Officer and a select number of senior managers will report to the CEO in managing respective areas of the SPE operation. The CEO is accountable to the board of directors.

The executive management organization will be structured commensurate with the SPE's scope of operation and the associated risks it assumes, with four main areas of responsibilities:

Chief Executive Officer	(Area of responsibility)
Manager, Finance & Administration Department	Financial Management, Accounting, Budget, Treasury Operation, HR Administration, General Administration, [Board Secretariat]
Manager, PFI Lending Department	Front Office for PFI Lending (Initiator of loan approval process)
Manager, Credit Analysis & Risk Management Department	Credit analysis of PFI on-lending loans, On-lending loan portfolio analysis, PFI credit analysis
Manager, Business Development Department	Advisory to PFIs (and SMEs) on TSL, Industrial research activities,

Source: JICA Expert Team

Figure 16.4.1 Management Team

The 4 managers operate under the direction of the CEO. In aiding the executive decision-making processes of the CEO and the managers, the CEO will establish a select number of management committees in the areas of cross-departmental issues, such as:

- Loan Appraisal Committee
- Finance Committee

16.4.2 Management Committees' roles / responsibilities

(1) Loan Appraisal Committee

Members

- Chair: CEO
- Credit Analysis & Risk Management Head, Finance & Admin Head (CFO), Operations Head, and Business Development Head

Responsibilities

Make decisions on:

1) Credit reviews on PFIs
2) Approval of individual on-lending loan applications
3) Loan portfolio assessment
4) Credit management policies and procedures and their revisions to be proposed to the Board Committee (Investment & Risk Management Committee).

(2) Finance Committee

Members

- Chair: CEO

- Finance & Admin Head (CFO), Operations Head, and Business Development Head, Credit Analysis & Risk Management Head.

Responsibilities

1) Business planning, budget (Formulation, regular reviews and management actions).
2) Regular financial review of the balance sheet (loans vs funding = preferred shares) and projected net interest income flows, and management actions where needed.
3) Review of financial statements to ascertain integrity of reported financial results
4) Review of integrity of internal control of the company.

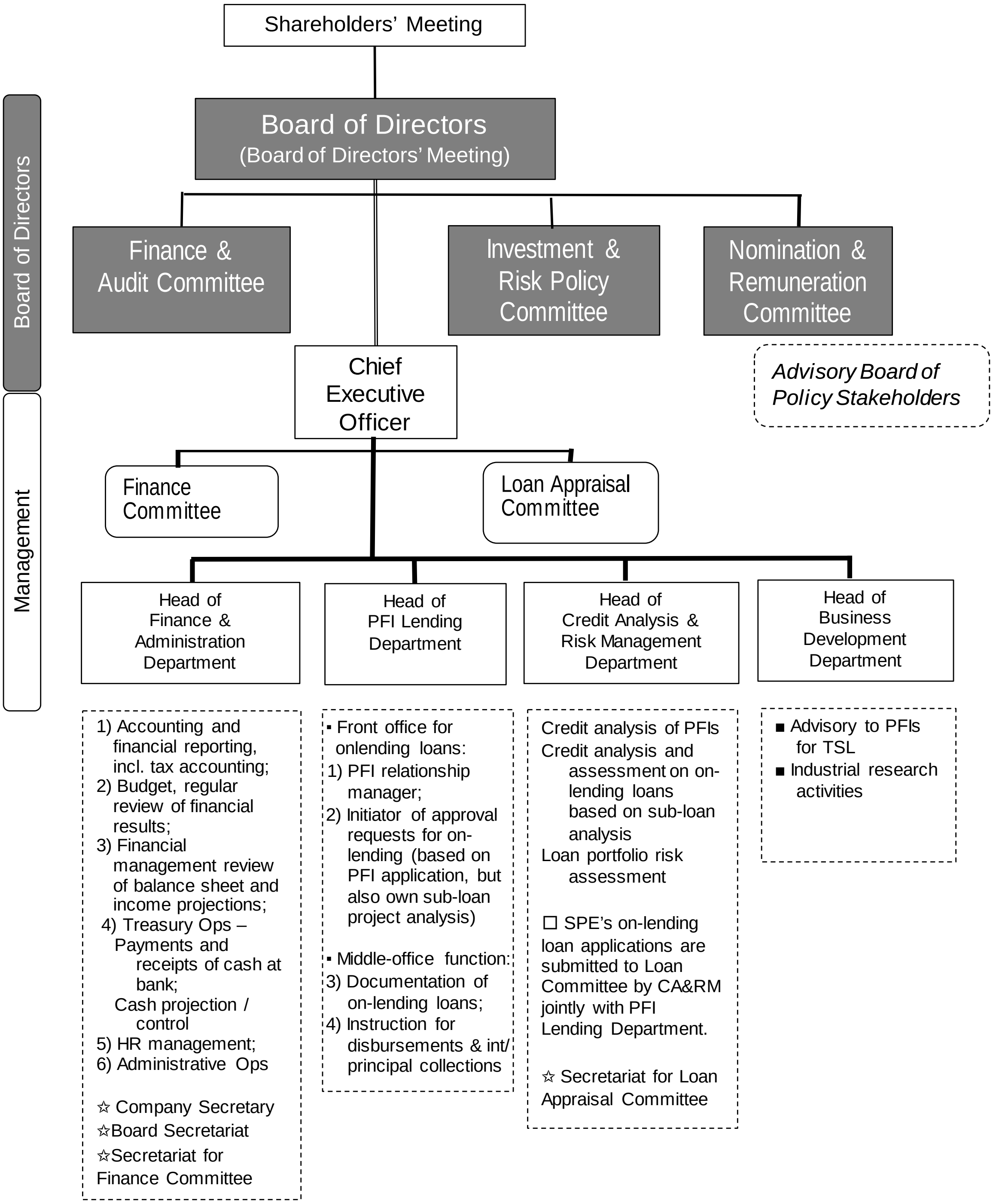
(3) Management Meeting

CEO holds Management Meeting regularly (weekly) with the 4 executive managers to discuss, review and resolve issues arising from the SPE operations.

16.5 Stakeholder Consideration: Advisory Board of Policy Stakeholders

In addition to the board committees and management's committees, it is advisable to establish an advisory board of policy stakeholders. The advisory board may consist of development policy owners that have hitherto been represented in the Counterpart Steering Committee (CSC) of the TSL Project. It should provide policy-level inputs to the SPE's Board of Directors and CEO. It will inherit part of CSC's role that has directed the TSL operation from the perspective of policy-owners, e.g., MOFALI, MONET, etc. (On the other hand, of the roles performed by CSC, appraisal and approval of the TSL loans and ongoing credit review of the loan portfolio will be taken over by the SPE's Loan Appraisal Committee (management committee), while guidance and oversight of the Board of Directors over credit policy issues will be taken over by Investment & Risk Policy Committee of the board.)

The Advisory Board of Policy Stakeholders may meet twice a year. The CEO and the management team may brief the Advisory Board on the latest business plan, progress report, and the latest main policy changes, while the Advisory Board members provide feedback and inputs to the Board of Directors and the management team in the meeting.



Source: JICA Expert Team

Figure 16.5.1 Expected Corporate Governance & Management Structure of SPE

16.6 Legal Requirements and International Best Practice

16.6.1 Corporate governance requirements of Mongolian Laws

In determining the corporate governance structure of the SPE as presented above, legal and regulatory requirements were duly taken into account. Below is a summarized review of such requirements and expectations included in the laws and regulations of Mongolia that are discussed in Chapter 14.

(1) Requirements in Company Law

Company Law regulates incorporation of companies and basic governance requirements applicable to joint stock companies (listed companies), private LLCs and state-owned companies.

Table 16.6.1 Company Law requirements by company category

Requirements of Company Law			
	Company Category		
	Limited Liability Company State-Owned (SOE)	**Limited Liability Company Non SOE (incl. PPP)**	**Joint Stock Company (Listed Company)**
Number of Directors	**9 or more**	**No legal restriction** (“LLC may choose to not have a Board of Directors”)	**9 or more**
Independent Directors	**1/3 of directors shall be independent (i.e., 3 or more)**	**Optional**	**1/3 of directors shall be independent (i.e., 3 or more)**
Board Committees	**No requirements**	**No requirements**	**3 committees are required:** **- Audit Committee** **- Nominating Committee** **- Salary & Bonuses Committee**
Dual appointment for Board of Director and Executive Body	A member of Executive Body can be also a member of Board of Directors, except chair of the Board.	A member of Executive Body can be also a member of Board of Directors, except chair of the Board (in the case of Board of Directors established).	A member of Executive Body can be also a member of Board of Directors, except chair of the Board.
External Audit	Company may appoint an audit organization.	Company may appoint an audit organization.	**Auditing firm shall be retained.**
Accounting, Financial Reporting	In accordance with Accounting Law of Mongolia	In accordance with Accounting Law of Mongolia	In accordance with Accounting Law of Mongolia
Internal Audit	No requirements	No requirements	No requirements

Source: Company Law – English translation, Government of Mongolia

(2) Requirements in Law on State and Local Property

Law on State and Local Property provides rules on how public assets (state and local governments' assets) should be managed. In this context the law addresses government-owned companies (SOEs), and partially government-owned PPP companies with respect to representation of government's ownership interest in the company's governing body (board of directors).

Table 16.6.2 Law on State and Local Property requirements applicable to SOE and PPP

Requirements of Law on State and Local Property requirements for SOE and PPP companies		
	State-Owned Company (SOE)	**Non SOE (PPP)**
Procedure for State's director appointment	**Members of the representative governing board** shall be **<u>appointed by the government</u>** (State Property Commission) **in proportion to the state ownership**.	**Members of the representative governing board** shall be **<u>appointed by the government</u>** (State Property Commission) **<u>in proportion to the state ownership</u>**.
Regulatory supervision / audit	**MOF (together with State Property Committee) shall audit** economic and financial activity of a state owned legal person (once in 2 years)	(Not applicable)

Source: Law on State and Local Property – English translation, Government of Mongolia

(3) Requirements of Law on Non-Bank Financial Activities (LNBFA)

Law on Non-Bank Financial Activities regulates activities of non-bank financial institutions (NBFIs) The law does not differentiate requirements between company categories of ownership.

Table 16.6.3 Law on Non-Bank Financial Activities (LNBFA)

Requirements in Law on Non-Bank Financial Activities (LNBFA)		
	State-Owned Company (SOE)	**Non SOE (PPP)**
Lending Limits	♦Limit on loans & guarantees to one borrower and related parties: 30% of paid-in capital. ♦Limit on loans & guarantees to one shareholder, board member or executive officer: - Total for one person: 10% of paid-in capital - Aggregate sum for all such persons: 25% of paid-in capital ♦Limit on aggregate guarantees issued by NBFI: 70% of paid-in capital.	
Prudential ratios to be set by FRC	"Prudential ratios on (1) reserve fund, (2) liquidity, (3) capital adequacy, (4) loan loss provisioning, (5) foreign currency exposure and (6) other criteria shall comply with requirements set by FRC."	
Accounting	Accounting standards set by Bank of Mongolia in accordance with international standards	
Financial reporting cycle	Annually and Quarterly	
External Audit	"NBFI shall have financial statements audited by an auditing institution / auditor."	
Internal Audit	"Charter of company engaging NBFI activities shall include regulation of internal audit."	
Regulatory supervision	Financial Regulatory Commission (FRC)	

Source: Law on Non-Bank Financial Activities – English translation, Government of Mongolia

(4) Requirements in Corporate Governance Code of Mongolia

Corporate Governance Code is a regulation issued by Financial Regulatory Commission. It is directly applicable to joint stock companies or listed companies.

Table 16.6.4 Corporate Governance Code [Financial Regulatory Commission: Revised 2014]

Corporate Governance Code [Financial Regulatory Commission: Revised 2014] Corporate Governance Code issued by FRC is targeted at Joint Stock Companies and "can also be used by LLCs & other legal persons."	
Number of Directors	No specific requirements.
Independent Directors	Sufficient number of independent directors - **No less than 1/3**. **Board chair** should be an independent director.
Board Committees	The company may have the following committees: - **Remuneration & Nomination Committee;** **- Auditing Committee;** **- Risk Management Committee**
Accounting & Financial Reporting	The company shall follow international financial reporting standards
External Audit	The company shall select and hire auditor of a third party auditing company, Third party auditor should be appointed by the shareholders meeting.
Internal Control and Internal Audit	The Board of Directors shall ensure reliable internal control system that certifies results of company's financial goals and implementation. The company shall have an internal auditing unit as part of the company's internal control system.

Source: Corporate Governance Code – English Translation, Government of Mongolia

16.6.2 International Best Practice of Board of Directors Structure

In addition to the laws and regulations of Mongolia, determination of the SPE's corporate governance structure was also took international best practice standards. Below is a listing of such best practice examples with a particular focus on organizing the Board of Directors.

(1) Recommended Board Committees

<u>OECD Guidelines on Corporate Governance of State-Owned Enterprises (2015 edition)</u>

Board Committees: SOE boards should consider setting up specialised committees, comprised of independent and qualified members, particularly in respect to:

1) AUDIT
2) RISK MANAGEMENT
3) REMUNERATION

<u>G20 / OECD Principles of Corporate Governance (Sep 2015)</u>

Board Committees: Boards should consider setting up specialised committees, particularly in respect to:

1) AUDIT, and depending upon the company's size and risk profile
2) RISK MANAGEMENT
3) REMUNERATION

<u>Company Law of Japan</u>

Company Law of Japan requires large companies to select from two alternatives of governing structure: (a) maintain Statutory Auditors (3 auditors); or otherwise (b) establish 3 board committees comprising:

1) Nomination Committee
2) Audit Committee
3) Remuneration Committee

(2) Recommended Qualification Criteria for Board of Directors

<u>BIS: Corporate Governance Principles for Banks (July 2015)</u>

BIS's Corporate Governance Principles for Banks draws basic concepts from OECD's *Principles of Corporate Governance*. The BIS's *Principles* are generally applicable also to non-bank financial institutions. Below is a guidance summary from its section regarding qualification criteria of the board of directors.

■ Director selection criteria context:

Director candidates should:

i) possess the knowledge, skills, experience and, particularly in the case of non-executive directors, independence of mind given their responsibilities on the board and in the light of the bank's business and risk profile.
ii) have a record of integrity and good repute.
iii) have sufficient time to fully carry out their responsibilities.
iv) have the ability to promote a smooth interaction between board members.

■ Collective suitability of the board:

- Board members should have a range of knowledge and experience in relevant areas and have varied backgrounds to promote diversity of views. Relevant areas of competence may include capital markets, financial analysis, financial stability issues, financial regulation, corporate governance and management skills.
- The board collectively should have a reasonable understanding of local, regional and, if appropriate, global economic and market forces and of the legal and regulatory environment.
- Individual board members' attitude should facilitate communication, collaboration and critical debate in the decision-making process.

16.6.3 Notes on CEO and Board Membership

Chief Executive Officer (CEO) is the head of executive management. (This position is called Executive Director in the Company Law). The SPE's CEO will be also a director on the board. The rationale for the dual assignment of the CEO is as follows.

Pros:

- Constructive and effective working relationship between the board and the management is easier to be established with the CEO belonging to the both teams.
- The board's decision-making of oversight and guidance can be better handled with the inputs of hands-on business management information from the management. The board's guidance can be more effectively implemented by the management with the CEO's board-management interlock position.

Cons:

- The board's roles of oversight and supervision can be weakened if the CEO on the board can exercise undue influence over the board's decision-making.

Overall consideration for the SPE's CEO position:

- In the practice in Mongolian companies, joint stock companies and large companies more typically have the CEO's dual position on the board and the management, while smaller company CEOs typically do not have a board seat. In the case of the SPE, the complexity of the governance tasks makes it more appropriate for the SPE to have the CEO's dual seat on the board and management, in spite of the company's small organization size. The board's constructive relationship with the management enables the SPE to effectively work towards the government's development goals of SMEs and EP while being duly protected from political influence at the implementation level.
- To address the concern of the CEO's exercising undue influence over the board's decision-making, the CEO should not be allowed to be a voting member of the Board Committees of the SPE Board, which is in conformity with the best practice of corporate governance.

Chapter 17 Next Steps of SPE Establishment and Operation

The next steps of SPE establishment are as follows:

17.1 Cabinet Approval

The first step of SPE establishment is the Cabinet resolution. On April 3, 2018, the Finance Minister signed a draft of application for cabinet resolution and the draft was submitted to related ministries for their comments. The draft was also send to JICA. MOF plans to obtain a general approval on SPE establishment and authority to decide details and implement establishment procedures by Cabinet's resolution. MOF considers that they will receive the comments from related ministries by the middle of April 2018 and immediately submit the application for Cabinet resolution to the Cabinet. It is expected that the Cabinet will issue the resolution within one month after the application submission.

17.2 Establishment of SPE

The establishment procedures after the Cabinet resolution has three tasks.

- The first task is the legal procedure of LLC incorporation and acquisition of a license of non-banking financial institution.
- The second task is organization building. This includes the clarification of role of the Board, the nomination and selection of board members, the selection of committee members (the Nomination and Remuneration Committee, the Finance and Audit Committee, and the Investment & Risk Policy Committee are proposed in this Study), and recruitment of CEO and senior officers.
- The third task is the formulation of business plan and various regulations of SPE management including standard operating procedures (SOPs), code of conduct and pay regulation.

SPE can be established only after the completion of these tasks. At first, shareholders are decided, and a shareholder agreement is signed by them. Then, board members are decided, and they select CEO and senior officers. The shareholders agree a company charter, incorporate a LLC and make a company registration. Then, the LLC receives a license of non-banking financial institution and start the operation of financial activities.

The above-mentioned establishment procedures are usually implemented by founders (shareholders). Similarly, MOF, one of the major shareholders, is expected to lead the SPE establishment in consultation with the private shareholders (probably the Mongolian Bankers Association).

The roadmap of major events related to SPE establishment is as shown in the following Table (refer to Annex 4).

Table 17.2.1 Major Events Related to SPE Establishment

No.	Major events	Date	Time needed
1.	Consultation with related ministries and request for concurrence of JICA	Late March or early April, 2018	2 weeks
2.	Cabinet resolution	April or early May, 2018	n/a
3.	Preparation work of SPE Establishment	May - June, 2018	1 - 2 months
	Note: Closure of TSL Office and Completion of JICA T/A	End of May, 2018	
4.	Company registration	June - July, 2018	1 month
5.	Acquisition of NBFI operational license	July - August, 2018	1 month
6.	Start of operation as NBFI	September, 2018	n/a
7.	Transfer of TSL revolving fund	October, 2018	n/a
8.	Start of technical assistance from JICA	October, 2018	n/a
9	Start of Phase III of TSL Project	2020	n/a

Source: JICA Expert Team

17.3 Issues after SPE establishment

An important issue just after SPE establishment is a transfer of government assets, RV/F, to SPE. SPE will issue preferred shares of same amount to the Government. This transfer process should be smoothly implemented strictly according to prescribed procedures of the Government and relevant laws and regulation.

The construction of accounting system of SPE is also an issue because the accounting system of SPE should be based on corporate accounting instead of the existing public accounting.

The formulation of regulations of SPE management during the SPE establishment process only covers urgent essential regulations. Even after the start of operation, SPE should continue the preparation of legal documents, internal regulations and document formats required for LLC and NBFI.

17.4 Necessity of Technical Assistance to SPE

When the Cabinet resolution is passed in April 2018, the SPE establishment procedures can be started in May. It is considered that the establishment procedures, organizational building, selection of personnel and preparation regulations, are not easy tasks.

Technical assistance (T/A) on the management of SPE is considered necessary after the start of operation. Especially T/A on corporate governance is needed because SPE is the first case of financial institution based on PPP model.

At the early stage of operation, the Board and management of SPE should undertake a task of organizational development that is required for responsible non-banking financial institutions. This includes issues of how to realize functional Board and special committees, responsibilities and accountabilities, principles for major activities and regulations for internal control.

Under the above circumstance, SPE that possesses no experience of financial activities needs T/A by experienced outsider experts to implement organizational development.

The major areas of TA may include:

1) Establishment of management of financial institution
    - Organizational design and institutional building
    - Establishment of corporate governance and internal control mechanism
    - Design of work flows and preparation of SOPs
    - Business planning and accounting system
    - Capacity development on the above issues
2) Loan management and business development
    - Establishment of loan policies and loan management team
    - Capacity development on loan screening and loan management
    - Capacity development on PFI guidance
    - Capacity development on SME guidance
    - Capacity development on TSL promotion
    - Capacity development on economic and financial trend analysis
3) Financial management
    - Establishment of financial management policy:
        - Planning, monitoring and management of cash flows of assets and liabilities & capital

- Process of business & financial planning, monitoring and remedial action

- Establishment of implementation mechanism and discipline of the above

4) Risk management system
   - Establishment of risk management policy and organization
   - Establishment of credit risk monitoring mechanism
   - Capacity development on risk management

5) Document management
   - Establishment of corporate disclosure policies and organization
   - Capacity development on reporting
   - Capacity development on internal document management
   - Capacity development of customer information management

6) IT system
   - Formulation of IT system policy and plan
   - Establishment of database of TSL management
   - Establishment of IT system for management such as accounting and personnel management
   - Enhancement of website management

The monitoring standards and legal requirements for SPE may be moderate compared with those for commercial banks that accept deposits. However, it is recommended that SPE should establish the corporate governance and management of high standard (refer to Chapter 16 for details of corporate governance of SPE).

Since PFIs have sufficient experience of financial business, they can be a source of T/A, especially on business flows, SOPs, reporting to FRC, document management and IT system.

On the other hand, T/A by local and/or foreign outside experts is desirable for issues such as corporate governance, management discipline and independence from political intervention.

Part 4:

Plan of TSL Phase III

Chapter 18 Projection of Financial Demand for Small and Medium Enterprises

18.1 Approach Used for the Projection of Demand for SME Loan

This Chapter will present a projection of the demand of small and medium enterprises (SMEs) for financing capital investment in Mongolia. The SME's financial demand for the Phase III period (4 years covering the period 2020 - 2023) is projected in the following steps as illustrated in Figure 18.1.3.

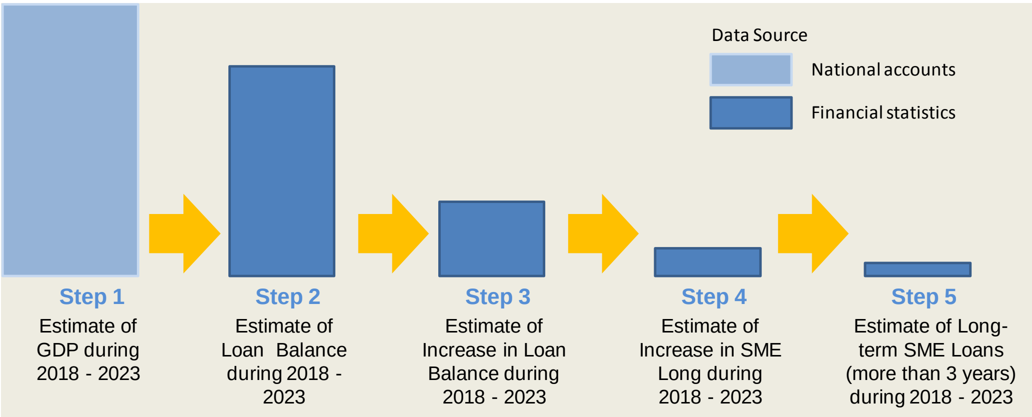
Step 1: Projection of GDP during the Phase III period

Step 2: Projection of loan balance during the Phase III period

Step 3: Projection of increase in loan balance during the Phase III period

Step 4: Projection of increase in SME loan balance during the Phase III period

Step 5: Projection of increase in long-term SME loan balance during the Phase III period



Source: JICA Expert Team

Figure 18.1.1 Steps for Projection

18.2 Estimate of GDP during the Phase III Period

For estimation of nominal GDP during Phase III, this study uses the projection made in "IMF Country Report No. 18/98 Mongolia Staff Report for the Third Review Under the Extended Fund Facility Press Release; Staff Report; and Statement by the Executive Director for Mongolia." The projection of nominal GDP is as shown in the following table.

Table 18.2.1 GDP Projection for the Phase III Period

	Actual				Projection					
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
GDP (Billion MNT)	22,227	23,150	23,936	27,167	30,662	34,383	38,014	42,291	48,205	54,174

Note: Data of the National Statistics Office of Mongolia for the figures of 2014 - 2017. IMF's projection for the figures of 2018 - 2023.

Source: National Statistical Office of Mongolia, IMF "IMF Country Report No. 18/98," April 2018

18.3 Projection of Loan Balance during the Phase III Period

Correlation between GDP and Bank Loans Outstanding

Economic production activities (supply side of the economy) is supported by financing by the financial sector. There is a correlation between the size of economy and the development of financial sector. The following table shows recent GDP data and bank loan balance.

The correlation between GDP at current prices and banks' loan balance as of the end of year is calculated for the period 2005 - 2017 based on the data in the Table below.

Table 18.3.1 Nominal GDP and Outstanding of Bank Loans (Billion MNT)

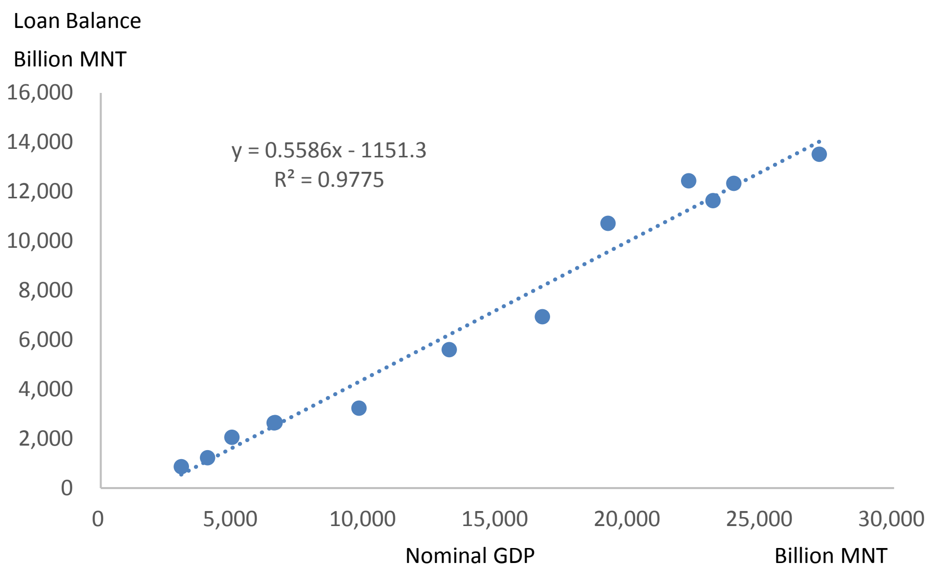
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
GDP	3,041	4,028	4,957	6,556	6,591	9,757	13,174	16,688	19,174	22,227	23,150	23,936	27,167
Loan Balance	859	1,222	2,055	2,635	2,655	3,228	5,598	6,941	10,716	12,441	11,634	12,338	13,512

Source: National Statistical Office of Mongolia, Bank of Mongolia

Regression analysis to identify the correlation between GDP and bank loan balance in Mongolia is conducted. The liner regression formula is as follows:

Loan Balance (Billion MNT) = 0.5586 x Nominal GDP (Billion MNT) - 1,151.3

The coefficient of correlation (R2) is 0.98. Thus, there is a strong correlation between nominal GDP and banks' loan balance.



Source: JICA Expert Team

Figure 18.3.1 Correlation between GDP and Bank Loan Balance

Projection of Bank Loan Balance during Phase III Period

Bank loan balance was projected using the regression formula and economic forecast during the Phase III period. The following table shows the result of the projection of bank loan balance.

Table 18.3.2 Projection of Long-term SME Loan during Phase III (Billion MNT)

	Actual				Projection					
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
GDP	22,227	23,150	23,936	27,167	30,662	34,383	38,014	42,291	48,205	54,174
Loan Balance	12,441	11,634	12,338	13,512	15,976	18,055	20,083	22,472	25,776	29,110

Source: Bank of Mongolia, National Statistical Office of Mongolia, IMF "IMF Country Report No. 18/98," April 2018

18.4 Projection of Increase of SME Loan Balance during the Phase 3 Period

Estimate of Ratio of SME Loans to Total Loans

Total balance of bank loans can be classified into public loans, private loans, financial loans, individual loans and other loans. Individual loan consists of mortgage loan, SME loan, consumer loan, salary loan, pension loan and other individual loan. The outstanding amounts of bank loans by type of loan as of the end of 2017 are as shown in the following table.

Table 18.4.1 Outstanding Bank Loans

Type of Loan		Amount (Million MNT)	Share (%)
Public Loan		41.0	0.3
Private Loan		6,806.1	50.4
	SME Loan	1,661.5	12.3
	Other Private Loan	5,144.6	38.1
Financial Loan		45.9	0.3
Individual Loan		6,608.2	48.9
	SME Loan	808.5	6.0
	Other Individual Loan	5,662.7	41.9
Other Loan		5.2	0.0
Errors and Omissions		5.4	0.0
Total		13,511.9	100.0
Reference:			
Total SME Loan		2,470.1	18.3
TSL		137.0	1.0

Note: As of the end of December 2017.
Source: Bank of Mongolia

The ratio of SME loans to total loan has tended to remain between 16% and 19%. It is assumed that the ratio of SME loans to total loans will be at 18.0% during the Phase III period. This assumption is based on the prospect that the economic recovery will lead to stronger demand for SME loans. The ratio of long-term loans to total loans is assumed to remain at the current level even though the ratio has been steadily increasing.

Table 18.4.2 Ratio of SME Loans to Total Loans

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Loans (Billion MNT)	2,635	2,655	3,228	5,598	6,941	10,716	12,441	11,634	12,338	13,512
SME Loans (Billion MNT)	505	483	625	1,043	1,189	1,805	2,176	2,049	1,980	2,470
Ratio of SME Loans to Total (%)	19.1%	18.2%	19.4%	18.6%	17.1%	16.8%	17.5%	17.6%	16.0%	18.3%

Note: As of the end of each year.
Source: Bank of Mongolia

Estimate of Ratio of Long-term Loans to Total Loans

In this projection, data of private loan by maturity are used for estimation of share of long-term loan in total loan because it is assumed that the composition of private loans represents the trend of business loans. TSL targets to provide business loans to SMEs. The composition of private loans by maturity is as shown in the following Table.

Table 18.4.3 Composition of Private Loans Classified as Standard by Maturity

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Loans up to 1 Year	71%	53%	44%	44%	36%	28%	22%	28%	25%	17%	15%	18%	19%
Loans of 1 - 5 Years	27%	45%	52%	53%	54%	66%	71%	65%	68%	75%	73%	72%	67%
Loans of 5 years and more	2%	1%	3%	4%	10%	6%	7%	8%	7%	8%	11%	10%	13%
Estimate of Loans of 3 years and more	11%	17%	21%	21%	28%	28%	30%	29%	30%	33%	36%	34%	36%

Note: As of the end of each year.
Source: Bank of Mongolia

It is assumed that the ratio of long-term loans to total loans will be 30% from the data of loans for 1 - 5 years and loans of 5 years and more in the above table.

With the purpose of checking the appropriateness of the above assumption, incremental bank loan balance to finance an increase in private fixed capital formation is estimated. From the past trend, IMF’s projection of gross capital formation until 2023 is used as base data of estimation. The share of gross fixed capital formation is assumed to be 70% from the recent trend. It is also assumed that private investors finance 60% of capital investments with bank loans. As the result of estimation, incremental amount of loan balance for increased private fixed capital formation is equivalent to 34% of the increase in total loan balance for 2020 - 2023. In other words, one third of demand for additional loans is considered for capital investment and this ratio is higher than the above assumption of 30%. It is also expected that a considerable part of capital investment will be made by foreign investors. Therefore, it is regarded that the above assumption of 30%, lower than 34%, is appropriate.

Table 18.4.4 Estimate of Demand of Additional Loans for Incremental Capital Investment

	2018	2019	2020	2021	2022	2023
GDP	30,662	34,383	38,014	42,291	48,205	54,174
Loan Balance	15,976	18,055	20,083	22,472	25,776	29,110
Net Increase in Loan Balance (A)	2,465	2,079	2,028	2,389	3,304	3,334
Gross Capital Formation (Private)	9,751	12,412	14,369	16,324	18,655	21,074
Increase in Private Gross Capital Formation （B）	1,111	2,662	1,957	1,955	2,331	2,418
Increase in Private Gross Fixed Capital formation (Bx70％)（C）	778	1,863	1,370	1,369	1,632	1,693
Increase in Borrowing for Gross Fixed Capital Formation（Cx60％）（D）	467	1,118	822	821	979	1,016
Ratio of Additional Capital Investment Loan to Additional Total Loan (D/A)	19%	54%	41%	34%	30%	30%

Source: Bank of Mongolia、National Statistical Office of Mongolia, IMF “IMF Country Report No. 18/98,” April 2018

<u>Estimate of New Demand of SMEs for Long-term Loans during Phase III Period</u>

New demand is defined as the net increase in loan balance (= the outstanding at the end of year minus the outstanding at the beginning of year). The difference of outstanding between the beginning of year and the end of year can be broken down into the difference between issuance of loan issued and loan repaid during the year. This difference must be financed by new bank funding.

With the above assumptions, new demand for long-term SME loans during Phase III period is estimated as shown in the following table. At first, new demand for bank loans is calculated, then new demand for SME loans is estimated from that figure, and finally new demand for long-term SME loans is estimated based on the estimated new demand for SME loans.

Table 18.4.5 Projection of Long-term SME Loans during Phase III (Billion MNT)

	Actual				Projection					
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Loan Balance (Billion MNT)	12,441	11,634	12,338	13,512	15,976	18,055	20,083	22,472	25,776	29,110
Net Increase in Loan Balance (Billion MNT)	1,725	-807	704	1,174	2,465	2,079	2,028	2,389	3,304	3,334
Ratio of SME Loan to Total Loan (%)	17.5	17.6	16.0	18.3	18.0	18.0	18.0	18.0	18.0	18.0
SME Loan Balance (Billion MNT)	2,176	2,049	1,980	2,470	2,876	3,250	3,615	4,045	4,640	5,240
Net Increase in SME Loan Balance (Billion MNT)	72	-127	-69	490	406	374	365	430	595	600
Ratio of Long-term Loan to Total Loan (%)	33	36	34	36	35	35	35	35	35	35
Net Increase of Long-term SME Loan Balance (Billion MNT)					122	112	110	129	178	180

Source: Bank of Mongolia, IMF "IMF Country Report No. 18/98," April 2018

18.5 Projected SME Loan Balance during the Phase III Period

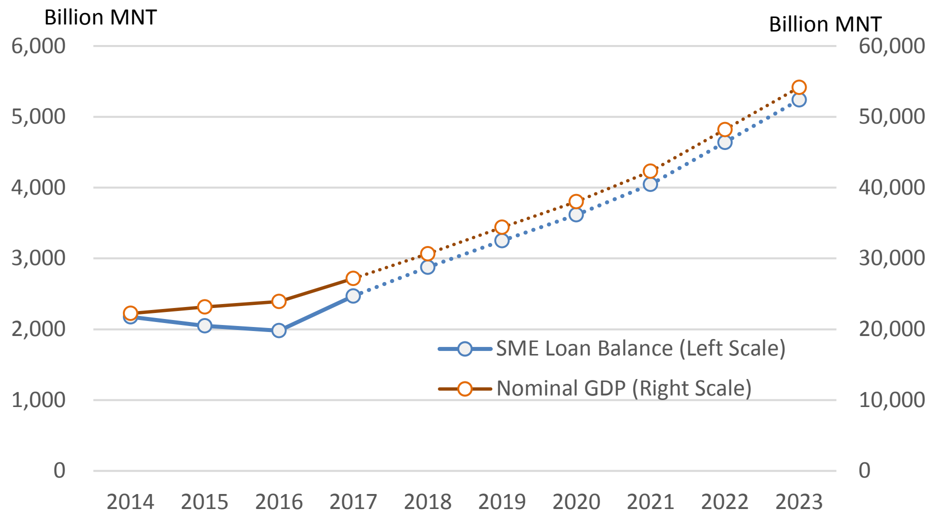
During the period 2020 - 2023, it is estimated that there will be a demand of MNT 597 billion for incremental long-term loans for SMEs. The projected figure is considered conservative. In consideration of the current constraints of high interest rate for SMEs and maturity mismatch for banks, actual demand for long-term SME loan is estimated to be much higher than actual loans realized.

Table 18.5.1 Projected SME Loan Balance during the Period

Unit: Billion MNT

	2020	2021	2022	2023	Total
SME Loan Balance	3,615	4,045	4,640	5,240	
Net Increase in SME Loan Balance (New demand for SME loans)	365	430	595	600	1,990
Net Increase of Long-term SME Loan Balance (New demand for long-term SME loans)	122	112	110	129	597

Source: JCIA Expert Team



Source: JICA Expert Team

Figure 18.5.1 Projected SME Loan Balance

Chapter 19 Preparatory Analysis of TSL for SMEs under Phase III

19.1 Executing Agency (E/A) of TSL Project Phase III

Although GOM has been strongly requesting to JICA to launch Phase III of TSL Project just after Phase II was terminated, budget support and economic stability is deemed to be more important in current economic situation in Mongolia. On the other hand, there is an agreement between GOM and JICA that an independent financial institution called SPE is to be established as the executing agency (E/A) of TSL Project in place of GOM in order to keep sustainability of TSL project Thus, the borrower for Phase III shall be MOF on behalf of GOM, and E/A shall be SPE.

19.2 Proposed Project Scale of TSL Project Phase III for SMEs

The economic growth rate of Mongolia dropped to 1.4% in 2016, however, it is forecasted that Mongolia's economy will recover in the coming years. The financial demand by SME for capital investment is predicted to increase during the Phase III period keeping pace with the economic growth. It is also expected that the banking sector will be strengthened with BOM's policies. The capacity of commercial banks has been enhanced because of the expansion of branch network and improved capacity of credit analysis

Hence, the loan amount of TSL Phase III is proposed at JPY 10 billion (including Environmental Protection Loan (EPL): JPY 1 billion).

19.3 Review of Terms and Conditions

19.3.1 Sub-loan Borrowers

The sub-loan borrowers should be SMEs registered with the state or local government agency concerned, as well as the General Department of National Taxation (GDNT), paying corporate taxes in preferential tax rate of 10% for SMEs. This is in accordance with the Law on Corporate Income Tax which came into force on June 29, 2006.

During the implementation of TSL Phases I and II, an issue has been raised from time to time wether the educational institutions, as they are entitled to be exempted from any tax payment, are eligible or not. It is well understood that education is essential for economic development as capacity building of people, and one project was approved on this basis. But this project involved only the construction of a dormitory and a gym which has nothing to do with productivity enhancement. Subsequently, the Counterpart Steering Committee (CSC) has always rejected such applications from educational institutions including kindergartens except for vocational training offered by private companies.

The SME Law has been applied to decide whether the applicant is SME or not. The law defines SMEs in terms of the number of employees and annual turnover as follows:

- For industries other than services, the number of employees should not be more than 199 and annual turnover should be up to MNT 1.5 billion.
- For service industries, the number of employees should not be more than 49 and annual turnover should be up to MNT 1.0 billion.

Considering the fact that the current law was ratified in 2007, which is more than ten years ago, Ministry of Food, Agriculture and Light Industry (MOFALI) is working on its revision. In this regard, PFIs mainly requested for the annulment of the provision on sales turnover, which seems reasonable considering recent economic expansion. It is recommended therefore to review the definition of SME, particularly on the annual sales turnover for eligibility requirement of sub-borrowers. CSC intend to revise the restrictions on annual sales turnover with reference to the inflation rate in the country.

The other eligibility criteria for the sub-borrowers, to which TSL Phase III will provide, are basically the same as those applied in Phases I and II as follows:

- Majority are privately-owned by Mongolians
- Debt service coverage (net income/debt service): 1.3~
- Loan/Project Cost: ~80%
- Financial internal rate of return (FIRR): 13%~
- No previous defaults

As for medical services or social services, it is desirable to apply conditions of borrowers with flexibility and assess a proposal on a case-by-case basis.

19.3.2 Subproject Sector

The sectors of potential sub-borrowers are generally classified into the following: i) agriculture; ii) mining; iii) manufacturing; iv) construction; v) trade; and vi) services. In TSL Phases I and II, mining, construction, and trade sectors are excluded from eligible sectors, although any type of business needs capital investment in fixed assets. Exclusion of mining may be justifiable in view of the 70%–80% of FDI flowing into this sector. Exclusion of construction and trade may also be justified because their major fund requirement is for the short term which banks are delighted to provide, although they also need fixed assets investment to some extent. In this context, it is recommended to maintain the same negative list for eligible sectors for the TSL Project phase III

The proposed negative list is presented below.

- Loans for trade services (wholesale and retail trade, except repair services)
- Loans for entertainment business that is harmful to the society
- Loans for real estate activities, including construction of buildings
- Loans for environmentally-damaging projects
- Loans for refinancing, except bridge loans with sales/contract attached
- Loans for military activities
- Loans for financial and insurance activities

TSL Phase III is proposed to put its emphasis on the government policy of priority sectors and key industries in a value chain. The subprojects to be prioritized at present are the followings which are for export-oriented or import-substitution.

<u>Priority sectors in the current government policy:</u>

- Agriculture for import substitution
- Food processing industry for export/import substitution
- Apparel industry for export promotion

<u>Other key industries in a value chain:</u>

- Livestock
- Textile industry
- Manufacturing of construction materials
- Transport/freight service
- Packaging industry

19.3.3 Use of the Proceeds of Sub-loan

As well as TSL Phases I and II, Phase III shall be designed to promote SMEs in Mongolia through providing sub-loans to SMEs on capital investment for their facilities and equipment. The ODA loan is proposed to finance mainly machinery and equipment to be purchased by SMEs in priority industries. Refinancing will not be allowed except a bridge loan to start the project before the TSL sub-loan is approved.

Besides, land and buildings should be covered by own fund not by TSL sub-loan. However, buildings like factories which are directly used for production purpose could be applied for sub-loans, exceptionally.

On the other hand, working capital financing is not acceptable in Phase III as well in principle. Again, it is understood that most of the working capital requirements are in the short term and in local currency, which banks would always be delighted to finance. However, some cases may require working capital in foreign currency such as raw materials that are available only through importing. Such cases may be considered acceptable in receiving the JICA loan.

19.4 Proposed Terms and Conditions

19.4.1 Sub-loan Amount

TSL Phase I was instituted for a minimum amount of USD 10,000 (or MNT equivalent) and a maximum of USD 600,000 (or MNT equivalent). The actual minimum sub-loan disbursed was MNT 12 million (USD 10,000 equivalent) in TSL Phase I and MNT 24 million (USD 17,000 equivalent) in TSL Phase II. On the other hand, the maximum was USD 600,000 both in TSL Phases I and II (except for one bigger EPL project in Phase II).

Given that Mongolian economy has expanded, the minimum and maximum limits to sub-loan amount of TSL Phase III are proposed to be instituted as follows:

- Minimum sub-loan amount: USD 10,000 or MNT equivalent
- Maximum sub-loan amount: USD 1,000,000 or MNT equivalent

The following considerations are given to formulate the above proposal for the revision of the maximum amount of sub-loan:

- Potential trend of economic growth: 5.9 times larger over the past decade
- Strong demand of SMEs for term loan in a wider range of loan amount[1]

Requirement for the introduction of advanced technology. On the other hand, it is necessary to consider how to segregate TSL sub-loans from microfinance, and also the minimum cost needed by PFIs for loan operation and transaction. To conclude, USD 10,000 would be appropriate amount as the minimum loan at present.

19.4.2 Loan-to-Own Capital Ratio

Necessary capital contribution from SMEs is estimated at 20% of the total project cost and PFIs are generally reluctant to ease the current condition. They consider that 20% of their contribution is minimum to let them have a strong sense of responsibility as the owner of the project.

[1] According SAPI-2 Report, 24 SMEs out of 150 respondents requested for the JICA loan exceeding USD 600,000 through the SME Survey conducted during SAPI-2.

19.4.3 Term and Grace Period of Sub-loan

Although a larger size of sub-loans is proposed for TSL Phase III, the term of sub-loan is proposed to be set at three to ten years with the following grace period.

Table 19.4.1 Proposed Term and Grace Period of Sub-loan in TSL Phase III

Term of Loan	Grace Period
3 years	Up to 1 year
3-5 years	Up to 2 years
5-10 years	Up to 3 years

Source: SAPI-2 Report

It is considered that the lending term of 10 years is sufficient for SME projects regardless of project size. In fact, most of the cases requested for rescheduling were for production of construction materials. Such requests were received right after the so-called “Lehman Shock”. Their requests were up to 8 years only, well within the 10-year term. In addition, if the use of loan proceeds are restricted to machinery and equipment only, the depreciation period (usually considered as the life of the item) for such items is set at10 years in Mongolia, which also justifies the maximum loan tenure of 10 years.

19.4.4 Interest rate of Sub-loan

Since the prime purpose of TSL Projects is to foster SMEs through improving financial access on their business, the interest rate of sub-loans should be defined based on the market rate. There is no long-term loans in Mongolia so far; therefore, the interest rate of sub-loans in TSL Projects tends to be a sort of benchmark in Mongolia among financial projects assisted by other Donors. SME development fund provided by GOM is also apply a similar level of the interest.

Currently the interest rate of sub-loans is set at 8.0% in MNT, and 5.8% in USD. The interest of on-lending loans from GOM to PFIs is set at 4.0% and 2.29% respectively to which added PFIs margins (4% in MNT, 3.49% in USD) for banks. In Phase III, cost/ margin of SPE as new E/A should be counted and on-lending interest to PFIs is estimated at 6-7% including risk hedge fee for exchange risk and credit risk of PFIs, therefore aggregated cost of sub-loan becomes about 11%.

Despite of the limited margin, the reasons why PFIs expect to launch TSL Phase III are as follows: i) plenty amount of loans, ii) stable supply of funds, and iii) discretion in project selection, loan amount, and loan conditions.

To set interest rate of sub-loans for TSL Phase III, it is necessary to bear the following issues in mind.

- Consistency with the market rate of interest is also necessary to be concerned. The market rate in Mongolia hovers at a high 20%. Although GOM has been placing emphasis on this issue and trying to downward it, there is no progress so far. Under such situation, GOM expects TSL Phase III as a significant fund sources. In this connection, to set the interest rate of sub-loan in what level would be a crucial issue in Phase III.
- It is essential to continuously support PFIs. Banks in Mongolia have suffered weakened financial basis during recent economic recession seriously. Regarding such situation, IMF sets conditions for reinforcement of financial basis of banks to provide an extended fund facility (EFF) to Mongolia. Under the current situation, it is inevitable to discuss raising PFI’s margin rate.

Considering above issues, it is assumed that the appropriate interest rate could be examined in the range of 11% (interest rate of on-lending loan 7% + PFI margin 4%) per annum for TSL Phase III.

19.4.5 Collaterals

While sub-loans under TSL also need to be secured as per PFIs’ internal regulation because PFIs take full credit risks of sub-borrowers, availability of collaterals is generally very limited. Although it is up to PFIs to evaluate and decide on what to hold for security, basically they hold collateral on properties. In addition, most PFIs accept machinery and equipment for production as collaterals Also, a few PFIs are partially secured by accounts receivable and stocks of raw materials and products.

Other alternatives could be utilizing the credit guarantee fund (CGF) and leasing. According to SAPI-2 Report, close coordination with CGF was recommended. Leasing is a small but growing sector in Mongolia, where it represents an important alternative to bank lending for SMEs in need of vehicles and equipment. Among PFIs, Xac ban and TDB are active in leasing. It is generally observed that leasing is one of the effective solutions for SMEs lacking collateral for bank borrowing. However, leasing activities in Mongolia are still immature and inappropriate to be incorporated as a component or an eligible sector of the TSL Project.

19.5 Proposed Co-financing Scheme with PFI's Own Fund

19.5.1 Background

As discussed in the above, financing supply has not met SME's increasing financing demand. In this regard, it is proposed to establish a co-financing scheme in which PFIs provide TSL loan with loan from their own fund (PFI loan). This scheme is recognized as beneficial for the following reasons:

- As more money would flow into the market, more SMEs would be able to receive funds
- PFIs would increase their profit by utilizing their own funds more efficiently
- PFIs can enhance its project analysis capacity, resulting in reduced moral hazard

19.5.2 Proposed Design for Co-financing Scheme

Basic features of the proposed scheme are as follows:

1) Proportion of co-financing loan: 80% from TSL and 20% from PFI loan.

2) Interest rate of the PFI's portion is determined by the PFI.

   PFI can apply their own interest rate to their own portion (20%). Therefore, interest rate of the sub-loan is to be calculated by the weighted-average of the TSL and PFI loan, which will be slightly higher than TSL Phases I and II. This benefits PFIs by increasing its margin. Although this scheme might result in causing the difference in sub-loan interest rate for each PFI, completion principal is expected to limit the difference to stay within 1%. This would, therefore, not widen the disparity among the PFIs.

3) Preferential treatment in the repayment period to the PFI loan is applied.

   Given that most of PFI's financial sources are still short-term, repayment of the PFI loan would be made preferentially. PFIs would have to deal the loan for four years at longest in order to avoid mismatch between funding and financing.

4) PFIs owe SME risk, the same as in Phases I and II.

5) The co-financing scheme shall be applied for all sub-loans.

6) Government's Position

   The JICA Study Team consulted MOF as well as BOM and heard that co-financing is a very appropriate scheme for the Mongolian economy.

7) PFIs' Position

   The JICA Expert Team conducted a questionnaire survey to all the seven PFIs and followed up the survey with face-to-face interviews. This survey proved PFIs' positive intention that they are in favor of co-financing as long as above mentioned, items 1)-6) are conditioned satisfactorily.

19.5.3 Improvement of Loan Administration in TSL Project

At present, the number of TSL project is counted more than 750 projects and would be double if Phase III is realized. They are scattered in the rural area and therefore loan administration of these project loan requires a lot of resources.

As a more basic requirement for project operation to ensure repayment of principal and payment of interest as scheduled, SPE shall issue invoices to PFIs for receivable principal and interest for all the outstanding on-lending loans every month. The JICA Expert Team recommends a management information system to accommodate such function: i.e., preparing invoice for repayment of principal and payment of interest.

SPE will have to adopt a corporate accounting system on which financial statements will have to be prepared. Financial management system based on the accounting system should be also introduced. SPE shall launch its operation from the beginning of 2018. At the initial period, SPE shall take over RV/F from TSL Phase I and II, and focus on its operation. SPE shall expand its operation to TSL Phase III as E/A when Phase III is realized.

Chapter 20 Preparatory Analysis of TSL for Environment Protection under Phase III

20.1 Relevance of the Environmental Protection Loan (EPL)

20.1.1 Background

In Mongolia, Government of Mongolia (GOM) has introduced market economy since the early 1990s and promoted economic growth and poverty reduction which driven from the private sector development. As the environmental policy, a balanced environment and sustainable regional development are defined as prioritized areas in the Economic Growth Support and Poverty Reduction Strategy (EGSPRS). Also, green development, especially renewable energy development, is centrally focused in the action plans. Furthermore, GOM has strengthened legal system on environment by restructuring laws and regulations which messed up after 1990s by having many similar laws and regulations.

Air pollution has been an urgent problem to be eased, particularly in Ulaanbaatar. The Government of Mongolia (GOM) and international organizations/donors have so far spent more than MNT 200 billion to improve ger stoves, replace old heat only boilers (HOBs), and promote utilization of various types of energy efficient products as countermeasures against air pollution in Mongolia. The EPL component of the Two-Step Loan (TSL) is one of the pioneer cases of environmental financing in Mongolia which uses loan as an effective financial instrument for the private sector, particularly, small and medium enterprises (SMEs) to run environment-friendly businesses. Particularly, the JICA-TSL Phases I and II have responded to issues specifically related to energy consumption and air pollution, respectively.

Sustainable environmental financing for the private sector is needed to preserve the environment, particularly air quality acceptable to the world standard (World Health Organization (WHO) standard). It is vitally important to finance implementation of air pollution mitigation measures with the concessional loan. However, there appears to be short of financial resources for the implementation of environmental protection measures. It is crucial for this reason to implement TSL Phase III, targeting air pollution in Mongolia.

The obvious question raised by investors and stakeholders in green products in Mongolia is the market size and potential demand of green businesses. Recently, the study to assess the green credit market of Mongolia was conducted by the UN Partnership for Action on Green Economy (PAGE) project jointly with the Ministry of Environment and Tourism (MET) and the Mongolian Bankers Association (MBA). Mongolian Marketing Consulting Group (MMCG) LLC, the market research company, executed the study in 2016. Although the study based on the questionnaire (on expectations and opinions of business management), it is the first study to attempt to measure the market size for environment friendly and green business loans in Mongolia.

The survey found that 80% of business entities in environmental activities has demand for green credit, while only 35% of business entities in non-environmental activities expressed their interest to have green financing. Also, according to the study, the size of green credit demand over the next 5 years from 2017 to 2022 will be MNT 4.8 billion. MNT 3.9 billion of this total demand belongs to non-environmental business projects, while MNT 0.9 billion belongs to environmental business projects.

Table 20.1.1 Examples of Projects Planned by Environmental Business Entities

Main fields of activities	Projects
Forest institution	Arable farming production and services Forestry and wooden products Afforestation and remediation Equipment improvements Producing patent fuel
Implementing environment-friendly technology	Cleaning and reusing household wastewater Establishment of solar power station Industrial equipment improvements Waste recycling Agriculture, arable farming and livestock breeding
Wastewater sewerage, treatment	Improving building exploitation and services /professional consulting services/ Establishment of tree nursery Waste recycling and reusing in agriculture and production Industrial equipment improvements
Underground remediation	Tree nursery Importing plant seeds Agriculture and arable farming
Production of organic products	Planting sea buckthorns Macaroon production Vegetable cultivation Hog breeding Cosmetic production
Renewable energy production	Establishment of solar power station
Waste collection and recycling	Equipment improvements Production of pavement blocks by using waste tires Establishment of nails plant

Source: Market study on Green Credit of Mongolia 2016, executed by Mongolian Marketing Consulting Group LLC, upon request from MBA and Ministry of Environment and Tourism Mongolia.

20.1.2 JICA TSL Environmental Protection Loan

Environmental financing is provided mostly by the State budget or development aid agencies. Mongolians lack experience in implementing environmental protection measures receiving a loan. Implementation of environmental protection measures receiving a loan creates a sustainable financing source of the environmental protection. Sustainable financing is much needed to protect Mongolian environment. We are learning to undertake business-oriented environmental projects. The most important findings of EPL Phase I& II are changing people’s mind set and supporting Mongolians in undertaking business-oriented environmental projects.

(1) Classification of TSL Phase I EPL sub-projects by type of their Environmental impact

Main objective of EPLs of TSL Phase I was to support and improve business-oriented environmental projects. The breakdown of total 24 projects is as follows:

1) Category A: Greenhouse gas emission reduction/ Environmental Regulation Compliance -10 sub-projects
2) Category B: Resource and Energy Saving /3R approach –Reduce, Reuse, Recycle/- 8 sub-projects
3) Category C: Nature Protection /Environmental Awareness Approaches/- 6 sub-projects.

(2) Classification of TSL Phase II EPL sub-project by type of their Environmental impact

Main objective of EPLs of TSL Phase II was to reduce emissions of air pollutants and increase energy efficiency. The breakdown of total 48 projects is as follows:

1) Category A: Greenhouse gas emission reduction/Environmental Regulation Compliance/ Renewable energy- 13 sub-projects

2) Category B: Resource and Energy Saving /3R approach - Reduce, Reuse, Recycle/- 11 sub-projects

3) Category C: Nature Protection /Environmental Awareness Approaches/- 24 sub-projects

Difference between EPLs Phases I &II is as explained below:

1) As of July 17, 2017, the number of Environmental Protection Loan sub-projects is increased by two times.
2) There is a growing tendency that Mongolian Small & medium size company entrepreneurs started to use advanced technology in implementing EPL sub-projects.
3) Selection criteria for EPLs and role of each stakeholder in the selection procedure was clarified and it positively impacted to formulate and evaluate EPL project proposals.
4) Emissions are estimated totally using the following monitoring indicators which were provided by Environmental Guideline of EPL. For example: Electric Energy (kWh/year), Coal consumption (ton/year), Dust (ton/year), SO2 (ton/year), NOx (ton/year), CO2 reduction, CO (ton/year). The estimation provides the possibility to evaluate environmental impact.
5) EPL Phase II promotes reduction of emissions of air pollutants and energy efficiency projects. It means that Phase II is considering the most urgent issue of Mongolia and it increased the effectiveness of EPLs.

20.2 Demand and Target Areas of the TSL for EPL

20.2.1 Demand for EPL

Investment needs for EPL are identified based on the following: (i) EPL projects in TSL Phases I and II and (ii) EPL pipeline list received from the PFIs in order to grasp further demand. According to the number of EPL projects requested during Phase II, as shown in the table below, Golomt, Khan, and Xac banks often receive EPL project requests for their assessment for submission to the TSL Project Office.

Table 20.2.1 Requested and Approved Loan Amount and Number of EPL Projects*

Period	Requested Amount (JPY million)**	No. of Requests	PFIs	Approved amount (JPY million)**	No. of Approved	PFIs
2011	31.70	2	Golomt, Xac	49.72	1	Golomt
2012	263.97	23	Capital, Golomt, Khan, Xac, TDB	235.25	9	Capital, Golomt, Khan, Xac, TDB
2013	614.77	25	Capital, Golomt, Khan, Xac	286.15	25	Capital, Golomt, Khan, TDB
2014	279.20	17	Golomt, Khan	229.73	17	Golomt, Khan, TDB, Xac, Capital, UBCity
2015	218.10	6	Golomt, Khan, TDB	166.28	6	Capital, Golomt, Xac, Khan, TDB
2016	177.35	10	Capital, Golomt, Khan	162.10	10	TDB, Xac
2017	401.90	16	Capital, Golomt, Khan	191.04	7	TDB, Golomt
Total	1,986.99	99		1,320.27	75	

Note: * The information provided in the table covers only those EPLs during 2011-2017; no. of EPLs disbursed during 2007-2011 is 18 and the loan amount was JPY 263.4 million.
** Exchange rate used is BOM rate, dated Dec 31, 2017.
Source: TSL Project Office

As described in the above table, EPL projects increased from December 2011 to 2014. Due to the closure of the special account in 2015, EPL projects have been decreasing which utilize limited budget from the revolving fund (RV/F).

20.2.2 Potential EPL Subprojects

UB is suffering from both air pollution and soil contamination. It is necessary to continue EPL on air pollution but also expand to soil and water contamination.

Successful strategy to address air pollution should include a combination of short-term and long-term solutions. Short-term approach for air pollution reduction includes HOB replacement and improvement of ger stoves and clean fuel efficiency. The long-term approach will target reduction of air pollution through manufacturing of more renewable energy and energy efficient products, control of fugitive dust, and environmental business.

HOB, ger stoves, and fuels are the only short-term “emergency” measures to combat the current severe air pollution. These approaches cannot be effective in the long term as users are still dependent on raw-coal burning. In order to ensure environmental sustainability in the future, it is important to promote further renewable energy production as alternatives in the long run. Thus, renewable energy such as solar, wind, and geothermal can bring more positive impact in the future and has a good potential to bring economic returns. In order to improve the outcome of EPLs, large renewable energy projects will be required. Energy-efficient heat insulation construction materials have a huge potential to reduce air pollution and carbon emission. This type of manufacturing is fully supported by TSL throughout Phases I and II. Continuing the effort, EPL in Phase III will support not only the manufacturing of heat insulation materials, but also the promotion of cleaner production in order to reduce fuel, electric power, and wastes in order to increase energy efficiency in production.

According to the study on soil contamination from Ulaanbaatar city by 200 soil sampling in Ulaanbaatar, soil contamination is largely due to the sewage issue in the ger area. Most of the household in the ger area use pit latrines and sewage holes. Also, they release living drainage directly to land. Contaminants in soil have accumulated longer than water, air and plant life, and over many years. Mongolia has suffered from severe soil pollution for a long time.

It is recommended to expand EPL widely into the following areas:

Control of fugitive dust: One of the main air pollution sources in Ulaanbaatar is fugitive dust from roads, ash of HOBs, stoves, and power plants. Modification of paved method for roads has great impact on emission reduction. Cement manufacturers in Japan use waste recycled materials such as ash as their raw materials. Therefore, in Phase III, it is also possible to finance sub-projects for buildings or constructing concrete roads by utilizing ash and other recycled materials.

Carbon fixation: Carbon fixation is the process of capturing waste carbon dioxide (CO2) from large point sources. This aims to prevent the release of large quantities of CO2 into the atmosphere. In the case of TSL, tree planting for carbon fixation in the cities could be considered as eligible subprojects in Phase III.

Eco-toilet installation: One of issues of public sanitation and pollution is toilets in Mongolia since the sewage disposal system has not been developed. MOG has a plan but has been facing difficulties to implement it so far. Pit latrines are commonly practiced, but it seems they are not efficiently and hygienically used. To improve such situation, installing eco-toilet are able to be a sub-project in the Phase III.

Low-carbon technology: A business using low carbon and environmentally advanced technologies does not directly reduce emissions, but the business is an important activity for future outlook of the air pollution control strategy.

Environment-related Business: Environmental businesses include emission monitoring service for checking exhaust gas in compliance with the air law and the Mongolian emission standards.

20.3 Financial Demand in Protection for Air Pollution

(1) Demand for Heat Only Boiler (HOB) Replacement

Due to the Millennium Challenge Account (MCA), most privately-owned HOBs and old HOBs in Ulaanbaatar city were already replaced by boilers of good quality in the last five years.

Privately-owned HOBs occupy a substantial share, i.e., 52% of the total HOBs in Ulaanbaatar and 66% of the total HOBs in rural areas. Out of the total 389 existing HOBs throughout 19 rural provinces, privately-owned HOBs are 257 while the remaining (132) are publicly-owned. The energy efficiency of HOBs in rural areas is much lower than those in Ulaanbaatar. As a result of privatization, the conditions of HOBs were expected to be improved in terms of efficiency performance, proper maintenance, working environment, safety, and emission reduction. In general, most HOB entities have financial strains and lack of financial capacity to renovate old boilers. In particular, there is a shortage of financial resources for the renovation of boilers of thermal stations in rural provinces.

It is possible to finance high-efficiency HOBs by providing loan with low interest and favorable condition. Eligible entities are still able to be private companies and cooperatives running HOB services. In terms of HOB installation and replacement, it is necessary to expand loan eligibility to the public entities, since the private entities face the lack of mortgage.

The construction plan of Thermal Power Plant No. 5 could reduce requirements for HOB replacement in Ulaanbaatar. Demand for HOB replacements in the next stage will be expected in the rural areas rather than in Ulaanbaatar.

(2) Demand for Clean Fuel

The land and water contaminations are the most problematic and outstanding issues that cause harm for biodiversity of the nature and livelihood of the people. Potential financial demand in Mongolia for these solutions is roughly calculated.

According to Ulaanbaatar Statistical Office, as of 2015, there were about 218,665 households in Ger district of all 9 Ulaanbaatar districts, of which 205,559 households were living in Ger district at central 6 districts where air and soil pollutions are the core issues.[1] As mentioned above, the main causes for land and air contaminations are inadequate pit latrines and sewage system, and toxic chemical compound emitted from combustion of raw coal and automobile fuel. The study initiated by the Ministry of Environment and Tourism was conducted by 64 voluntary workers covering 2448 household in Ger area, of which 1003 households live in houses and the remaining 1445 in traditional ger dwelling, in 6 main districts of Ulaanbaatar.

Some results of the survey were illustrated briefly as follows:

- Very low income households stoke a fire only 1-2 times a day
- Households with relatively good income (e.g. own small and medium sized businesses, with stable jobs, etc.) stoke a fire continuously or 4-8 times a day
- SMEs operate along the main streets contribute the most for the air pollution. For example, some car and tire repair shops, garages, local eateries, and mini shops use used technical oil, old car tires and rubber as a fuel for heating
- SMEs with low pressure stove consume 2.4 - 4.8 tons of raw coal a month, that is roughly one-year consumption of an average household

The results show that the households with relatively high income and SMEs along the main streets contribute the most for the pollution.

Currently, Ulaanbaatar city households living in ger areas approximately use 1 million tons of raw coal every year. For the processed coal, the current supply of semi coking coal is only 4,000 tons, while the

[1] http://www.ubstat.mn/horoo/detail.aspx?TableID=d4c76b55-c52a-4729-a92c-3cf99ec76e1a&year=2015&view=table

demand for semi coking coal is 600,000[2] tons. Therefore, there is a great demand for manufacturing processed coals. However, production cost for such environment-effective products like semi-coke briquettes or semi coking coal is high. Since coal gasification and liquefaction plant require a substantial investment, it might be difficult for SMEs to start such environmental business by themselves. To facilitate clean fuel projects, it is recommended for TSL Phase III to remove loan ceiling and limit of company size to make SMEs challenge such project, and also large companies apply EPL to contribute environmental protection.

(3) Demand for Electric Stove

There are around 200,000 ger households using 200,000-300,000 ger stoves in Ulaanbaatar. MCA and the World Bank (WB) already replaced a total of 173,000 pieces of old high efficient Turkish stoves, however, it still stays in a little change. According to the emission monitoring data from "Capacity Development Project for Air Pollution Control in Ulaanbaatar city, Mongolia, Phase I", impact to prevent air pollution is not so strong so far. On the other hand, demand for the electric stove is increasing since GOM promote it by making free of charge during night time.

(4) Demand for energy efficient technology and control of fugitive dust

In line with the growth of construction demand throughout the country, projects on production of heat insulating construction materials have been in high demand during TSL Phase II and this trend would continue further. Additionally, to reduce fugitive dust from dust disposal center and land hazard, demand for related technologies has been increased, for example, block production made from dust, forestation to reduce dust, and so on.

20.4 Financial Demand in Protection for Land Contamination

Main sources of soil pollution in Mongolia are mining, processing plants, ger district pit latrines and sullage, solid and liquid waste and air pollution. Bacterial contamination of soil is high in urban areas, which is linked to the use over 100,000 of pit latrines and sullage of 184,000 of households live in ger districts. Mining and solid and liquid waste of aimag and soum centers is main sources of soil pollution in rural areas.

Main sources of soil pollution in Ulaanbaatar are as follow.

- *Pit latrine & sullage*
  85% of ger district household have inadequate pit latrine, 89% have insufficient sullage and sewage system.
- *Solid and liquid waste disposal*
  Approximately 210-260,000 ton of solid waste produces each year in Ulaanbaatar. Waste water treatment plant generates 190,000 m^3 of polluted water.
- *Toxic chemical compound emitted from combustion of raw coal and automobile fuel*
  Over 184,000 households live in ger district of Ulaanbaatar and approximately 3,200 entities use the heat only from boilers in the capital. Number of cars emitting pollutants as carried out by vehicle inspection is 331,564.

The importance of sanitation is vital for good health, dignity, equality and safety, as well as being a good investment for a clean environment and the benefits of improved sanitation can accelerate the achievement of MDG 7 targets in Mongolia. The sanitation situation in Mongolia is in much need of improvement. Due to pit latrines and sullage in ger districts, groundwater has been polluted which has resulted in various subsequent diseases among the population.

Companies can provide their eco-friendly improved sanitation facilities as models of alternative facilities that would be suitable in the Mongolian context and harsh winter climate. It is important to consider

[2] Demand for semi-coking coal was estimated by Air Quality Department, Ulaanbaatar Mayor's Office

simple and affordable eco-friendly sanitation options and promote partnerships with companies and factories that finance and produce soap, latrines and waste management facilities.

Financial demand in protection for land contamination

(1) Disinfection of latrine waste and sullage

Pit latrines and sullage are major cause of soil pollution in Ulaanbaatar. According to the soil pollution survey of Geography and Geoecology Institute of the Mongolian Academy of Sciences, which was held in 2014, 88% of all soil samples was contaminated by bacteria, mold and fungus and nearby large trade and service centers have been polluted largely by ammonia. A significant proportion of pollutants were heavy metals. On average, 2-10% of heavy metals are polluted more than the standard.

The amount of sulfur, ammonia or ammonia gas is higher than other gases. It causes oxidation reaction in the air and then poisonous gas spreads throughout the city. Active period of harmful effects of poisonous gas continues at least 18 months and it affects negatively people’s health. Poisonous gas can be destroyed using bio-preparation “Tamir-Em”. Disinfection of pit latrine using bio-preparation “Tamir-Em” in ger district is possible solution for the problem. “Irves intertrade” LLC produces bio-preparation “Tamir-Em” for disinfection of latrine waste on-site or after the resettlement.

(2) Eco toilet

There are over 100,000 simple pit latrines in the city and more than 80% of them do not meet the standard requirements. In order to address the overall potentiality of the market in the area of land contamination the following exercises with rough estimations were executed.

Table 20.4.1 Estimation of Financial Need for One Time Disinfection of Pit Latrines in Ulaanbaatar City

No.	Items	Amount
1	Total number of households	218,665
2	Estimated number of pit latrines in the minimum	100,000
3	Average cost of a disinfection of pit latrine using bio-preparation, USD	7.003
4	Total estimated cost for disinfection, USD	700,000

Source: Mrket study on Green Credit of Mongolia 2016, executed by Mongolian Marketing Consulting Group LLC, upon request from MBA and Ministry of Environment and Tourism Mongolia.

Table 20.4.2 Approximate calculation of financial need in introducing the new type of Eco toilet - The Ventilated Improved Pit Latrine (VIP)

No.	Items	Amount
1	Total number of households	218,665
2	Estimated number of pit latrines to renovate (at least 80% of all pit latrines)	80,000
3	Average cost of a ventilated improved pit latrine[4], USD	220
4	Total estimated cost, USD	17,600,000

Source: Market study on Green Credit of Mongolia 2016, executed by Mongolian Marketing Consulting Group LLC, upon request from MBA and Ministry of Environment and Tourism Mongolia.

Humanure compost toilet systems are based upon the recycling of human manure, urine, and other organic materials by combining the materials with a carbon-based material such as sawdust, leaves or other plant cellulose based materials. This allows the toilet material to be converted into humus via micro and macro organisms in a thermophilic composting process. Emphasis is placed upon simple, low-cost systems that are designed for specific localities.

3 The service price by TamirEm

4 Manual on Low Cost Sanitation Technologies For Ger Areas, Mongolia. Prepared by Community-led Infrastructure Development Project Management Unit of the Second Ulaanbaatar Services Improvement City of Ulaanbaatar

The Ventilated Improved Pit Latrine (VIP) and EcoSans toilet, designed for use in households and institutions in the rural and peri-urban areas. The affordability, eco-friendliness, cultural appropriateness and ease of construction and maintenance of the VIP latrine have been examined by experts.


Integrated Livelihoods Improvement and Sustainable Tourism at Khuvsgul Lake National Park Project is being implemented by ADB and Japan Fund for Poverty Reduction grants. Eco-friendly model toilet facilities are planned to be built at the Khuvsgul Lake National Park within framework of the project. Blue prints of toilet facilities have been developed and introduced to the officials of the Administration of Protected Areas of the Ministry of Environment and Tourism and Department of Clean Technology, Investment and Production. These are as follows:

i) Draw-out technology dry toilet facilities with sealed tank at public quayside in Khatgal Village

ii) Drying technology toilet facilities at public camping points and stopover points in the national park

iii) Portable dry toilet facilities with litter bin for use during public events

The offered technologies are widely used in national parks in Switzerland, Finland and USA, where also has drinking water resources. They should also comply with MNS5924:2015 standard of Mongolia.

(3) Small Scale Composting Production Facility

The introduction of environmentally friendly fertilizers using human manure, which is polluting the environment, is a significant step to reduce soil pollution. Human manure or feces will be mixed with organic waste such as sawdust, straw. The ratio will be 1:1:1 of sawdust and straw to human manure.

(4) Import of unleaded gasoline

Soil pollution reaches a disastrous level in some cities of the world. Soil is contaminated by chemicals and heavy metals in these cities due largely to metallurgical and chemical plants, while leaded petrol is discharged directly into and pollutes the environment in Mongolia. In developed countries, use of leaded gasoline was phased out.

One of the soil pollution sources is leaded petrol in Mongolia according to the soil pollution survey of Geography and Geoecology Institute of the Mongolian Academy of Sciences which was held in 2014. Generally, metal pollution was not a serious problem in the city and there was no significant evidence of infiltration of metal solutions into subsoil (at a depth of 30 cm). However, it was recently found that the arsenic (As) concentration in soil was higher than guideline value and lead (Pb) content in some samples was higher than normal. This result indicated that Pb pollution is related to vehicle emission resulting from the use of leaded gasoline. Recently, the number of used cars in Ulaanbaatar has increased sharply. Unfortunately, leaded gasoline is still being used in Mongolia, and used cars release a considerable amount of smoke containing lead (Pb) and other toxic chemicals.

The use of lead as a petrol additive has been a catastrophe for public health. Leaded petrol has caused more exposure to lead than any other source worldwide. It is required to support the import of unleaded gasoline.

(5) Solid waste sorting or classification

Separation recycling is to classify and choose garbage according to the density, size, magnetic and optical properties and other physical properties of various components in urban living garbage, and have the resource recycling to those useful things. The municipal solid waste sorting machine not only achieves the best utilization of resources, but also address easily an issue of recyling. In addition, both investment and operation cost are low. Combining separation recycling waste classification and collection can achieve a good effect.

(6) Recycling of plastic bags

“San-Orgiu” LLC produces lid for trench cover, chair, fence pole, and substitute plank using used plastic bags and bottles. It is environmentally friendly. Bureau of Advanced Technology Support, in cooperation with private companies such as “San Orgiu” and “New Cycling”, has installed plastic bag recycling facilities in Dornod, Tuv and Dundgobi aimags in order to create a nationwide network of small and medium scale waste recycling factories. The companies aim to introduce new technology and expand their production.

(7) Initiatives of the Mongolian National Association of Waste Recycling

The purpose of the Association is to re-use of secondary raw materials, reduce waste at the source and recycle using advanced technology.

Initiatives of the Mongolian National Association of Waste Recycling and member companies:

- Recycling Factory of Used Engine Oil - HBOil LLC, Altan Orshikhui LLC
- Recycling Factory of Alloys- Amarsanaa Step LLC
- Recycling Factory of Waste Glass- Margad Erkhi LLC
- Recycling Factory of Plastic Bottles and Bags - Eco Plastic LLC
- Recycling Factory of Used Tires
- Recycling Factory of Old Accumulators
- Recycling Factory of Used Leaded Battery-“Zalamt Gol” LLC
- Center of Large Sized Scrap Metal Collection
- Export Factory of Collected Plastics
- Center of Secondary Raw Material Collection
- Collects plastic bottles and bags, cans, glass bottles, iron, copper, brass, accumulators, lead, stainless steel, aluminum and alloys.
- Waste collection system

20.5 Financial demand in protection for water contamination

Water pollution main sources are mining industry, and non- treated and semi-treated human and industrial waste discharge.

Mongolia's mining industry is linked with water pollution issues. Inefficient use of large quantities of water for the purposes of extracting gold have caused further pollution and the drying up of streams. Mining has been identified as the cause of pollution in 28 rivers and streams. Water pollution can also be linked to non-treated and semi-treated human and industrial waste discharge. Annually over 120 million cubic meters of waste water is disposed of without treatment. Additionally, the state has a weak site monitoring system.

Water quality results of all rivers and lakes in Mongolia according to the survey of surface water quality which was held in 2015-2016.

Table 20.5.1 Water Quality in Mongolia

Water quality indicators	2015	2016
"Absolutely clean"	93%	91%
"Clean"		
"Low polluted"	3%	5%
"Polluted"	4%	1%
"Very polluted"		3%

Source: The survey of surface water quality, State of the Environment report 2015-2016, Ministry of Environment and Tourism

The most polluted and immediate action required rivers of the surface water resources are Tuul, (the down Ulaanbaatar between Songino and Altanbulag), Khangal (the lowest point of Erdenet between lower bridge of railway station and Altanbulag), Khiagt and Khuder river.

Main sources of Tuul and Khangal river pollution are non-treated and semi-treated waste daily discharge of the Central Waste Water Treatment Plant to Tuul river in Tolgoit and wastewater from Waste Water Treatment Plant of Erdenet Ore-Dressing Enterprise. Main source of Khuder river pollution is gold mining company activities in the river basin.

Monthly level of cleanliness of the Central Wastewater Treatment Plant in Ulaanbaatar is fluctuated irregularly, purifying ability of the Central Wastewater Treatment Plant in Tolgoit is only 26% -81%. It indicates that wastewater is not properly treated to the required level.

Clean drinking water supplies are available in 77% of Ulaanbaatar, and sewerage for sanitation is available in 35% of the city. Sewerage significantly lags behind drinking water in other regional towns and cities, where 41% have access to drinking water and 10% to sewerage.

<u>Financial demand in protection for water contamination</u>

(1) Small Scale Wastewater Treatment Plants

During the last years many rural areas were provided with some kind of water supply system. The availability of water leads to wider spread use of flush toilet systems. These systems mainly use simple toilets to discard the waste water either directly into the porous underground or into simple holes. At the same time many soums still supplement their water supply from shallow wells which are often located in the direct neighborhood of the toilets. Even if people consider the possible contamination of their well through their own toilet and locate them far apart they cannot avoid the location of their neighbor's toilet close to their well. A similar risk of water body contamination occurs where soums situated on the banks of a small river discharge their wastewater without treatment. It is expected that Small Scale Wastewater Treatment Plants (SSWTP), under certain circumstances, are the solution for these problems. More specifically the SSWTP technology could be applied where:

- Conventional sewage is simply too costly
- Environmental conditions require a high effluent quality
- Conventional on-site treatment proved to be of low community acceptance
- Low technology solution, such as composting toilets seem to be inappropriate.

Consequently, the objectives of the SSWTP project are summarized as follows:

- To identify appropriate waste water treatment technologies for ger district (e.g. treatment by plants, high-loaded treatment lagoons, community septic tanks).
- To identify conditions under which a certain number of toilets can be connected to a single small-scale waste water treatment plant (economic, technical and social viability).
- The formulation by participating countries of specific project proposals for further implementation.

In the context of the project, these objectives mean that the project is not necessarily trying to find the best sanitation technology for a given problem but to list the conditions where SSWTP represents an efficient alternative to either conventional sewage or on-site wastewater treatment/disposal technologies. Wastewater treatment knowledge is basically non-existent among ger district residents and a general description that summarizes the basics of wastewater treatment is offered.

It is important to identify appropriate waste water treatment technologies taking into consideration of the complexity of the different systems as well as the effluent quality that can be achieved by the respective treatment technology.

(2) Grey water system

In recent years, drinking water resources have been decreasing in Ulaanbaatar.

Grey water or sullage is all wastewater generated in households or office buildings from streams without fecal contamination, i.e. all streams except for the wastewater from toilets. Sources of grey water include, sinks, showers, baths, clothes washing machines or dish washers. As grey water contains fewer pathogens than domestic wastewater, it is generally safer to handle and easier to treat and reuse onsite for toilet flushing, landscape or crop irrigation, and other non-potable uses.

The application of grey water reuse in urban water systems provides substantial benefits for both the water supply subsystem by reducing the demand for fresh clean water as well as the wastewater subsystems by reducing the amount of wastewater required to be conveyed and treated. In times of drought, especially in urban areas, grey water use in gardens or toilet systems helps to achieve some of the goals of ecologically sustainable development.

20.6 Financial Demand in Protection for Biodiversity

Mongolia's territory ranges from the super-arid desert in the south to moist Taiga forest in the north, and from rolling steppe grasslands in the east to alpine terrain and glaciated peaks in the west. This varied terrain contains a wide array of ecotypes; many exhibiting unique characteristics found nowhere else on the globe. This unique, varied, and substantially undisturbed territory supports a wide diversity of living organisms, many of which are endemic to Mongolia. Mongolia harbors the last remaining populations of a number of species internationally recognized as threatened or endangered, including the snow leopard, Argali sheep, Wild ass, Saiga antelope, Bactrian camel, Mazaalai bear, and others.

However, Mongolia's biodiversity resources are facing substantial and increasing threats. Factors like Mongolia's growing population, coupled with urbanization, economic development, and an increasing per-capita demand for natural resources, have resulted in expansion and intensification in land use by people and domestic animals, and in increasing pressure to develop and utilize the country's natural resources. At the same time, the recent transition from a centrally controlled economy to a free market economy has opened the country's natural resources to free enterprise and market forces.

Main causes of the loss of biodiversity are as follows.

1) Climate change

The continuation of global climate change has already had a negative impact on soil moisture, temperature, vegetation cover and the habitats of herbivorous animals. During the last 50 years or so, the average annual temperature in Mongolia has increased by 0.7^{o}C. This drop in the average temperature has resulted in a variety of changes including serious impacts on the growth of natural and cultivated plants.

2) Desertification

Desertification deteriorates the environment and reduces its biological resources. It worsens the environment and conditions for the normal propagation of plants, hence reducing resources for rare animals and plants in the desert and desert-steppe zones.

3) Illegal hunting & predator eradication programs

Inadequately controlled or illegal hunting, and predator eradication programs also contribute to pressures on wildlife and on the natural balance in many areas.

4) Mining activities

Increasing economic activity such as mining, land cultivation and crop farming, and the production of wild and domestic animal products for internal consumption and export, have resulted in the disturbance hitherto undisturbed natural areas and the loss of wildlife habitat.

5) A large number of livestock

The livestock sector is one of the most significant contributors to today's most serious environmental problems also a major source of land and water degradation.

<u>Financial demand in protection for biodiversity</u>

(1) Satoyama initiative

There was limited understanding about the landscape approach among the local communities. By taking into account the inter-actions between core elements (land, water and forest) of natural elements and the ecosystem services they produce, rather than considering them in isolation from one another, rural communities are able to maximize productivity, improve livelihoods, and reduce negative environmental impacts.

During the community consultations, we understood that SGP Grantee R. Dagvadorj started already to implement the Satoyama initiative and created socio-ecological production landscape in his community garden (Beekeeping, artificial pond, well, vegetable growing in green house and open field, orchard or fruit tree planting, windbreak, small scale wine production, flower planting and underground storage pit. There were plenty of biological diversities in the community garden: hedgehogs, birds, squirrels, frogs, rabbit, bees, butterflies, earthworms, flowers, trees, and vegetable etc.). His community garden is an example of a new business model of the Satoyama initiative.

The landscape scale conservation is more effective than species-based conservation and it will help to improve their surrounding nature, biodiversity, culture and knowledge which are very new to the rural communities.

(2) Beekeeping

Currently, Mongolia uses 650 tons of bee products annually. Only 200 tons of consumed products are produced domestically, while 450 tons are imported. The country currently imports approximately 70% of its annual honey demand. According to the Ministry of Food and Agriculture, beekeeping business has been quickly expanding, with 1,700 bee colonies being kept by 60 companies 7,700 bee colonies being kept by 450 individual beekeepers. As ministry officials have noted, domestic production was only 50 tons three years ago, and has quadrupled in a short period of time.

A move by the government to raise the import tax on bee products to 20% is credited for spurring the growth of the domestic industry. A study done by the UN FAO revealed that more than 90% of honey produced in Mongolia is classified organic as organic. Regarded as one of the more ecologically friendly agricultural businesses, 12 different bee products can be produced from beekeeping. The Ministry also reported that companies from Japan and Europe have shown interest in Mongolia’s beekeeping industry and are currently conducting studies of its products.

20.7 Terms and Conditions /Preferential Terms of EPL/TSL Phase III

The terms and conditions to be applied for EPLs Phase III will be as follows:

- Sub-loan interest: Sub-loan interest rate for EPL projects in Phase III should be lower than that for SME development. This is because interest rate of original yen loan for EPL projects will be 1.3% while that for SME development is 1.5%.
- Expansion of coverage: It is important to expand target area of EPL to cover environmental issue widely to accelerate environment protection in Mongolia.
- Mortgage condition: It is necessary to cooperate effectively with the credit guarantee fund to overcome the issue on lack of mortgage which makes SMEs difficult to apply EPL and SME projects.
- Redefinition of loan ceiling and floor: In case of EPL projects which are expected to have a positive impact on environmental protection, it tends to require relatively large investment. To remove the ceiling of the projects could be a possible option to realize such projects.
- Examination of loan term and concession on repayment: Considering the term to exert the social impact of EPL projects which are inclined to long time, it is recommended to set longer period as loan term and concession on repayment.

Chapter 21 Overall Project Scheme and Implementation Plan

21.1 Overall Project Scheme of the Two-Step Loan (TSL) Project Phase III

21.1.1 Proposed Scheme of TSL Phase III

12 years have passed since TSL Phase I started in 2006. PhaseⅢ, which would follow Phases I and II, is proposed to make existing system more effective and consolidate operations. The main features of the newly proposed Phase III are as follows.

i) The borrower would be the Government of Mongolia (GOM)and the Special Purpose Entity (SPE) would be the executing agency (E/A) in the PhaseⅢ, which is expected to be established in 2018. SPE would be a non-bank financial institution raising equity funds from GOM, the private sector, International Financial Institutions (IFIs). SPE is expected to be a highly efficient and fair institution utilizing know-how of the private sector in terms of efficient management and operation, and good governance of IFIs.

ii) The loan amount of TSL Phase III would be JPY 10 billion excluding Consulting Services.

iii) Sub-loan maximum amount is to be raised from USD 0.6 (Phase I, II) miliion to USD 1.0 million (no ceiling for EPL).

iv) The following issues are expected to be challenged when Phase III is launched.

- Merging of RF/As
- Adoption of a computer system to manage the project financial account
- Introduction of co-financing with PFIs
- Borrowing a loan from IFIs and markets
- Promotion of cooperation with Loan Guarantee Fund

21.1.2 Outline of the Proposed TSL Phase III

Loan conditions of the proposed TSL Phase III loans are as follows:

Table 21.1.1 Outline of the Proposed TSL Phase III

Lender	:	JICA
Borrower	:	Government of Mongolia
Amount	:	JPY 10.0 billion (USD 100 million equivalent) excluding consulting services fee
Interest	:	1. 5% for SME Development Loan 1.3% for Environmental Protection Loan (EPL)
Maturity	:	30 years (including 10-year grace period) for SME Development Loan
Implementation	:	30 years (including 10-year grace period) for EPL
Period	:	3 years
Components		Category A (SME Development): JPY 9.0 billion Category B (Environmental Protection): JPY 1.0 billion

Source: JICA Expert Team

21.1.3 Outline of the Proposed On-lending Loans

In proposed Phase III, there are two methods of MOF providing on-lending loans to PFIs. One is the traditional method at Phase I and Phase II. The other is a method of providing through SPE.

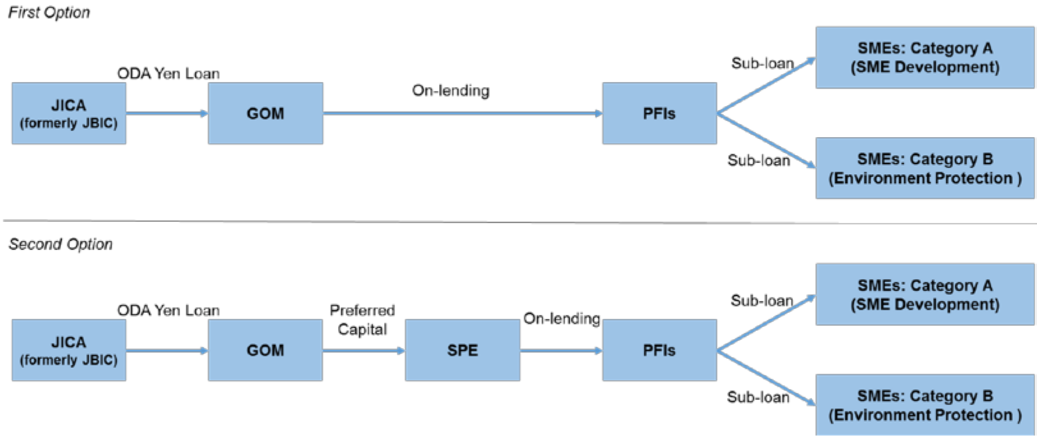
First Method: procedure following the existing practice

On-lending loans are transferred from the special account (S/A) in the Bank of Mongolia (BOM) to PFIs along with applications compiled to the project implementation unit (PIU) by PFIs. Once applications approved, the loan amounts in MNT/USD equivalent to the Yen amount are transmitted to the PFI's account in BOM.

Second method: procedure through newly established SPE

Proceeds of ODA Loan received in S/A in BOM will be transferred to SPE as preferred shares (as in the same manner of transfer of RV/F to SPE as preferred shares) and SPE will use these sources to provide on lending loan to PFIs.

As the establishment of SPE is the MOF's policy, it is assumed that the second method will be adopted in Phase III.



Source: JICA Expert Team

Figure 21.1.1 Fund Flow with and without SPE at TSL Phase III

The decision over which option to be chosen would be made by the negotiation between MOF and JICA. The outline of the proposed on-lending loans for Phase III is described in the next table.

Table 21.1.2 Outline of the Proposed On-lending Loans (Second Option)

Lender	:	SPE
Borrower	:	PFIs to be newly selected
Amount	:	Lump sum requested amount
Currency	:	MNT or USD
Maturity	:	3-10 years (including grace period of 1-3 years)
Interest rate	:	SME Development Loan(MNT):7% (TBD) EPL(MNT): 1.1%lower than the rate of SME Development Loan (TBD)

Source: JICA Expert Team

21.1.4 Outline of Sub-loan

Outline of the sub-loan from PFIs to SMEs is summarized in the Table below. The only difference from Phases I and II would be the maximum amount of each sub-loan increased to USD 1 million from 0.6 million based on the strong request from the private sector.

Table 21.1.3 Outline of the Proposed Sub-loan

Lender	:	Selected PFIs
Borrower	:	SMEs meeting the following conditions: 1) Established and operating in Mongolia 2) All (main targets are agricultural and manufacturing sectors) but ineligible loans below: - Loans for trade services (wholesale and retail trade except repair services) - Loans for accommodation and food/ beverage service activities - Loans for real estate activities, including construction of buildings - Loans for environmentally-damaging projects - Loans for refinancing, except bridge loans with sales/contract attached- Loans for military activities - Loans for financial and insurance activities * Loan request for buildings and inventory would be strictly examined. 3) Majority are privately owned 4) Number of employees is 199 or less 5) Annual sales turnover is less than 1.5 billion (to be reviewed and revised by CSC every year) 6) No previous default
Currency	:	MNT or USD
Amount	:	Minimum USD 10,000 or equivalent Maximum USD 1,000,000 or equivalent * No ceiling for EPL
Terms & Conditions	:	Maturity: 3-10 years (including grace period of 1-3 years)
Interest Rate	:	11%
Collateral	:	To be defined by PFIs
Co-financing Scheme	:	Fund resource for sub-loan will be composed of the TSL and PFIs own capital

Source: JICA Expert Team

21.1.5 Comparison of the Proposed TSL Phase III with Phases I and II

The conditions of the official development assistance (ODA), on-lending loan, and sub-loan in each phase is as follows:

Table 21.1.4 Comparison of Loan Conditions in the Proposed TSL Phase III with Phases I and II

Loan	Conditions	Phase I	Phase II	Phase III
ODA Loan	Implementation schedule	28 Mar 2006 (signed) – Jan 2010	19 Nov 2010 (signed) – Jun 2014 (planned)	
	Lender → Borrower	GOJ → GOM		
	Currency	JPN		
	Amount	3.0 bil	5.0 bil	10.0 bil
	Interest rate	0.75% per year (fixed)	0.65% per year (fixed)	SME: 1.5% per year (fixed) EPL: 1.3% per year (fixed)
	Maturity	40 years (whereas grace period 10 years)	40 years (whereas grace period 10 years)	SME: 30 years (grace period 10 years) EPL: 30 years (grace period 10 years)
On-lending Loan	Lender → Borrower	MOF → 7 PFIs (TDB, Golomt, Khan, Xac, Capitron, Zoos/State, Anod)	MOF → 6 PFIs (TDB, Golomt, Khan, Xac, Capital, UB City)	MOF → PFIs to be selected newly
	Currency, Amount, Maturity	Same as the sub-loan's conditions		

	Interest rate	SME: MNT: Average demand deposit rate EPL: same as SME		7% (TBD) EPL: 1.1% lower than SME Dev Loan's interest rate (TBD)
	Lender's margin	Interest rate of on-lending loan minus the rate of ODA loan		MOF 4% SPE 4%
Sub-loan	Lender → Borrower	PFIs → SME		
	Currency	Either MNT or USD		
	Amount	USD 10,000 – USD 600,000 or equivalent MNT	USD 10,000 –600,000 or equivalent MNT (no ceiling for EPL)	USD 10, – USD 1 million or equivalent MNT (no ceiling for EPL)
	Maturity	3-10 years (including 3 years grace period)		
	Interest rate	On-lending rate + PFI's margin		11%
	Lender's margin	Set by MOF (MNT: 4%, USD: +3.6%)		Set by MOF for TSL portion, market-based for PFI loan, MNT 4%

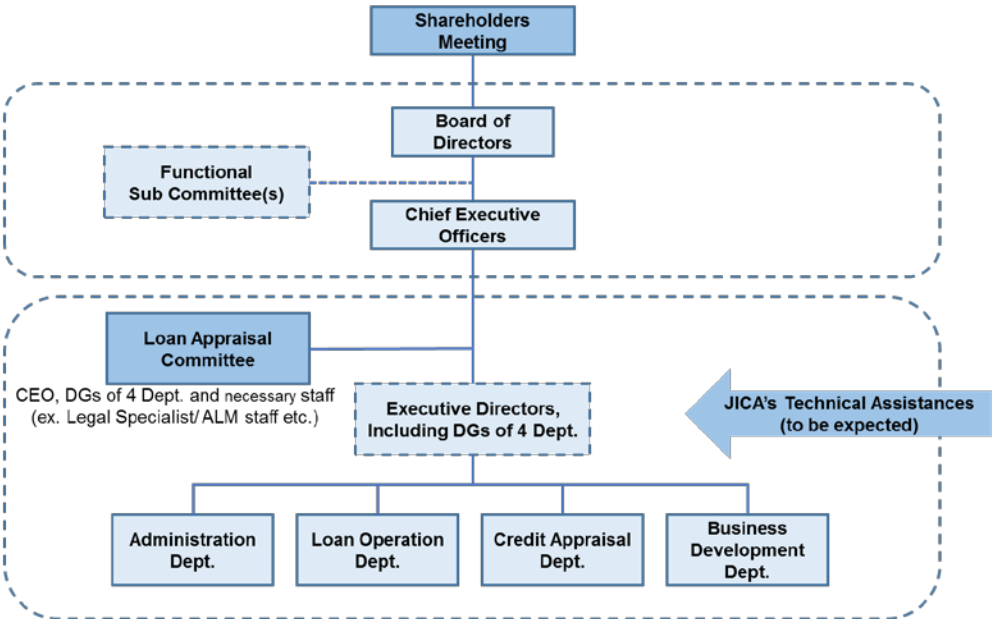
Note: [green] Revised from Phase I, [yellow] Revised from Phase II
Source: JICA Expert Team

21.2 Function of Each Implementation Organization

21.2.1 Special Purpose Entity (SPE)

SPE shall be the executive agency (E/A) for entire TSL projects handling new Phase III and RV/F of Phases I and II. It shall be established as a limited liability company (LLC) in Mongolia with the stakeholders consisting of the government, the private sector and IFIs. Also, it shall be operated as a non-bank financial institution accredited by the Financial Regulatory Commission (FRC).

In this section, key organizations in Phase III are introduced as follows starting with SPE.



Source: JICA Expert Team

Figure 21.2.1 Expected Organization of SPE

BOARD

The board shall be a supreme body for SPE for the policymaking function including loan decisions which was used to be handled by CSC. The board member shall be selected by the shareholders meeting. At present, it is planned to be total 7 seats as follows: Three seats from Shareholders and four seats for independent persons including nominated by ADB. The chairperson of the board shall be chosen by the mutual vote at the board.

The board meeting shall be held once or twice per month at the inception of SPE, and it could be hold about six times per year when SPE gets on a track and other twice with urgent issues.

EXECUTIVE OFFICE

In SPE, the executive office shall be set up which is equivalent to PIU in MOF during TSL Phases I and II. About 15 staff shall be assigned to the executive office by personnel rotation utilizing the personnel who have been in charge of TSL Projects in MOF.

The executive office shall be composed of four departments: namely, Administration Department including Accounting Unit, Loan Department, Credit Analysis Department and Business Development Department). The first three departments shall be responsible for each task shown in their name. The Business Development Department shall be a unique unit particularly for SPE which in charge of TSL Phase III, existing and new loans, co-finance with PFIs, co-works with the credit guarantee fund, and so on.

21.2.2 Participant Financial Institutions (PFIs)

In the PhaseⅢ, PFIs will receive on-lending loan from SPE and provide sub-loan to SME. All present PFIs will have to be re-examined on its eligibility at the commencement of the PhaseⅢ. And also during the implementation period, its eligibility would be better reviewed regularly. If inadquateness were identified, necessary action should be ataken in consultation with MOF.

21.2.3 Mongolian Bankers Association (MBA)

As PFIs are not allowed to be shareholders by the banking law, MBA shall be a main shareholder representing the private sector holding 36% of common share. MBA would receive contribution from 8 Participating Financial Institutions (PFIs). Each among all PFIs will have to keep the same number of shares in the 36% regardless how many PFIs in the group of PFIs.

21.2.4 Ministry of Finance (MOF)

MOF shall be a borrower for Phase III with a loan agreement (L/A) with JICA. MOF shall transfer on-lending loans to SPE as a form of preferred stock. SPE will provide on-going loans as E/A to PFIs which provide sub-loans to SMEs for SME Development or EPL. SPE will make repayment with interest to MOF along with the repayment plan stipulated in L/A.

MOF will have 34 % of common stock of SPE as a representative of the government. MOF will be responsible to SPE in its overall operation by assigning board members as a shareholder. Besides, MOF will reform PIU as a unit in charge of TSL to coordinate SPE, BOM, FRC, and other stakeholders.

21.2.5 Financial Regulatory Commission (FRC)

SPE is proposed to be a non-bank financial institution under the supervision of FRC. FRC shall provide annual audit addition to the supervision for daily work.

21.2.6 Bank of Mongolia (BOM)

BOM supervises PFIs during TSL project. SPE itself will be supervised by FRC legally and got advisory by MOF. Legally SPE is not under the direct supervision of BOM; however, it will be affected by financial policy executed by BOM.

In addition, fund management for TSL Phase III will be handled by BOM as well as Phases I and II. Along with the direction by MOF, BOM will be in charge of funds delivery between JICA and MOF.

21.2.7 Japan International Cooperation Agency (JICA)

JICA shall be the lender of TSL Phase III and sign L/A with MOF.

21.3 Fund Management and Flow

21.3.1 Lending Agreement

(1) On-lending Loan

On-lending Loan Agreement shall be concluded between MOF and PFIs. MOF would on-lend the proceeds of the ODA loan to PFIs in either MNT or USD. The lender (i.e., GOM) bears the foreign exchange risks between JPY and the currency of on-lending loan (MNT or USD). Repayment term shall be the same as that of the sub-loans to be financed. Once SPE established, SPE might provide on-lending loan to PFIs on behalf of MOF as explained above (section 21.1.4) and below (section 21.3.2) of this chapter.

(2) Sub-loan

Sub-loan Agreements shall be concluded between PFIs and the end-borrowers. PFIs would lend sub-loans to the end-borrowers in either MNT or USD. PFIs shall make repayment of the on-lending loans to MOF for each instalment, which will be collected from the end-borrowers.

21.3.2 Disbursement Procedure

(1) Disbursement of the ODA Loan

Disbursement requests shall be made to JICA by MOF as the executing agency (E/A) which would be defined in the Loan Agreement (L/A). The disbursement procedure to be applied shall be the "Special Account (S/A) Procedure" with the exception of the funds for consulting services. For the consulting services portion, the "Commitment Procedure" shall be applied.

The GOM shall establish a non-resident yen account with the MUFG Bank, Tokyo, to receive the ODA loan. In parallel, MOF shall establish the S/As with BOM for receiving the disbursed proceeds of the ODA loan. Replenishment of the S/A shall be made upon the request of E/A accompanied by the summary sheets of payments for each category of the TSL component presented in accordance with the S/A procedure. When JICA finds the documents in order and in conformity with the L/A, JICA will complete the disbursement or replenishment of loan in JPY by paying into the GOM's non-resident yen account with the MUFG Bank, Tokyo. The E/A will transfer the amount to S/As, denominated in JPY with BOM.

(2) Disbursement of On-lending Loan

The method of disbursement of on-lending loan shall be decided when SPE is established. On-lending loan would be disbursed through the following methods.

<u>First Option: procedure following the exiting practice</u>

On-lending loans shall be disbursed from S/As that will be established with BOM to PFIs on the basis of an application by PFIs to SPE. The payment of interest and the repayment of principal collected from PFIs shall be deposited into the RF/A of SPE and after that the RF/A shall be managed by SPE. The features of this option are that while JICA could obtain project information at the time of disbursement of the first installment, SPE on the other hand could not get enough project information, so SPE might have difficulty in undertaking project/loan administration.

<u>Second Option: procedure through SPE in each process</u>

On-lending loans shall be made through SPE. In this procedure JICA would provide ODA loans as a lump-sum payment in advance without project information. That is to say, ODA loans would be formed as a global line. Repayment procedure is the same as the first option. This option is favorable for SPE in terms of availability of project information but not for JICA. However there is a benefit for the both that disbursement could be made smoother.

The decision to decide which method to choose would be made by the negotiation between MOF and JICA.

21.4 Project Management System

A well-designed computer system is needed for the effective control of the project operation when SPE established. SPE is recommended to develop their own computer system to effectively and efficiently process the on-lending loan applications, make disbursement to PFIs, and monitor the payments by PFIs. In addition, it is preferable for such computer system to produce management information for the overall management of the project, including fundamental information on the implementation of the subproject and the status of sub-borrowers. Expected information for project management includes the following items in particular, but not to limited to:

- On-lending loan application
- On-lending loan disbursement
- List of loan application
- On-lending loan approval
- Conditions for re-examination
- Interest received under on-lending loan
- Fund flow
- Due date table of each loan
- List of sub-loans in arrears
- List of rescheduled on-lending loans and sub-loans

The computer system should allow PIU monitoring of the actual progress of the approval process of on-lending applications. The information produced should keep PIU well informed of the monthly progress and performance of on-lending loans, including the approval of new on-lending loan applications, disbursements made within the month, recovery of the principal, collection of interest, fund flow, and balance of on-lending loan in an aggregate figure. The collection of the principal and interest in the future shall also be supported. The due date table of on-lending loans should include the maturity date and details of the amount of repayment for principal and interest per loan. This table can be used as the basis of PIU in issuing the notice of due dates of principal and interest to the banks.

It is a matter of course, prior to build up of the system, that a well-designed operating guidelines for PIU and PFIs should be established in order to facilitate PIU and PFIs to thoroughly understand the policies and mechanism of the TSL Project, to process the ODA loan to GOM, and to realize the successful implementation of the TSL Project on sustainable basis. It is noted that during the implementation of TSL Phases I and II, a manual for PFIs and guidelines for CSC have been distributed and explained, but not for PO. In Phase III, establishment of the operating manual for PO is expected, which would include the following points:

- Project's objectives
- Project's scheme
- Project management structure
- Governing agreements of all the stakeholders and revision
- Eligibility of projects and borrowers

- Financing scheme
- Eligibility of PFIs and selection procedures
- Processing of applications by PIU and PFI
- Debt-servicing including rescheduling and default
- Fund management
- Promotional activities
- Monitoring and reporting
- Revision of guidelines

21.5 Eligibility and Selection of PFIs

21.5.1 Selection of New PFIs

It is recommended that the selection of PFIs for Phase III should be made in principle in the same way as adopted in Phases I and II. The selection of PFIs shall be conducted by MOF or SPE as follows:

Step 1: Candidate banks shall fully comply with the prudential ratios required by BOM as shown in the Table below.

Table 21.5.1 Prudential Ratios for the Selection of Eligible PFIs

Types	Prudential Ratio	BOM Prudential Norms
Capital Risk	Capital adequacy ratio*	greater than 12%
	Tier I ratio*	greater than 6%
Credit Concentration Risk	Single borrow exposure ratio*	less than 20%
	Total related parties lending ratio*	less than 20%
	Single related party lending ratio*	less than 5%
Foreign Exchange Rate Risk	Foreign exchange (Forex) exposure ratio in single currency	between +/-15%
	Forex exposure ratio in total	between +/-40%

Note: Capital Adequacy Ratio (CAR) represents the ratio of one bank's capital to its risk weighted-asset: asset discounted according to different levels of risks by each asset.
Tier 1 ratio is the ratio of Tier1 capital to its risk-weighted capital. Tier 1 capital is a core capital of the bank, which consists of share capital and reserve, retained earnings, etc.
Ratio of the 'amount of loan to a single borrower and parties connected to the borrower' to the bank's 'Capital'.
Ratio of the 'amount of loan, loan equivalent assets, guarantees, and warranties issued to the bank's related party' to the bank's 'Capital'.
Ratio of the 'foreign currency open position' to the bank's risk-weighted capital. 'Foreign currency open position' mainly refers to the net difference between on-balance foreign currency assets and foreign currency liabilities.

Source: JICA Expert Team

Step 2: After compliance with Step 1 criteria, the candidate banks are then evaluated through the following four specialized items: 1) growth of the bank, 2) management capability, 3) observance of prudential principles, and 4) performance in corporate finance. The second item (management capability) would be evaluated through BOM's regular evaluation (CAMELS*). Each item is graded with 1 to 5 points (1 represents the highest creditability and 5 as the lowest). Then, the grand total is calculated by summing up weighted points of the four components as shown in Table 15.5-2 below, and is required to rate less than 2.5 points to be selected.

Table 21.5.2 Rating for the Selection of PFIs

Item	Main Content of Evaluation	Weight	Evaluation Ranking						
			Range					Total	Weighted Total
1. Growth	Growth, in percentage	-	Less than ave. -10%	Between ave. -10% and ave.+5%	Between ave. +5% and ave.+15%	Between ave. +15% and ave.+25%	More than ave. +25%	-	-
	Assets	10%	5	4	3	2	1	1 to 5	0.1 to 0.5
	Earnings	10%	5	4	3	2	1	1 to 5	0.1 to 0.5
	Capital	10%	5	4	3	2	1	1 to 5	0.1 to 0.5
	Total	*30%*							*0.3 to 1.5*
2. Management	*Evaluation through CAMELS* by BOM*	*30%*	*Evaluated by BOM*						*0.3 to 1.5*
3. Prudential Requirement	Tier 1 ratio (>6%)	3%	less than 0	1-2	3-6	7-9	more than 10		
			5	4	3	2	1	1 to 5	0.03 to 0.15
	Capital adequacy ratio (>12%)	4%	less than 4	5-9	10-12	13-15	more than 15		
			5	4	3	2	1	1 to 5	0.04 to 0.2
	Foreign exchange exposure ratio in single currency (<±15%)	3%	more than 20	18-20	15-17	10-14	less than 9		
			5	4	3	2	1	1 to 5	0.03 to 0.15
	Foreign exchange exposure ratio in total (<±40%)	4%	more than 60	50-59	40-49	20-39	less than 19		
			5	4	3	2	1	1 to 5	0.04 to 0.2
	Single related party lending ratio (<5%)	3%	more than 7	5-7	3-4	1-2	less than 1		
			5	4	3	2	1	1 to 5	0.03 to 0.15
	Total related parties lending ratio (<20%)	4%	more than 25	20-25	15-19	10-14	less than 10		
			5	4	3	2	1	1 to 5	0.04 to 0.2
	Single borrow exposure ratio (<20%)	4%	more than 25	20-25	15-19	10-14	less than 10		
			5	4	3	2	1	1 to 5	0.04 to 0.2
	Total	*25%*							*0.25 to 1.25*
4. Corporate Finance	Ratio, in percentage	-	less than ave. -10%	Between ave. -10% and ave.+5%	Between ave. +5% and ave.+15%	Between ave. +15% and ave.+25%	More than ave. +25%	-	-
	Ratio of corporate loan to total loan	5%	5	4	3	2	1	1 to 5	0.05 to 0.25
	Ratio of term-loan to corp. total term-loan	10%	5	4	3	2	1	1 to 5	0.1 to 0.5
	Total	*15%*							*0.15 to 0.75*
Grand Total		*100%*							

Note: *CAMELS: The BOM examines commercial banks regularly through the following six factors: i) Capital adequacy, ii) Asset quality, iii) Management quality, iv) Earnings, v) Liquidity, and vi) Sensitivity to market risk (CAMELS). The factors are rated on a scale of 1 to 5; 1 is the best and 5 is the worst. When selecting PFIs in TSL, it has to be confirmed to be able to obtain the CAMELS evaluation.

Source: SAPI 2

Step 3: CSC shall approve the result of Steps 1 and 2.

Step 4: MOF shall submit the following materials to JICA and attain concurrence on the result of the selection.

- Result of Steps 1 and 2
- Minutes of CSC meeting (summary)
- MOF’s comments on CSC’s decision with evidence of figures.

It is also recommended that during the whole TSL Project implementation period., the PFIs should be reassessed for meeting the eligibility criteria on periodical basis, in order to make sure that:

- PFIs maintain and meet the eligibility criteria
- TSL Project funds are securely provided to the eligible end-users to meet the TSL project objectives.
- TSL Project funds are safely paid back from the sub-loan borrowers.

21.5.2 Continuation of Current PFIs

Although the current PFIs in Phases I and II would be re-evaluated through the same selection criteria mentioned above, all the PFIs are expected to be eligible in principle. If a PFI could not meet the criteria, the PFI would be restricted in its financial operation to SME by the degree of dissatisfaction of the criteria, in consultation with BOM.

21.6 Consulting Services

Consulting services amounting JPY 300 million was included for Phases I and II together. In the consulting services, local consultants as well as a few foreign consultants were hired and they contributed to the smooth implementation of the TSL Project. The consulting services in Phase I included the training and advisories to CSC on ODA loan procedures and to PFIs on project analysis and loan administration. The consulting services in Phase II covered various other fields such as conduct of a research on two themes, “Necessity of Term-Loan” and “Challenges Faced by SMEs to Access Finance”, study tour in Japan, and weekly introductory seminars on TSL at the Mongolia-Japan Center for Human Resources Development (MOJC).

Through these consulting services, TSL Phases I and II, as a whole, have been performed satisfactorily. However, after the Expert Team reviewed operation of Phases I and II, the Team identified following tasks which are expected to achieve newly or future during Phase III:

i) Promotion of co-finance
ii) Integration of SA/F and RF/A in TSL Phases I and II
iii) Collaboration with credit guarantee fund
iv) Collaboration with GCF
v) Introduction of a computer (IT) system for PIU’s project management
vi) Capacity Building of PFIs(project financial analysis and credibility analysis of sub-borrowers)
vii) Capacity Building of SME (preparation of loan application, formulation of bankable project) (To be undertaken with PFIs)

As SPE is scheduled to be established even before PhaseⅢ, the consultant to be hired might undertake some or much of the above.

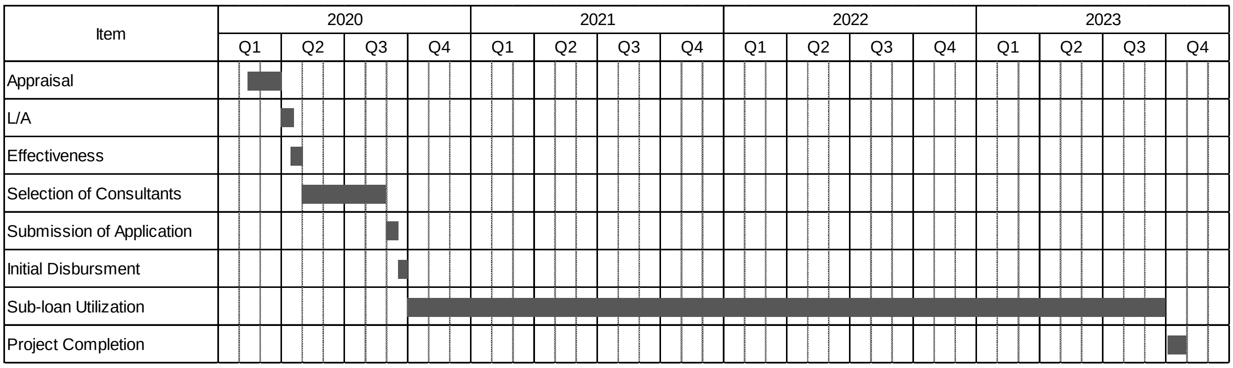
21.7 Project Cost

It is proposed for TSL Phase III that the project cost covers SME development loan and EPL with totally JPY 10 billion, at present.

Consulting services would be also necessary to support MOF, FRC and SPE. In Mongolia, establishment of SPE as a non-bank financial institution applying Public-Private-Partnership (PPP) model is the first challenge with high expectation among GOM. Most of the consulting services would target SPE and relevant entities to support its smooth and solid operation to provide expected function.

21.8 Implementation Schedule

TSL Phase III would be implemented from 2020 if the situation is met. Assuming that happens, expected implementation schedule is shown below.



Source: JICA Expert Team

Figure 21.8.1 Proposed Implementation Schedule of TSL Phase III

Sub-loan provided from S/A of Phase III is scheduled to be disbursed in three years from 2020 to 2023. In the first year (October 2020 to September 2021), 40% of the amount is supposed to be utilized, another 40% is in the second year (October 2021 to September 2022), and remaining 20% is in the third year (October 2022 to September 2023). However, it is very much expected that Phase III would be realized much faster than this schedule.

Appendix 1

Draft Prospectus Summary

For the Establishment of the Special Purpose Entity for Sustainable Operations of TSL Project for SME Development and Environmental Protection

March 12, 2018

Ministry of Finance,

Government of Mongolia

CONTENTS

Introduction

The Japan International Cooperation Agency (JICA) conducted the Special Assistance for Project Implementation-2 (SAPI-2) Study in 2014, which proposed an initial idea of establishing a special purpose entity (SPE) with a joint capital of three parties; the Government of Mongolia (GOM), the private sector and international institutions for the sustainable long term operations of the Two-step Loan (TSL) Projects for SME Development and Environmental Protection (TSL Phase 1 and Phase 2).

JICA's TSL Project is a joint project of GOM and the Government of Japan (GOJ) to promote development of the SME sector through provision of affordable long-term financing to eligible SMEs. GOJ provided concessional loans of JPY2.9 billion (equivalent to USD25 million) and JPY5.0 billion (equivalent to USD62 million) to GOM for the implementation of the TSL Phase 1 in 2006 and Phase 2 in 2011 respectively for the purposes of on-lending to SMEs through participating financial institutions (PFIs).

The TSL Project has outperformed its initial objectives: provision of longer term SME project finance, creation of employment and the very low level of non-performing sub-loans. It has been successfully administered by the JICA TSL Project Office under the guidance of the inter-ministerial Counterpart Steering Committee (CSC) and with the support of consultants funded by JICA technical assistance (TA). However, the extended TSL consultancy service will be concluded in May 2018 due to completion of the Contract for Consultants' Services for Two-Step-Loan Project for Small and Medium-Scaled Enterprises Development and Environmental Protection. In connection with TSL Phase 3 that is under consideration, Ministry of Finance of Mongolia (MOF) and JICA have jointly come to a conclusion of MOF's exit policy with organizational arrangements to take over the administration of the TSL loans upon termination of JICA's support.

It was further agreed that this objective would be best achieved through establishment of an independent financial institution to ensure continuity of the management of the TSL operations based on professional business management principles. The proposed SPE mechanism aims to secure the sustainability and expansion of the TSL Project activities (initially with additional assistance through the Phase 3 and potential loans from IFIs) and aims at expanding funds mobilization for SME support beyond the TSL project.

The Working Group for SPE Establishment under the MOF has started the preparation of SPE establishment and prepared this prospectus summary for SPE establishment with the assistance of technical assistance experts dispatched by JICA.

Executive summary

Necessity to sustain the TSL system: The SME development need in terms of financing gaps for SMEs, particularly for long-term project financing, remains widely underserved. GOM and JICA have come to share the common view that the operation of the TSL Project needs to be sustained in the long term and to be further expanded in order to serve the development policy goals more significantly. Further expansion is necessary both in terms of the products and services it offers to SMEs through PFIs and the magnitude of services, through the leverage of its facility and attracting incremental long term development financing. These objectives would be achieved through establishment of a professional development financial institution with a robust shareholding and governance structure, viable business model and professional management team. The establishment of a SPE as the institution for sustained operation of the TSL

Project (hereinafter SME Finance Corporation – SME FC) has been agreed between the main stakeholders (JICA, MOF and PFIs). It was endorsed as a key element of MOF's viable exit policy for the final stage of the JICA assistance for the TSL Project.

Recommended PPP model: The shareholding structure shall reflect a balanced presence of interested and requisite parties in pursuing the TSL operation, that is, the public sector, the private sector and International Financial Institutions (IFI), all of whom benefit from and contribute to the SME FC's operations. The public sector has direct interest in the development objectives and will continue to provide financing made available by ODA loan resources, while the private sector participants ensure the broad developmental objectives are carried out efficiently with a robust business model: the combination of both is best achieved through a PPP structure. The balance between the public and private sector roles would be further enhanced through involving IFI(s) to provide expertise in efficient development lending, commitment to independent governance and access to incremental development funds.

Phased approach: Achieving an optimal PPP structure for SME FC requires careful planning and sequential approach, particularly in a circumstance where diverse investors with differing objectives, policies, procedures and strategies commingled. An indicative shareholding proportion of 30/40/30 for public sector (GOM through MOF), private sector and IFI respectively is recommended as a long-term objective. The recommended proportion is indicative in the sense that it aims at achieving balance and optimizing unique features/ability of the relevant stakeholders: public, private and IFI. GOM as the owner of the TSL Project and the provider of the Revolving fund, will initiate the establishment of the SME FC together with MBA representing the private sector, while reserving room for IFI(s) to join afterwards.

Unique Capitalization: The SME FC's proposed capitalization will consist of:

(i) Common Shares: Authorized common shares capital of MNT15 billion, of which 34% will initially be subscribed by GOM/MOF (public sector) together with 36% to be subscribed by MBA (private sector), and the remaining 30% of the authorized common shares will be reserved for IFI(s) expected to join later; and

(ii) Preferred Shares: The on-lending loans to PFIs of TSL Revolving Fund (RV/F) will be transferred from MOF to SME FC. Concurrently GOM/MOF subscribes to preferred shares, utilizing the RV/F loan asset transfer as in-kind payment for the preferred share investment. The exact amount of the RV/F assets (and therefore the amount of the preferred shares) is to be determined at the time of transfer. It is presently estimated at MNT147.9 billion as of 31 December, 2017. Of the total amount of the preferred shares, a major portion that corresponds to the sum of disbursements of TSL Project Phases 1 and 2 will form a separate class of the preferred shares which is redeemable by the SME FC in due respect of GOM's JICA loan repayment schedule over the next 25 – 33 years.

With the transferred assets being funded by the preferred shares, the SME FC will therefore start operations with a very large equity base, which is needed to comply with applicable single borrower limitations. In addition, the proposed capitalization of SME FC through issuance of the preferred shares matching the transferred TSL RV/F assets, combined with issuance of the common shares, will ensure that: (i) funding made available by the JICA loans to GOM/MOF will continue to be utilized for the intended purposes; and (ii) the SME FC has capacity to redeem the preferred shares with the sustained on-lending operation, supporting MOF's repayments of the JICA loans of TSL Phase 1 and Phase 2.

Wholesale financing under the NBFI license: The SME FC will be a limited liability company (LLC) conducting non-bank financial activities subject to a special license issued by the Financial Regulatory

Commission of Mongolia (FRC). Hence the structure of the SME FC is based on the Mongolian Company Law. Inheriting the current TSL Project scheme, the SME FC will continue to provide affordable financing to SMEs through PFIs on a wholesale basis. However, it is envisioned that SME FC will develop into a professional financial institution with much broader mandate and financial activities and services compared to TSL project operating unit.

1. Rationale for establishing SME FC

The SAPI-2 study conducted by JICA in 2014 has concluded that there is still a significant demand for TSL type of financing from Mongolian SMEs. Notwithstanding the current economic difficulties, the backbone of the economy still heavily relies on SMEs. This is evidenced in the current backlog of TSL funding requests from PFIs. In the context of the need for continued support for SME development, the following outlines main aspects of the rationale for establishment of an SME FC with strong institutional capacity.

Continuation of the TSL Project in a sustainable manner. The TSL Project has outperformed its initial objectives: provision of longer term SME project finance, creation of employment and the very low level of non-performing sub-loans. However, the extended TSL consultancy service will be concluded in May 2018 due to completion of the Contract for Consultants' Services for Two-Step-Loan Project for Small and Medium-Scaled Enterprises Development and Environmental Protection. GOM and JICA share the common understanding that, in order to further pursue the project's development goals, it is critical to continue the TSL Project operation in a sustainable manner and to expand beyond Phase 1 and Phase 2 of the TSL Project. The proposed SME FC is designed to secure the sustainability and expansion of the TSL Project activities (initially through assistance of the Project's Phase 3 and other additional funding sources) and to expand beyond the expected completion of funding under the TSL project.

Mobilization of TSL Phase 3. GOM/MOF requested JICA to extend TSL Phase 3 loan upon conducting SAPI-2. During the initial consultations for the Phase 3 loan JICA requested MOF, as a precondition for extending TSL Phase 3 Loan, to define an exit policy of MOF with respect to JICA's Technical Assistance (TA) support for project implementation, in a manner ensuring sustainable operations of the TSL Project for the intended purposes for the duration of the TSL Loan. Establishment of the SME FC has been agreed as a feasible exit mechanism for sustainable operation of the TSL Project including the operation during the expected Phase 3, therefore satisfying the requirements of JICA for extending TSL Phase 3 loan to GOM.

Support to GOM policy objectives. In its effort to promote economic development and diversification, GOM implements diverse programs to support the SME sector. However, there remains a large portion of the underserved SMEs that require longer term business-oriented project financing. This necessitates the establishment of a professional financial institution so as to efficiently channel development resources in line with the principles successfully implemented through the TSL project and furthermore mobilize additional financing leveraging its own resources. This requires management of the institution to stay focused on the policy objectives, guided by a solid governing structure of high standards of transparency and accountability.

New type of financial institution based on PPP model. The continuation and expansion of the TSL project through a successor entity requires involving more partners, including PFIs as well as IFIs. To grow into a creditworthy wholesale lending institution, the SME FC will require: (i) solid capitalization, achieved through the transfer of RV/F; (ii) proven operating track record, through continuation of the successful TSL Office performance; and (iii) strong capacity of sustainable growth, with a focused business model, good governance, efficient organizational structure and operating know-how transfer. With the SME FC structured in the PPP model, GOM/MOF will stay actively involved as the development policy owner, and as an important partner in the strategic decision-making and monitoring. GOM/MOF will also be a beneficiary of the PPP-structured SME FC in the form of investment return cash flows that contribute to MOF's financial management, in addition to improved efficiency in implementing the SME support financing that contributes to GOM's national development goals.

2. Objectives of the SME FC

Deriving from the rationale for the establishment of the SME FC with strong institutional capacity, the objectives of the proposed SME FC are summarized below.

Sustain and build upon the current TSL System. SME FC is seen as the best option to continue the TSL system, strengthening and expanding the current TSL organizational structure and thereby further improving the successful decision-making and execution processes of the TSL system.

Achieve improved Governance, Transparency and Accountability. The SME FC is expected to follow the international best practice in terms of good governance and business-oriented decision making as described in Section 8. This will ensure the GOM's and JICA's objectives of continuing to implement the original TSL objectives keeping good governance.

Mobilization of additional development financing. The successful implementation of the TSL project and the well-performing TSL RVF create a unique set of endowments for its successor. The successful realization of this unique opportunity will expedite the mobilization of additional financial resources, firstly the Phase 3 of the TSL Project and the expected ADB loan that can be channeled through the SME FC. This will in turn support its long-term sustainable and profitable operation.

In accordance with the above rationale and objectives for the SME FC, the establishment of a development finance corporation (DFC) as an LLC, structured on the PPP model and operating under the Non-Bank Financial Activities law is proposed, based on the study as illustrated in the Annex 4 in the Attachment.

3. Functions of the SME FC

It is envisioned that the SME FC will develop into a professional institution with the appropriate shareholding structure, solid governance and sustainable (reasonably profitable) business model so that it could maintain its operations and support GOM development policy objectives by expanding the SME project financing facility through a co-financing mechanism with PFIs as well as bringing in additional development finance moving forward. MOF envisions SME FC to be developed into a one-stop shop for SMEs where they can receive SME financing, credit information and guarantees.

Wholesale financing institution/Lending: The need and importance of SME financing is broadly recognized. However, in an environment of scarce resources (liquidity shortage), the SME sector is largely underserved. Inheriting the TSL Project scheme, the SME FC will continue to provide affordable financing to SMEs through PFIs on a wholesale basis.

Development financing: The development need and SME financing gap, particularly for long term project financing remains widely underserved. Hence, an important additional function of the SPE will be to attract and mobilize additional financing and channel it efficiently for the intended purposes of the original TSL project while ensuring the development objectives are achieved. The SME FC will complement and contribute in introducing new (and enhancing existing) policy instruments to support SMEs. These will include collaboration with the Credit Guarantee Fund, provision of business focused project financing and working capital, expansion of leasing services and lending and/or guarantee mechanisms implemented through EXIM banks.

Capacity building: The project financing approach and the availability of long term lending are instrumental in promoting the SMEs. The ability of SMEs to develop bankable projects and the proper evaluation of such proposals by PFIs are the core business interests of the SME FC. Hence, it is the built-in function of the SME FC to promote and build capacity of both SMEs as project developers and PFIs as financiers.

Self-sustainable operation: Development objectives are achieved and sustained in the long term when financing is implemented and channeled efficiently through professional institutions with robust business model. An important function of the SME FC, therefore, is to service GOM in implementing development objectives and policies through the support of sound business projects, thus maintaining successful operational policies such as co-financing with PFI, while being more resourceful in promoting capacity building in project analysis and monitoring.

4. Good practice Introduced

In view of the recent experience in some of the policy support efforts for SME development in Mongolia, it is essential to introduce a set of good practice for the proposed SME FC in terms of the ownership and governance structure to help solidify management on business principles and organizational discipline of transparency and accountability.

Local experience: The TSL Project has demonstrated the need and importance of long term SME project financing mechanism, which has led to a careful study of similar efforts/mechanisms to support under the Government Special Fund Law of Mongolia and currently administered by the Ministry of Food, Agriculture and Light Industry), UB city SME development fund (a subsidiary of UB city Municipality) and SME financing programs financed by the Development Bank of Mongolia (DBM).

PPP structure recommended: Public sector's shortcomings in the management of development financing is a common thread shared among many countries. Among various past efforts and experiences the PPP structure of similar institutions received particular attention and demonstrable success. The public sector has direct interests in the development objectives of the program and provides the financing, while the private sector participants ensure that the broad development objectives are carried out efficiently. Thus the integration of both has often been best achieved through the PPP structure. However, the differing nature of decision making with respect to investment, strategy, policy and procedures of public, private and IFIs, might complicate the establishment of a PPP type institution in a single phase. Hence, a careful planning and phased approach is required to achieve a smooth start-up of its operations. There will be shifts in structure and ownership of the SME FC down the road as there is no unique structure for this type of institution and it should evolve adapting to circumstances, as these will develop. It is precisely to provide expertise and guidance in that respect that the active involvement of an IFI is essential.

International good practices: The proposed SME FC's shareholder and governance structure (presented in Section 6) has been designed following the international best practice developed and tested by the World Bank and IFC (WBG) in establishing development finance companies (DFCs) in more than 50 countries. The adopted basic principles ensure that realistic development objectives are implemented effectively. The WBG DFC model was based on the private sector management for broadly defined development objectives. In practical terms, that meant setting up financial institutions that are privately owned (in part or fully) and privately managed, and that would finance only those projects which are both consistent with the Government development priorities and having realistic business prospects as viewed from the private sector perspective and experience.

This mechanism is supported through active involvement of IFIs, i.e. concessional financing and/or direct investment as well as active monitoring. IFIs share development objectives, offer solid governance and play a role of honest broker at the infant stage of the institution. This WBG DFC model has been generally very successful and appears to be well suited for the SME FC role in support of Mongolia's SMEs development program. Therefore, about 30% of the authorized common shares are reserved for future participation by IFIs.

5. Legal Status of the SME FC

Several organization options have been considered. Under the Mongolian Law a privately managed Investment Fund would be limited to investments in specified assets (primarily Government and corporate bonds and shares of companies) and would not be allowed to conduct lending operations (see Annex 4). The Banking Law of Mongolia is currently being debated to include the regulation of specific financial institutions such as the Wholesale Bank, though it is currently at a very early stage of the discussion.

Company Law: Under the proposed structure, the status of the SME FC will be a limited liability company (LLC) providing wholesale loans to PFIs with a Non-Bank Financial Institution (NBFI) license under the supervision of the Financial Regulatory Commission of Mongolia (FRC). The structure of the SME FC shall be established based on the Company Law. An LLC is seen as the appropriate structure as it enables the working of a PPP type of arrangement, selection of the management structure to succeed the TSL functions and ensure the compliance with good governance and transparency. There are only two major types of lending institutions in Mongolia, bank and NBFI (excluding savings and credit cooperative). The NBFI option is preferred compared to a bank because the function of SME FC is wholesale banking and does not include depositary and other retail banking services. Please refer to Annex 4 for the detailed description on the appropriate legal structure for the proposed SME FC.

Under the Company Law, listed joint stock companies and state-owned companies are required to establish a board of directors that should comprise 9 or more directors, and one third of the directors need to be independent directors. Smaller LLCs are not subject to the requirement to establish a board of directors and any requirement of minimum number of directors including independent directors. The SME FC to be established with GOM's common share ownership to be 34% of the total authorized common shares will not be subject to the requirements for state-owned companies or for listed joint stock companies. For the SME FC, while the board size should be smaller than 9 directors, the board structure should generally follow the higher levels of requirements of the Company Law in order to establish solid transparency and accountability for the SME FC as recommended in the subsection of Board of Directors Structure at the end of Section 6.

Law on State and Local Properties: Under the proposed structure of the SME FC in which GOM's share of common equity ownership will be 34%, the asset transfer of the TSL RV/F to SME FC will need to be handled in accordance with the Law on State and Local Properties. Of the directors to be appointed, GOM needs to appoint directors in proportion to the share of GOM ownership. These lending limits in terms of capital are the basis for strong capitalization recommended in Section 6 (i.e., Capital base to support Lending Facility).

Law on Non-bank financial activities: The operation of the SME FC shall be conducted under the Law on Non-bank financial activities (Law on NBFA). FRC issues a license to conduct non-bank financial activities and supervises compliance of NBFIs subject to Law on NBFA and regulatory procedures and ratios approved by the FRC. Law on NBFA stipulates single borrower limits. Limit on loans and guarantees to a single borrower is 30% of paid-in capital. Limit on loans and guarantees to a single shareholder borrower is 10% of paid-in capital.

Law on Public Procurement: Where the percentage of the shareholding right of the GOM in the SME FC is more than 50 percent, planning, reporting, selection of vendors, procedure of the procurement of goods, services and works conducted by the SME FC should be in incompliance with the Law on Public Procurement law.

While the operations of the SME FC in the foreseeable future are envisioned under the existing laws and regulations, the broad objectives and mandates granted to SME FC might require amendments into legal and regulatory environment down the road. In particular, the unique shareholding (PPP) and capitalization structure, the mandate of continuing the TSL Project operations as a wholesale lender, envisioned expansion of operations through new instruments and partnership with credit guarantee, mobilization and securing of long term development financing might require special treatment, or amendment(s) to existing laws and regulation, and possibly even a dedicated law in the future.

6. Capitalization of SME FC and Governance

Capital base to support Lending Facility of the SME FC – Preferred Shares

RV/F assets to be transferred as SME FC's initial loan assets:

The existing RV/F assets (the TSL project's on-lending asset portfolio) will be the SME FC's starting loan portfolio on the asset side of its balance sheet. Upon incorporation of the SME FC, the RV/F assets (mostly loans and residual cash balance) will be transferred from MOF to the SME FC. This asset transfer will be handled in accordance with the Law of State and Local Property. While the exact amount will be determined at the time of SME FC incorporation, the amount of the RV/F assets reached MNT 147.9 billion as of the end of 2017. The RV/F assets have been generated by two distinct

components of funding: (i) approximately MNT 116.3 billion being the MNT equivalent of the successive disbursements for sub-loans through PFIs from the JPY-denominated JICA ODA loans (TSL I and II) at the JPY/MNT and JPY/USD historical exchange rates used for each disbursement (referred to as seed capital component); and, (ii) approximately MNT 26.5 billion being accumulated earned interest on loans to PFIs (currently at 4%), which MOF has added to the RV/F for the purpose of providing additional PFIs/SME lending resources (referred to as accrued interest component). In future after the transfer, the RV/F asset portfolio will continue to grow through the relending of the SME DFC net cash flow.

SME FC's Preferred Shares subscribed by MOF in exchange for RV/F assets as in-kind payment:
To continue performing its function of a wholesale lender (specifically, being a direct lender to only a few PFI borrowers) under the NBFA Law, the SME FC needs a large equity base so as to avoid being constrained by the NBFA Law provisions related to single borrower restrictions. The most practical way to ensure adequate capital funding for the SME FC's initial and future on-lending portfolio is for the SME FC to issue Preferred Shares (PS) to MOF, in exchange for the transfer of RV/F assets to the SME FC as in-kind payment for the equity investment in the Preferred Shares.

In recognition of the different characteristics of the two RV/F components, it is recommended that the Preferred Shares have two classes, A (PS-A) and B (PS-B):

(i) PS-A: Approximately MNT 116.3 billion, equating to the seed capital component, i.e., the sum of all original disbursements from the JICA loans at the corresponding historical exchange rates. PS-A will be entitled to a preferred dividend at a rate fixed at 1% p.a. The rate is set in consideration of GOM's interest payments (0.65% and 0.75%) due on the JICA loans. PS-A will be redeemable by the SME FC in due respect of the GOM's JICA loan repayment schedule of the next 25-33 years.

(ii) PS-B: Approximately MNT26.5 billion equating to the accrued interest component of the on-lending to PFIs. PS-B will be entitled to a preferred dividend at a fixed rate of 3% p.a. The rate is set in consideration of the expected nominal return of the on-lending under the present practice of the TSL project. PS-B will not be redeemable.

The preferred share is a type of equity that gives the holder the benefit of priority rights with respect to dividends and asset recovery upon liquidation. For the SME FC, it establishes a strong equity base in support of the SME FC's lending facility for PFIs. The strong equity base can also facilitate future borrowings from investors.

Founders of SME FC – Common Share Ownership Structure

The balance between major shareholder groups, i.e. GOM/MOF, private sector and eventually IFI(s) needs to be carefully balanced to minimize potential conflict and ensure smooth collaboration for sustainable continuation of the TSL Project operations and development of a professional financial institution. By nature, these groups have differing objectives: (i) Government is aiming to achieve broad development objectives; (ii) private sector would be seeking a reasonably profitable operation, even though in this case PFIs through an institution representing collective and broader interests in the SME FC wholesale lending, such as Mongolian Bankers' Association; and (iii) IFI(s) would aim to ensure a fair and effective combination of the two. The IFI(s) interests are not tied to the (sometimes, conflicting) objectives of the major shareholders, and because of their experience and commitment to efficient development finance delivery are traditionally considered as the ideal neutral honest broker. Therefore, IFI participation, contributing through technical expertise, good governance and political clout to the successful operations of the SME FC, is considered essential by both Government and private sector stakeholders.

Ideally, the balance is achieved through equitable distribution of shareholding structure that fits the objectives of the shareholding groups: host government, IFI(s) and private sector, represented by MBA.

Therefore, MOF has been approaching IFIs for equity participation in SME FC and will continue to do so going forward. In the case of Asian Development Bank (ADB), it was indicated that ADB is unable to make an equity investment in SME FC in the current circumstances. ADB, however, indicated a possibility of extending a loan to SME FC in the future. Furthermore, ADB expressed willingness to appoint a Director on SME FC's Board if so requested, recognizing the importance of its institution building role.

It is recommended that the SME FC authorized common share capital be set at MNT15 billion, of which initially it is envisaged that 34% (or MNT5.1 billion) would be subscribed by GOM/MOF, 36% (MNT5.4 billion) would be subscribed by MBA, and the remaining 30% (MNT4.5 billion) would be reserved for IFIs / international private investors for participation at the next stage. This phased approach is considered appropriate for enabling the SME FC to start operations as soon as possible as required by the agreements between MOF and JICA. It would also maintain symbolically in evidence the ultimate objective of the IFI direct investment when circumstances would permit.

While it is broadly recognized that PPP structure is optimal for effective delivery of the development policy, MOF and JICA aim to avoid SME FC turning into a "privatization exercise". Hence it is important to keep a prudent balance among initial stakeholders and reduce risk of diluting from original intended purposes down the road, particularly during the initial stages of operation.

Proposed shareholding structure is shown in the Table below.

Proposed Target Capitalization structure of the SME DFC

Category	Capitalization	
	(in billion MNT)	(% of common shares)
Authorized shares	**157.9**	
Preferred shares	**142.9**	
Preferred A (GOM)	116.3	
Preferred B (GOM)	26.5	
Common shares	**15.0**	**100.0%**
GOM	5.1	34.0%
Private sector (MBA)	5.4	36.0%
International Institutions	4.5	30.0%

Board of Directors Structure

Board Composition and Nomination Sources

Board of Directors composition by nomination sources

Director nomination sources	Common share ownership		Director seats to be nominated			
	(in billion MNT)	(% of common shares)	Director Seats	Non Independent	Independent	CEO candidate
	15.0	100.0%				
GOM*	5.1	34.0%	2	1	1	
Private sector (MBA)	5.4	36.0%	2	1	1	
IFIs / International private	4.5	30.0%				
ADB (non-shareholder)	-	-	1		1	
Nominee selected under consensus of stakeholders**			2		1	1
Total			7	2	4	1

* The number of directors GOM should appoint is required by Law of State & Local Properties to be proportional to GOG's ownership share of common equity.
** All director nominations should be finalized with the consensus among all the shareholders. Under this consensus nomination process, the number and names of GOM's appointments may be determined to comply with the proportional appointment requirement of the law.

Under delegation of authority by the shareholders' meeting for ongoing governance of the company, the board of directors: (i) provides guidance for the SME FC (determines high level policies and high-level strategies of the SME FC business), and (ii) provides oversight on the SME FC management and overall operation (monitors the management team's execution of the policies and strategies and evaluates operating results). Under the board of directors' policies and strategies, the management team is responsible for making executive decisions and implementing the operation of the SME FC in adherence to the professional business principles required for sustainable and successful business concerns.

Based on the examination of the nature of the SME FC operation, a board of 7 directors is recommended as an appropriate size for effective and efficient governance. In the case of the SME FC to be formed as an SOE (government 100% owned), the board will be made up of 9 directors since the Company Law requires 9 directors for SOE irrespective of the size of the company.

Nomination sources of directors are recommended to be split among the shareholders and stakeholders as shown in the table above. MBA, representing the PFIs should be a source of professional talents for director nomination. IFIs supporting the SME FC such as ADB even before equity participation can be a source of director candidates who can act as an honest broker within the board. The nomination by these source groups including GOM should include independent director candidates as shown in the table.

Independent Directors: The Board of Directors is recommended to include 4 independent directors. Chairperson of the Board shall be an independent director. This is in line with the Company Law's requirements for listed joint stock companies and SOEs for which the law expects higher standard of accountability and transparency.

"Independent director" is defined as a person who meets all of the *criteria of independence* below (in consistency with the Company Law Article 79):

a) Does not own 5% or more of the SME FC common shares (Company Law Art. 79);
b) Does not hold an official position in the SME FC in the last 3 years (ditto Art. 79);
c) Shall not be public servant other than public service officer (ditto Art. 79);
d) Shall not be related to the SME FC's business in any way (ditto Art. 79);
   As the above is applied to the SME FC situation,
   ✓Shall not be related to the shareholders, PFIs (borrowers), sub-loan borrowers and providers of funding of the SME FC.

Board Committees

In order to promote appropriate corporate governance of the SME FC, in particular, protecting the SME FC operation from political pressures for uneconomical programs and political interference for individual sub-borrowers and projects, the SME FC should adopt the following Board Committee structure from the initial stage. The structure here is in conformity with the best practice recommended in FRC's Corporate Governance Code of Mongolia, as well as international guidelines such as OECD Guidelines on Corporate Governance of SOEs, and G20 OECD principles of Corporate Governance.

The SME DFC's Board of Directors will have the following committees:

(1) Nomination and Remuneration committee;
(2) Finance and Audit Committee;
(3) Investment & Risk Policy Committee

Committee chairperson of the 3 Board Committees (see below) shall be an independent director.

7. Expected Contribution/Assistance from the Concerned Entities

MOF

MOF is the principal founder because of its position as the originator of TSL Project, the predecessor of the SME FC. MOF's relationship with SME FC can be summarized as below:

Investor of Common shares: MOF is expected to lead the process of establishing the SME FC in its capacity as the representative of the GOM as the principal investor. It is expected (at least during the initial establishment) that MOF would declare its subscription to 34% of the SME FC authorized common shares (MNT5.1 billion assuming MNT15.0 billion authorized capital).

Investor of Preferred shares: Most importantly, MOF is the principal investor for the SME FC's lending facility, by transferring the TSL RVF assets to the SME FC and, in exchange, investing in preferred shares of the SME FC. The preferred shares are considered as Tier 2 equity capital as per the definition by the FRC. It is the RVF that facilitates the establishment of the SME FC and its business model as described in more detail in Sections 6 and 8.

As a policy setting institution: MOF will ensure the GOM policy objectives are clearly conveyed through its representative on the SME FC Board of Directors, and by monitoring compliance with the Memorandum on management policy guidelines (MPG), though it will not be involved in the day-to-day operations of the SME FC.

Local Private Sector

Investor of Common shares: Contribute to the Mongolian private sector equity investment of 36% (MNT5.4 billion) of the recommended authorized common shares base of MNT15.0 billion.

Shareholder Group Representative: Appoint an institution as the trustee representing all the shareholding domestic financial institutions from the private sector.

Attraction of private sector investors: To facilitate and encourage other potential private sector investors (domestic and international) to invest into the SME FC.

Promote and support to the establishment of the SME FC: Commit to the roadmap for the establishment of the SME FC and provide continued support to the SME FC operations.

ADB

The presence of an IFI is considered essential by both MOF and the private sector, to provide the experienced guidance needed to promote a smooth collaboration between public sector and private sector interests and to ensure a constructive integration of development objectives and business-like management criteria. The MOF has therefore requested the participation of the Asian Development Bank (ADB) in the project as well as their direct involvement in supporting the institution's governance and evolution through a seat on the Board of Directors.

ADB indicated a possibility of extending a loan to SME FC on market terms in the future. Furthermore, ADB expressed willingness to appoint a Director on SME FC's Board if so requested, recognizing the importance of its institution building role.

The ADB TA can complement the expected TA to be provided by JICA.

JICA

TSL Phase-3: This loan will be the most expected contribution from JICA. TSL Phase-3 has been officially requested before the conclusion of Phase-2 and JICA has taken necessary procedures so far. While discussion is ongoing between GOM and JICA, expectations are that Phase-3 would start by 2020. TSL Phase-3 would contain a Technical Assistance portion in its loan similar to the previous Phases of 1 and 2 schemes.

Technical Assistance (TA): JICA has been providing its TA to assist MOF for the consideration process of establishment of a finance scheme for SMEs during the period from April 2016 until May 2018. It is expected that JICA would consider another TA to assist with the implementation of a financial institution to be established if necessary. It is assumed that the SME FC management team will be assisted by JICA advisors on a short-to-long-term basis under the TA if considered necessary. This will ensure the fulfillment of the SME FC policy objectives as well as to fill in the potential professional gap at an initial stage.

Monitoring of the Governance of SME FC: JICA will contribute to good management and governance of the SME FC through its monitoring rights granted in the existing loan agreements and other related documents for the TSL Phases 1 and 2, and potentially Phase 3. The contribution could be materialized by providing the above TA advisory service to the Board and the shareholders' meeting. This function can also be facilitated through potential foreign investors who would place supporting pressure on SME FC for solid governance in its pursuit of successful and expanding operation.

8. Business Plan of SME FC

The SME FC business plan is designed to achieve the crucial medium- and long-term rationale and objectives outlined in Sections 1 and 2, which have led the MOF to promote its establishment. The successful establishment and operations of the SME FC will achieve several important policy objectives, as highlighted below. Its organization and staffing, its financial structure and its operating policies are coordinated in support of those objectives.

To keep and expand lending activity in an innovative manner: The broadly recognized immediate priority is to ensure the continuation of the highly successful TSL Project in a sustainable and efficient manner. In particular, the TSL Project shall evolve into its second phase in terms of implementation mechanism by transitioning from the existing TSL structure into self-sustainable (profitable) independent institution that can expand beyond the original TSL Project outreach. The SME FC is structured to take over responsibility for the program as well as for its further expansion both in terms of resource mobilization and diversification of support services. The SME FC strong equity base and business-oriented organization are consistent with these functions.

The SME FC will continue its established policy of lending to SMEs through PFIs, therefore maintaining the existing wholesale lender model. The SME sub-borrowers credit risk analysis will be continued primarily by the PFI's responsibility, with the project feasibility analysis being actively monitored by the SME FC in collaboration with the PFIs through the expanded TA activities in support of capacity building. SME FC specifically, the management and staffing outlined in the attached organization charts (Annex 5 and 6) will make it possible for a significant increase in the technical assistance activities.

A new important feature is to be introduced. Co-financing with PFIs in sub-loans to SMEs will become a regular policy, with a standard minimum ratio of 20% for the PFI component, so as to leverage the RVF resources by mobilizing incremental resources. The aggregate principal amortization schedule will provide for the PFIs shorter term component to be repaid first. Furthermore, since the interest on PFIs' own funding will be higher, the SME FC will consider the possible introduction of time-averaging features to even out interest payments to the benefit of the SME borrowers.

TSL operation aligned with pursuit of policy objectives and generation of investment return for MOF: The proposed capitalization of the SME FC through issuance of the preferred shares matching the transferred TSL RVF assets, combined with issuance of the common shares, will ensure that: (i) funding made available by the JICA loans will continue to be utilized for the intended purposes, and therefore MOF policy implementation in providing financial and technical assistance to SMEs will be successfully sustained in the long term; and (ii) the SME FC has capacity to redeem the preferred shares with the sustained on-lending operation, supporting MOF's repayments of the JICA loans of TSL Phase 1 and Phase 2.

As shown in the financial projection results in Section 9 below, the SME FC under the business plan based on the business model developed through Phase 1 and Phase 2 will generate income and cash flows that are respectable as a viable wholesale financial institution. After corporate income tax payments(*), the projected net income and cash flows allow for payments of Preferred Share dividends, Preferred Share A (PS-A) redemptions in increment, along with Common Share dividends. The investment return cash flows for MOF will reach about MNT64.1 billion by 2023 (and continue until 2050 with maximum payments of MNT 18.0-28.0 billion per annum during 2024-2046), comprising dividends on Preferred (MNT44.9 billion) and Common Shares (MNT2.0 billion) and redemption of Preferred Shares (MNT16.1 billion). A total of MNT632.9 billion of payments, of which MNT291.6 billion in dividends and MNT341.3 billion redemptions, are projected be made to MOF till end of 2050.

(*) As an independent and self-sustaining financial institution, SME FC will pay corporate income tax, estimated initially at MNT584.5 million in 2019 (the first year of operation) and reaching an average of about MNT2.0 billion from 2022 onwards.

Enhanced SME support: In comparison to the current administrative costs of the TSL program (until now covered by Phase-2), the SME FC will need to cover incremental operating expenses of about MNT1.9 billion due to the buildup of an independent organization with expanded technical assistance capacity in addition to its project finance role. Indeed, the SME FC is designed and capitalized to provide tangible support (in the form of long-term financing) as well as intangible forms of support (through TA for the improvement of business practices), both essential for SMEs development and growth. The SME FC will thus be able to significantly expand the annual volume of financing mobilized, including the new co-financing policy, to an average of about MNT60-80 billion in the early years, stabilizing over time at MNT70 billion. The number of sub-loans per year is expected to stabilize at about 110, reflecting the gradual increase in the average size of loans, in itself a positive development indicating higher requirements from growing SMEs. The planned management and staffing organization will enable the SME FC to expand its technical assistance in support of both PFIs and SMEs capacity building, particularly with respect to project analysis and business planning.

Interest Rate Policy: As noted above, the SME FC will need a stronger organization than the current TSL set up to carry out such expanded range of activities. Its operating budget will be at least double than that of the present TSL office, and will have to be covered by its own revenues, since the SME FC will operate as an independent and creditworthy financial institution. In addition, the SME FC will assume a significant financial burden for reimbursements of financing provided by MOF. Under the present circumstances the lending rate to the ultimate SME borrowers was fixed at 8%, comprising 4% accruing to MOF and 4% as lending margin to the PFIs. In line with the new responsibilities of the SME FC operating as a self-sustaining provider of long term funding, an increase in the lending rate up to 12% is considered necessary, to be split between the SME FC (up to 8%, up from a notional 4%) and the PFIs (at around 4%).

SME FC Role in Mobilizing Additional External Financing: Notwithstanding the enhanced program outlined above, demand from SMEs and PFIs remains well in excess of current resources, resulting in a significant applications backlog. It is undeniable that the potential for growth in lending operations has been constrained in recent years by limited availability of resources. The reason is that upon completion of the initial disbursements from TSL Phase1 and Phase2, new loans could only be funded through the RVF cash balance, which is generated by repayments from existing loans and by the accruing 4% interest on outstanding loans. Additional funding is urgently needed and it is precisely for that purpose that the SME program is being transferred to the SME FC, a self-sustaining financial institution structured to be a creditworthy and professional development finance institution that can raise financing on its own right. In the medium- and long-term SME FC's proposed strong capitalization based on the existing RVF and its strengthened organization can and should be leveraged to mobilize additional funding in support of SMEs.

9. Financial Projections

Financial projections have been prepared to show the base case for the possible financial outcome over the next 30 years. The projection incorporates an assumption of additional financing of the TSL Phase 3 in the amount of and on the terms of the potential Phase 3 loan under consideration. Other initiatives discussed in the Business Plan section above are not reflected in this base case projection, such as mobilization of new external funding and loan interest rate policy change. The summary financial projections are attached in Annex 7.

The financial projections have been run through 2050, by which time MOF's repayment of JICA loans will be completed. The financial projection assumes the same treatment for the additional financing, that is, MOF's transfer of TSL loan proceeds to the SME FC and concurrent subscription of Preferred Shares A3 issued by SME DFC. The redemption schedules used in the projection were made to correspond to the MOF amortization schedules to JICA.

Projected Balance Sheets show a sharp increase in total on-lending portfolio already by 2024, to MNT389.8 billion under the assumption of the Phase 3 funding. Without new additional funding initiatives incorporated in the projection, the loan portfolio balance is expected to plateau at that level. In the longer term, by 2050 total loan portfolio is projected at MNT566 billion, on the assumption of full redemption of Preferred A shares. While 30 year projections are subject to countless variables and uncertainties, they are nevertheless indicative of structural trends. In this case, they confirm the long-term validity of the SME FC model as a sustainable and creditworthy institution capable of mobilizing additional financing in support of SMEs and in amounts substantially greater than the simple continuation of TSL project utilizing existing resources.

The ability to raise external funding is the fundamental medium-term objective of the SME FC, and its PPP type structure is well supported by the IFIs. The projections indicate that with only a modest increase in staffing, the SME DFC organization will be able to easily handle its operations, initially up to an additional MNT220 billion and additional 80 to 100 sub-loans per year, with further growth over time due to the rollover of net cash flow.

The **projected Income Statement** shows annual interest revenue reaching MNT25.9 billion by 2023 upon full disbursement of loan proceeds, and further increasing thereafter because of the compounding effect of net cash flow rollover for new sub-loans. Dividends on total Preferred Shares A reach MNT38.3 billion in 2023, and accruing to MNT237.4 billion on account of Preferred A shares in 2050.

The **Cash Flow projections** are based on additional funding availability assumed to be in the amount and on the terms of the potential TSL Phase3 loan: an amount of MNT225 billion (equivalent to JPY10.0 billion), disbursed for sub loans in 4 years starting from 2020 in equal semi-annual tranches of MNT28.1 billion. In line with TSL Phase 1 and 2 facility the loan proceeds are assumed to be made available by MOF to the SME FC against issuance of Preferred Shares (PS-A3). Similarly to the original PS-A (for Phase 1 and Phase 2), PS-A redeemable on the 10 years grace and 30 years amortization schedule expected for TSL Phase-3, and carrying a 4.0% annual dividend under current Japanese ODA Loan terms and conditions for lower Middle-Income Countries. However, this terms and conditions are subject to change in the future.

The projections indicate annual resources for sub-loans increasing by MNT50 billion in 2020 and further to maximum of MNT225 billion in 2024 upon full disbursement of the assumed TSLPhase3 loan and rollover of net cash flow. Mobilization of additional funding in the mid to late 2020's will be a desirable strategy for the SME FC in order to better meet the expected high level of SMEs' long term financing needs.

10. Road Map

The roadmap of major events related to the establishment of the SME DFC and its earlier stage of operations thereafter is shown below as:

Major events related to SME DFC establishment

No.	Major events	Date	Time needed
1.	GOM/MOF commitment for SME DFC to JICA	Early March, 2018	n/a
2.	Approval of the SME DFC proposal by the Cabinet	March , 2018	1 month
3.	Establishment of the SME DFC as an LLC	April, 2018	2 months
4.	TSL Phase-2 Completion	May, 2018	n/a
5.	Obtain the NBFI operational license from the Financial Regulatory Commission	May, 2018	n/a
6.	SME DFC starts	July, 2018	n/a
7.	Transfer of TSL revolving fund assets and issuance of Preferred shares	July-August, 2018	n/a
8.	JICA TA is expected	August, 2018	n/a
9.	Start of the invitation for Potential new international investors Proposal (IFIs and the private sector)	August, 2018	n/a
10.	Start of Phase-3 of TSL Project	December 2020	n/a

11. Transaction documents

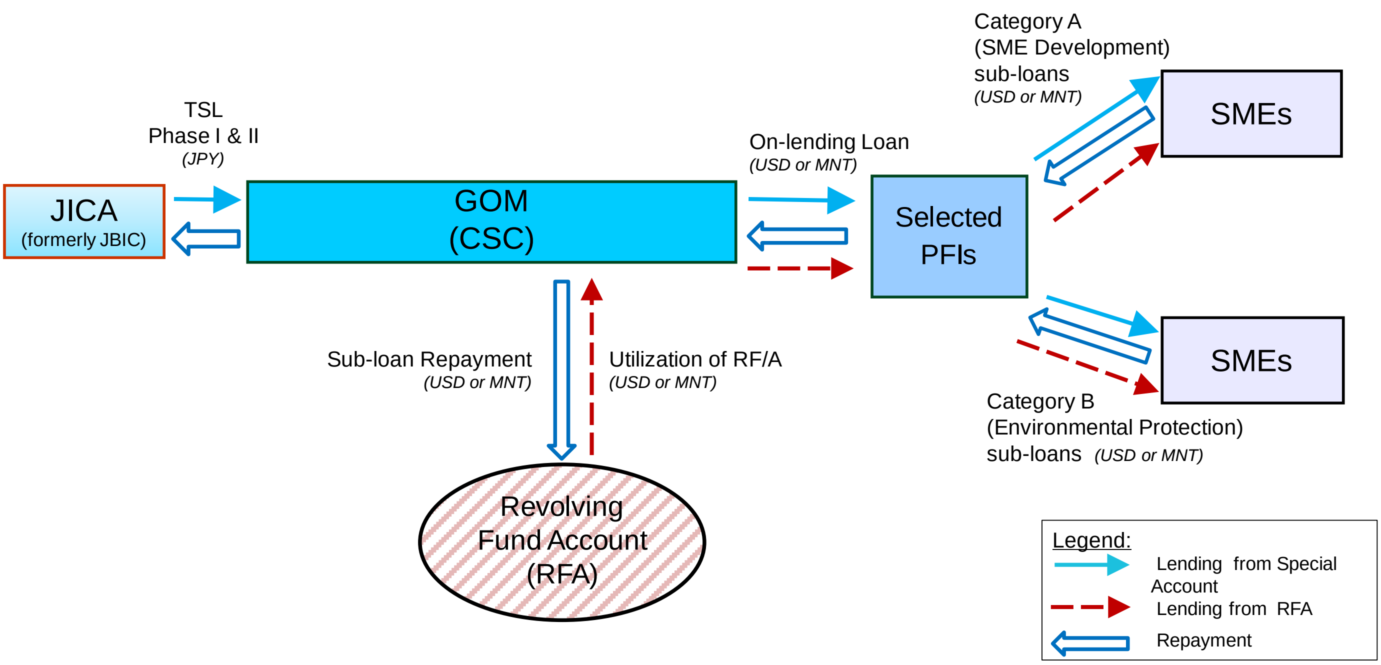
The major transaction documents related to the establishment of SME DFC and its earlier stage of operations thereafter is shown below as:

No.	Transaction documents	Main content	Expected dates for execution
1.	SME DFC incorporation related		
a.	Cabinet Resolution	Incorporation of the SME DFC appointment of the representative exercising the shareholder's right on behalf of the GOM -may approve Charter	Expected within September, 2017
b.	Cabinet Meeting Minutes	SME DFCcifying the procedures of the registering the SME DFCE and appointing state organizations for their reSME DFCctive tasks	On the same date as the Cabinet Resolution
c.			
d.	Decree of the representative exercising the shareholder's right on behalf of the GOM (ministry and/or ASPM)	Appointing state representative to the Shareholder's meeting and nominating the directors to the Board of Directors.	Upon the issuance of the Cabinet Resolution
e.	Founding Resolution	Approving Charter, Appointing the Directors of the Board and its committee, if any Appointment of Executive Director, Company Secretary (Board may issue a separate resolution)	Upon the issuance of the Cabinet Resolution
f.	Company Charter of SME DFC	According to the Company law	On the same date as Founding Resolution.
g.	Other ancillary documents required for SME DFC registration	Translation of incorporation documents, office rental agreement, applications to the registration authority, Power of Attorney for registration, the registration fee etc.	Upon registration
h.	Term sheet	Reflecting key issues of Shareholders agreement and SME DFC operation, between GOM, Private Sector and IFIs	Within the first quarter of 2019
i.	Shareholders Agreement	SME DFC's corporate governance (General meeting and board, its committee authority and operation, senior management), share authorization, share subscription, payment and issuance, preferred share subscription, issuance, payment and conversion and redemption conditions, shareholders and preferred shareholders rights, dividend and share disposal (Preemptive rights), liquidation and other conditions between the GOM, Private Sector and IFIs	After the conclusion of the Term Sheet.
2.	SME DFC licensing related		
a.	Application documents for NBFI license	According to NBFI law and FRC rules and regulations	On or after registration of SME DFC but before

			end of 2017
3.	SME DFC operation related		
a.	Board resolutions	Appointing Senior management Approving Corporate policies Business plan	On or before the registration of SME DFC (Before the NBFI license application)
b.	Contract with the Senior Management	Between the Board and Senior management	On or before the registration of SME DFC
c.	Corporate Policies	on Dividend policy, Remuneration and operation of the Board and its committees, Conflict of interest transaction policy, Internal audit policy, Risk assessment policy, Credit committee, Anti money laundering and terrorism financing policy, Internal labor policy by the General Meeting or Board as allocated to any of them under the Company Charter of SME DFC	On or following the registration of SME DFC
d.	Other documents	Required as per registration, license application and operation	

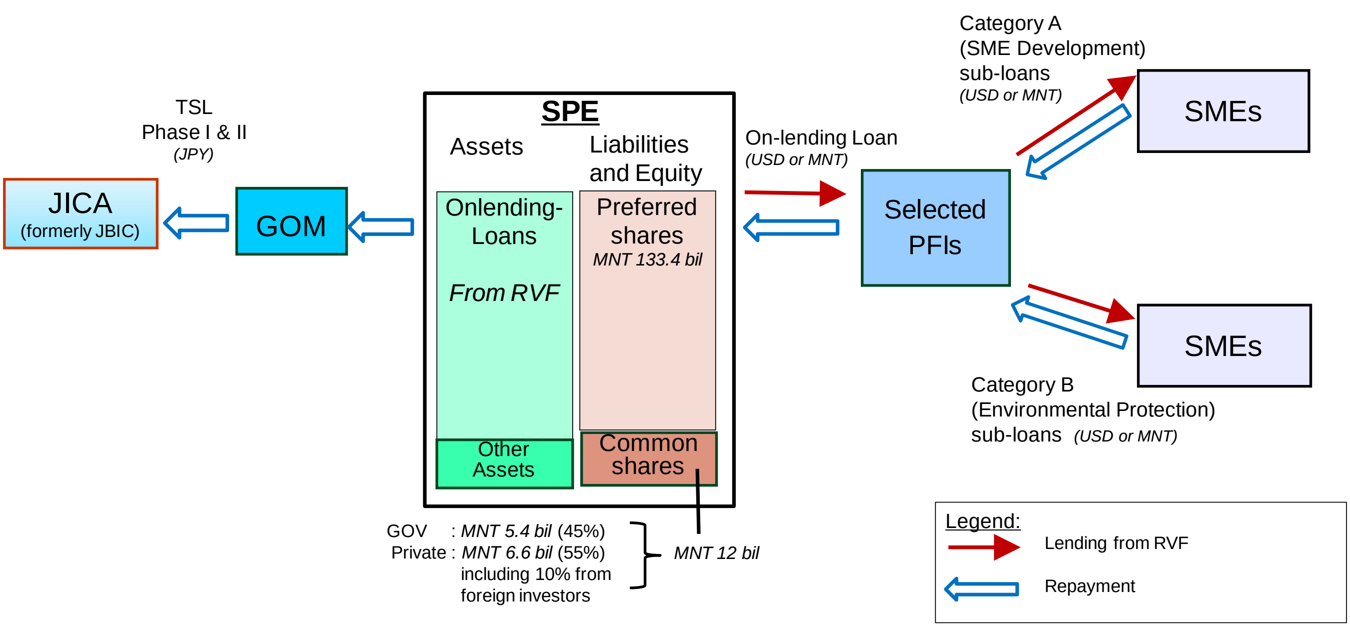
Appendix

Annex 1. TSL Function Scheme



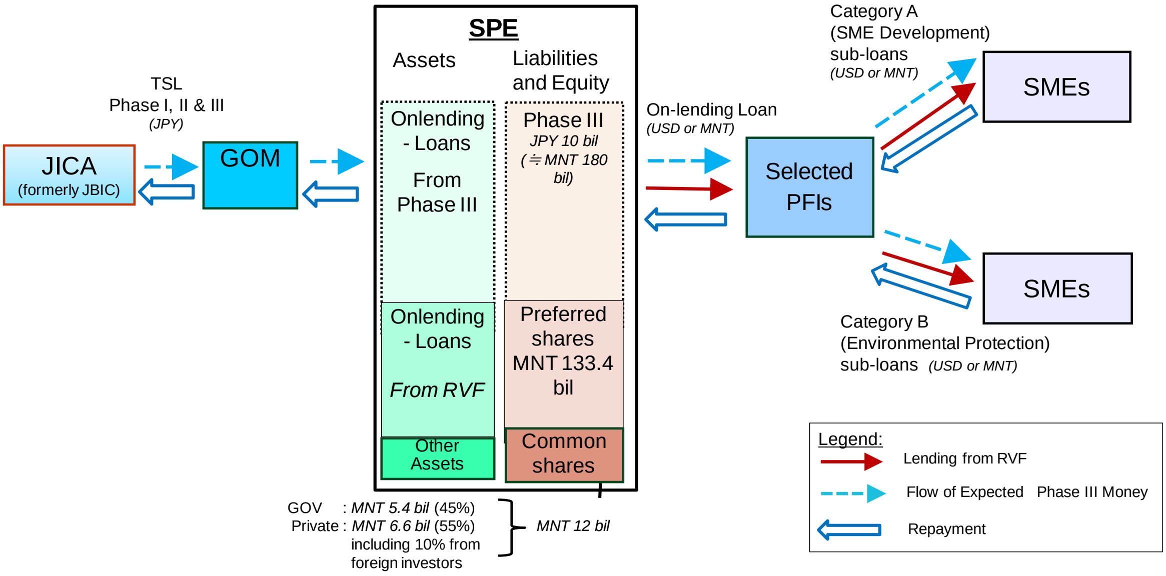
Source: JICA TA Experts

Annex 2. SME DFC Function Scheme



Source: JICA TA Experts

Annex 3. SME DFC Function Scheme (with Phase III)[1]

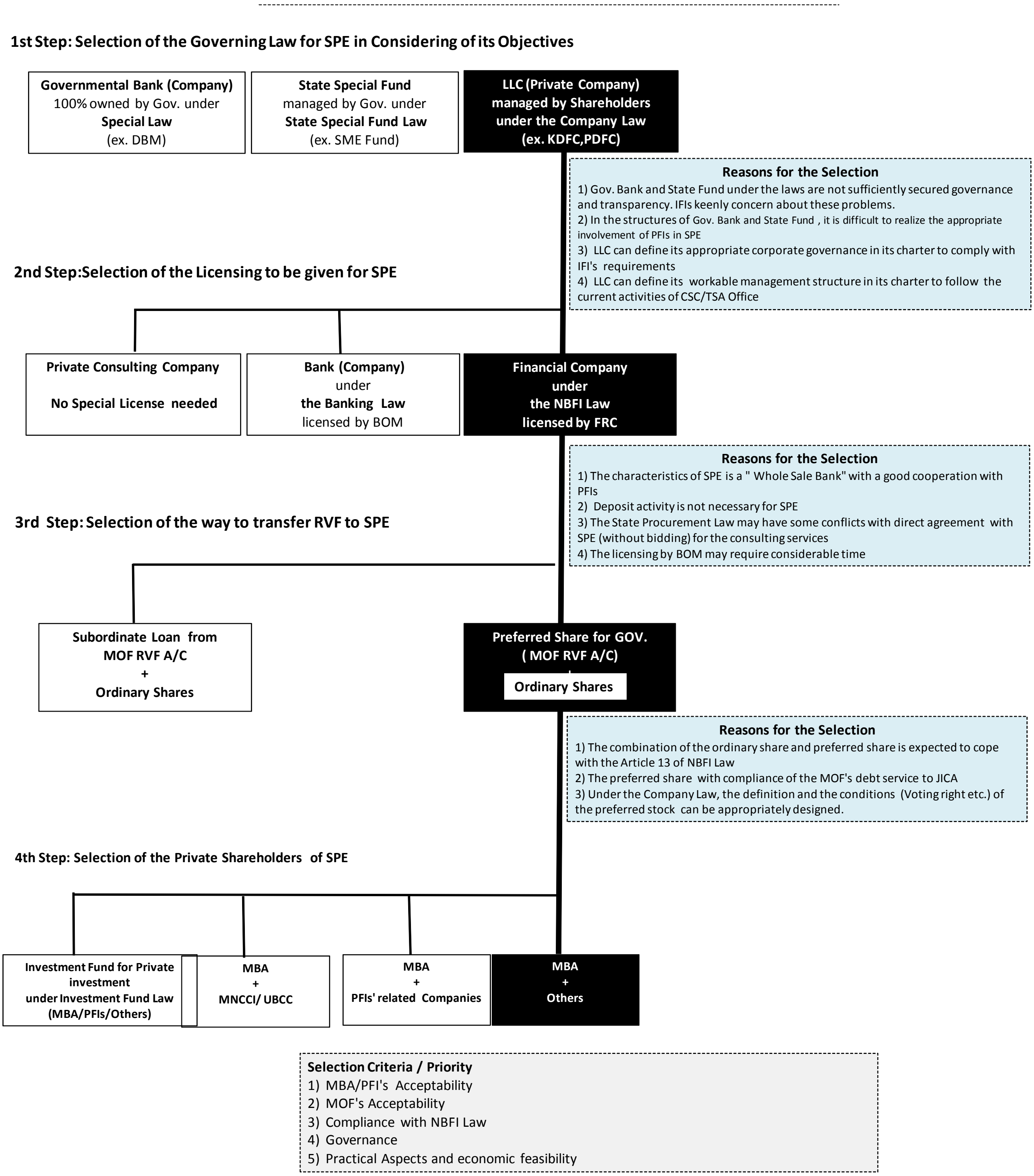


Source: JICA TA Experts

[1] JICA will appraise the validity of SME DFC as the executing agency of TSL Phase III during JICA's TSL III's appraisal stage.

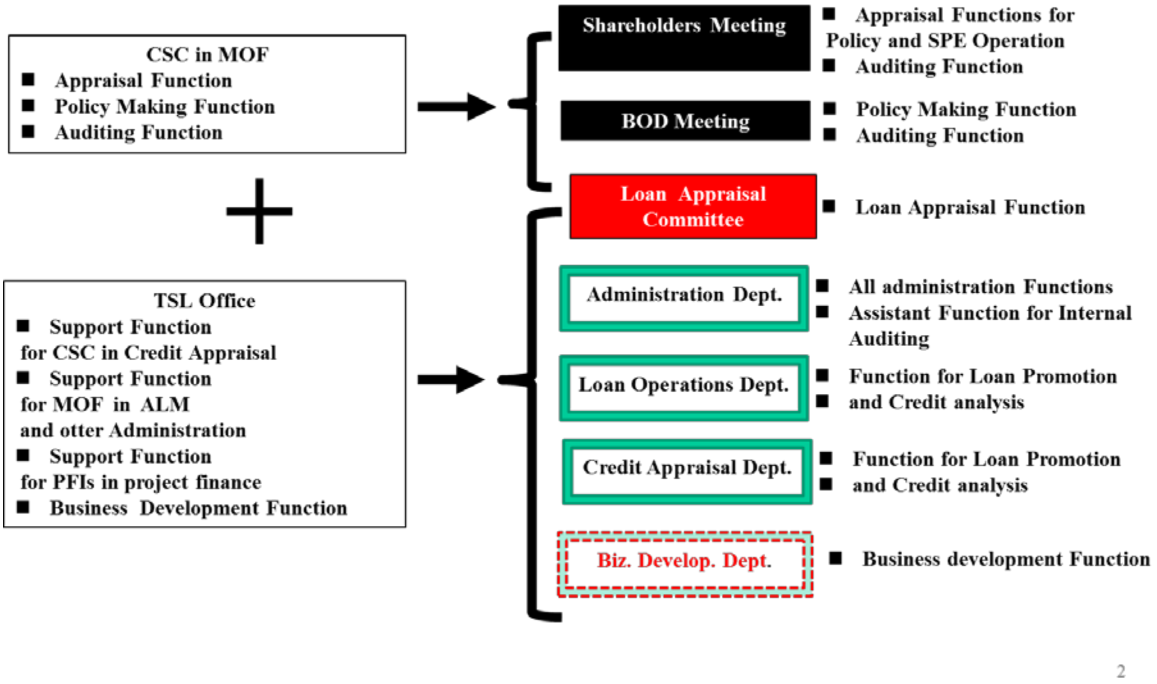
Annex 4. Steps for Selection of SME DFC Structure

Extended consultant service contract for the present TSL Scheme will be terminated in May 2017. Therefore, financial self-supporting SME DFC would have to be established to maintain the sustainability of TSL Project.



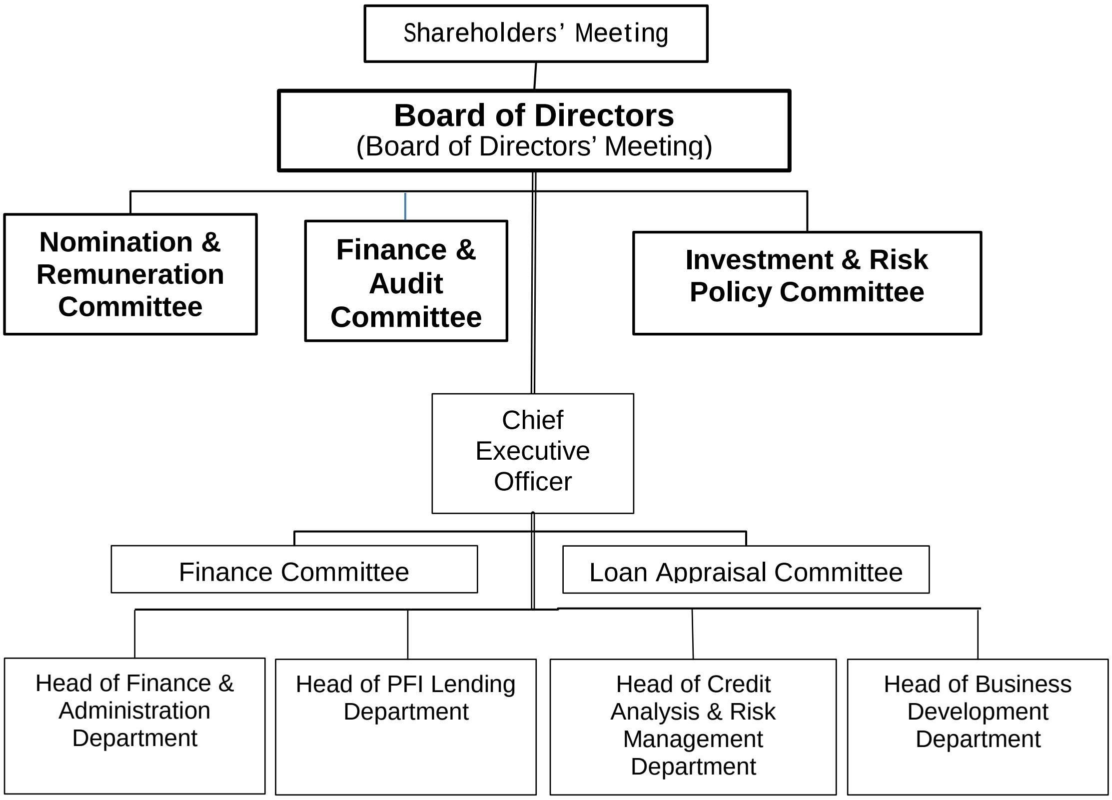
Source: JICA TA Experts

Annex 5. TSL Scheme and SME DFC Organization



Source: JICA TA Experts

Annex 6. Expected Organi



1) Accounting and financial reporting, incl. tax accounting;
2) Budget, regular review of financial results;
3) Financial mgmnt review of balance sheet and income projections;
4) Treasury Ops –
   - Payments and receipts
   - Cash projection / control
5) HR management;
6) Administrative Ops

☆Company Secretary
☆Board Secretariat

1) Front office for on-lending loans:
   - PFI relationship manager;
   - Initiator of approval requests for on-lending (based on PFI application, but also own sub-loan project analysis)
2) Middle office function:
   - collections

1) Credit analysis of PFIs
2) Credit analysis and assessment on on-lending loans based on sub-loan analysis
3) Loan portfolio risk assessment

□ SPE's on-lending loan applications are submitted to Loan Appraisal Committee by CA&RM jointly with PFI Lending Department.

1) Advisory to PFIs for TSL
2) Industrial research activities

Annex 7: Financial projections of the SME FC

Table 1: Projected Summary of Cash flows, mln.MNT

CASH FLOW SNAPSHOT							
Period	SME DFC RVF Beginning Balance	Sub-loans issued	Dividends paid	Redemption of Preferred shares	Loans repaid	Taxes paid	Ending Balance of SME DFC RVF
Totals	**145,647**	**2,780,954**	**324,858**	**341,316**	**-**	**103,957**	**566,268**
12/30/2023	290,880	333,119	49,565	16,143	-	7,150	317,905
12/30/2028	357,883	699,234	127,151	35,713	-	22,148	362,617
12/30/2033	378,665	1,098,494	197,477	100,282	-	38,595	378,695
12/30/2038	394,487	1,518,407	252,976	176,101	-	55,509	397,084
12/30/2043	432,370	1,978,807	293,311	251,920	-	73,707	437,901
12/30/2048	505,544	2,522,224	318,605	324,684	-	94,476	515,532

Table 2: Projected Summary of Financial Statements, mln.MNT

BALANCE SHEET SNAPSHOT							
ITEM	6/30/2018	12/31/2023	12/31/2028	12/31/2033	12/31/2038	12/31/2043	12/31/2048
ASSETS							
Cash & cash equivalent	-	50,381	43,497	40,546	43,066	49,876	61,112
Deposits (common share & reserves)	12,000	16,000	16,000	16,000	16,000	16,000	16,000
Subloan portfolio	145,647	317,905	362,617	378,695	397,084	437,901	515,532
TOTAL ASSETS	**157,647**	**384,286**	**422,114**	**435,240**	**456,149**	**503,777**	**592,644**
LIABILITIES & EQUITY							
Liabilities							
Accounts payable	-	-	-	-	-	-	-
EQUITY							-

Preferred A	116,316	325,173	305,604	241,035	165,215	89,396	16,633
Preferred B	29,330	29,330	29,330	29,330	9,330	29,330	29,330
Common shares	12,000	15,000	15,000	15,000	15,000	15,000	15,000
Retained earnings	**-**	**14,783**	**72,180**	**149,876**	**246,604**	**370,051**	**531,681**
TOTAL LIABILITIES & EQUITY	**157,647**	**384,286**	**422,114**	**435,240**	**456,149**	**503,777**	**592,644**

Table 3: Projected Summary Income Statements, mln. MNT

INCOME STATEMENT SNAPSHOT							
	6/30/2018	12/31/2023	12/31/2028	12/31/2033	12/31/2038	12/31/2043	12/31/2048
REVENUE							
Sub-loan interest	-	24,300	31,923	33,432	34,845	38,286	44,790
Deposit(s) interest	-	1,600	1,600	1,600	1,600	1,600	1,600
TOTAL REVENUE	**-**	**25,900**	**33,523**	**35,032**	**36,445**	**39,886**	**46,390**
EXPENSES							
Salary & Office expenses	-	1,929	1,919	1,916	1,919	1,921	1,919
Interest expenses	-	197	-	-	-	-	-
TOTAL EXPENSES	**-**	**2,126**	**1,919**	**1,916**	**1,919**	**1,921**	**1,919**
Profit before tax	**-**	**23,774**	**31,604**	**33,116**	**34,527**	**37,964**	**44,471**
CIT	-	2,377	3,160	3,312	3,453	3,796	4,447
Profit after tax	**-**	**21,397**	**28,444**	**29,804**	**31,074**	**34,168**	**40,024**
Dividends	**-**	**12,244**	**13,515**	**11,270**	**8,237**	**5,204**	**2,257**
Preferred A	-	11,071	12,342	10,096	7,064	4,031	1,084
Preferred B	-	1,173	1,173	1,173	1,173	1,173	1,173
Common shares	-	1,650	1,650	1,650	1,650	1,650	1,650
RETAINED EARNINGS	**-**	**7,502**	**12,869**	**16,885**	**21,187**	**27,314**	**36,118**

Table 4: Projected Summary of Statements of cash flows

STATEMENT OF CASH FLOW SNAPSHOT							
	6/30/2018	12/31/2023	12/31/2028	12/31/2033	12/31/2038	12/31/2043	12/31/2048
INFLOWS							
Sub-loan principal repayment(s)	-	37,402	77,577	78,450	79,566	86,875	98,682
Loans received	-	56,250	-	-	-	-	-
Retained earnings	-	7,502	13,279	16,885	21,187	27,314	36,118
TOTAL INFLOWS	**-**	**101,154**	**90,856**	**95,335**	**100,753**	**114,190**	**134,799**
OUTFLOWS							
Redemption of Preferred shares	-	3,914	3,914	15,164	15,164	15,164	13,941
Loan service	-	-	-	-	-	-	-
Sub-loans granted	-	91,761	84,555	78,044	85,039	97,600	118,216
Net cash flow	-	5,479	2,387	2,127	551	1,426	2,642
TOTAL OUTFLOWS	**-**	**101,154**	**90,856**	**95,335**	**100,753**	**114,190**	**134,799**

Annex 8. Schedule for SME DFC Establishment

Key transaction documents	**Milestone dates**
Establishment of SME DFC	
ProSME DFCctus/summary	
GoM resolution	
Ministry’s and/or ASPM’s decisions	
Founding resolution - Meeting memo	
Company charter	
Appointment and Contract with Executive management	

Board resolutions on SME DFC internal **<u>policy(s) and procedure(s)</u>** - Board meeting procedure - Dividend policy - Remuneration policy - Authority matrix - Labor policy - Conflict of interest transaction policy - Internal audit procedure - Risk assessment procedure - Credit committee procedure - Procurement procedure, and - All other relevant operation policy, procedures and guidelines	
SME DFC's operation related **<u>contract forms</u>** - Labor contract forms - TSL related loan agreement forms - Office rental agreement draft - Other procurement contract drafts	
SME DFC registration application documents - Application form - SME DFC's name confirmation - Bank account - Founding resolution (see 1.6) - Shareholders agreement (1.7) - Company charter (1.10) - Shareholders' incorporation documents - Shareholders' authorizations - Evidence for balance of paid in capital - Address (Office lease agreement) - Stamp duty payment slip - Power of attorney (authorization documents) Other documents	
Application of NBFI license(s)	By end of August

Application for a license	
Founding decision (see 1.6) - Cabinet Resolution - Founders resolution and - minutes of Founders meeting	
Authorizations for shareholders attending to the Founders meeting - GoM resolution - Ministry's and/or ASPM's decision	
Certificate of incorporation of SME DFC	
Company charter of SME DFC (1.10)	
Business plan	
Evidence documents showing source of fund is comprised of legalized earning	
Reference letters from relevant authorities for each of shareholder, Board member, chairman, executive management team: - overdue payment obligations under loan or guarantee contract - Criminal charge - Personal ID and professional background (copy of diploma for individuals)	
In case of foreign investor shareholders, Shareholder's warranty on no overdue obligations under loan or guarantee contracts.	
Beginning balance	
Evidence documents determining the minimum share capital is deposited in bank account of SME DFC.	
Descriptions of technology, equipment, software and work place to be used for SME DFC's operation as NBFI	

An appointment of officer in charge of compliance of Law on activities of combating money laundering and financing terrorism	
Other information and references stated in a law on activities of combating laundering and financing terrorism if necessary	

Source: JICA TA Experts

Annex

DRAFT TERM SHEET
SHAREHOLDERS AGREEMENT
FOR THE ESTABLISHMENT OF THE SPECIAL PURPOSE ENTITY FOR SUSTAINABLE OPERATIONS OF TSL PROJECT FOR SME DEVELOPMENT AND ENVIRONMENTAL PROTECTION

This term sheet is not intended to constitute the complete and all-inclusive terms of the related transaction. It is intended that an agreement based on the principles of this term sheet and containing more detailed terms will be agreed between the parties in accordance with the details below.

ITEM		TERMS
1	**Agreement**	Shareholders Agreement for the establishment of the Special Purpose Entity (SPE) for sustainable operations of Two-Step-Loan Project for Small and Medium-Scaled Enterprises Development and Environmental Protection (TSL Project).
2	**Parties**	(1) **Party A / Public sector:** Government of Mongolia (GOM), represented by the Ministry of Finance (MOF); (2) **Party B / Private sector:** [currently] Mongolian Bankers Association NGO (MBA) representing collective interests of the private sector investors in the SPE. [*The legal form of the private sector entity needs to be clarified, [probably not] MBA*] (3) **Party C / International financial institution:** TBC, if not identified at the point of the Agreement, shares shall be reserved for the later subscription.
3	**Recitals**	(1) The TSL Project is the GOM and the Government of Japan's joint project to promote the SME sector through enabling long term financing to eligible SMEs. GOJ provided concessional loans under the Loan Agreements dated March 28, 2006 and November 19, 2010 respectively (JICA Loan Agreements) for the purposes of on-lending to participating financial institutions in Mongolia (PFIs), and subsequently sub-loans to SMEs. (2) The Japan International Cooperation Agency (JICA) conducted the Special Assistance for Project Implementation (SAPI) 2 Study in 2014, which proposed an initial idea of establishing a special purpose entity (SPE) with a joint capital of three parties: the GOM, the private sector and international financial institutions for the sustainable long term operations of TSL Project. (3) The Parties agreed to determine a general basis for commencing negotiations for definitive agreements with respect to establishment of the SPE and joint development of the TSL Project.
4	**Rationale for the SPE**	(1) **Continuation of the TSL Project in a sustainable manner.** The TSL Project has outperformed its initial objectives: provision of longer term SME project finance, creation of employment and the very low level of non-

ITEM		TERMS
		performing sub-loans. However, the extended TSL consultancy service will be concluded in May 2017 due to the completion of the Contract for Consultants' Services for Two-Step-Loan Project for Small and Medium-Scaled Enterprises Development and Environmental Protection. GOM and JICA share the common objective of continuation of the TSL Project in a sustainable manner and expand beyond Phase 1 and Phase 2 of the TSL Project. The proposed SPE is designed to secure the sustainability and expansion of the TSL Project activities (through Phase 3 and other additional funding sources financial institutions) and expand beyond funding under the TSL project. (2) **Mobilization of TSL Phase 3.** GOM/MOF requested JICA to extend TSL Phase 3 loan upon conducting SAPI2. During the initial consultations for the Phase 3 loan (USD100 million) JICA requested MOF, as a precondition for extending TSL Phase 3 Loan, to define an exit policy with respect to JICA's Technical Assistance (T/A) support for project implementation, in a manner ensuring sustainable operations of the TSL Project for the intended purposes for the duration of the TSL Loan. The establishment of an SPE has been agreed as a feasible exit mechanism for sustainable operation of the TSL Project, including TSL Phase 3, therefore satisfying the requirements of JICA for extending TSL Phase 3 loan to GOM. (3) **Support to GOM policy objectives.** In its effort to promote economic development and diversification, GOM implements diverse programs to support the SME sector. However, there remains a large portion of the underserved SMEs that require longer term business-oriented project financing. This necessitates the establishment of a professional financial institution so as to efficiently channel development resources in line with the principles successfully implemented through the TSL project and furthermore mobilize additional financing leveraging its own resources.
5	**Relationship Principles**	(1) Each party must perform its obligations and exercise its rights under the Agreement in accordance with the relationship principles to be agreed between the parties. (2) This will include: a. Party B represents private sector investors into the SPE; b. Party B shall provide equal opportunity to all its private sector member institutions to participate and invest in the SPE (through Party B); c. Party B's equity interest in the SPE shall be equally distributed to each of the private sector entities who invest in the SPE through Party B, provided that no

ITEM		TERMS
		single private sector entity's interest (direct or indirect) in the SPE (including affiliates and ultimate beneficial owners) will exceed more than 5% of total outstanding issued Common Shares of the SPE; d. In the event of absence of the IFI at the point of establishment of the SPE, Parties agree to reserve at least 30% of the Common shares for later subscription by IFI(s).
6	**Form of legal entity**	The SPE will be incorporated as a limited liability company under the Company Law of Mongolia.
7	**Scope of Business and License**	The SPE shall independently manage TSL project operations in a sustainable manner and expand as fits to its objectives. The SPE shall obtain a license necessary to continuing TSL project operations [NBFI or other].
8	**Capitalisation**	**Common Share capital (paid-in capital):** Total amount of common share capital of the SPE will be MNT15 billion: a. MNT4.5 billion to be subscribed by the Party A; b. MNT6.0 billion to be subscribed by the Party B; c. MNT4.5 billion to be subscribed by the IFI(s). Nominal value and the amount of the Common Shares will be determined by the Parties in the Agreement and Company Charter of the SPE. The Common shares are paid in the form of monetary asset only. **Preferred Share capital:** a. Assets (TSL loan receivable from PFIs) in value equivalent to outstanding principal balance of the MOF loan receivable from PFIs under the TSL Project to be transferred to the SPE as Preferred shares. b. The assets will be transferred at the Fair value (or par value of the outstanding principal balance and accrued interest) at the Transfer date.
9	**Shareholding structure (Common Shares)**	**Authorized Common Shares:** Total authorized Common Shares of SPE will be: a. Party A / Public sector: 30%; b. Party B / Private sector: 40%; c. Party c / IFIs: 30%. **Issued Common Shares:** In the event of the absence of the IFI(s) at the Agreement date, the SPE will issue Common Shares to the Parties as follows: a. Party A / Public sector: 43% (30% of total authorized

	ITEM	TERMS
		Common Shares); b. Party B / Private sector: 57% (40% of total authorized Common Shares); and c. **3**0% of total authorized common shares will be reserved for IFIs' subscription.
10	**Preferred Shares**	The SPE will issue Preferred Shares at the fair/par value of MOF's on-lending loan assets to the Party A, which will be divided into following classes: a. Class A: MNT[116.3] billion b. Class B: MNT[17.5] billion c. Class C: MNT[4.5] billion Nominal value, the amount of Preferred Shares, redemption and dividend schedules, voting rights and other matters associated with the Preferred Shares will be determined in the Preferred Share Subscription Agreement, reflecting loan repayment schedules and other contractual obligations of GOM/MOF under the JICA Loan Agreements.
11	**Party A's option to convert**	The Party A shall have an option to convert Class C - Preferred Shares into Common Shares of the SPE under the Special circumstance. The Special circumstances include but not limited to: a. the SPE fails to pay any amount due under Preferred Share Subscription and Redemption Agreement on the due date, unless such failure to pay is caused by administrative or technical error and payment is made within seven (7) Business Days of its due date. For the avoidance of doubt, failure of the SPE to pay any amount due to insufficiency of funds in its accounts in accordance with the conditions agreed under other agreements involved with MOF shall not amount to an Special circumstance; b. NPL of the SPE loan portfolio [on-lending loans to PFIs] accumulates to an amount equivalent to 20% of the total subscribed common shares. c. the SPE breaches its obligations and undertakings under Shareholders Agreement or any of the Key transaction documents and/or relevant laws and regulations which in the opinion of the Shareholders, is capable of resolution, is not resolved to the satisfaction of the Shareholders within thirty (30) days from the date the SPE becomes aware of such breach or is notified of such breach; d. it becomes unlawful for the SPE to operate under the Key transaction documents; e. the SPE changes the nature or scope of its business, suspends, ceases or threatens to suspend or cease a substantial part of its business operations;

ITEM		TERMS
		f. the SPE repudiates any or all of its obligations and liabilities (contingent or otherwise) under the Key transaction documents or its loan assets deteriorates threating the performance of its obligations and liabilities (contingent or otherwise) and the Party A is of the opinion that such of an asset is likely to have a material adverse effect; g. any of the material provisions in the Key transaction documents becomes ineffective, invalid or unenforceable and in the opinion of the Party A, such an event is materially prejudicial to the interests of the shareholders; h. any party to the Key transaction documents breaches its representations or warranties, obligations and undertakings under such documents and if capable of remedy, is not remedied to the satisfaction of the Party A within thirty (30) days from the date such party becomes aware or is notified of such breach; [*we will need to define the "special circumstance" situation to make it clear the conditions of the conversion of the C class Preferred Shares*]
12	**IFIs' subscription**	The Party A and Party B agree and acknowledge that IFIs shall have a right to subscribe 30% of Common Shares of the SPE which will be authorized and reserved upfront upon incorporation of the SPE.
13	**Subscription Agreements and payment of the Common Shares**	**Common Share Subscription Agreement:** The Parties shall make payments for Common Shares in one tranche to the SPE's designated bank account upon execution of the Agreement and the Common Share Subscription Agreement but before state registration (incorporation) of the SPE. **Preferred Share Subscription Agreement:** The Preferred Share Subscription Agreement will be entered between the SPE and Party A, following incorporation of the SPE. As part of this subscription agreement, the Assets (sub-loans) Transfer Agreement will be entered among the SPE, MOF and each of PFIs.
14	**Board of Directors**	The Board of Directors of SPE will have 7 (seven) Directors. a. Party A nominates 3 directors; b. Party B nominates 3 directors; c. IFI (ADB) nominates 1 director under the Cooperation Agreement. Qualifications and criteria on nomination and appointment of the Directors will be determined in the Agreement and Company Charter of the SPE.
15	**Dividend policy**	No dividend will be distributed for common shares until the Preferred Shares are fully redeemed.

ITEM		TERMS
16	**Sale of common shares to a third party**	Sale of the common shares to any third Party is subject to shareholders' collective agreement and consent.
17	**Assignment**	Parties may not assign all or any part of their rights and obligations to any third party without prior written consent of the other party.
18	**Governing Law**	The Agreement will be governed by and construed in accordance with the laws of Mongolia.
19	**Representations and Warranties**	Each of the Parties makes certain representations and warranties in each of their respective responsibilities with respect to itself and the assets transferring into the SPE, including but not limited to: a. that the Parties have the power to and has taken all necessary actions to ensure due authorisation for making the Key transaction document, each of which constitute valid, binding and enforceable obligations of the Parties; b. the assets transferred for purchasing Shares of the SPE and the documentation relating thereto are in the sole and absolute beneficial ownership of the Parties and, will, when a transfer thereof is effected confer a good title on the SPE or its nominee and or any purchaser thereof from the SPE, and there is no impediment to the registration/completion of such transfer; c. there is, in respect of each loan asset, no amount owing to the PFI by the Party A and in respect of which the PFI is entitled to exercise any right of set-off in respect of any of the monthly instalments; d. that accounts, records and documentation relating to the loan assets have been properly kept and maintained and are up to date at least with transactions up to the transfer date and in the possession of the Party A or held to its order; and e. the execution, delivery and performance of the of the Key transaction documents by the Parties are in compliance with all applicable laws.
20	**Dispute Resolution**	All disputes arising out of or in connection with the Agreement, the Parties shall meet to endeavour to resolve by mutual agreement and negotiation. Where the dispute cannot be resolved by mutual agreement between the Parties, the disputes shall be referred to and finally settled by Court of Mongolia.
21	**Confidentiality**	(1) Appropriate confidentiality provisions to be included. (2) In addition, Parties agree that the terms of this Term Sheet, including its existence and the contents of any communications relating to this Term Sheet, are confidential information ("**Confidential Information**"). (3) Neither party shall disclose or use or communicate to third

ITEM		TERMS
		parties Confidential Information unless agreed by the other party, or until such material comes into the public domain generally (except as a result of a breach of this Term Sheet) or to the extent that disclosure is required by law or similar competent authority.
22	**Language**	The Agreement shall be executed in Mongolian.
23	**Key transaction documents**	Parties shall negotiate in good faith in order to agree an Agreement and other associated documents on terms consistent with the principles detailed in this Term Sheet. Key transaction documents are: (1) GOM resolution; (2) Founding resolution of SPE; (3) Shareholders Agreement (Agreement); (4) Common Share Subscription Agreements; (5) Preferred Share Subscription Agreement; (6) Company Charter; (7) Cooperation Agreement (MOF, MBA, JICA and IFI (ADB)) (8) Assets (sub-loan) Transfer Agreement (SPE, MOF and each of PFIs); (9) Other documents.
24	**Term**	This Term Sheet shall become effective upon signing by the legal representatives or the authorized persons of the Parties and shall remain in effect for indefinite period until the Agreement has been concluded between Parties or either Party has informed the other Party in writing of its intention to terminate this Term Sheet not less than one month before the intended termination date.
25	**Non-binding effect**	This Term Sheet is intended to serve as a general basis for commencing negotiations for definitive agreements with respect to the matters referenced herein. This Term Sheet does not contain all of the detailed provisions to be incorporated in any such definitive agreement(s), but does reflect the current mutual intentions of the Parties. With the exception of Paragraph 21 [Confidentiality] hereof, neither Party A nor Party B shall have any legal obligation under or by virtue of this Term Sheet, including any obligation to enter into any definitive agreement or to make any investment or to pay any consideration or compensation, whether or not expressly described herein; provided that the Parties agree to cooperate in good faith along the lines described in this Term Sheet.

Agreed by the Ministry of Finance

____

Authorised Representative
Name:
Title:
Date:

Agreed by Mongolian Bankers Association

____

Authorised Representative
Name:
Title:
Date:

ANNEX 2

Approved by Shareholders Meeting Resolution # […] of the [*Small and medium enterprise development financing corporation*]dated […]

CHARTER

OF THE [*SMALL AND MEDIUM ENTERPRISE DEVELOPMENT FINANCING CORPORATION***]**

LIMITED LIABILITY COMPANY

Ulaanbaatar

Approved by Shareholder's Meeting Resolution
[…], dated […]

CHARTER OF "[*SMALL AND MEDIUM ENTERPRISE DEVELOPMENT FINANCING CORPORATION*]**" LIMITED LIABILITY COMPANY**

1. GENERAL PROVISION

1.1. " [*SME development financing corporation*] (hereinafter referred to as a "Company"), a company incorporated under the laws of Mongolia approves its Charter (hereinafter referred to as "Charter") in accordance with Company law of Mongolia.

2. NAME AND OFFICIAL ADDRESS OF THE COMPANY

2.1. The name of the Company shall be:

2.1.1. in Mongolian: [*Жижиг дунд үйлдвэрлэлийн хөгжлийн санхүүжилтийн корпораци*] ХХК]; Acronym: ЖДҮ ХСК;

2.1.2. in English: [*Small and medium enterprise development financing corporation*] LLC; Acronym: SME DFC.

2.2. The official address of the Company shall be:

[…]

Phone: […]

Fax: […]

Website: […]

Email address: […]

2.3. The Company shall use its own stamp and letter head approved by the Shareholders' meeting.

3. POWERS OF THE COMPANY

3.1. The Company is a legal entity established in accordance to the Company law of Mongolia, exercising rights and assuming responsibilities on its name, having independent statements, and having bank accounts. It shall operate in the form of limited liability Company, and its share capital shall be divided into shares, and the right to dispose such shares shall be limited by this Charter.

3.2. The Company shall have the right to conclude contracts and agreements in its own name with foreign and Mongolian organizations, to acquire property and non-property rights, to assume obligations, and to become plaintiff or defendant in courts and arbitration proceedings.

3.3. The Company shall not be liable for the obligations of a shareholder. The Shareholder shall not be liable for the obligations of the Company and shall only bear the obligation to the extent of the amount of shares possessed by him/her.

3.4. The Company may set up its subsidiary or representative offices on the territory of Mongolia as well as abroad.

3.5. The Company shall use its business name "[*SME development financing corporation*]" LLC in its all activities.

3.6. The Company shall have togrog and foreign currency accounts in national and foreign banks.

4. BUSINESS ACTIVITIES OF THE COMPANY

4.1. The mission of the Company is to support development of small and medium enterprises and environmental protection through cost-efficient and long-term financing through participating financial institutions.

4.2. Business activities of the Company are provided as follows:

4.2.1. [non-bank financial activity];

4.2.2. […].

5. SHARE CAPITAL OF THE COMPANY AND SHARES

5.1. The statutory capital of the Company shall consist of the nominal value of all shares consist of common and preferred shares and amounts to MNT 153,300,000,000 (one hundred fifty three billion and three hundred million).

5.2. Shares in the Company represent ownership interests in the Company, but do not represent respective ownership interests in the Company`s property.

5.3. **Common shares**.

5.3.1. <u>Authorized common shares</u>: The total number of the authorized Common shares of the Company shall be 1,500,000 (one million and five hundred thousand) Common shares and each share having a nominal value of MNT 10,000 (ten thousand).

5.3.2. <u>Issued common shares</u>: The total number of the issued Common shares of the Company shall be 450,000 (four hundred fifty thousand) Common shares.

5.4. **Preferred shares**.

5.4.1. <u>Authorized preferred shares</u>: The total value of the authorized Preferred shares of the Company shall be MNT 138,300,000,000 (one hundred thirty eight billion three hundred million) with nominal value of MNT100,000 (one hundred thousand) per share; of which 1,163,160 (one million and one hundred sixty three thousand and one hundred sixty) A class Preferred shares having nominal value of MNT100,000 (one hundred thousand) per share; and 220,000 (two hundred twenty thousand) B class Preferred shares having nominal value of MNT100,000 (one hundred thousand) per share.

5.4.2. <u>Issued preferred shares</u>: The total number of the issued Class A Preferred shares shall be 1,163,000 (one million and one hundred sixty three thousand) and the total number of the issued Class B Preferred shares shall be 220,000 (two hundred twenty thousand).

5.5. Following conditions apply for Class A Preferred shares:

5.5.1. The dividend on each Preferred share of Class A is […] [(*in words)*] per year, payable annually no later than 30 (thirty) days after the date of Ordinary Shareholders Meeting.

5.5.2. Any unpaid dividends or dividends not fully paid on class A Preferred shares shall accumulate and no dividends shall be paid to other class and types of shares held by the shareholders until the accumulated dividends on class A Preferred shares paid fully.

5.5.3. The liquidation value of each Class A preferred share is […] [(*in words)*].

5.5.4. Each class A Preferred share entitles its owner to 1 (*one)* vote on all issues on which Class A Preferred shares provide the right to vote.

5.5.5. The Company shall redeem […] [(*in words)*] A class Preferred shares having nominal value of MNT 100,000 (one hundred thousand) per share and total value of […] [(*in words)*] no later than […] [(*in words)*] days from the date of the first Ordinary Shareholders Meeting after issuance of the A class Preferred shares.

5.5.6. Except as provided in Clause 5.4.5 of this Charter, The Company shall redeem […] [(*in words)*] A class Preferred shares having nominal value of MNT 100,000 (one hundred thousand) per share and total value of […] [(*in words)*] no later than […] [(*in words)*] days from the date of the Ordinary General Meeting of the Shareholders.

5.6. Following conditions apply for Class B Preferred shares:

5.6.1. The dividend on each Preferred share of class B is […] [(*in words)*] per year, payable annually no later than 30 (thirty) days after the date of Ordinary General Meeting of the Shareholders.

5.6.2. Any unpaid dividends or dividends not fully paid on class C Preferred shares shall accumulate and no dividends shall be paid on Common shares until the accumulated dividends on Class B Preferred shares paid fully.

5.6.3. The liquidation value of each class B preferred share is […] [(*in words)*].

5.6.4. Each class B Preferred share entitles its owner to 1 (*one)* vote on all issues on which class B Preferred shares provide the right to vote.

5.6.5. The Company shall redeem […] [(*in words)*] B class Preferred shares having nominal value of MNT 100,000 (one hundred thousand) per share and total value of […] [(*in words)*] no later than […] [(*in words)*] days from the date of the first Ordinary Shareholders Meeting after the issuance of the B class Preferred shares.

5.6.6. Except as provided in Clause 5.4.5 of this Charter, The Company shall redeem […] [(*in words)*] B class Preferred shares having nominal value of MNT 100,000 (one hundred thousand) per share and total value of […] [(*in words)*] no later than […] [(*in words)*] days from the date of the Ordinary Shareholders Meeting.

5.7. **Redemption of Preferred shares.** Company shall redeem Class A and Class B Preferred shares in accordance with the terms and conditions shown in Annex-1 of this Charter.

5.8. Common shares payment shall be made in monetary assets.

5.9. Preferred shares payment shall be made in non-monetary assets.

5.10. The amount of the Company's share capital may be altered in accordance with the Company law of Mongolia based on the resolution of the Shareholders' meeting.

6. SHARHOLDERS

6.1. The Company has 2 (two) shareholders who own the total issued shares of the Company with following ratios.

Name of the Shareholders, Registration number, Certificate number	Address	Types and number of shares owned	Types and classes of shares owned	Par value	Price of the shares owned	Percentage of the shares owned
		quantity		Togrog	Togrog	Percentage
Government of Mongolia, represented by Ministry of Finance	Government Building 2, Danzan.S Street 5/1, Ulaanbaatar – 15160, Mongolia	450,000	Common shares	10,000	4,500,000,000	100 %
		1,163,000	Class A Preferred shares	100,000	116,316,000,000	100 %
		220,000	Class B Preferred shares	100,000	22,000,000,000	100 %
					142,800,000,000	

7. SHAREHOLDER'S RIGHTS AND RESPONSIBILITIES

7.1. A Common shareholder of the Company shall have the following rights and responsibilities:

7.1.1. To participate in the Shareholders' Meeting and vote pro rata to the shares owned;
7.1.2. To receive dividend pro rata to the shares owned;
7.1.3. To have right to have access to the Company's financial reports, and other documents and reports related to the Company's activities;
7.1.4. To receive its share of the proceeds from the sale of company assets upon the liquidation of the Company as specified in Article 28 of the Company Law;
7.1.5. As specified in Article 38 of the Company Law and this Charter, to have pre-emptive right to purchase newly released shares of the Company and convertible securities;
7.1.6. To have pre-emptive right to purchase the shares of the Company and other Shareholders, associated certificates to purchase the shares, and convertible securities pro rata to the shares owned at the price offered to third parties in conformity with this law and the Charter of the Company;
7.1.7. To strictly keep the Company's confidential information;
7.1.8. In cases other than specified in Article 9.4 and 9.5 of the Company Law, to bear responsibility to the extent of shares owned;

7.2. Preferred shareholders of the same class possess the same rights and obligations.

7.3. Preferred shares have no voting rights at the General Shareholders Meeting unless provided by this Charter.

7.4. All Preferred shareholders of the Company shall have the following rights and responsibilities:
7.4.1. Preferred shares entitle their owners, relative to the owners of the Common shares, with first priority to receiving dividends;
7.4.2. attend Shareholders Meeting with voting rights with respect to following matters:
(I) Adoption of the decision to issue particular class of preferred shares with respect to the same class of preferred shareholders.
(II) adoption of amendments to, or a new version of the Company Charter, that limit the rights of such shareholders;
(III) requiring conversion of preferred shares into common shares or other securities or property in the course of reorganization of the company.
7.4.3. Upon the liquidation of a company, to receive accumulated unpaid dividends and the liquidation value of such shares, from proceeds from the sale of assets of the company during the liquidation process;
7.4.4. To strictly keep the Company's confidential information.

7.5. A decision of the Shareholders' Meeting on the Clause 7.4.2 of this Charter shall be adopted upon the majority vote of the shareholders with voting rights participating such meeting.

7.6. Class A preferred shareholders entitled for first priority for receiving dividends and the liquidation values of shares belonging to them under Clause 7.2.4 (IV) relative to the owners of the Common shares and other class Preferred shares.

7.7. Upon the satisfaction of the conditions set forth under Clause 7.6 of this Charter, Class B preferred shareholders entitled for priority for receiving dividends and the liquidation values of shares belonging to them pursuant to Clause 7.2.4 (IV) relative to the owners of the Common shares.

7.8. Shareholders shall have such other rights and obligations as established by the Company Charter and applicable laws.

8. MANAGEMENT OF THE COMPANY

8.1. The highest governing body of the Company shall be the Shareholders' Meeting.

8.2. The Board of Directors (“BoD”) is the governing body of the Company between the Shareholders Meeting.

8.3. The Executive management shall oversee the day-to-day activities of the Company.

9. THE POWER OF SHAREHOLDERS’ MEETING

9.1. The ordinary Shareholders Meeting shall be called by the Board of Directors and held within four (4) months following the end of each fiscal year of the Company.

9.2. The extraordinary Shareholders Meeting shall be called by the Board of Directors if the circumstance set forth under Article 61.1 of the Company law occurs.

9.3. If the ordinary Shareholder Meeting is not called and held within the period specified in Clause 9.1 of this Charter, the authority of the Board of directors provided by this law and the Company Charter except for the authority to call the shareholders meetings shall be terminated.

9.4. A shareholders meeting shall have exclusive authority to consider and decide the following matters

- 9.4.1. amendments to the company charter or the adoption of a new version of the charter;
- 9.4.2. reorganization of the company by consolidation, merger, division, or transformation;
- 9.4.3. an exchange of the company` s debts for shares, issuing additional shares, determining its numbers;
- 9.4.4. changing the form of the company;
- 9.4.5. liquidation of the company and the appointment of a liquidation committee
- 9.4.6. a split or consolidation of the company` s share;
- 9.4.7. election of members of the Board of Directors and termination of their power prior to the expiration of their terms;
- 9.4.8. whether the shareholder is to exercise the preemptive rights of shareholders to acquire the company`s shares or other securities as provided in article 38 of this law;
- 9.4.9. consideration and approval of reports prepared by the Board of Directors with respect to the company` s annual operations and financial statements;
- 9.4.10. approval of any major transactions in case of that the Board of Directors fails to decide in accordance with procedures stated in laws;
- 9.4.11. approval of any conflict-of-interest transactions in case of that the Board of Directors fails to decide in accordance with procedures stated in laws;
- 9.4.12. To allow the Company to repurchase its shares;
- 9.4.13. Report as specified in Article 96, clause 96.4 of the Company Law;
- 9.4.14. To resolve issues raised by the Executive Management for resolution at the Shareholders’ Meeting and other issues specified by the Company Law.

9.5. The rights of holders of a Company`s Common shares to vote on matters submitted for consideration and approval at a shareholders meeting are governed by article 34 of the Company law and the rights of holders of Preferred shares are governed by article 35 of the Company law.

9.6. There shall be a quorum at the Shareholders Meeting if shareholders holding more than fifty percent (50%) of the company` s voting shares participate in the meeting.

9.7. To be effective, any matter submitted to a shareholders meeting for consideration, other than election of members of the Board of Directors shall be adopted by a majority of the votes of shareholders that are eligible to vote on the matter who attend the meeting.

9.8. In the case of election of members of the Board of Directors the candidates who receive the largest number of votes shall be elected as members.

10. BOARD OF DIRECTORS

10.1. The Company shall have a BoD consisting of 9 directors of which 5 directors shall be independent directors.

10.2. The term of the BoD's authority shall be 3 years.

10.3. Each independent director of the BoD shall meet following requirements:

- 10.3.1. shall not be a shareholder owning more than 5 % of the Company's shares alone or in conjunction with a related party;;
- 10.3.2. does not hold official position in the Company for last 3 years;
- 10.3.3. shall not be public servant other than public service officer;
- 10.3.4. shall not be related to the company's business in any way;
- 10.3.5. at least 5 years of experience in working at international financial institutions, at least 3 years of experience in mobilizing the financial resources;

10.3.6. Other requirements as defined by the shareholder(s).

10.4. The Board of Directors shall have authority with respect to the following matters:

- 10.4.1. to determine the authorities of the executive management;
- 10.4.2. to appoint the Executive Director of the Company, to determine his/her powers, and to terminate his/her powers before its expiration;
- 10.4.3. to determine the executive management's salaries and incentives;
- 10.4.4. to discuss the conclusions adopted by the Executive Director on the Company's annual operation and financial reports;
- 10.4.5. to approve internal procedures for the activities of the Company's Board of Directors, executive management, and the Company's governance;
- 10.4.6. to select the Company's auditor;
- 10.4.7. to determine the amount of dividends and to approve the procedure for its payment;
- 10.4.8. to establish branches and representative offices of the Company;
- 10.4.9. to determine the market value of property and property rights of the Company;
- 10.4.10. to give the approval of concluding major and conflict-of-interest transactions;
- 10.4.11. to review issues submitted for discussion by the executive management;
- 10.4.12. other issues provided by the Company's Charter

10.5. Chairman of the Board of Directors shall be elected by the majority votes of the directors.

10.6. The Board of Directors Meeting shall be held once monthly and, if deemed necessary, additional meetings may be held.

10.7. An overwhelming majority of members of the Board of Directors shall constitute a quorum at meetings of the Board.

10.8. Each member of the Board of Directors shall have one vote with respect to each matter considered at any meeting of the Board.

10.9. Decisions of the Board of Directors must be adopted by an overwhelming majority of votes of members who participate in the meeting.

10.10. BoD shall have at least following standing committees:

10.10.1. Governance, nomination and remuneration committee;

10.10.2. Audit committee;

10.10.3. Investment, finance and risk management committee.

10.11. BoD shall adopt the operation procedures for the committees ascribed under Article 10.10 of this Charter and the head of such committees shall be the independent director of the BoD.

10.12. If it deems necessary, the Board of Directors may establish aadditional standing and temporary commitee in charge of a particular matter.

11. EXECUTIVE MANAGEMENT

11.1. The Executive management will be implemented by the Executive Director within the framework specified by this Charter and the Contract entered with the Shareholder;

11.2. The Executive management shall conduct activities related to approval of entering into negotiations within the imposed rights and to represent the Company on behalf of the Company without power of attorney;

11.3. The Executive Director shall exercise following rights and duties:

11.3.1. To organize the work for the implementation of resolution of the Shareholders' Meeting, business plan of the Company in accordance with this Charter and relevant laws and regulations;

11.3.2. To conduct policies and activities to strengthen the Company reputation;

11.3.3. To determine the company staff, to approve the amount of basic wages, bonus and allowance of employees;

11.3.4. To establish work scope of employees, to appoint employees to their positions, to conclude and terminate employment contracts;

11.3.5. To sign contracts, negotiations, official letters and documents;

11.3.6. To issue an order for the Company's activities and ensure the implementation thereof;

11.3.7. To perform personally the duties provided by this Charter;

11.3.8. To submit a claim to the court for the purpose of remedying damages caused to the Company, to represent the Company as a plaintiff or defendant or to grant a power of attorney;

11.3.9. To sign a payment order of the Company;

11.3.10. To appoint an independent audit on contractual basis to provide independent audit for the Company’s financial reports, and to issue conclusion upon the approval of the audit report;

11.3.11. The Executive management shall ensure the accuracy of the Company’s accounting reports;

11.3.12. Other rights and duties specified in the Contract.

11.4. The Executive Director shall assign his/her duties to other person during his/her absence for the reasons of vacation, external and internal secondment or sickness leave. Such assignment shall not serve an excuse for exempting him/her from the liabilities.

12. RESPONSIBILITIES OF THE COMPANY’S AUTHORIZED OFFICIALS

12.1. The following shall be the authorized officials:

12.1.1. Members of the Board of Directors;

12.1.2. Executive Director;

12.1.3. Chief Accountant ;

12.1.4. […]

12.2. Depending on the scope of the Company’s activities, the Shareholders’ Meeting shall approve the competent officials.

12.3. If the Company’s authorized officials failed to implement the obligations and incurred damage to the Company by intent, direct wrong activity and negligence, he/she shall reimburse the damage by his/her own capital.

12.4. Chief Accountant shall:

12.4.1. Keep the Company’s capital, profits and expenditures of the Company in an accurate and complete manner;

12.4.2. Prepare regular (e.g. annual and quarterly) financial reports/statements of the Company in conformity with the relevant accounting laws and regulations of Mongolia and with due consideration of the customary international practices and standards;

12.4.3. Have the right to carry out the Company’s capital expenses as authorized by the Shareholders’ meeting;

12.4.4. be accountable to the Executive Director and Shareholders’ meeting on all financial transactions and on the state of financing of the Company

13. TAXATION, FINANCIAL REPORTING AND ALLOCATION OF DIVIDEND

13.1. The Company’s fiscal year shall start on the date of registration and end on December 31. In the year of the Company’s liquidation, the fiscal year starts on January 1 and end on the date of liquidation. In other years, the fiscal year shall start on January 1 and end on December 31.

13.2. Financial reporting and accounting shall be maintained according to the appropriate legislations of Mongolia as well as the internationally accepted accounting principles and standards.

13.3. The selected auditor of the Company shall be a certified accountant or an accounting firm authorized to provide accounting services according to the Mongolian and international accounting standards. At the demand of the Shareholders' Meeting, the Company shall retain the services of an independent accountant or auditor to perform an audit of the Company's financial documents.

13.4. The Company shall pay in due manner any taxes or payments imposed under the legislation of Mongolia.

13.5. After the payment of the income tax to the state budget according to the legislation of Mongolia, the Company, depending on its financial standing, may establish a reserve fund and other funds in the amounts approved by the Shareholders' Meeting.

13.6. The Company shall establish a depreciation fund in accordance with the legislation of Mongolia.

13.7. Annual audits of the Company's accounting statements shall be performed by an independent auditor and audit reports must be submitted to the Shareholders' Meeting, and appropriate authorities of Mongolia.

13.8. The Company shall allocate dividend in connection with the Company Law and Dividend Distribution Policy approved by the Company.

14. REORGANIZATION, LIQUIDATION AND DEBT SETTLEMET OF THE COMPANY

14.1. The Company may be reorganized or liquidated pursuant to the decision of the Shareholders' Meeting or the ruling of the court.

14.2. The reorganization of the Company shall be solved based upon Articles 18-29 of the Company Law.

14.3. In case the Company is liquidated, the assets remaining after the settlement of all its debts and obligations shall be distributed as decided by the Shareholders.

14.4. The activities to reorganize or liquidate the Company shall be implemented in accordance with the provisions specified in Chapter 4 of the Company Law.

15. DURATION

15.1. The Company shall operate for an indefinite period of term.

16. GOVERNING LAW

16.1. The matters related to approval of this Charter, its validity, implementation, amendment and invalidation of its provisions shall be regulated by the relevant laws and legislations of Mongolia.

17. MISCELLANEOUS

17.1. This Charter is executed in 3 copies and one copy shall be kept with each Shareholder, one copy shall be kept with State Registration Office and the other copy shall be kept with the Company.

17.2. This Charter shall enter into force and effect upon the registration with the State Registration Office and issuance of the State Registration Certificate.

17.3. This Charter shall be considered the governing document of the Company.

17.4. The relations not covered by this Charter shall be regulated by the Company Law and other relevant laws and legislations of Mongolia.

[Remainder of the page intentionally left blank; signature page to follow]

SHAREHOLDER:

THE MINISTRY OF FINANCE, FOR AND ON BEHALF OF THE GOVERNMENT OF MONGOLIA,:

Signature: [_____________________]

Name: [_____________________]

Title: [_____________________]

ANNEX 3

30/01/2018

DRAFT

PROPOSED CONCERNED PARTIES AGREEMENT BETWEEN MOF / ADB / MBA / JICA ON THE ESTABLISHMENT OF SPE

This Agreement between the Ministry of Finance of Mongolia (MOF), the Asian Development Bank (ADB), *[the Japan International Cooperation Agency (JICA)]* and the Mongolian Bankers Association (MBA) representing private sector investors, (hereinafter referred to as “the Parties”), outlines the objectives and the commitments of the parties in supporting the establishment of a Special Purpose Entity (the SPE) and confirms their decisions on the basic features of its implementation, including specifically ADB’s role through a seat on the SPE’s Board of Directors (BOD) as requested by MOF and MBA.

JICA has extended to the Government of Mongolia through the MOF two ODA loans for the purpose of providing financing to Small and Medium Enterprises (SMEs) on a revolving basis (Two Step Loans, TSL). The Revolving Fund (RVF) comprising the portfolio of sub-loans funded by TSL 1 & 2, has been successfully administered by the JICA TSL Project Office under the guidance of the inter-ministerial Counterpart Steering Committee (CSC) and with the support of consultants funded by JICA technical assistance (T/A).

Looking at the future, MOF and JICA have agreed on the need to establish an independent financial institution to take over the TSL Project Office functions and provide professional continuity to the management of the TSL loans.

In reviewing alternative institutional models, it was further agreed that this objective would be best achieved through a broad scope development finance company (the SPE), structured as a Public Private Partnership (PPP), with the active involvement of private sector participants (represented by the MBA) and of an international financial institution (IFI).

The MOF and the MBA (as representative of the private sector), are the founding shareholders of the SPE. While in line with international best practices, such a PPP structure for a DFC would be highly innovative in Mongolia. The presence of an IFI is therefore considered essential by both MOF and MBA to provide the guidance needed to ensure a smooth collaboration between public sector and private sector interests, so as to achieve a constructive integration of development objectives and business-like management criteria.

The MOF requested ADB’s participation in the project as well as their direct involvement in supporting the institution’s governance and evolution through a seat on the SPE’s Board of Directors. ADB has agreed, and has indicated as well its willingness to provide a T/A support as required.

Therefore the Parties hereby pledge and commit to act, both as shareholders and/or through their BOD representatives (as the case may be), as follows :

(i) to ensure that the SPE operations will be free of political pressure;

(ii) to ensure the priority maintenance of the SME development objectives of the TSL loans, through the MOF substantial presence as a shareholder and on the BOD;

(iii) to safeguard the public sector ultimate control of the Revolving Fund (RVF) assets, since the RVF will be entrusted to the SPE through issuance to the MOF of preferred shares;

(iv) to maintain independent and professional management of day-to-day operations in line with private sector practices : the MBA's key role is in taking responsibility to ensure that financing continues to be provided to projects having both development merit and sound business fundamentals; and,

(v) to assist in the development of the SPE expanded role in incremental resource mobilization on its own credit standing.

In addition, a Statement of Management Policies (SMP), setting forth the basic principles regulating the SPE's governance and operations, will be agreed between MOF, ADB and MBA and adopted by SPE as integral component of its Charter.

The decisions and commitments of the Parties outlined in this Agreement are expected to be included in the SPE Shareholders' Agreement.

Establish SME FC - Tasks and Execution Timeline

Area of Issues	Tasks	Who is responsible	Execution Timeline						
			March	April	May	June	July	August	Sept
Cabinet approval	Coordinate concerned ministries								
	Obtain concurrence of JICA								
	Obtain Cabinet Resolution approved								
	Issue Cabinet Mtg Minutes								
	Issue Decree of State Rep for MOF/GOM								
RVF asset transfer	Clear state asset transfer process requirements for RVF transfer (State Property								
	Draft RVF Asset Transfer Agreement								
	Draft Preferred Share Prospectus & investment agreement								
MBA- GOM Public Procurement	Clear Public Procurement requirements for private shareholder (MBA)								
MBA matters	Determine MBA's equity investment scheme with PFIs								
	Clarify MBA-PFIs relations (shareholder representative, Directorsr candidates, etc)								
	(PFI's internal procedure) Obrtain PFI's own investment approval								
Recruit Directors & Officers	Recruit Directors [Independent Ds (4), Non-Independent (2), CEO (1)]								
	Determine CEO (Executive Director) under cocensus of shareholders								
	Recruit / determine other senior officers, determine Company Secretary								
Founding Resolution	Determine Board Structure (Chair, Committees)								
	Determine management structure (Departments & roles)								
	Draft Company Charter								
	Obtain consensus on company objectives, BOD structure, CEO, etc.								
	Hold Founding Shareholders' Meeting - Approve Founding Resolution								
Equity transaction	Open bank account of SME FC								
	Pay in for common equity Issue common equity)								
	Transfer RVF assets from MOF to SME FC								
	Issue Preferred Shares to MOF								
Company Registration	Ascertain required info for registration								
	Determine office location/address, office rental doc, etc								
	Prepare Registration Application / Power of Attorney / other docs required								
	Submit application docs to Registration Office								
NBFI license	Resolve shareholder lending limit (connected party) issue with FRC								
	Ascertain required documents for application								
	Prepare required documents (Fincnacial statements - B/S, I/S?)								
	Submit application docs of NBFI license to FRC								

Area of Issues	Tasks	Who is responsible	March	April	May	June	July	August	Sept
Shareholders Agreement	Draft Term Sheet (Key issues to be included in Shareholder Agreement)								
	(1) SPE's mission / objective statement								
	(2) BOD structure, Board Committees' structure/authority&responsibility /etc								
	(3) Senior management structure								
	(4) Preferred share: Redenption conditions (language that preserves PS's equity status)								
	(5) Conditions between GOM and Private shareholders								
	(6) Other key legal matters								
	Obtain consensus on key issues (Term Sheet) - sharehoders & management								
	Draft Shareholders Agreement								
	Obtain Shareholders' approval & signature								
Corporate Policies (legally required)	Identify legally required corporate policies								
	Prepare Policies -- Obtain approval at BoD meeting or Shareholders' Meeting:								
	- Divident Policy								
	- Board remuneration & operation Policy								
	- Conflict of interest transaction policy								
	- Anti money laundary & terrorist financing policy								
	- Internal labor policy								
	Obtain BoD approval at BoD meeting								
Corporate Management Policies	Identify/determine Board & Management Policies required for running SME FC								
	Draft policies - Obtain approval at BoD meeting:								
	- Finance & Audit Committee Charter								
	- Credit Risk Management Committee Charter								
	- Nomination & Remuneration Committee Charter								
	- (Management) Loan Committee Charter								
	- (Management) Finance Committee Charter								
	- HR management policy								
	- Loan policy (-- lending business principles)						To be determined		
	- Credit management policy								
	- Finance management policy								
	- Operation management policy								
	- Procurement policy								
	- Internal Audit Policy								
	Obtain BoD approval at BoD meeting								
Business Plan	Formulate SME FC Business Plan								
	Obtain BoD approval at BoD meeting								
Operational Forms	Prepare various business forms for operational use as needed								
Concerned Party Memorandum	Draft Concerned Party Memorandum of MOF, MBA, JICA to ensure SME FC be managed to stay focused on the objectives of SME development of TSL without political interference -- Obtain agreement and signatures								
	Obtain signatures of MOF, MBA, JICA								

Appendix 2

Appendix 2

МОНГОЛ УЛСЫН ЗАСГИЙН ГАЗАР САНГИЙН ЯАМ

Two-Step-Loan Project

for

Small and Medium Enterprise Development

and Environment Protection

Best Practice Survey

1. General

In the framework of the JICA TSL Project, there were more than 700 sub-loans disbursed during the project implementation of TSL Phase I and II. In order to reveal the social and economic impacts of the TSL Projects, around 50% of the borrowers (363 companies) were surveyed with a questionnaire from December 2016 to February 2017.

To reveal the most successful cases that can be recognized as the best practices among surveyed 363 companies, 15 companies were selected and interviewed according to the interview template designed especially for this occasion. The companies were interviewed from late February to end of March 2017.

Out 15 companies interviewed, 5 companies were identified as the best practices, and reported case by case.

This summary gives overall picture of the survey, and main findings of all interviewed companies are consolidated below.

1.1 Objectives of the Survey

The goal of the Best Practice Survey is to identify factors for successful TSL Projects and obtain lessons for future TSL projects.

1.2 Methodology of the Best Practice Survey

- Personal contact with the owner or top management of the company;
- Interview of the owner / top management of the company; and
- Interviews are conducted according to developed template (see attachment)

1.3 Selection Criteria

i) Geographically, 15 companies to be interviewed should be selected as of the disbursement proportion of the total TSL portfolio: 65% in UB city (no more than 10 companies) and 35% (at least 5 companies)

ii) Based on its experience during the TSL project implementation, the TSL Office advises 15 successful companies which benefited sub-loans and showed a notable success, to be recognized as the Best Practice. The Best Practice is recognized as significant improvement in the following fields:
   - Place the company in a **top percentile ranking** within its industry;
   - Introduction of **new import substitution or export-oriented products**;
   - Noticeable increase of **sales income**;
   - Leverage and take advantage of **technology**;
   - Improve **quality** and **speed**, and also **lowering costs**; and
   - Give management more **control** and **influence**;

1.4 Selected Companies

Based on the above criteria, interviews were conducted in personal meetings with the top management of selected 15 companies. The list of interviewed companies is shown in the next table.

Table 1: Interview List

	Name of the Company	Business Activity Supported by the TSL	Location	Classification	PFI
1.	Shilen Khiits Co., Ltd.	Solar panel factory	Ulaanbaatar	Environment protection project	Golomt Bank
2.	EECC Co., Ltd.	Meat processing factory	Ulaanbaatar	SME Project	TDB
3.	Pyramid Industry Co., Ltd	Foam panel of construction polyester isolation material	Ulaanbaatar	SME Project	XAC Bank
4.	Snow Fields Co., Ltd.	Cashmere product factory	Ulaanbaatar	SME Project	Khaan Bank
5.	Yanmal Co., Ltd	Socks factory	Ulaanbaatar	SME project	TDB
6.	Batseju Co., Ltd.	Labor gloves factory	Ulaanbaatar	SME Project	Khaan Bank
7.	Esun Od Food International Co., Ltd.	Chocolate factory	Ulaanbaatar	SME Project	Capitron Bank, TDB
8.	Nyamsuld Co., Ltd.	Plastic frame vacuum window factory	Ulaanbaatar	SME Project	Capital Bank
9.	Jivertiin Orgil Co., Ltd.	Sea buckthorn processing factory	Ulaanbaatar	SME Project	TDB
10.	Elma Khujirt Co., Ltd	Sanatorium	Uvurkhangai Province	SME Project	TDB
11.	Tushnee Co., Ltd	Bakery	Dornod Province	SME Project	Golomt Bank
12.	Bayan Turuun Co., Ltd.	Gynecological clinic and diagnostics	Uvs Province	SME Project	XAC Bank
13.	Bat Zurgaan Khoshuu Co., Ltd	Pig farm	Tuv Province	SME Project	Khaan Bank
14.	Tsogt Bat Mergen Co., Ltd.	Tourist camp	Zavkhan Province	SME Project	Khaan Bank
15.	Mungut Khairkhan Co., Ltd.	HOB (Heat-Only-Boilers) - Heating supply	Uvurkhangai Province	Environment Protection Project	Khaan Bank

Source: JICA Expert Team

2. Lessons Learned

2.1 Factors contributing to success of sub-loan projects

Proper studies and research of the product and technology;

Without proper expertise, it was impossible to reach high standard product. Expertise of Research Centers in foreign countries played a significant role in success and improved much the reputation of the companies.

Successful know-how transfer;

The know-how ensures the product quality. The success of four companies out of interviewed 15 been enabled only with participation of foreign expert with large experience in certain production, helping to set up the production line, use the equipment efficiently and correctly, and achieve good quality of the products. Without this expertise, it would be hard to achieve success in a totally new production.

Adequate business plan;

All surveyed companies emphasized an importance of a good business plan. An attractive and realistic business model should be proposed in the business plan.

Personal discipline, commitment and enthusiasm of the owner/top management to reach the goals;

Hard work and commitment of the company's founder is one huge part of success. A success or failure of a project mostly depends on the capability of a founder. There are several important factors such as vision, aspiration, executive ability, consistency, sense of responsibility, etc. The success of all interviewed companies depended largely on the capabilities of founders. In all surveyed companies the founders worked personally in a General Director position in their companies.

Choosing right momentum for the investment;

Invest at the right time in the right business. There are statistics that 80% of start-ups fail. The overwhelming majority of surveyed company is in the successful minority that survived, and even thrived in its business. Provision of sufficient investment at right time to catch a momentum can enable noteworthy growth.

Qualified and motivated personnel;

Educating and professionally upgrading of staff is crucial for success in modern business. Motivated personnel targeted at quality and productivity is the most valuable asset.

Choosing the product with unique characteristics;

Success of overwhelming majority of surveyed companies depended on the product with unique characteristics that were introduced at the first time to Mongolian market.

Awareness of existing market demand and market development trends;

All surveyed companies reported that the key in their success is the right selection of business and awareness of market demand.

Close cooperation with clients and perseverance for client satisfaction;

All surveyed companies reported that they pay much attention to the changing customer needs, creating constructive dialogues on constant product improvements, elimination of mistakes in products and providing after-sale services.

Multi-beneficial cooperation with production-supporting community, industry players and state authorities;

A multi beneficial cooperation is important. The policy to cooperate with competitors and local municipalities, and support the local community such as farmers, food staff producers, technical workforce, construction workers, carpenters, gardeners, etc. can bring multiple benefits, especially in remote rural areas. This fact was true for all six companies surveyed in countryside, as well as for some producers in Ulaanbaatar city.

Export access;

One of the key to success is seeking for export markets always. Success of seven companies out of interviewed 15 was also depending on an access to export markets, which contributed to their successful operations a lot. Since the domestic market of Mongolia is small (Mongolia has only population of 3 million people), very soon the producers should face the satisfaction of market volumes, and should not be able to grow financially further. With export markets such as huge neighboring markets such as China and Russia, the producers have unlimited growth potential. Also, in circumstances of economic downturn and decline of purchasing power of population facing Mongolia last two years, access to the export markets make the producers less vulnerable to domestic economic conditions.

Advanced technology and modern equipment;

All surveyed companies emphasized that advanced technology and modern equipment improved their quality and outlook.

Best product quality and growing reputation;

All surveyed companies expressed that improved product quality was appreciated by the customers and strengthened their reputation, which contributed much to their business success.

Sufficient production capacity;

All surveyed companies expressed that increased production capacity has drastically increased their income and market shares, positioning them in a market leader level.

2.2 Problems faced by SMEs

Seasonal nature of sales affect the evenly planned repayment;

Plan your credit repayment schedule by yourself. It is common that the PFIs plan the repayment schedule to be paid evenly throughout the year. However, most of the companies have some seasonal influences in their sales, and in some repayment periods it is stressful to fulfill the payment obligations, whereas in some periods they have excessive income. The lesson from that is to plan the repayment schedule according to borrower's seasonal nature of income.

MNT rate depreciation against foreign currency affects planned purchase of equipment;

As usual, it takes considerable time from the moment of ordering the equipment and receiving the credit from bank used for the down-payment of equipment order, and the final payment and arrival of equipment. For example, one surveyed company waited for 12 months till ordered equipment got ready and came to the factory. During this time the company was paying interest for the credit, having no any income from the production. So it is advisable to finance the down payment of equipment purchase by own funds of companies, and use the credit only at the final stage of equipment purchase.

At the moment of equipment final payment MNT can depreciate against the foreign currency in comparison to the initial calculation. Thus, the borrowers can lack again funds to make the final payment, when they convert MNT funds to foreign currency. So, when receiving loan in MNT the borrower should be aware of timing and foreign currency exchange rate changes during projected time period.

If a Company has sales in MNT, it should repay the loan in MNT;

Some of the borrowers received loans in USD, though they have sales in MNT, considering the purchase of equipment abroad using foreign currency. By the time the USD exchange rate started to appreciate, and it turned to be more and more unprofitable to convert income in MNT to increasing USD and repay the loan interest and principal payments. The support came from the JICA TSL Project, which considered to convert the USD loan of the Company to MNT loan. It could be a good approach to solve this problem.

High transportation costs of equipment, inventory, and construction materials and to remote rural areas;

In remote rural areas, the transportation cost is considerable part of expenditures during implementation of project. The borrowers in remote rural areas who received TSL with purpose of expansion, mainly renovating their old premises of constructing new ones. It means they had to transport bulk of construction materials, nearest from Ulaanbaatar city, or even from the China. This expense item is not usually included in the loan pattern, but can create a great financial pressure on working capital of a company during the implementation of the project. It might be good idea to include transportation costs in the loan total amount.

2.3 Recommendations for future TSL projects

- Good business plan is needed;
- Studies and researches of the product and technology are needed;
- Amortization fund is needed;
- Make down payment of the equipment purchase from Company's own funds, and engage the loan at the final payment stage;
- Stick to the investment plan;
- Plan the loan repayment according to the seasonal nature of sales;
- Build your people;
- Plan a business based on the understanding that a customer is the King; and
- Cooperate on various levels, e.g., with supporting companies and clients.

CASE STUDIES

ELMA KHUJIRT CO., LTD.

Traditional water and mud treatment – the Black Perl and Blue Perl – Gifts of Mother-Nature

Summary

Elma-Khujirt Co., Ltd was established in 2005 in Khujirt settlement of Uvurkhangai Province, distanced by 400 kilometers from the Capital city Ulaanbaatar, giving second birth to the collapsing sanatorium that previously belonged to Erdenet Copper Mining Corporation.

Khujirt area has a natural hot-spring deposit with hot earth-water containing sulfur, chlorine, sodium, iodine, saline, hydrogen, nitrogen, fluorine, potassium, iron and hydro-carbonate. This mineral combination has healing effects to skin, lungs, kidneys, digesting, respiratory and nervous system disorders, as well as women impregnation system. The place is a Mongolian traditionally healing place discovered 400 years ago, mainly used for recreation of warriors' injuries, fractures and body joints using mud and water from the hot-spring.

The company was supported with TSL two times with cumulative sum of MNT 1,300 million for Sanatorium expansion and renovation of premises, as well as purchase of medical equipment and inventory.

The major reasons for this successful performance are excellent services based on unique natural establishment, and commitment and hardworking abilities of the founder.

1. Company Profile

Key Figures

■Year of Establishment:	2005
■General Manager	Mrs. Dorjsuren Gerelmaa (Age 66)
■Address:	Khijirt Settlement, Uvurkhangai province, Mongolia (400 kilometers distanced from the Capital City Ulaanbaatar)
■Product:	Traditional hot-spring and mud-treatment
■Capital:	MNT 4 billion (As of 2016)
■Number of Employees:	42 (As of March 2017)
■Annual Turnover	MNT 1.4 Billion (2016)
■Shareholders	Mrs. Dorjsuren Gerelmaa (100%)

Brief History of Company

The founder, Mrs. D. Gerelmaa has a post-graduate education of Trade Economist, graduated in 1974 in Mongolia during the socialist regime. She made a carrier from a Specialist position to the Head of Department during 1974-1985 at the "Ulaanbaatar City Trade Base" State Enterprise. With transition of Mongolia to market economy in 1990 she started to teach at the Agricultural University of Mongolia. In 1991 she started her first entrepreneurial activities, fountaining with business ideas: she was the first private entrepreneur to be granted by the state permission to produce bottled beverages and vodka; also, she was the first person to establish animal gut processing factory and processed gut export to sausage producers in Germany. In her entrepreneurial activities she was always supporting orphan teenagers, becoming mother to 20 children who previously lived on the streets. She gave them roof below their heads, meal and motherly care, and with the time they became the most loyal and loving helpers.

In 2002 Mrs. Gerelmaa sold her previous businesses at MNT 100 million, and made an acquisition of the former sanatorium of Erdenet Copper Consortium, and named her sanatorium as Elma-Khujirt, where Elma is part of her name Ger**ELMA**a, and **Khujirt** is the name of famous place with healing hot-springs and mud.

2. Background of TSL Project

Mrs. Gerelmaa
General Manager
(At the Mongolian Women-Entrepreneur Forum- 2016)

The Khujirt area in Uvurkhangai Province of Mongolia is located 400 kilometers to the south-east of the Capital city Ulaanbaatar on height of 1,600 above sea-level, and has a natural hot-spring deposit with hot earth-water containing sulfur, chlorine, sodium, iodine, saline, hydrogen, nitrogen, fluorine, potassium, iron and hydro-carbonate. The water has sodium-alkaline base, which in combination with its chemical structure has healing effects to skin, lungs, kidneys, digesting, respiratory and nervous system disorders, as well as women impregnation system. The place is a Mongolian traditionally healing place discovered 400 years ago, mainly used for recreation of warriors' wounds and body joints using mud and hot-spring. Khujirt Sanatorium is very popular among Mongolians, but also foreign tourists come from Japan, Russia, China, and Korea.

After establishment of Elma-Khujirt Co., Ltd, Mrs. Gerelmaa invested all her available financial resources to recover the sanatorium and to bring it to the level that satisfy modern demands of clients. As of calculation of the founder Mrs. Gerelmaa, she invested around MNT 23 billion in her sanatorium until 2012. As a result of her efforts, the sanatorium became the most popular place in Khujirt area not only to receive treatment, but also stay as in a hotel.

68th Yokozuna Asashoryu

The 68th Yokozuna of the Professional Sumo Wrestling, Asashoryu Akinori, whose father was born in the Khujirt Settlement, often visits his mother-land. The Yokozuna prefers to stay at the Elma-Khujirt Sanatorium when visiting the Khujirt Settlement, which shows the comfort ability and hospitality of the Elma-Khujirt Sanatorium. Also the Yokozuna likes to bring his Japanese friends to the healing resort, and this is a vital contribution to the income of the sanatorium. Considering that direct tourism services can be accounted as export activities of Mongolian attractions, the company has export access to some extent.

After acquisition of the sanatorium during six years Mrs. Gerelmaa has spent all her savings and financial opportunities for recovering the collapsing sanatorium, and brought it the considerable level of operations and comfort ability. But she was facing crucial need for additional investment for expansion and renovation of the buildings and services.

3. Investment by JICA TSL

The company has applied for a TSL in 2009 at the Golomt Bank, one of the PFIs of the TSL Project, but with no success. The reason was that the entrepreneur has already reached the age of 55, which is the retirement age for women in Mongolia. It is true for employees, but not for entrepreneurs. After three years in 2012, at the age of 61 of Mrs. Gerelmaa, the Trade and Development Bank (TDB) of Mongolia has granted a decision to extend a loan in amount of MNT 800 million to the company, considering the future perspectives and importance of rehabilitation services of Elma-Khujirt Sanatorium. Until today Mrs. Gerelmaa appreciates very prompt services of TDB, which has made its decision and all accompanying procedures within three working days. It can be identified as a record time in disbursement process of the TSL.

With the first TSL of MNT 800 million in April 2012 Mrs. Gerelmaa made investment for renovation of the old building and bought additional equipment for physical therapies.

The company has applied for the second TSL in July 2015 with purpose of expansion of the sanatorium and increase the capacity, and as a consequence to increase its turnover and market shares. In September 2015, the company was granted with second TSL in amount of MNT 500 million. The financing was used as investment in new expansion building and purchase of necessary equipment.

Table 1: Investment Plan

1st Investment	Amount		Funding
	MNT Million	%	
Renovation and expansion of the Sanatorium building	800.0	79	JICA Loan
Equipment and inventory	202.0	19.9	Own capital
Transportation and installation of the equipment	10.7	1.1	
Total	1.012.6	100	
2nd Investment	**Amount**		**Funding**
	MNT Million	%	
Renovation and expansion of the Sanatorium building	287.4	27.9	JICA Loan
Equipment, furniture and inventory	212.6	20.6	
Office and sanatorium premises	531.8	51.5	Own capital
Total	1.012.6	100	

Source: TSL Office

With the second investment Elma-Khujirt Co., Ltd has significantly increased the service capacity: the previous capacity of the Sanatorium was 70 persons per day, and after investment it has been increased by more than three times and reached 225 persons per day.

Table 2: Comparison between Before Project and After Project

	Before Project (2010)	After Project (2012)
Number of Service Packages	5	12
Number of Special Equipment	0	24
Number of Employees	12 persons	42 persons
Service Capacity	70 persons per day	225 persons per day
Annual Turnover	MNT 1,5 billion	MNT 4,5 billion
Market Share	19.5%	28%

Source: Elma-Khujirt Co., Ltd.

The result of the project can be evaluated as very satisfactory. Above all, the JICA TSL had a significant impact because it could provide low-interest and long-term fund needed for a large investment tripling the service capacity.

The TLS project has brought the following results:

- Expansion capacity of Sanatorium for three-fold increase;
- Employment creation and support for sustainable livelihoods of the local community;
- Introduction of new and modern rehabilitation health services, bringing the services to higher standards on the whole local market;
- Export revenue in form foreign tourists visiting the site;
- Income opportunity for local producers (bakeries, vegetables, diaries and etc.)

Table 3: Comparison between Before Project and After Project

At the Time of Acquisition (2002)	 

Before the Project (2012)	
After Project (March 2017)	

Photos of Elma-Khujirt Sanatorium before and after the Project

4. Key Success Factors of the Company

The success factors of Elma-Khujirt Co., Ltd can be summarized into the following factors:

- ✓ The founder, Mrs. Gerelmaa, had the highest motivation, correct ambitions, sufficient knowledge and hardworking abilities to reborn the collapsing sanatorium.
- ✓ TSL financial support came in at the crucial moments development.
- ✓ The service quality of the Sanatorium set new challenging standard on the local market.
- ✓ The expansion of Sanatorium capacity and increased comfort-ability, in combination with attractive service packages at competitive prices including accommodation, 5 times meal and individual treatment were appreciated by the clients.
- ✓ Environment-friendly approach of business activities were appreciated by customers and governmental authorities.
- ✓ Mrs. Gerelmaa has made continuous and diligent efforts for the realization of her business and success.

Product

We can name two basic natural products used in the recreation services of the Elma-Khujirt Sanatorium:

- The warm mud of Khujirt area, honored by local people as "Black Perl of Khujirt", and;
- The hot water of spring (spurt-out of the spring has temperature up to 60^{o} Celsius), honored by local people as "Blue Perl of Khujirt".

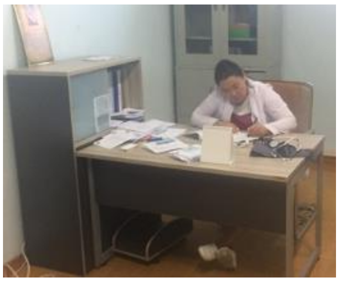
These natural products have healing effects for a human body, and this fact is proven by practice during 400 years history. Minerals and micro-elements in the chemical content of mud and water give shock to nerve-ends in skin and, moreover, to the whole central nerve system and brain crust. This effect creates return reaction in damaged organs and body parts, followed by remedial effects to those organs and body parts. In other words, combination of many chemical elements such as sulfur, chlorine, sodium, iodine, saline, hydrogen, nitrogen, fluorine, potassium, and iron contained in the hot-water and mud of the Khujirt area has rehabilitating and healing effects to humans.

Using these natural products, the Sanatorium offers wide range of services of physical treatment, including hot-spring water bath, mud wrapping/applying, massaging by massager and using special back-chair/bed, stretching on a special bed, nephrite balls massaging, acupuncture and cauterization, cupping glass suction and bloodletting, sweat-bath, treatment with water under pressure, various types of physical exercises/loads and etc.

The Sanatorium has developed service packages, generally based on days to be spent at the sanatorium. Usually the medics of the Sanatorium advice to have one course treatment of 10 days, but the client can stay for 6 days (the minimum short package). Some of the clients stay for longer time such as three weeks and one month. In fact, the client can stay as long he wants.

The payment is calculated by days of stay; the average charge is MNT 50,000 per day (USD 20.2), and this charge includes room charge, 5 times meal per day, and all medical treatments.

The sanatorium offers various types of rooms as luxury king-size bed room, twin-bed rooms, family apartments, and even group-rooms with 8 beds.



The **treatment is defined individually for a person** based on what problem the person has: internal organs, reproductive organs, disabilities, wounds or fractures. The doctors of the Sanatorium advice a course treatment program for every patient.

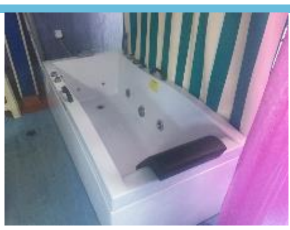
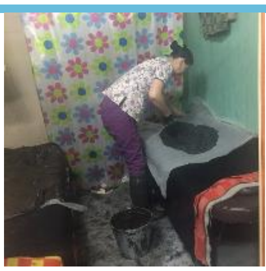
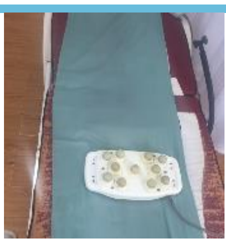
The Sanatorium offers 5 times meal per day: breakfast at 8 am, juice from dried grape at 11 am, soup and main dish at 1 pm, Mongolian traditional curd drink at 4 pm, and dinner at 7 pm. It has upgraded its kitchen equipment and inventory; however, with expansion of accommodation the sanatorium needs to expand the kitchen and dining hall capacity.

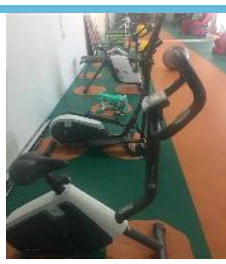
The Sanatorium has conference room for meetings to be held at the place and library for leisure time of kids and grown-ups, as well as professional reading in health sciences, natural sciences, and legal issues.

Technology

Table 4: Service Process

Process		Photo
Acquisition of hot-spring water	The hot spring is pumped from the depth of 120 meters using ground well and water pump, isolated in a special premises. The hot-spring water can be obtained throughout a year.	

Acquisition of hot-spring water	The water is transferred via isolated pipes to the Sanatorium.	
Acquisition of mud	The mud is obtained at swampy area of the hot-spring site, and transported to the Sanatorium. In winter time the Sanatorium uses mud that has been especially reserved aforetime during autumn.	
Providing physical treatment	Hot-spring water bath with Jacuzzi.	
	Mud wrapping/applying to body parts.	
	Massaging by massager and using special back-chair/bed	
	Nephrite balls massaging, acupuncture and cauterization, cupping glass suction and bloodletting.	
	Stretching on a special bed.	

Providing physical treatment	Sweat-bath and treatment with water under pressure.	
	Various types of physical exercises/loads.	

Source: Elma-Khujirt Co., Ltd.

Marketing and Sales Promotion

Despite excellent services and comfort-ability, the Elma-Khujirt Sanatorium sets its price below the level of competitors' price in order to have more clients and earn the best reputation within short time.

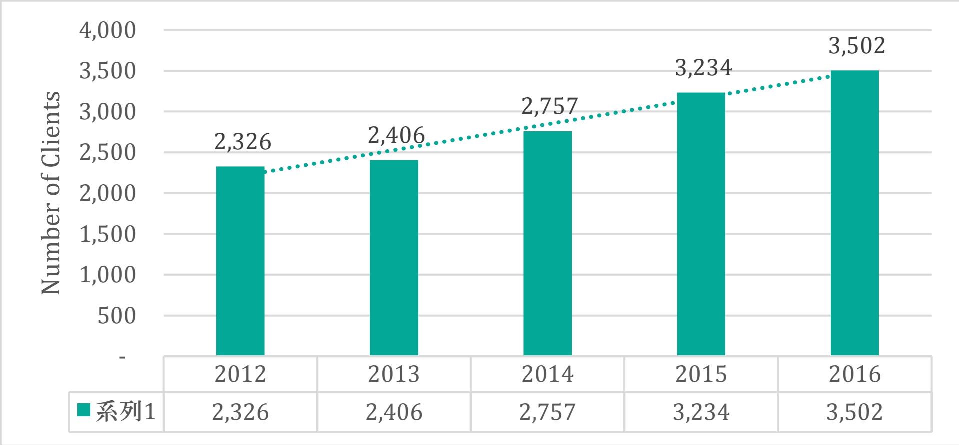
Table 5. Prices of Elma-Khujirt Co., Ltd.

Band	Price (average charge per day)
Elma-Khujirt Co., Ltd.	MNT 50,000
Competitors	MNT 55,000-60,000

Source: Elma-Khujirt Co., Ltd.

The overwhelming majority of the Sanatorium's clients come from Ulaanbaatar city, 400 kilometers away; thus the distance from the main market should create problems. But not in case of Elma-Khujirt: there is a shuttle bus departing every day from Ulaanbaatar Western Bus Terminal. The trip takes around 5 hours, and price of trip is very reasonable – MNT 18,000 (USD 7.28) per person.

The Sanatorium exercises mouth-to-mouth advertising, which is a very effective method in case of Elma-Khujirt Co., Ltd. Mrs. Gerelmaa strives to provide the best hospitality and excellent service, and satisfied clients (mainly older people) talk about their good experience at the sanatorium with their friends and familiars. Thus, in a very cost-effective manner the number clients of the Sanatorium increase year by year.



Source: Elma-Khujirt Co., Ltd.

Figure 1: Number of Clients of Elma-Khujirt Co., Ltd.

The 2017 is expected to have the highest client numbers, because the Sanatorium just opened in January 2017 the expansion building financed by TSL, jumping from capacity of 70 clients per day to 225 clients per day. Considering this development, the Sanatorium plans to receive about 10,000 clients in 2017.

Another valuable advantage is that they offer 50% discount for pensioners and disabled people. According to the social care program of Mongolia these people have rights to be treated at sanatoriums once a year with discount, and the state repays the discounted sum to the sanatoriums. But in order to have this opportunity, sanatoriums have to be accepted for their services, accommodations, meals, infrastructures and etc. Elma-Khujirt Sanatorium is an accredited institution within the frame of this social care program. People that can be covered by social care program make about 30% from the total number of clients.

The sanatorium has clients all year-around. The high-season starts in March and ends in November. The lowest season is January-February.

Photos of Khujirt Settlement and Elma-Khujirt Sanatorium

Human Resource Management

Human resource management is an important issue of Elma-Khujirt Sanatorium. It is fact that in remote rural areas educational level of local residents is very weak. Mrs. Gerelmaa personally manages the Sanatorium, training and guiding her personnel in every action. As she says, some of the newcomers have great desire to work and earn money for their families, but at the beginning have no ability to even write correctly their job application.

The employees are very loyal and thankful to company due to very limited jog opportunities in Khujirt settlement.

As part of human resource management policy of the company, the personnel receives constant on-the-job trainings and outsourced training. Considering the service industry specifics, it starts with smiling and respecting the client, and goes further to their professional skills.

The company provides incentives including dwelling to competent staff.

The level of wages after the project in comparison to the level before the project has been increased by 150% for graduate staff with medical education and by 100% undergraduate staff.

The company practices Employee Support Fund for urgent financial needs of employees, and every month the company grants one needed electric home appliance to one chosen employee as promotion.

Competition

The Elma-Khujirt Sanatorium differentiates its services by price, comfort-ability, quality, and 50% discount for pensioners and disabled individuals.

There 3 competitors providing rehabilitation services in the territory of Khujirt hot-spring area:

1. Khujirt Sanatorium, established in former socialist times, a state enterprise. It has a capacity to receive 500 clients per day, however, the service and accommodation quality is poor.
2. Semjid-Khujirt Sanatorium, established few years ago, private enterprise, with capacity of 40 clients per day. The problem with this Sanatorium is that they are located exactly on the spurt-out of hot-spring, which is prohibited by the laws and regulations.
3. Anand-Khujirt Sanatorium, established few years ago on a base of kindergarten premises. Though it has a capacity of accommodation for 20 clients per day, it lacks

experience in medical treatment, necessary equipment and inventory. Because it is located just near the Elma-Khujirt Sanatorium, people stayed at the Anand-Khujirt come to Elma-Khujirt to receive medical treatment.

Elma-Khujirt Sanatorium is a step above the competitors by their service quality. As of today it occupies 28% of market share.

5. Recent Performance of Elma-Khujirt Co., Ltd.

The sales trend of the Sanatorium for the recent years is as shown in the following table. The sales has shown a constant increase in spite of economic downturn.

Table 6: Recent Performance of Elma-Khujirt Co., Ltd.

	Annual Turnover	Profit before Tax
2014	MNT 961 million	MNT 384.4 million
2015	MNT 1.13 billion	MNT 452.4 million
2016	MNT 1.09 billion	MNT 436.8 million

Source: Elma-Khujirt Co., Ltd.

The income and profit in 2016 has been slightly decreased compared to the previous year because the Sanatorium was under construction for several months, constructing its expansion. However, with tripled capacity in 2017 they expect to have about 10 thousand clients in 2017 and the income will increase at least by 100%.

The recent future plans of the company is as following:

1) Construction of summer cottages for family stays.

The company has already developed blueprints of the summer cottages and made necessary calculations for construction. Using the free space belonging to the company around the Sanatorium, it plans to build 5-8 cottages convenient for family stays in warm season of the year, which will considerably increase the capacity of the Sanatorium.

2) Expansion of service range and improving the service quality.

The company seeks opportunities to invest in modern equipment for physical treatment in order to expand their service capacity in pace with extended capacity of accommodation. It also needs more qualified and experienced doctors to work with patients. The management understands that special know-how in exercise/physical loads for injured or disabled people shall improve their quality of services, which in turn will increase the reputation of the Sanatorium among competitors and increase the profitability.

3) Expansion of capacity of dining hall and kitchen facilities.

   With expansion of the clients' accommodation with JICA TSL, the Sanatorium now can receive 225 persons per day (previous capacity: 70 persons per day). The existing dining hall has a capacity of 80 persons, so the Sanatorium urgently needs to expand the dining hall. This is true for kitchen as well: they should increase the kitchen equipment capacity.

The above goals are responding the challenges to Elma-Khujirt Sanatorium. It should continue to upgrade its competitiveness against competitors and create new market segments in the small domestic market. Export in form of foreign tourists coming the Sanatorium is potential for further growth, but, the Sanatorium needs continuous efforts for the competitiveness of quality health services.

6. Contribution to Industry

Mrs. Gerelmaa recognizes his mission is to "**best health services based on unique natural healing gift**". She has managed to set new service standards on the market of Khujirt hot-spring and mud rehabilitation services, is the pioneer of several new types of services such as hot-spring Jacuzzi and spinal column/hip-joint physical treatment. The influence of Elma-Khujirt Sanatorium on the competitors is big: The state enterprise Khujirt Sanatorium made urgent renovation to fit in the competitiveness rush, and all competitors now have to compare their services to Elma-Khujirt standards and improve them.

From his experience, Mrs. Gerelmaa gives the following advice to future SME borrowers:

✓ Always comply to all regulations and legal requirements !

✓ Strive to be the best on the market !

✓ Don't concentrate on today's profit, look at future perspective !

At this point it should be mentioned about great contribution of the Sanatorium to the local community. The Khujirt settlement of Uvurkhangai Province has about 3,000 residents, and job opportunities in this small place are very limited. There are very few municipal organizations and private companies offering jobs, and Elma-Khujirt Sanatorium is one of the biggest employers proposing very competitive wages at the region. The sanatorium employs 42 people, directly supporting income and sustainable livelihood of their families, but also indirectly supporting the local producers of food staff, people with skills of working on constructions sites, carpenters, gardeners and etc. The company is one of the biggest taxpayers in the region, and pays utility fees of MNT 20 million every month to the budget of the Khujirt settlement. This is a great support for the local budget, enabling the municipality to manage recurrent expenses such wages to state employees and renovation of infrastructure.

The Elma-Khujirt Sanatorium has **set new environment-friendly operation standards** to the local market. It installed its own water cleaning facility with three purifying steps for water used in the process of medical treatments and other waste-water. It also refused to use coal burning for heating during cold seasons, and installed electric appliances to heat the premises, while other sanatoriums still using coal, contributing to the pollution and global warming. Only for heating the Elma-Khujirt Sanatorium pays bills of MNT 12 million per month during cold months, but puts the issue of **environmental responsibility above today's profitability**.

7. Lessons for TSL Project

The lessons from Elma-Khujirt Sanatorium case can be summarized as follows:

1) Hard work and commitment of the company's founder is one huge part of success

   Success or failure of a project mostly depends on the capability of a founder. There are several important factors such as vision, aspiration, executive ability, consistency, sense of responsibility, etc. The success of the Sanatorium is largely attributable to the capability of Mrs. Gerelmaa. In the beginning of her business she was standing up in the morning at 5 am, working with papers until 7 am, and continue to work during whole day as director, accountant, stock-keeper, cook, and even room service all in one face until midnight every day.

2) In remote rural areas the transportation cost is considerable part of expenditures during implementation of project.

   The Sanatorium benefited TSL with purpose of expansion, mainly constructing and renovating its buildings. It means they had to transport bulk of construction materials, nearest from Ulaanbaatar city 400 kilometers away, or even from the Chinese border-city Erlian, distanced from Khujirt settlement by 1,180 kilometers. This expense item was not included in the loan pattern, but created a great financial load on working capital of the company during the implementation of the project. It might be good idea to include transportation costs in the loan total sum.

3) It's never too late to start a successful business.

   Mrs. Gerelmaa was aged 58 when she applied for TSL at Golomt Bank, and the application was rejected because she got over the age of pensioners (55 years old for women in Mongolia). However, she was granted by the TSL from the Trade and Development Bank after three years at the age of 61. The second loan was granted in 2015 when she was 64. Now she is 66, and the business is expanding and growing. So it is never too late for success in business if you have inspiration, experience, and good management skills.

ESUN OD FOOD INTERNATIONAL CO., LTD.

First fine chocolate maker in Mongolia producing European quality chocolate

Photo of Company Product Booklet

Summary

The Esun Od Food International Co., Ltd was established in 2004 to produce chocolate made by Belgium technology. It is the very first chocolate producer in Mongolia, and today it is the leading local chocolate maker. The products of the company were the first Mongolian products to be accepted and sold via worldwide online shop Alibaba.

The company has international standard production technology, products of excellent quality, and had acquired the market recognition in Mongolia and in some extent to China. With TSL loan the company has increased its production capacity by 2 additional production lines.

The major reasons for successful operations of the company is quality of the products. As the owner says, “the fine taste of our products is the main key to success”. This case shows how an import substitution and national production development project can achieve a success.

1. Company Profile

Key Figures	■Year of Establishment:	2004
	■General Manager	Mrs. T. Narantsetseg (Age 56)
	■Address:	Golden Gobi Factory, Khoroo 20, Sukhbaatar District, Ulaanbaatar, Mongolia
	■Product:	Chocolate
	■Capital:	MNT 1.6 billion (As of 2016)
	■Number of Employees:	23 (As of January 2017)
	■Annual Turnover	MNT 1,649 Million (2016)
	■Shareholders	Esun Od Co., LTD (50%), Mr. Robert Thys (50%)

Brief History of Company

The founder, Mrs. Narantestseg owned company Esun Od Co., Ltd, operating in importation and trading of food staff. Seeing the increasing market demand and recognition of premium chocolates imported from Belgium and Holland, in yearly 2000s she's got an idea to establish a chocolate factory in Mongolia.

However, there was need of financing, and, most importantly, the international standard technology and expertise of doing fine chocolate. After extended studies and negotiations she managed to acquire foreign direct investment from Belgium with accompanying technology of Belgian chocolate production.

In 2004 she established Esun Od Food International Co., Ltd, owning 50% of the company, and the foreign investment was represented by Mr. R. Thys as co-founder with another 50% ownership.

At the time of the loan application to JICA TSL in 2013 the company was operating for 9 years, and already was on the domestic market.

With JICA TSL the company was enabled to use its full production capacity, introduce new products and create well designed packaging, which boosted sales increase.

2. Background of TSL Project

In 2012, the domestic market of chocolate was estimated at 7 thousand tons per year, from which the company owned about 3% of the market shares.

The company's full production capacity of 5 tons per day, or 1.2 thousand tons per year. However, in order to work with their full capacity the company needed to expand their cooling line. Also, it needed several types of packaging equipment in order to give their products various forms and make their products more eye-catching.

Mrs. Narantsetseg
General Manager

3. Investment by JICA TSL

The company planned to use its full production capacity and improve product assortment and packaging by purchasing new cooling line, product forming and packaging machines. The financing needs could be satisfied by local commercial banks, however, the local loans were in general for working capital: with loan maturity of 24 months and interest rate of 20% per year. For investment with long term return these loans were highly inappropriate. In 2013 Capitron Bank, one of the PFIs of the JICA TSL approved the loan of MNT 400 million, which enabled them to buy the cooling line and product forming equipment. In 2015 the company benefited the second JICA loan approved by the Trade Development Bank of Mongolia. The second loan was also equal to MNT 400 million, by which the company financed purchase of three types of packaging machine.

Table 1: Investment Plan

Investment	Amount		Funding
	MNT Million	%	
Cooling line	800.0	73	JICA Loan
Product forming and packaging machinery			
Raw materials and inventory	295.9	27	Own capital
Total	1,095.9	100	

Source: TSL Office

With the investment, Esun Od Food International Co., Ltd has significantly increased its production and product assortment. The market share has increased to approximately 6% of domestic market and started export in 2015, currently exports to China.

Table 2: Comparison between Before Project and After Project

	Before Project (2013)	After Project (2016)
Number of Products	41 types	51 types
Number of Equipment	11	24
Production Capacity	40 tons per year	100 tons per year
Number of Employees	5 persons	23 persons

Annual Production	41.5 tons per year	92 tons per year
Annual Turnover	MNT 827 million	MNT 1,650 million
Market Share	3%	6%

Source: Esun Od Food International Co., Ltd.

The result of the project can be evaluated very satisfactory. Above all, the project had a significant impact because it could provide low-interest and long-term fund needed for a large investment, doubling the production output, annual turnover and market shares.

The TLS project has brought the following results:

- Improvement of production output and product assortment
- Employment creation
- Import substitution
- Export and foreign exchange earning
- Income opportunity for local traders
- Poverty alleviation through job creation and increase of personal income in form of wages

Before **Project (January 2013)**

After Project (March 2016)	   

Photos of Esun Od Food International Co., Ltd production before and after the Project

4. Key Success Factors of Esun Od Food International Co., Ltd.

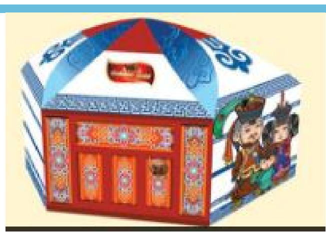
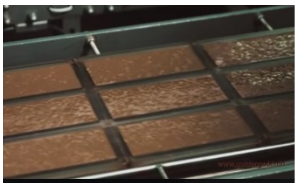
The success factors of the company can be summarized into the following factors:

- ✓ The company imported the one of the best technologies worldwide for chocolate making.
- ✓ The owner of the company gives the highest priority to the quality of the products.
- ✓ The business plan was realistic.
- ✓ Sales activities were down-to-earth by placing importance on appeal of good quality to consumers.
- ✓ Product packaging design was innovative, reflecting Mongolian national unique staff, which enabled export window through Alibaba online shop and boosted the sales during Mongolian national celebration “Tsagaan Sar”.

Technology

The technology was imported from Belgium as part of the foreign direct investment, evaluated as intangible asset by the foreign partner Mr. Robert Thys. He has extended experience producing chocolate in Belgium, and during first years of productions he was personally supervising the production and ensuring the product quality. This transfer of know-how was crucial for successful operation of the company: the production can be fully equipped with all necessary machinery, but the taste of the final product is defined by how they follow the technology. Even one minute in the heating and mixing stage changes the chocolate taste.

Table 3: Production Process

Process		Photo
Procurement of raw materials	Esun Od Food International Co., Ltd procure raw materials (cocoa, cocoa butter, cocoa liquor, sweeteners, soya milk) from Europe and China.	
Design	The company designs the chocolate forms and packaging by itself, reflecting unique Mongolian features, for example, nomadic tent "Ger".	
Melting	This is very sensitive process of the production. The timing and heat temperature directly influence the taste of the end-product. Inspection is conducted at this at this process.	
Mixing	The ingredients are mixed according to the certain type of product. Inspection is conducted at this at this process.	
Forming	The mixed mass is formed according to the product design.	
Cooling	Cooling should be done immediately after forming in order to keep the product shapes and design.	

Packaging	Attractive packaging is one part of the successful product. The inspection of end-product is conducted at this process.	
Inventory	Due to sensitivity of the product, the inventory is managed through production increase/decrease, depending on the celebration seasons, which are the pick of sales.	
Marketing & Selling	The company sells chocolate to traders and retailers. At the same time, they sell at own retail outlets and on the website.	

Source: Esun Od Food International Co., Ltd

Marketing and Sales Promotion

The products of the company is mostly designed mostly for market segment with above-middle income level. It is only around 30% of Mongolian households. However, in order to promote the sales it has marketing and sales promotion strategies for special market segments:

- Tourist segment: Each year Mongolia receives around 600 thousand tourists from 25 countries. Chocolate packed in Mongolian style is very popular among tourists, and after tasting the Golden Gobi brand products the chocolate-lovers appreciate the quality and buy chocolate to present for their families and friends after their return.
- Children segment: Around 40% of the total population of Mongolia are children. Chocolate packed in interesting manner for children is attracting them.

- Segment with health limitations: the company produces chocolate with low content of cacao for people with cardiovascular problems, and sugar-free chocolate for people with diabetics.

The seasons of chocolate sales in Mongolia is February-March (Lunar New Year Celebration), July-September (Mongolian Naadam Festivity and tourism season) and November-December (New Year Celebration). The company manages its stock inventory according to this seasonal sales booms by production output.

The chocolate sold in the brand shops of the company, large supermarket chains, duty free shops of the Chingiskhaan International Airport, as well as 5,800 small retailers in total.

Product

Before the TSL the company was producing 41 types of products, and after TSL the product assortment has been increased to 51 types.

Golden Gobi brand chocolate products are targeted to the middle and high-income segment of the market. Their products were priced a bit lower than imported chocolate. The price of the products is highly competitive with imported fine chocolate, while the quality is the same.

Human Resource Management

Esun Od Food International Co., Ltd created 15 new jobs after the TSL. Considering that before the TSL the company employed 8 employees, the number of workforce has been almost tripled.

In a pace with production and sales development of the company, the management increased the salaries of the personnel by 40-50% in comparison to 2013.

An important issue of Ulaanbaatar citizens is buying apartment. Using mortgage credit scheme of local commercial banks, the company supported its employees by financing down payment of the apartment loan, which equal to 30% of the loan.

Competition

There are 5 - 6 producers in Mongolia who produce candies and chocolate products; however, the Golden Gobi brand differentiates its brand by design and quality. The Esun Od Food International Co., Ltd is the only producer of fine chocolate, so there is no any domestic producer competing in this market segment.

Chocolate imported from the Switzerland, Belgium, and Germany are very strong competitors. In order differentiate from these products the company uses unique packaging styles and competitive prices. Today Esun Od Food International Co., Ltd occupies around 6% market share even though imports still account for approximately 90%.

5. Recent Performance of Esun Od Food International Co., Ltd.

The sales trend of Esun Od Food International Co., Ltd for the recent years is as shown in the following table. The sales has shown a steady increase in spite of economic downturn supported by exports.

Table 4: Recent Performance of Esun Od Food International Co., Ltd.

	Annual Turnover	Profit before Tax
2014	MNT 827.9 million	MNT 82 million
2015	MNT 1,091 million	MNT 110 million
2016	MNT 1.649 million	MNT 170 million
Only in January-February of 2017	MNT 800 million	MNT 80 million

Source: Esun Od Food International Co., Ltd.

Mrs. Narantsetseg has led the company with his initiative for more than ten years. She maintains his passion for growth. The recent strategy further development is as follows:

1) Expansion of the production capacity

   The company has sufficient land and production premises. Based on the increasing reputation of the brand products and sales, it would like to expand their capacity at least for two times.

2) Differentiation of production lines

   With the increase of capacity, which is mainly purchase and installation of additional production line, the company would like to separate lines by main products. This will increase productivity in a whole, saving time for adjusting the lines for certain product.

6. Contribution to Industry

Mrs. Narantsetseg is the pioneer of production of fine chocolate in Mongolia, and Esun Of Food International Co., Ltd stays the only one producer of this product till now. Besides its contribution to development of the national sweets production sector, the products of the company represent Mongolia in front of foreign tourists arriving to Mongolia and also on the enormous market of China.

From his experience, Mrs. Narantsetseg gives the following advice to future SME borrowers:

✓ Make very thorough calculations and projections of future activities !

✓ Product quality is key to success !

✓ Make realistic plan and stick to the plan !

7. Lessons for TSL Project

The lessons from Esun Od Food International case can be summarized as follows:

1) The know-how ensures the product quality.

   The success of the company products has been enabled only with participation of foreign expert with large experience in production of chocolate. Without proper expertise it is impossible to reach high standard product.

2) Include waiting time when planning a project.

   In the process of planning the commencement of the factory the company did not realize that producers of equipment and lines require much time. The equipment producers first develop design of the production line, receive an order and down payment of the order, and only after that they schedule the production of ordered equipment. If the equipment producer have many orders before your order, it can take a year waiting for the equipment.

3) Make comprehensive estimation of all factors that can affect the plan and have an amortization fund.

   From the time of ordering the equipment and receiving the credit from bank used for the down payment of equipment order, the company waited for 12 months till ordered equipment got ready. During this time the company was paying interest for the credit, having no any income from the production. So the owner advises to finance the down payment of equipment purchase by own funds.

   At the moment of equipment final payment MNT was much depreciated against the foreign currency in comparison to the initial calculation moment. Thus, the company lacked again funds to make the payment, when they converted MNT funds to foreign currency. So when receiving loan in MNT the borrower should be aware of timing and foreign currency exchange rate changes during projected future.

ЖИВЭРТИЙН ОРГИЛ ХХК

JIVERTIIN ORGIL CO., LTD.

Sea buckthorn grants health and vitality to you

Photo of Company Website

Summary

The Jivertiin Orgil Co., Ltd cultivates sea buckthorn berries and produces Shar Doctor (Yellow Doctor) brand juice, syrup and 100% pure sea buckthorn kernel and tegument oils from sea buckthorn, adding value to its agricultural output. The sea buckthorn berries are grown in ecological clean soil of Mongolia and processed in a modern production premises using international standard technologies.

The company has possessed the strengths of production technology, created brand products of excellent quality, and had acquired good market recognition in Mongolia and to some extend in Japan.

With TSL the company has increased its product range by three new products, which increased its sales by 40%, and expanded its production line by purchasing additional equipment from Germany.

The major reason for this successful performance Success of this TSL project mostly depended on the product unique characteristics. Ecologically clean product with highly positive features for human health played a significant role in overall sustainable development of the company.

1. Company Profile

Key Figures

■ Year of Establishment:	2005
■ General Manager	Mr. Natsag Sainjargal
■ Address:	Shuvuun Fabrik 64/2, Khoroo 13, Khan-Uul District, UB, Mongolia
■ Product:	Sea buckthorn berries, beverages and oil
■ Capital:	MNT 3.2 Billion (As of 2016)
■ Number of Employees:	47 (As of March 2017)
■ Annual Turnover	MNT 3.4 Billion (2016)
■ Shareholders	Mr. Natsag Sainjargal 100%

Brief History of Company

The company has started its activities in 2005 by researching business opportunities in production of ecologically clean products. As a result, they decided to cultivate sea buckthorn berries and produce beverages. At the start they ran kind of experimental production of beverages in small scales, concentrating on building its agricultural capacity of sea buckthorn bush cultivation. The sea buckthorn bushes require 5 years of cultivation to start to produce its maximum output. Therefore, only in November 2011 the company has opened its beverage factory with capacity of processing 5 tons sea buckthorn and cooling warehouse with capacity of 400 tons.

Sea buckthorn 100% pure juice with oil, which is well pressed by production methods, is used at the production of the brand juice Shar Doctor. The sea buckthorn pure oil is prepared with kernel and tegument of berries with the method of compression. The major goal of the company is to deliver to consumers this “natural medicine” not removing its valuable qualities.

At the time of creation of upgraded factory the company has directed 80% of the total investment into production premises and necessary infrastructure. Thus, due financial ability of the company limited the investment in equipment. The installed production line had insufficient capacity for further planned growth of the company.

2. Background of TSL Project

Mr. Sainjargal
General Manager
(Interview on the Bloomberg TV)

The company has applied for the TSL in 2013 in order to expand its production line via Trade and Development Bank of Mongolia. At the time of credit application there were 6 producers of sea buckthorn beverages on local market, not counting micro-sized home producers, and no import of such products. However, the company was the only one to produce pure juice by pressing and processing the sea buckthorn berries. In 2013, the domestic market of sea buckthorn beverages was estimated at MNT 7.3 billion.

Sea buckthorn 100% pure juice with oil, which is well pressed by production methods, is used at the production of the brand juice "Shar Doctor". The sea buckthorn pure oil is prepared with kernel and tegument of the berries with the method of compression. The major goal of the company is to deliver to consumers this "natural medicine" not removing its valuable qualities.

For information, the Sea buckthorn berries contain many types of vitamins, oil, hydrocarbon, proteins, biological active substances and microelements. The full-grown sea buckthorn contains 50-500mg/% of ascorbic acid or Vitamin C and this sea buckthorn bush leaves and branches also contain Vitamin C. As well as sea buckthorn contains several types carotenoids such as carotene, likopine, ksantofile (or lutein), and Vitamins A, E, P, K1, B1, B2, B4, B6, B9, D, PP and microelements such as Fe, Mg, Mn, B, S, Al, Sn, Cl, Pb, NI, Mo, Cu and proteins and free amino-acids.

In 2012 the company started exports of its products to Japan. Takarajima Japan Co., Ltd became a Distributor of the company, introducing the brand Yellow Doctor on the market of Japan since 2012. The brand Yellow Doctor has been successfully participated at the International foodstuff fair FoodEx Japan-2013, which was organized in March 2013. The distributor company in Japan is located in Tsukuba city, which is considered as the Japanese Research Centre of related productions.

3. Investment by JICA TSL

Mr. Sainjargal has planned to expand and improve the production capacity by purchasing additional equipment such as Automatized glass bottle packaging line, Conveyors and other supportive equipment, and Oil pressing and purifying line. The TSL was administered by the Trade and Development Bank of Mongolia. The company received MNT 650 million 6 years tenure and grace period of 12 months in January 2014.

The use of loan was as shown in the following table.

Table 1: Investment Plan

Investment	Amount		Funding
	MNT Million	%	
Automatized glass bottle packaging line	650.5	80	JICA Loan
Conveyors and other supportive equipment			
Oil pressing and purifying line			
Factory building	-	-	Own capital
Working capital	162.5	20	
Total	812.5	100	

Source: TSL Office

With the investment, the company was enabled to introduce three new products to the product range, increasing its turnover by 40%. The market share has increased up to approximately 60% of domestic market, and the export activities started in 2011 was considerably supported by the investment.

Table 2: Comparison between Before Project and After Project

	Before Project (2013)	After Project (2016)
Number of Equipment	20	50
Production Capacity	50 tons	500 tons
Number of Employees	35 persons	47 persons
Annual Production	40 tons or 200 thousand units	250 tons or 1,400 thousand units
Annual Turnover	MNT 877 million	MNT 3,400 million
Market Share	20%	60%

Source: Jivertiin Orgil Co., Ltd.

The result of the project can be evaluated very satisfactory. Above all, the project had a significant impact because it could provide low-interest and long-term fund needed for a large investment supporting the development of national brand products.

The TLS project has brought the following results:

- Employment creation and poverty alleviation;
- Support of national food and agriculture sector;
- Export of Mongolian products and foreign exchange earnings;
- Income opportunity for local traders;
- Creation of products supporting human health;
- Indirect support to farming community.

Before Project (November 2013)	 
After Project (May 2016)	     

Photos of Jivertiin Orgil Co., Ltd Production before and after the Project

4. Key Success Factors of Jivertiin Orgil Co., Ltd.

The success factors of the company can be summarized into the following factors:

- ✓ The founder, Mr. Sainjargal, has selected highly promising product for his business and has made extended researches in development of his products.
- ✓ Uniqueness of ecologically clean product that can grow only in geographical latitude of Mongolia has supported the success of the company.
- ✓ Export opportunity and TSL financing at the right time enabled the business rapid growth.

- ✓ Close relationship with and support of farming community brought positive effect of sustainability raw material supply.
- ✓ Cooperation with Research Centre in Tsukuba city, Japan, has enabled the highest quality of the product and increased the reputation of the company.

Technology

The technology of making sea buckthorn beverages and oil can be splitted in three main stages:

(1) Raw material classification and initial processing;

(2) Sea buckthorn substance processing and mixing with other ingredients;

(3) Bottling, labeling, cooling and storing.

The production process can be summarized as of following:

Table 3: Production Process

Process		Photo
Procurement of raw materials	The company procures sea buckthorn berries from its own plantation. Also, it created a network of planters who supply the berries to the factory, directly supporting their income.	
Classification of berries	The berries are classified according to their characteristics for different production lines.	
Processing	In the processing stage of the berries there are several types of processes such as washing, pressing, heating, separation of peel and seed particles, drying and etc.	

Mixing	The processed sea buckthorn mass is mixed with sweeteners and other ingredients according to certain product qualities.	
Bottling, Cooling and Labeling	The ready mixture is bottled and labeled according to type of products.	
Inventory	The inventory increases in autumn-winter time because of seasonality of demand.	
Marketing & Selling	The company has its own product distribution vehicles that bring their products directly to the retailers.	

Source: Jivertiin Orgil Co., Ltd and TSL Office

Marketing and Sales Promotion

Before the project, the company has been producing about 200 thousand product units and selling mostly on the domestic market.

Today the company 1.4 million product units and sell its products in Mongolia and Japan.

The company has its own distribution vehicles delivering their goods to more than 20 supermarket chains throughout Mongolia. 500 supermarkets in the Capital city and rural areas sell Shar Doctor Brand products.

It is noticeable that the pharmacy stores also sell the Shar Doctor Brand oil and beverages.

The highest season of sales is winter time due to healing qualities of the product. Mongolians generally believe that hot sea buckthorn juice prevents flue and improve immune system of people.

Product

The sea buckthorn participates as a mediating activator in the oxidizing-fermentation processes, which are regularly happen in the human body, and it improves human immune system against to infectious diseases. It makes blood vessels walls flexible and prevents people from hemorrhage and heart attack. Also the sea buckthorn is helpful to heal various infectious diseases, pneumonia and to disinfect and to restore human body tissue wounds.

This berry is also helpful to cure liver and intoxication of human body.

Scientists report that oil of sea buckthorn has high antioxidant, anti-inflammatory, and antiviral properties that help promote total body wellness. Here are some potential benefits of sea buckthorn oil:

•**Promote skin health.** Oral and topical applications of sea buckthorn oil both have benefits on skin problems. It promotes skin hydration, elasticity, and skin regeneration, and even helps treat and prevent acne.

Sea buckthorn oil may also be beneficial for rosacea, a chronic inflammatory condition that causes small red bumps on the face.

•**Help with weight management.** Experts say that the fatty acids in sea buckthorn oil helps signal your body to stop storing fat. According to Dr. Mehmet Oz, the oil can even help keep off weight for longer periods compared to conventional weight loss programs.

•**Help prevent dementia and Alzheimer's disease.** The vitamin B12 in this herbal oil can help improve cognitive decline. The omega-3s and other fatty acids in this oil may also contribute to this benefit.

•**Promote healing of ulcer and gastroesophageal reflux disease (GERD).** Sea buckthorn oil can help soothe the mucosal tissue in the digestive tract, and may also be useful in treating gastric ulcers. It can also work for other GI tract problems, including upset stomach, dyspepsia, and constipation.

•**Relieves dry eyes.** Sea buckthorn oil provides relief from dry eye, a condition commonly seen in older people and menopausal women and is often caused by hormonal changes.

According to Dr. Tori Hudson, a study found that oral supplementation of sea buckthorn oil in individuals with dry eyes for three months had a positive effect on osmolality and dry eye symptoms, such as burning and redness.

•**Prevents liver damage.** An animal study found that this herbal oil has a potent hepaprotective activity due to its potent antioxidant power. The oil reduces the concentrations of aflatoxins in the liver and diminishes their adverse effects.

Another clinical study, published in the Journal of Clinical Science, found that it helps normalize liver enzymes and serum bile acids.

The company produces pure sea buckthorn oil mainly for export, and beverages mainly for the domestic market.

But it should be noted that all beverages of the company contain sea buckthorn oil.

Table 4. Products of Jivertiin Orgil Co., Ltd.

	Product Definition	Photo of the Product	Price	Price of Competitors
1	Shar Doctor sugar free sea buckthorn beverage, 500 ml		MNT 5,300	MNT 4,900-5,900
2	Shar Doctor sea buckthorn beverage, 280 ml		800 төгрөг	No presence of similar product
3	Shar Doctor sea buckthorn syrup		MNT 4,800	MNT 3,900-5,100
4	Shar Doctor sea buckthorn 100% pure oil		MNT 20,000	MNT 16,000-35,000

5	Shar Doctor sea buckthorn 100% pure oil		MNT 10,000	MNT 8,000-3,5000
6	Shar Doctor sea buckthorn beverage		MNT 1,500	MNT 920-1,100
7	Gift Set - sweetened juice		MNT 10,000	No presence of similar product
8	Gift Set- sugar free juice		MNT 15,000	No presence of similar product
9	Gift Set - Bottled pure juice		MNT 3,000 *6 bottles = MNT 18,000	No presence of similar product

Source: Jivertiin Orgil Co., Ltd

Human Resource Management

In 2011, when the factory has started its production, the company has been employing about 20 staff. As of today it employs over 47 staff, doubling the number employees and creating 27 new jobs.

The company pays a lot of attention to the increase of income of workers in order to support the sustainability of their livelihoods. During the implementation of the project the technical personnel wages were increased by 400%, and managerial position personnel by up to 800%.

Competition

The company identifies that there are 7 competitors in Mongolia.

(1) UFC Co., Ltd, producing 2 types of sea buckthorn syrup;

(2) Bio Co., Ltd, producing 2 types of sea buckthorn syrup;
(3) Organic Sea Buckthorn Co., Ltd, producing 1 type of sea buckthorn syrup;
(4) Monos Co., Ltd, producing 1 type of sea buckthorn syrup and sea buckthorn oil;
(5) Vitafit Co., Ltd, producing sea buckthorn beverage;
(6) Teso Co., Ltd, producing sea buckthorn beverage;
(7) Hubba Haya Co., Ltd, producing sea buckthorn beverage and sea buckthorn oil.

However, the company holds 60% of the total market shares, which means it is the dominating market player.

The company differentiates its products by successful brand Shar Doctor. The company is a step above the competitors by their experience and market presence.

5. Recent Performance of Jivertiin Orgil Co., Ltd.

The sales trend of the company for the recent years is as shown in the following table. The sales has shown a constant increase in spite of economic downturn, supported by exports.

Table 5: Recent Performance of Jivertiin Orgil Co., Ltd.

Year	Annual Turnover	Profit before Tax
2013	MNT 877 million	-
2014	MNT 2.400 million	MNT 28.1 million
2015	MNT 3,100 million	MNT 405.5 million
2016	MNT 3,400 million	MNT 458.9 million

Source: Jivertiin Orgil Co., Ltd.

Mr. Sainjargal has led the company with his initiative for 12 consecutive years. He maintains his passion for growth. The recent strategy of Jivertiin Orgil is as follows:

1) To introduce production of dried essence from sea buckthorn

   The challenge of this production is to save all vitamins and nutritious elements in the dried substance. The company has already calculated the investment for this expansion: it makes USD 1.2 million. The company plans to invest USD 0.2 million by its own sources and apply for loan of USD 1.0 million.

2) To constantly seek for attractive products for export

   The company plans to expand its export activities to number of countries, overcoming effects of present economic crisis in Mongolia. The sea buckthorn oil is booming product nowadays: the unique high fatty acid content of sea buckthorn oil and the wealth of nutrients it contains make it one of the most health-promoting herbal oils today.

3) Development of farmers' network

As of today, the company purchases about 80% of all sea buckthorn berries grown in Mongolia. In order to increase its production, the company needs more and more harvests collected from the farmers. Thus, the export strategy success is directly depends on the successful farming. Therefore, Mr. Sainjargal plans to support by all available means the farming community.

6. Contribution to Industry

The company supports and cooperates with farmers in order to develop sea buckthorn production in Mongolia. It organizes various supportive measures such as direct purchase of harvested sea buckthorn from farmers, financing of transportation costs of their products, organizing tours for farmers to the countries that export sea buckthorn, and providing farmers with professional guidance.

Also the company encourages individuals and business entities that constantly supply the company with best-quality berries. As the leading producer of sea buckthorn products the company is able to recommend good berry farmers to the Food and Agriculture Ministry of Mongolia in order to have them supported in framework of state subsidies and soft-loan schemes.

The company alone purchases about 80% of the total sea buckthorn berries grown by farmers in Mongolia.

Mr. Sainjargal recognizes his mission is to "**deliver the unique gift of nature – the sea buckthorn – to the people**". Today the company is the leading producer of sea buckthorn industry, and he brought this Mongolian product to the level that can be internationally recognized. Besides Japan, export of sea buckthorn oil is discussed with buyers from Russia, China, Korea, Taiwan, Kazakhstan, and Arabian Emirates.

From his experience, Mr. Sainjargal gives the following advice to future SME borrowers:

- ✓ Choose the right product !
- ✓ You can start small, but think big !
- ✓ Cooperate !

7. Lessons for TSL Project

The lessons from Jivertiin Orgil Co., Ltd case can be summarized as follows:

1) Unique product is a key to success

   Success of this TSL project mostly depended on the product unique characteristics. Ecologically clean product with highly positive features for human health played a significant role in overall sustainable development of the company.

2) Always seek for export markets

The company's success was also depending on an access to export market of Japan, which contributed to their successful operations a lot. Since the domestic market of Mongolia is mall (Mongolia has only population of 3 million people), very soon the company should have face the market volumes satisfaction, and should not be able to grow financially further. With export markets such as huge markets of Japan, China and Russia, the company has unlimited growth potential. Also, in circumstances of economic downturn and decline of purchasing power of population facing Mongolia last two years, access to the export markets make the company less vulnerable to domestic economic conditions.

3) Proper studies and researches are crucial.

Expertise of Research Centre in Tsukuba city, Japan, played a significant role in success of the company's products on Japanese market, and improved much the reputation of the company on the domestic market.

4) Importance of a multi beneficial cooperation.

The policy to support local farmers, cultivating sea buckthorn, brought multiple benefits to the company: it was enabled to receive 80% of total sea buckthorn grown in the territory of Mongolia, which boosted the production scales of the company, thus, sales income was increased by four times after the implementation of the project.

ШИЛЭН ХИЙЦ

SHILEN KHIITS CO., LTD.

The company that contributes to mitigation of environmental footprint in Mongolia

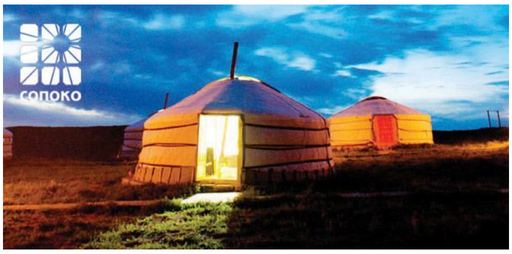


Photo of Company Website

Summary

Shilen Khiits Co., Ltd. is the first and leading local producer of solar panels on the Mongolian market.

At the time of creation of solar panel production factory Mongolia had already certain market demand of solar panels with accompanying accessories, because about 20 percent of total households of Mongolia live in rural areas, cultivating nomadic way of life, and off-grid. Therefore, nomads usually use solar panels to charge their cellphones, watch satellite-dish television and light up their homes.

The TSL of USD 580 thousand was approved by Golomt Bank in December 2011 for the company. With TSL financing the company invested in technology and equipment, bringing their production to the international standard level.

The products of the company have now great success among nomadic herders.

The major reasons for this successful performance are excellent awareness of market demand, close cooperation with clients on identification of their actual needs, and constant development of human resources.

This case shows how an import substitution project in environment protection can achieve a success.

1. Company Profile

Key Figures

■Year of Establishment:	2002
■General Manager	Mr. Dontor Gantulga (Age 47)
■Address:	Khoroo 12, Songino-Khairkhan District, Ulaanbaatar, Mongolia
■Product:	Solar panels
■Capital:	MNT 3 Billion (As of 2016)
■Number of Employees:	110 (As of March 2017)
■Annual Turnover	MNT 6 Billion (2016)

Brief History of Company

Mr. Gantulga
General Manager

The founder, Mr. Dontor Gantulga, a former military officer, has started his business activities by importing and trading car windshields in 1997. After 5 years of trading glass products he established his company Shilen Khiits Co., Ltd in 2002 with main activity of glass processing. By the time of the loan application in 2011 the factory had a capacity to process 660-720 tons of glass per year, supplying door/window/wall glass to the market. Until today it is the leading glass supplier on the Mongolian market.

2. Background of TSL Project

With raising awareness of environmental responsibility worldwide and particularly in Mongolia, the owner got an idea to assemble solar panels in Mongolia, introducing new production line to his factory.

In 2011 there were no any producers of solar panels in Mongolia. There were some traders of solar panels and accompanying accessories, but they were just importing finished products, mostly from China. For the company, there was a business opportunity to import essential parts such as sells of solar panels and assemble solar panels in Mongolia, supported by already existing plastic/metal frame and glass processing lines of the company. In this conditions the company was planning to deliver the end product more cost efficiently, which could be reflected in competitive price of their products comparing to the imported goods.

With population of 3 million people Mongolia has 50 million livestock, bred by livestock herders in rural areas, living off-grid by nomadic style of life. The herders were the target market of the company.

In 2011 the target market for the company was estimated as 100 thousand herder households, and the company set its market segment at 30 thousand households of higher income herders at estimated market volumes of USD 12 million.

3. Investment by JICA TSL

In order to introduce new product line, the company needed investment in equipment and working capital, totally USD 900 thousand. The company could afford to invest USD 320 thousand, or 35.5 percent of the total investment. The rest USD 580 thousand or 64.5 percent of the total investment was planned to be financed by a bank loan. Therefore, the company has developed an investment project and submitted it to the Golomt Bank, one of the JICA TSL Project implementing financial institutions. This project has been supported as an environment protection project.

Shilen khiits Co., Ltd received a loan of USD 580 thousand from Golomt Bank in January 2012. The loan condition was 8-year repayment including 2-year grace period and 5.0% of interest rate per annum.

The use of loan was as shown in the following table.

Table 1: Investment Plan

Investment	Amount		Funding
	USD thousand	%	
Cutting equipment for EVA film and TPT	500	55.5	JICA Loan
Half-automated laminating machine			
Automatic solar panel cell molding machine (Robot)			
Aluminum framing machine			
Other equipment (5 types)			
Raw materials and inventory	80	9	
Factory building	-	-	Own capital
Working capital	69.4	35.5	
Total	852.4	100	

Source: TSL Office

In order to have clear picture on feasibility of the solar panel production line, during implementation of the project the owner established a daughter company named Sopoco Co., Ltd with separate balance from the mother company Shilen Khiits. Thus, the table below shows exactly the results of the solar panel production.

Table 2: Comparison between Before Project and After Project

	Before Project (2012)	After Project (2016)
Number of machines in production	0	9
Number of product packages	0	3
Production Capacity	0	10,000 panels per year
Number of Employees	0	23 staff + 11 sales representatives in countryside
Annual Production	0	1,100 panels per year
Annual Turnover	MNT 0	MNT 1,6 billion
Market Share	0%	50%

Source: Shilen Khiits Co., Ltd.

The result of the project can be evaluated as excellent. Above all, the project had a significant impact because it could provide low-interest and long-term fund needed for a large investment for a business start-up. It should be also noted that the timing of loan matched a change of business environment and market behavior.

The TLS project has brought the following results:

- Support of successful start-up;
- Employment creation;
- Import substitution of solar panels;
- Development of national industry;
- Indirect support of local herder community

Before Project (September 2011)

After Project (March 2017)	

Photos of Shilen Khiits Co., Ltd Production before and after the Project

4. Key Success Factors of Shilen Khiits Co., Ltd.

The success factors of the company can be summarized into the following factors:

- ✓ The founder, Mr. Gantulga, is a born businessman with sufficient knowledge and capability of doing business in Mongolia;
- ✓ Japanese know-how was introduced in the beginning of the production.
- ✓ The product packages designed for herders answered exceptionally to the demand of the customers;
- ✓ Product quality itself and accompanying warranty were appreciated much by the target market.
- ✓ Mr. Gantulga has made continuous and diligent efforts for the realization of his business and success.

Technology

Having all necessary machines is not the full technology, one of the important parts is know-how.

The company was very lucky to receive technical assistance from the EBRD Business Advisory Serves Program. An **International Expert from Japan, Mr. Toridami-San**, who worked in the Sharp Corporation for his whole life, and particularly on the production of solar panels for more than 20 years, helped to set up the production line, use the equipment efficiently and correctly, and achieve good quality of the products. Without this expertise it would be hard to achieve success in a totally new production.

Table 3: Production Process

Process		Photo
Procurement of raw materials	The company procures main raw materials such as solar cells, aluminum lists, and glass from Japan, China, Taiwan and Russia, depending on the market price of this countries.	
Positioning the solar cells	The cells are placed on a platform according to the product size. There are three different sizes of the products, differentiated by energy output.	
Molding of the cells by a robot machine	Molding is automated by molding robot machine, which is the most expensive equipment in the factory. However, this robotized production stage ensures the high quality of the end-product.	
Covering the cells	Covering positioned cells with EVA (Ethylene Vinyl Acetate) film and TPT (Tedlar Polyester Tedlar) cover.	

Placing protection layer	Placing protection glass shield on the product and laminating, keeping in heat for 20 minutes.	
Framing	The product is framed in aluminum frames to reach good durability. With aluminum frames the average weight of a solar panels is 20 kilograms.	
Inspection	Inspection of the end product quality with various testers: cell tester, IL and IV testers.	
Inventory	The factory uses only 11% of its capacity. If large orders come in, they can react very promptly, so the Factory keeps a small amount ready products in inventory.	
Marketing & Selling	The company sells their product packages at their factory store and at the main markets in Ulaanbaatar. Also, the company have 11 regional representatives in regions.	

Source: TSL Office and Shilen Khiits Co., Ltd

Product

The company produces three types of solar panel, differentiated by size, which is reflected in solar energy production capacity and end-price of the product.

However, having product packages designed for the client's special needs is more comprehensive approach, and it is made enormous positive effect in successful realization of the products.

Today the company offers a number of product packages designed as solar panel + battery + electric household appliance. The electric appliance can be TV set, refrigerator, freezer, or any appliance that can be operated with 12 Volts.

The company has made technological upgrade of its products during the project implementation. Following the world progress in solar cell production, now the solar panels produced by the company can receive sun energy on the both sides of the panel. While the front-side of the poly-panel receives 100% of sunlight and produce energy by its full capacity, the back-side of the panel receives reflected sunlight and contribute more 30% energy production.

The price policy of the company is to have equal price or less price than imported solar panels. However, imported (mostly from China) mono-panels receive sunlight only on front-side. Therefore, considering that poly-panels of Shilen Khiits produce additional 30% energy, the company has huge advantage in competition.

Table 4: Prices of Shilen Khiits Co., Ltd.

Band	Price (Men's Socks)
Panel with 80Watt capacity	MNT 150,000 (USD 60.7)
Panel with 160Watt capacity	MNT 400,000 (USD 161.9)
Panel with 80Watt capacity	MNT 600,000 (USD 242.9)

Source: Shilen Khiits Co., Ltd

Marketing and Sales Promotion

Due attractive product packages designed for everyday life of herder family living off-grid, the products of the company are getting well-known with every year on the domestic market, and reputation of the company's products is growing rapidly.

Today the company operates a factory shop, as well as shops on the main open-markets, where usually people arrived from countryside make their purchases. Besides this, the products can be offered online and the payment can be done via mobile banking services using a cellphone.

The company has already 11 regional operators representing it in the remote rural areas. The product packages of the company can be seen in every corner of Mongolia with huge territory (in comparison, 4.3 times bigger than Germany).

The customer satisfaction is the most important thing for the company. They are available to give their consultation during 24-hours on the phone.

Another valuable advantage of the company is that it gives 20 years product warranty to their solar panels, whereas traders with imported solar panels are not available to provide such warranty.

The products have some seasonal effect in sales depending on the income of the herders. However, the solar panels and product packages are sold during whole year. The high season are periods in March-June, when herders have income from cashmere and wool, and late autumn, when herders have income from meat sales.

Photos of Directly-managed Shops of Shilen Khiits Co., Ltd.

Human Resource Management

Human resource management and development is a very important issue to Shilen Khiits Co., Ltd. While the solar panel production employs 23 staff, there are 110 staff is employed totally in Shilen Khiits Co., Ltd.

The company pays a lot of attention to the professional development of its personnel. It exercises Japanese-style human resource management with implementation of 5S Philosophy on Business Productivity. Each year 8 workers are attended the training at the Mongolian-Japanese Center by grant of the company. Also, 6-8 persons are sent every year to Japan to attend training on 5S Philosophy, granted by the company. This has huge effect on motivation of the workers.

The company pays attention to the household needs of workers as well. 11 workers were provided with accommodation by the company, and 6 persons were enabled to buy new apartments with the help of the company (the company paid 30% down payment in the mortgage loans).

Comparing to the start of the project, the wages of the personnel were increased by 40% on the average as of today.

Competition

The company was pioneer in the production of solar panels in 2012, and competitors were only traders importing similar products.

By the time there is only one additional solar panel producer was established in Mongolia. This company was established with direct foreign investment from Japan, and produce solar panels in Mongolia and exports them. They have no any sale activity on the domestic market. Therefore, it is hard to identify this company as competitor on the local market.

Today the company, started from scratch 5 years ago, occupies 50% of the local market.

5. Recent Performance of Shilen Khiits Co., Ltd.

The sales trend of the company for the recent years is as shown in the following table. The sales has shown a steady increase in spite of economic downturn.

Table 5: Recent Performance of Shilen Khiits Co., Ltd.

	Annual Turnover	Profit before Tax
2014	MNT 400 million	-
2015	MNT 900 million	-
2016	MNT 1,600 million	MNT 300 million

Source: Shilen Khiits Co., Ltd.

Mr. Gantulga has led the company with his initiative for 15 years. He maintains his passion for growth. The recent future development strategy of Shilen Khiits is as follows:

1) **Upgrading the solar panel production**

At the time of production start the company purchased the most modern equipment with 3-busbar molding technology. By the time the development of solar panel production is progressed to 5-busbar technology. The company plans to invest in the modern technology and estimates the investment for production upgrade as USD 400 thousand.

2) **Expansion of glass processing line**

The company plans to invest in additional equipment for the glass processing line. Estimated value of investment is USD 1 million.

3) **Implementation of solar energy station project**

Mr. Gantulga is aspired to build a solar energy station in order to contribute to the clean energy production of the country. As of the Energy Authority of Mongolia report, only 3% of total energy produced in Mongolia is from renewable sources such sunlight and wind.

This is challenging, but decent task for the company in today's circumstances of global warming and increasing public awareness to environmental issues.

6. Contribution to Industry

Mr. Gantulga recognizes his mission is to "**erase the difference of quality of life between city residents and nomadic families**". He is the pioneer of solar panel production in Mongolia. The influence of Shilen Khiits on the quality of life of residents in remote rural areas, cultivating nomadic way of life, is very considerable.

From his experience, Mr. Gantulga gives the following advice to future SME borrowers:

✓ Customer satisfaction is at utmost importance !

✓ Human resource development and motivated personnel are the key success !

✓ Always do your best !

7. Lessons for TSL Project

The lessons from this case can be summarized as follows:

1) **Invest at the right time in the right business.**

There are statistics that 80% of start-ups fail. The company is in the successful minority that survived, and even thrived in its business. The key in this success is the right selection of business and awareness of market demand.

2) **If you have sales in local currencies, do not borrow in foreign currency.**

The company sells solar panels on the domestic market, having sales in MNT. However, the loan was disbursed in USD, considering the purchase of equipment from abroad. By the time the USD exchange rate started to appreciate, and it turned to be more and more unprofitable to convert income in MNT to increasing USD and repay the loan interest and principal payments.

The support came from the JICA TSL Project, which considered to convert the USD loan of the company to MNT loan. The company appreciates this conversion a lot.

3) **Build you people.**

Educating and professionally upgrading of staff is crucial for success in modern business. Motivated personnel targeted at quality and productivity is the most valuable asset.

4) **Plan your credit repayment schedule by yourself.**

During loan disbursement procedures the Golomt Bank planned the repayment schedule to be paid evenly throughout the year. However, the company has some seasonal influences in its sales, and in some repayment periods it is stressful to fulfill the payment obligations, whereas in some periods the company has excessive income. The lesson from that to plan the repayment schedule according to borrower’s seasonal nature of income.

5) **Know-how is key to the quality product.**

The company received technical assistance from the EBRD Business Advisory Service Program: **International Expert from Japan, Mr. Toridami-San**, who worked in the Sharp Corporation for his whole life, and particularly on the production of solar panels for more than 20 years, helped to set up the production line, use the equipment efficiently and correctly, and achieve good quality of the products. Without this expertise it would be hard to achieve success in a totally new production.

YANMAL CO., LTD.

First socks maker in Mongolia offering high quality socks

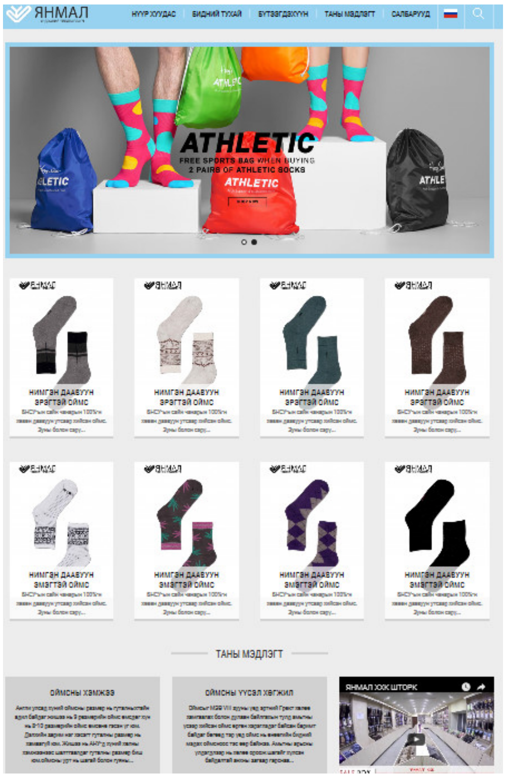


Photo of Company Website

Summary

Yanmal Co., Ltd. was the first and leading local socks maker in the Mongolian market. Yanmal possessed the strengths of production technology, products of fair quality, and had acquired the market recognition to some extent. With TSL Yanmal increased its production capacity by 20 new knitting machines from 28 secondhand machines to 48 machines. Owing to this investment of right money at right time, Yanmal could significantly increase the market share and start export.

The major reasons for this successful performance are internal technological resource, new machines of higher performance, and above all the managing director's commitment to the project. This case shows how an import substitution project can achieve a success.

1. Company Profile

Key Figures

■Year of Establishment:	2006
■General Manager	Mr. Lhagvajav Davaayam (Age 44)
■Address:	15-230, Khoroo 13, Chingeltei district
■Product:	Socks
■Capital:	MNT 2.5 Billion (As of 2016)
■Number of Employees:	80 (As of January 2017)
■Annual Turnover	MNT 6,500 Million (2016)
■Shareholders	Mr. Lkhagvajav Davaayam 100%

Brief History of Company

The founder, Mr. Lkhagvajav Davaanyam worked at a socks manufacturer in Korea, Su Son LLC for 8 years. After he returned to

Mongolia, he established Yanmal Co., Ltd. in July 2006 and started the production of socks with three people by purchasing two secondhand knitting machines from Korea. The company slowly but steadily increased their sales in the domestic market for good quality and better prices by competing with imported socks.

2. Background of TSL Project

In 2010, the domestic market of socks was estimated at 17.1 million pairs, of 92% which were imported, mainly from China (75%). There existed 2 domestic socks makers, Yanmal Co., Ltd. (5.5% of market share) and Mongol Oims LLC (2.5%). Yanmal is the largest domestic maker and pioneer of socks production in Mongolia.

Mr. Lhagvajav

Mr. Lhagvajav identified big business opportunity because of the good quality of his socks and the growing recognition among consumers. In addition, he had a mission that he must deliver good socks to all Mongolian people because of his belief in technology and quality of his socks.

Yanmal had increased knitting machines step-by-step with own money. However, for the further growth of the company, there was a problem of funding for a SME like Yanmal.

3. Investment by JICA TSL

Mr. Lhagvajav planned to expand and improve the production capacity by purchasing new knitting machines in addition to the existing 28 machines. He visited large banks for loans but was rejected by those banks. Finally, he received good response from TDB and was introduced the JICA TSL program.

Mr. Lhagvajav prepared and submitted an investment plan and loan application in consultation with the TSL Office and loan officers of TDB. Yanmal received a loan of MNT 685 million from TDB in August 2011. The loan condition was 6-year repayment including 1-year grace period and 8.0% of interest rate.

The use of loan was as shown in the following table. Yanmal purchased 20 new Korean knitting machines.

Table 1: Investment Plan

Investment	Amount		Funding
	MNT Million	%	
New knitting machines: 20 units	434.5	51	JICA Loan
Socks sealing machines: 3 units			
Air compressors: 3 units			
Ironing machine: 1 units			
3-story factory building	146.9	17	
Raw materials and inventory	102.9	12	
3-story factory building	98.7	11	Own capital
Raw materials and inventory	69.4	9	
Total	852.4	100	

Source: TSL Office

With the investment, Yanmal significantly increased the production and improved its quality. The market share has increased to approximately 50% of domestic market and started export in 2014, currently exports to Russia, Kazakhstan, etc.

Table 2: Comparison between Before Project and After Project

	Before Project (2010)	After Project (2012)
Number of Knitting Machines	28 units	48 units
Production Capacity	1 million pairs	3.5 million pairs
Number of Employees	35 persons	55 persons
Annual Production	1 million pairs	3.5 million pairs
Annual Turnover	MNT 1,500 million	MNT 4,500 million
Market Share	5.5%	23%

Source: Yanmal Co., Ltd.

The result of the project can be evaluated very satisfactory. Above all, the project had a significant impact because it could provide low-interest and long-term fund needed for a large investment doubling the production capacity one time. It should be also noted that the timing of loan matched a change of business growth in the market.

The TLS project has brought the following results:

- Improvement of technology and quality of socks supply
- Employment creation
- Import substitution of socks
- Export of socks and foreign exchange earning
- Income opportunity for local traders

Before **Project (July 2011)**	
After Project (February 2012)	

Photos of Yanmal's Production before and after the Project

4. Key Success Factors of Yanmal Co., Ltd.

The success factors of Yanmal can be summarized into the following factors:

- ✓ The founder, Mr. Lkhagvajav, had sufficient knowledge and capability of stock making which enabled the production of socks with good quality and good price.
- ✓ Yanmal has concentrated on only socks that the fonder was very familiar.

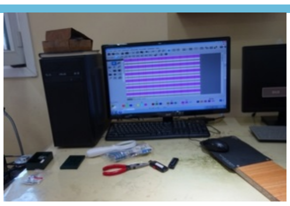
- ✓ The business plan was realistic but had a challenging character.
- ✓ Sales activities were down-to-earth by placing importance on appeal of good quality to consumers.
- ✓ Mr. Lhagvajav has made continuous and diligent efforts for the realization of his business and success.

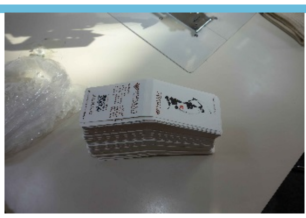
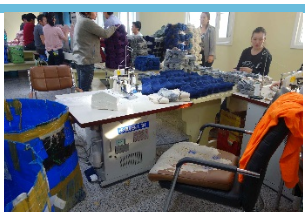
Technology

Mr. Lhagvajav worked at the socks maker in Korea and acquired necessary technology there since he designed socks and operated the production. He purchased the machines he had used in Korea. He was accustomed to those machines. He also acquired his passion for socks making and learned hard-working of Korean companies.

At Yanmal, he designs socks, manages production and fixes machines. Yanmal uses Korea-made machines and china-made machines. He ordered machines of his specifications when he introduced new product lines, that is, larger size of socks for Russian market.

Table 3: Production Process

Process		Photo
Procurement of raw materials	Yanmal procure raw materials (cotton and wool) from China and Korea. Yanmal currently prepares the internal production of threads and dying.	
Design	Mr. Lhagvajav develops designs of socks using the computer software.	
Knitting	Knitting is automated by done by entering design data. One operator supervises 8 - 9 knitting machines.	

Linking	Parts knitted separately are attached into a final form.	
Boarding	Socks are heated by steam so that they take a sock shape.	
Labeling	Paper labels are printed outside. Design of label has increased importance for branding.	
Pairing and Inspection	Socks are paired with a label. Socks are joined in pairs together with a label. The inspection is conducted at this process.	
Packaging	A pair of socks is packed into a plastic bag. Yanmal also uses paper packaging.	
Inventory	The inventory increases during the period from March until September because of seasonality of demand.	
Marketing & Selling	Yanmal sells socks to traders and retailers. At the same time, they sell at own retail outlets and on the website.	

Source: TSL Office

After the TSL project, the productivity significantly increased. One operator operated 3 - 4 knitting machines before the project, but one operator could operate 8 - 9 machines. That means the productivity jumped to more than 2 times. The machines purchased by the project were all new. Machine breakdown was much occasional, therefore, this also contributed to the productivity improvement.

Marketing and Sales Promotion

Before the project, Yanmal sold their products to local markets. At the initial stage, Mr. Lhagvajav approached to traders at local market places. Trades saw his socks were fake that attached Mongolian label on Chinese socks and rejected. He repeatedly visited traders and provided samples to let them understand the quality of his socks. He also organized a team of students to promote his socks.

After the project, Yanmal has steadily upgraded its position in the market with the improved quality and increasing awareness of Yanmal's brand among consumers. Their products are sold in every region. Yanmal has entered supermarkets and department stored in addition to traditional market places. Yanmal has established their own retail outlet, and there currently are 4 outlets in Ulaanbaatar City. Yanmal has opened B-to-C e-commerce on its website and this has improved access by consumers in regions.

The highest season of Yanmal's socks is September and October. This is because the demand of socks for the winter is high. The sales of socks significantly drop after New Year's Day. During the period from March and September, the inventory of Yanmal gradually increases because Yanmal continue the production for this period targeting the high season.

Photos of Directly-managed Shops of Yanmal Co., Ltd.

Product

Yanmal started the production of cotton socks with imported raw materials mainly from China and Korea. This was because Mr. Lhagvajav had produced cotton socks in Korea. Then it started wool socks in order to respond the needs of domestic market.

The socks market has been experiencing a change since 2011. Mongolian consumers have been more design-conscious. Preference of color and packaging has been more important. Yanmal could respond to this change. In other words, Yanmal has led the market trend.

Yanmal has been increasing the variety of socks and developing new designs including three-dimensional knitting patterns.

Yanmal's socks are targeted to a middle segment of the market. Their products were priced a bit lower than imported socks. As the quality improves, they have increased prices.

Yanmal's product lines are thick and thin men's, women's and children's socks of cotton, wool, camel wool, cashmere, yak, etc.

Table 4: Prices of Yanmal Co., Ltd.

Band	Price (Men's Socks)
Yanmal Co., Ltd.	MNT 1,700
Local Makers	MNT 1,650
Imported	MNT 2,200

Source: TSL Office

Human Resource Management

Human resource management is an important issue of Yanmal. Mr. Lhagvajav points out that training and employee retention are main issues. According to him, once a new employee continues to work for 6 months, he/she does not quit. He tries to let him/her understand the attractiveness of the job and the company during this period.

Yanmal provides incentives including dwelling to competent staff. The level of wage was at the level of the legal minimum wage, but it currently pays three times of the legal minimum wage. It also prepares a nursery room for employees' welfare.

Photos of Nursery Room within the Company

Competition

There are 5 - 6 competitors in Mongolia. Yanmal differentiates its brand by design and quality. Yanmal is a step above the competitors by their experience. Yanmal occupies 30 - 40% market share even though imports still account for approximately 50%.

5. Recent Performance of Yanmal Co., Ltd.

The sales trend of Yanmal for the recent years is as shown in the following table. The sales have shown a steady increase in spite of economic downturn supported by exports.

Table 5 : Recent Performance of Yanmal Co., Ltd.

Year	Annual Turnover	Profit before Tax
2014	MNT 5,900 million	MNT 892,5 million
2015	MNT 6,000 million	MNT 900 million
2016	MNT 6,500 million	MNT 975 million

Source: Yanmal Co., Ltd.

Mr. Lhagvajav has led the company with his initiative for more than ten years. He maintains his passion for growth. The recent strategy of Yanmal is as follows:

1) Construction of a new factory

   Yanmal built a new factory and moved production equipment to the new factory. The former building is used for retailing and warehouse.

2) Production of threads

   Yanmal completely depends of import for raw materials. In-house production of threads enables higher added-value and stable supply of raw materials. Yanmal currently prepare the production of threads. At the same time, Yanmal is building an in-house dyeing factory.

3) Development of successors

   Mr. Lhagvajav has planned to delegate responsibilities to subordinates. He would concentrate on more high-level management and decision-making by gradually sitting back from the front-line. There are an engineering manager and a sales manager who support Mr. Lhagvajav. In 2017, he has organized a team of designers and marketers to meet the market trend.

The above strategy is responding the challenges to Yanmal. Yanmal should continue to upgrade its competitiveness against competitors and create new market segments in the small domestic market. Export is potential for further growth, but, Yanmal needs continuous efforts for the competitiveness of quality and price.

6. Contribution to Industry

Mr. Lhagvajav recognizes his mission is to "**create a culture of socks in Mongolia**". He is the pioneer of socks making in Mongolia and he has produced several followers that have grown as major makers. The influence of Yanmal on those followers and consumers is big.

From his experience, Mr. Lhagvajav gives the following advice to future SME borrowers:

✓ Make a good business plan !

✓ Allocate money only to that business plan !

✓ Work hard !

7. Lessons for TSL Project

The lessons from Yanmal's case can be summarized as follows:

1) Capability of company president properly

   Success or failure of a project mostly depends on the capability of a company president. There as several important factors such as vision, aspiration, executive ability, consistency, sense of responsibility, etc. The success of Yanmal is largely attributable to the capability of Mr. Lhagvajav.

2) Differentiated strengths of a borrower

   Yanmal had a distinctive strength in its technology for good quality socks and the increasing brand recognition. As a result, Yanmal could increase its market share even though they significantly increase its production capacity.

3) Importance of a business plan properly.

   A business plan is important as Mr. Lhagvajav mentions. An attractive business model should be proposed in the business plan. Yanmal's was ambitious but realistic based on the fair competitiveness of the company, demands of local market, and the company's capability of implementing the project.

4) Provision of sufficient investment at right time to catch a momentum

   Yanmal had visited two PFIs but was refused by them due to a large amount of investment. Finally Yanmal gained TSL and it could double the production capacity and improve the quality at one time and seized the market. The investment was timely and enabled noteworthy growth.

5) Evaluate of benefits of a project by TSL Office and PFI

   TSL Office and PFI properly evaluated the expected benefits of Yanmal's project, i.e., its technology innovation to the level of Mongol's status quo, import substitution, and benefits of Mongolian consumers. Then, the loan application was approved. In consideration of achievement of the project, it can be concluded that the evaluation by TSL Office and PFI was appropriated.

Zurgaan Khoshuu Co., LTD

Intensified Pig Farm Project

Summary

Zurgaan Khoshuu Co., Ltd operates one of the largest pig farms in Mongolia and considered as a sole supplier of the quality pork produced and sold on the domestic market. With the number of pigs exceeding 4,000, the farm operations expand into the value-added processing and sales of the assorted pork through their contracted agents and regular clients. The company products (assorted pork products) is well known and highly appreciated on the domestic market for its freshness, quality and affordable price.

The years of experience in the pig farming business, as well as the favorable financial support provided by JICA-TSL Project have helped the company to expand its faming business and succeed in their business expansion plans.

With the successful implementation of the TSL Project, the company has been able to achieve not only its business objectives of expanding the business, increasing the sales/profits, adding value, etc, but indirectly contributing to the SME development through retaining/creating employment opportunities in the region, generating more household income at the grassroots-level, being a role-model/catalyst for other similar companies or the companies in the supply change to emerge and develop.

1. Company Profile

Key Figures		
	■Year of Establishment:	2004
	■General Director:	Mr. Zolzaya Magsar
	■Address:	Tsergiin Khotkhon, Khoroo 20, Songino Khairkhan District, UB, Mongolia
	■Product:	Pork, retail and whole sales
	■Capital:	MNT 4.5 Billion (As of 2016)
	■Number of Employees:	20 (As of March 2017)
	■Annual Turnover:	MNT 1.5 Billion (2016)
	■Shareholders	Mr. Zolzaya Magsar (60%) Mr. Erdenebayar Magsar (40%)

Brief History of Company

The Company was established in 2004 majoring in intensified pig farm operations and trade of pork produced by the farm. The farm operations started from a small-scale survival business and gradually, expanded into a major farm, producing high quality pork of domestic origin. With the expansion of the farm operations, the company established its own feed mill with the capacity of producing 2 tons of pig feed. Starting from 2015 the company switched from the wholesale of pork carcasses into a value-added retail sales of freshly assorted pork by establishing its own small-scale assortment factory.

Located in the Bayantsogt sum, Tuv Province (100 km north of Ulaanbaatar), the farm land covers 2.3 he of area and houses over 400 sows for the breeding purpose.

2. Outline of TSL Project

2.1 Sub-loan Project - 1

Background and Purpose for Applying to the JICA-TSL Project Financing

Since its establishment in late 2000's, the company had been mainly engaged in foreign trade and meat processing activities and employed up to 5 people on full-time basis. With the purpose of aggressively expanding its survival pig farm into a major business, the company applied for the TSL Project Loan at the end of 2006.

The main purpose of the project was to expand the existing pig farm by (1) purchasing new farm premises and redevelop them into custom-designed semi-automated pig farm with modern facilities (2) establishing required infrastructure for the new farm (3) purchasing necessary equipment and machineries and (4) increasing the number of pigs by purchasing additional sows and hogs. The total cost of the project was MNT 871,137,600 and the company planned to implement the project within 2 years.

Sub-loan Project Implementation Status and Its Outcome

Right after the approval and disbursement of the loan in May, 2007, the company started to implement the project by purchasing old cow farm complex in Bayantsogt sum, Tuv Province. Located 100 km north of UB, the new farm site proved to be an ideal place for establishing an intensified pig farm with capacity of over 2,000 pigs. With the completion of the farm building redevelopment and infrastructure development, the company proceeded with the purchase and installation of necessary equipment and machineries. At the next stage of the project implementation, 18 hogs and 100 sows of good quality breed were purchased and imported from China. As of late 2008, the company had started its operations about a half of year ahead of the time, with 27 full-time employees.

In the process of the project implementation, the proceeds of the TSL project loan have been used for the following purposes, which are:

1. Purchase of the old cow farm premises – MNT 350 million
2. Purchase and installation of the new ventilation system – MNT 150 million
3. Infrastructure development – MNT 73 million
4. Purchase of 176 sows and 18 hogs – MNT 123 million

Table 1: Business Expansion Plan - 1

<table>
<tr><th rowspan="2">Investment</th><th colspan="2">Amount</th><th rowspan="2">Funding</th></tr>
<tr><th>MNT Million</th><th>%</th></tr>
<tr><td>Purchase of the old cow farm premises</td><td rowspan="4">MNT 696.1
/US$ 598,000/</td><td rowspan="4">79.9%</td><td rowspan="4">JICA-TSL
Project Loan</td></tr>
<tr><td>Purchase and installation of the new ventilation system</td></tr>
<tr><td>Infrastructure development</td></tr>
<tr><td>Purchase of pigs for breeding purpose</td></tr>
<tr><td>Working capital and purchase of farm equipment</td><td>MNT 175.1
/US$ 150,400/</td><td>20.1%</td><td>Own
Resource</td></tr>
<tr><td>Total</td><td>MNT 871.2</td><td>100%</td><td></td></tr>
</table>

Source: TSL Office

The project was successfully implemented in accordance with the initial project application. As a result of the TSL project loan, the company has been able to become one of the major/leading pig farms of Mongolia. In terms of the contribution to the SME development in Mongolia, the following positive outcomes can be observed on this specific company, which are:

i) The company was able to increase its farm capacity substantially and grow from a small scaled survival pig farm into a major intensified pig farming complex, which produces premium quality pork on the national market. The number of pigs has reached from 300 to over 3,000 pigs, enabling the company to slaughter 300-350 pigs per month and generate the annual sales exceeding MNT 1,400 million, which is 13 times of the amount prior to the TSL project financing. Taking up to 20% of the market share, the company is contributing significantly to the government's efforts for the provision of safe healthy food supply through increasing import substitute production.

ii) The accumulation of retained earnings through the project finance enabled the company to start its own pig feed/fodder processing factory.

iii) Due to the fact that the company produces and sells pork on a whole sale basis, several companies (or individuals) have emerged to act as retail agents specialized on sorting and packaging of the company's produced pork. Also, the pork produced by the Zurgaan Khoshuu provides a reliable supply of good quality raw materials for the sausage production factories in Ulaanbaatar. In this sense, the company is acting as a reason or motivator for other SMEs to emerge and develop.

iv) The growth of the company has provided a positive impact on the local and regional development through providing better employment opportunities for the locals and investment opportunities to the local community development. In terms of the actual number of jobs created, 35 new jobs have been created directly (mostly recruited from local residents) and over 80 new jobs created indirectly (mainly on the retail chains).

v) The success of the farm has been highly appreciated by the government authorities and the farm has become a model for other pig farmers to learn and exchange their expertise and experiences, and in some cases to get encouragements or become a reason to start this type of farm business. The farm has become the sole supplier of the elite breed of pigs sold domestically for the breeding purposes only. Also, the company is cooperating with other organizations, vocational schools, etc by offering their farm facilities for the training and apprentice purposes.

Table 2: Comparison between Before Project and After Project

Major Benefits	Before the Project (2008)	After the Project (2012)
Number of pigs	300	3,500

Number of pigs slaughtered	50 pigs per month	300 pigs per month
Production space	300 sq. m	4,000 sq. m
Number of employment	5 full-time workers	Over 30 new jobs directly and 80 new jobs indirectly
Annual sales	MNT 100 million	Over MNT 1,400 million
Employment salary increase	MNT 100,000	3.5 times
Market share	3%	30%

Source: Zungaan Khoshuu Co., Ltd.

2.2 Sub-loan Project - 2

Background and Purpose for Applying to the JICA-TSL Project Financing

With its Sub-loan Project-1 implemented successfully, the company needed to keep up with the birth rate of farm sows and applied for the second TSL project funds with their farm expansion project for establishing a second farrowing house.

Sub-loan Project Implementation Status and Its Outcome

With the sub-loan fund disbursement, the borrower implemented the sub-loan project in accordance with the project application, without any major difficulties and the production started as planned. A part of the existing farm house was redeveloped and 500 sq.m of space was created to house 60 sows for farrowing purpose.

In the process of the project implementation, the proceeds of the TSL project loan have been used for the following purposes, which are:

1. Farrowing house for 60 sows – MNT 300 million
2. Purchase of farrowing equipment – MNT 70 million
3. Infrastructure development – MNT 130 million

Table 3: Investment Plan of Project 2

<table>
<tr><th rowspan="2">Investment</th><th colspan="2">Amount</th><th rowspan="2">Funding</th></tr>
<tr><th>MNT Million</th><th>%</th></tr>
<tr><td>New farrowing house</td><td rowspan="2">500.0</td><td rowspan="2">74.3%</td><td rowspan="2">JICA-TSL Project Loan</td></tr>
<tr><td>Purchase of farrowing equipment</td></tr>
</table>

Infrastructure development			
Pig house redevelopment	172.3	25.7%	Own Resource
Equipment			
Hogs			
Total:	672.3	100%	

Source: TSL Office

With the successful implementation of the project, the company was able to expand its operations and increase its production capacity. As a result of the second sub-loan project, the company has been able to retain its market leadership. In terms of the contributions to the SME development in Mongolia, the following positive outcomes could be observed on this pig farm, which are:

i) The increase of the farrowing capacity by two times, from 30 to 60 creates.
ii) The increase of the farm capacity by 30% and the number of pigs by 1,000.
iii) Creation of employment opportunities in the region.
iv) More favorable and stress free environment for the sows to give birth.

Table 4: Comparison between Before Project and After Project

	Before Project (2012)	After Project (2016)
Number of pigs	3,500	4,000
Number of pigs slaughtered	300 pigs per month	350 pigs per month
Production space	4,000 sq.m	4,500 sq.m
Number of employment	30	Over 38 new jobs directly and 20 new jobs indirectly
Annual sales	MNT 1,400 million	MNT 1,800 million
Employment salary increase	MNT 350,000	MNT 650,000 (2 times)
Market share	30%	35%

Source: Zurgaan KhoshuuCo., Ltd.

Before Project (2008)	
After Project (2012-2015)	    

Photos of the Pig Farm Project (before and after the Project)

4. Key Success Factors of Zurgaan Khoushuu Co. Ltd.

The success factors of the Company can be summarized into the following points, which are:

- ✓ The founder Mr. Zolzaya's experience and expert-knowledge in breeding pigs and managing the pig farm business;
- ✓ High domestic market demand in pork and pork related products as an alternative meat source.

✓ Favorable conditions of the TSL Project financing as well as the right time of the loan disbursement;

Technology

The technology of producing pork can be summarized into the following main stages:

i) Breeding and farrowing the sows;
ii) Nurturing the newborn piglets;
iii) Feeding up the 2 to 5-month-old junior pigs for gaining weight;
iv) Slaughtering adult pigs for producing pig carcasses; and
v) Processing of the pig carcasses into assorted pork.

Products

The pork is highly valued for its nutrient content and considered as a good source of protein for the human body. With the recent increase in urban development in Mongolia, the people's live style and dietary behaviors have been directly affected and as a result, the city residents tend to look for other alternative meat source, such as pork, poultry, fish, etc. This trend has created a lot of demand and market opportunities for the pork and pork related products on the domestic market. Reflecting this fact Zurgaan Khoshuu company has been offering the following portfolio of products on the market.

Table 4. Products of Zurgaan Khoshuu Co., Ltd.

	Product Definition	Photo of the Product	MNT Price Per kilo
1	Pork belly		14,600
2	Ribs		12,600

3	Knuckle		9,500
4	T-bone steak		12,600
5	Rounds		12,600
6	Pork feet		4,000
7	Pork loin		12,600
8	Head		16,000

9	Skin		3,000
10	Neck		13,600
11	Tenderloin		13,600
12	Fat		3,000
13	Jowl		18,000

Human Resource Management

As of the latest, the company employs 20 people on full-time basis and other 10 people on part-time basis. The important point for the company's success with its farm expansion project was its human resource policy of training and retaining employees from the regions.

Competition

The Company takes around 30% of the market (pork produced domestically) shares with following major competitors.

i) Altan Taria Co., Ltd;
ii) Grand Piglet;
iii) Other small pig farms (30 companies);

Business Strategy

The company has been pursuing the following business strategy:

1) To provide the domestic market with a steady supply of freshly produced pork of good quality and high hygiene standards.
2) To switch from the wholesales production into the retail oriented business operations by adopting more value-added production approach of assorting and processing pork into ready-made for consumption products for the end-users.
3) To reduce the production cost and increase the operational efficiency.
4) To expand the farm operations to be a supplier of sows sold for the breeding purposes on the domestic market.

10. Lessons Learnt

The major lessons learnt from the pig farm operations of Zurgaan Khoshuu Co., Ltd are:

1) Experience and expert knowledge about this specific business;
2) Market demand has created a favorable opportunity;
3) A good and feasible business plan;
4) Financial support with favorable conditions.

BATSEJU CO., LTD.

First labor safety gloves maker in Mongolia

1. Background of the TSL Project

Batseju Co., Ltd. is the first producer to make safety labor gloves on the Mongolian market. The founder, Mr. Batjargal used to work at a safety labor gloves manufacturer in Korea. After his return to Mongolia, he established Batseju Co., Ltd. in 2008 and started the production of labor gloves with two second-hand glove knitting machines from Korea, working himself as an operator. The company slowly but steadily increased their sales in the domestic market for good quality and better prices by competing with imported labor gloves.

In 2008, the domestic market of knitted labor gloves was estimated at 3 million pairs, 100% of which was imported mainly from China. Batseju Co., Ltd was the pioneer of safety labor gloves production in Mongolia.

By the time of loan application in 2014, the number of glove knitting machines of the Company reached 40, but they were second-hand and outdated, which was influencing the end-quality of the product, as well as reducing the productivity of the Company by creating delays and breakdowns. The Company had plans to implement a production expansion project by investing in advanced glove knitting and resin coating equipment.

2. TSL Financing

In order to implement the production expansion, the Company required MNT 400 million for investment in equipment for applying protective resin on labor safety gloves and MNT 500 million for purchase of new-generation glove knitting machines produced by world-leader manufacturer Shima Seiki of Japan. With assistance of one of the JICA TSL PFIs, Khan Bank, in 2014 the Company received two loans totaling to MNT 900 million for the purposes described above.

3. Key success factors

1) ***Good quality products with highly competitive prices;***
2) ***Commitment of the owner;***

Major reasons for this successful performance are improved quality of products, new machines of higher performance, and above all the managing director’s commitment to the project. This case shows how an import substitution project can achieve a success.

4. Recent development strategy

a) Introduce a new product – leather labor safety gloves;

As of today, the Company holds 50% of market shares of knitted labor safety gloves covered with protective resin. There is no local competitor existent, and only imported similar goods make competition to the Company's products. The Company aims to consolidate the success and enter the market of mining companies and heavy industry, where leather safety gloves are mainly used. Therefore, the Company has invested in leather glove sewing production line using its own resources and has already started this production.

b) Establish cooperation with mega mining projects;

With above-mentioned new product – leather safety gloves - the Company plans to focus on cooperation with large mining projects running in Mongolia. At the moment the Company applied for a supply tender of the Oyu Tolgoi mine, which has a consumption of 30,000 pairs of safety leather gloves per annum. At the same time Batseju Co., Ltd is actively contacting other large mining projects and heavy industry companies, for instance in metallurgy sector.

c) Diversify its business;

In 2017 the Company acquired 1,000 hectares of agricultural land in Khentii province and started to cultivate crops. This is totally new business line for the Company, but the owner wants to diversify his business in order to be less vulnerable to economic circumstances and reduce the risk of concentration on one economic sector.

5. Contribution to Industry

Today Batseju Co., Ltd is the solely leader on the market of safety labor gloves in Mongolia. The Company has 109 glove knitting equipment produced in Japan, 2 own production premises with total production area of 2,500 square meters, employing 76 staff, having a production capacity of 18,000 safety gloves per day. Since its establishment the Company has introduced a range of new products to the market of Mongolia.

The Company would like to convey to future SME borrowers:

- ✓ Desire and commitment to the business bring success !

6. Lessons for TSL Project

Good cooperation with the local community is very important;

The owner Mr. Batjargal was granted with high appreciation of the surrounding local community. When the business got successful, he started to share his benefits with the community, such as sharing the heat created by the production to neighboring households in winter time, employing people capable of working from home, hiring disabled people and etc. Today the Company has a network of people working from their homes on production of leather gloves. Mr. Batjargal has strong support of the local community, which brings back various positive impacts to his business activities.

BAYANTURUUN CO., LTD.

Medical services in remote rural areas

1. Background of the TSL Project

Bayanturuun Co., Ltd was established in 2002 in Ulaangom city, the Center of Uvs Province, which is distanced from Ulaanbaatar by 1,400 kilometers. The main activity of the Company is running a gynecology clinic. Besides the main activity, the Company has good diversification of business activities: supermarket, grocery store, café, bakery, and rental services of office premises and warehouse space. This kind of business diversification is vital in small markets such as Ulaangom city, which has only about 27 thousand residents. All these activities support the main activity of the Company, which is very humanitarian: save lives and heal the women in the most north-western remote rural area of Mongolia, where lack of adequate medical service in many cases endanger the life of population.

In order to enable early diagnosis of women diseases and perform qualitative control on pregnancy of its patients, the Clinic planned to invest in Samsung Accuvix A30 Ultrasound equipment with powerful high resolution and 4D imaging. This is a very rare equipment in the whole western region of Mongolia.

2. TSL Financing

With assistance of XAC Bank, in May 2013 the Company was granted with a loan in amount of MNT 100 million with 5 years maturity and 12 months grace period. The loan was used for increasing the quality of services of Gynecology Clinic, namely for purchasing Samsung Accuvix A30 Ultrasound equipment.

3. Key success factors

1) Personal commitment of owner;
2) Market demand on one side and limited capacity and outdated equipment of state hospitals on the other side;
3) Highly competitive prices of medical services;

4. Recent development strategy

a) Enhance cooperation with foreign hospitals;

A Korean clinic named CLWH, operating in Mongolia in the field of transplantation of fetus, admitted that the Clinic has most modern ultrasonic equipment and offered to cooperate with the Bayanturuun Co., Ltd on monitoring of correct development of unborn child during woman pregnancy. For this purpose the Company is planning to invest in better internet connection via broadband cable, purchasing necessary software and training the personnel. Other business cooperation opportunities with reputable hospitals in Korea and Japan are in the process of communication.

5. Contribution to Industry

Owner Dr. Badam recognizes her mission as “healthy citizen of western provinces”. The Clinic provides diagnostic services for early recognition of unborn child abnormalities during pregnancy, diagnosis on women cancer on and other deceases.

Financed by the JICA-TSL, the Clinic has the most modern equipment not only Uvs province, but in the whole western region Mongolia. Patients from neighboring provinces such as Khovd, Zavkhan and Bayan-Ulgii are headed to the Clinic to have prompt the accurate diagnosis and adequate medical services. So the contribution of the Clinic to the health protection of the population of western provinces is huge.

From her experience, Mrs. Saranchimeg gives the following advice to future SME borrowers:

- ✓ Allocate the credit funds strictly according to the investment plan !

6. Lessons for TSL Project

The lessons from case of Bayanturuun Co., Ltd can be summarized as follows:

Medical services are not really of business nature. When the patient comes with abnormal pain, but unable to pay the full amount of charges, the Clinic has to provide discounts and incentives based on humanitarian reasons. As of observation of Dr. Badam, about 25% of all patients have financial difficulties at the diagnosis procedures. Taking into consideration that the Clinic charges are four times less than similar diagnostic clinics in Ulaanbaatar, it is hard for a medical service entity to develop as a very profitable business in remote rural areas. However, thank to good business diversification, the Company maintains sound financial stability.

EECC CO., LTD.

Exporter of processed meat and livestock-origin products

1. Background of the TSL Project

EEC Co., Ltd. was established in 1996 with business activity of collecting and processing the animal casings and exporting it for sausage production in Switzerland, Germany and other European countries.

The difference between cost of livestock-originated products on the domestic market and price of processed same products on the European export markets has created excellent business opportunities. Admitting that Mongolia, with a population of little more than three million people, has more than 50 million heads of livestock, and every year more than 10 million heads of livestock have been slaughtered for domestic meat consumption and exportation purposes, this business should have solid basis for continuous success. However, due to relatively simple initial processing procedures, there were number of companies conducting the same activity (in total 17 companies, including EEC Co., Ltd). In this circumstances of rough competition, the Company had to differentiate itself by quality of its products and good management.

From the very beginning the Company had to set up highest quality to its products in order to comply with European standards. After 5 years of operations in 2002 the Company has managed to reach end-product that complies with EU standards. Thus, the Company has enabled its export opportunities, and exported 100% of its production output to European countries. By the time the Company became the leader of the animal casings processing industry in terms of market shares, technology and quality of products. The Company alone purchases about 30% of total animal casings available on the domestic raw materials market.

2. TSL Financing

By the time of the first loan application to JICA-TSL in 2012, the Company has been developing its business for 16 consecutive years since its establishment in 1996, and already invested about USD 4.5 million.

However, the Company was facing a drastic need for business expansion by investing in meat processing line and canned meat production line for export to Russian market. With assistance of the Trade and Development Bank of Mongolia, in January 2013 the EECC Co., Ltd received a loan of USD 600 thousand from the JICA-TSL for expansion of production premises and purchase of necessary meat processing equipment.

The second loan in amount of USD 400 thousand was received from the JICA-TSL in June 2015 again with assistance of Trade and Development Bank of Mongolia, with purpose of investment in mobile slaughtering unit, horse meat processing equipment, and production of canned pet food.

3. Key success factors

1) Good raw material market opportunity - natural and good quality raw materials in sufficient volumes;
2) Compliance with international quality standards;
3) 100% export of its production outputs;
4) Thorough planning and systematic researches prior to investment decisions;
5) Remarkable initiatives for creating value-adding chains and excellent business development perspectives.

It should be mentioned that the Company invests significantly in research and development of their products, which is not very common practice in Mongolia.

Before making an investment decision for its products focused on the market of Japan, the Company has made a comprehensive research on consumer behavior and product appreciation in several cities of Japan, continued for 12 months and employing four high professional Japanese specialists. Numerous tests, interviews, product presentations and events were made to shape the product features and characteristics. This Mongolian-Japanese cooperation on business level was enabled with great support of the JICA Mongolian-Japanese Center in Ulaanbaatar.

The owner and Director of the EECC Co., Ltd, Mr. Munkhzaya, has collaborated with the Center for many years, benefiting valuable trainings and supportive services, and, on the other hand, sharing his business experience and know-how to other clients of the Center. As a result, he decided to run export activities of processed horse meat and canned pet food to Japanese markets. With support of JICA Mongolian-Japanese Center, the Company made R&D of the products, cooperating with Japanese research team, and afterwards received a loan from JICA-TSL project.

This is an example of outstanding synergy within domestic and international business cooperation, JICA-TSL financing, and capacity building and technical assistance activities of Mongolian-Japanese Center of JICA in Mongolia.

4. Recent development strategy

a) Creating a national value-adding chain on processed livestock casings;

Mr. Munkhzaya has started a very promising initiative to create a national-wide value-adding chain for processed livestock casings.

Mongolia has a large territory, where herders bread their livestock in a natural nomadic way on pastures that spread out all over the country. Thus, there is a difficulty of collecting meat and by-side products of animal origin on time, before the short life-cycle of these products ends.

The end-quality of meat and livestock casings is much dependent on freshness, correct initial processing and adequate storing of half-processed products.

Therefore, the main initiative of EECC Co., Ltd is to establish initial processing units of meat and livestock casings in 16 locations all over the country, covering the main territories of livestock-originated products. It means creation of 16 independent businesses that collect and process animal casings followed by a sale to EECC Co., Ltd, which will make end-processing and export. There are multiple win-win situations for herders, slaughtering enterprises, processing units, the EECC Co., Ltd itself, and export consumers.

This project has been developed during last five years, starting from initial idea up to business project, with all necessary researches and calculations. International development agencies such as Swiss Development Corporation and USAID are already expressed their interest in providing of technical assistance during the implementation of the project, as well as in small-scale financing for processing units in rural areas. Again, we can observe a great synergy between domestic businesses and international aids and soft loans.

With implementation of this project EECC Co., Ltd has outstanding development perspectives.

b) Expanding export volumes of processed horse meat to Japan;

At the moment all products are exported to Japan by air, which is costly on one hand, and create volume limitations on the other hand. The Company is applying for a transit permission of their products with relevant authorities of China. When the permission will be granted, the Company intends to increase drastically its export volumes to Japan.

5. Contribution to Industry

Mr. Munkhzaya recognizes his mission as "**creation of Mongolian product quality understanding on the world market**". He appreciates rough competition on the domestic market, which will lead to the better quality of products. On other hand, he is confident that all Mongolian companies should unite when exporting their products to the world market. All his initiatives are based on these principles, and positive influence on its industry is significant.

From his experience, Mr. Munkhzaya gives the following advice to future SME borrowers:

- ✓ Make comprehensive R&D of the products !
- ✓ Create a positive synergy within all stakeholders, including international development bodies !

6. Lessons for TSL Project

The lessons from case of EECC Co., Ltd can be summarized as follows:

a) The success can be reached only in good cooperation within industry players;

The EECC Co., Ltd ran its business activities focusing on not only its interests, but also considering benefits of other industry players, and taking in mind the overall reputation on Mongolian products on export markets. This is the main key to creation of its successful business, as well as reputation of the Company within its industry.

b) Wise application of technical assistance, support and financial means of international development agencies in business activities can lead to a great success.

MUNGUT KHAIRKHAN CO., LTD.

Heat and electricity provider in Uvurkhangai Province of Mongolia

1. Background of the TSL Project

Mungut Khairkhan Co., Ltd is one of the examples of successful implementation of TSL project in the energy sector with implementation of environment protection project.

The Company was established in 1994 to run heat supply, tourist camp and cultivation of crops. The main business activity is supply of heat using steam boiler. At the moment of loan application the Company was providing heating to the local Municipality, Culture Palace, and Business Development Center of Uvurkhangai Province. With implementation of expansion project for heating production, the Company would be able to provide heating to local Police Department, Central Post Office, and Erdene Zuu Trade Center, covering 23 thousand cubic meters of premises.

The main goal of the project is reduction of harmful emissions produced by outdated equipment for heating and, therefore, contribution to the environment protection. The Company has planned to invest in filters that reduce harmful smoke substances by 50%.

2. TSL Financing

With assistance of Khan Bank, in September 2013 the Company was granted with a loan in amount of MNT 200 million with 10 years maturity.

The loan was spent for renovation of the steam boiler, purchase and installment of modern filters, pumps, partitions, and ventilation system.

In 2017 the Company has fully repaid the first loan before the maturity and applied for the second loan.

With assistance of State Bank, in June 2017 the second loan in amount of 475 million was granted to the Company with 10 years maturity and 12 months grace period in order to build new steam boiler. This expansion project is at the beginning stage today.

3. Key success factors

1) Existing demand of the market;
2) Favorable conditions of JICA-TSL with longer tenure and low interest rate, suitable for investment in environment protection projects.

4. Recent development strategy

a) To implement the second stage of production expansion;

In cold seasons there is still shortage of heating for about 40 premises in the area of operations the Company. The Company started to build new steam boiler with advanced environment protection features and implement the second stage of the production expansion project.

5. Contribution to Industry

The Company has greatly contributed to the environment protection and reduction of greenhouse emissions in Kharhorin city of Uvurkhangai Province. About 40 small outdated steam boilers, heating various organizations, have disappeared with the increase of production capacity of Mungut Khairkhan Co., Ltd.

The owner, Mr. Gansukh finds it hard to express the exact reduction of harmful emissions in tons per annum due to lack of measurement equipment, but it is observed that overall air pollution of Kharkhorin city has been much decreased. According to the technical characteristics of advanced filters, harmful emissions are reduced at least by 50%.

The Company conveys to future environment protection projects:

- ✓ Know exactly the subject of the production !
- ✓ Allocate credit strictly as of the investment plan !

6. Lessons for TSL Project

Build capacity on PFIs in remote rural areas;

Human resource capacity of branches of PFIS operating in remote rural areas is very limited. They lack professional knowledge, thus, during credit assessment of larger loans create delays and uncertainty to the borrower. The PFIs are recommended to improve the human resource capacity in their branches in provinces.

NYAMSULD CO., LTD.

Producer of glass doors and windows

1. Background of the TSL Project

The construction sector of Mongolia was stagnating for a decade after collapse of socialist regime and transition to market economy in 1990. However, starting from year 2000 it started to recover, and by the mid of 2000s the construction sector turned into one of the leading economic sectors, connected to the housing programs initiated by the Government and increasing demand of modern apartments and residential environs.

The Nyamsuld Co., Ltd was established in 2001, when the owner Mr. Otgonbayar has foresaw a boom of construction sector. There was a desperate need for modern windows and doors with metal or plastic frames and double or triple layers of glass, replacing the outdated wooden frames with single glass.

At the moment of the loan application in 2013 the Company was running production of metal or PVC framed windows and glass doors for 12 consecutive years and has collected significant experience. However, since the start the Company used second-hand machinery and raw materials produced mainly in China. After 12 years of operations the equipment became outdated, and the quality of end-products became not satisfying the market requests.

They had a goal to expand their production and upgrade their technology to European standards by investing in new machinery.

2. TSL Financing

In order to implement the expansion project the Company needed to invest MNT 1.7 billion. MNT 888 million or 51.5 percent of the total investment could be financed by the Company, but the rest MNT 835 million or 48.5 percent of the total investment was lacking.

The Company has reached Capital Bank, one of the JICA TSL Project Implementing Financial Institution, and after two months of credit assessment procedures the loan was adopted by the Credit Committee of the Capital Bank in March 2013.

The loan was used for purchase of two machines from a China and Turkey: glass cutting equipment with 12 technological steps and glass preparation equipment with 21 technological steps.

3. Key success factors

a) *Good market demand opportunity;*

The construction sector was booming at the time of loan disbursement in 2013. The new Government program of Mortgage loans with 8% annual interest fee was initiated, creating additional demand of apartments. About 20 thousands new apartments were built in 2013, which is two times more than in previous years. Connected with this construction sector activation, in 2014 the sales of the Company have been increased by 4 times in comparison to 2012.

b) Improved productivity;

Before the TSL project the Company had to perform many production steps with manual labor. After acquisition of automated equipment most of the production steps were performed automatically. Therefore, the productivity has been increased by 5 times: before project the Company was producing 15 windows per day, and after the project – 80 windows per day.

c) Improved quality of products;

With advanced automated equipment quality of the products was drastically improved. This was enabled due to minimization of mistakes and more precise and accurate measurements during technological steps. After implementation of the project the Company was able to offer quality products such as windows made by Eurofuture-70 technology of German producer Kommerling, windows and glass walls/doors produced by Turkish technology Wintech, and windows produced by technology of German producer Dimex.

4. Recent development strategy

Diversification of business;

The Company plans to diversify its business activities in order to decrease dependence on construction sector and reduce the risk concentration on ups and downs of domestic construction market. With this purpose the Company is implementing a project of food staff production, running product testing.

5. Contribution to Industry

Mr. Otgonbayar, the owner and general director of Nyamsuld Co., Ltd is very active within the sub-sector of production construction materials - windows and doors. He is an Honored Member of Association of Windows and Glass Door producers.

From his experience, Mr. Otgonbayar gives the following advice to future SME borrowers:

- ✓ Make detailed research of products and equipment !
- ✓ Make precise calculation of investment plan and strictly follow the plan !

6. Lessons for TSL Project

The lessons from case of Nyamsuld Co., Ltd can be summarized as follows:

Diversify the business;

Though the TSL project was implemented very successfully, economic circumstances of the country and construction market downturn caused decrease in sales of the Company starting from 2015. Therefore, Nyamsuld Co., Ltd started to invest in production of food staff in order to minimize risks of concentration on one sector and have a good balance of sales from different sectors. It is advisable for future TSL projects to have sound diversification of the business by sectors or by markets.

PYRAMID INDUSTRY CO., LTD.

Producer of construction foam blocks

1. Background of the TSL Project

The Pyramid Industry Co., Ltd. was established in 2008 with business activity of import and production of construction materials - polystyrene blocks for thermal isolation of constructions, also often called as construction foam blocks. From the importer of construction materials the Company has developed to national reputable producer of construction materials, consistently developing its business over 9 years.

In the beginning of 2010s the construction market of Mongolia has been developing rapidly. At that time the Company was able to offer construction foam blocks of type M-25 that was fully complying with the Mongolian Standard MNS EN 13163:2011. In 2013 the Company introduced new production line for coating panels of construction facade, using technology of inflammable stone painting.

In constant strive for market leadership and new advantageous products, the Company planned to introduce production technology of so called “Black Resin”, construction thermal isolation foam blocks with dark color that has high resistance to fire. In terms of thermal isolation this advanced product has 20% more protection than the normal foam block of white color, and this factor has environment protection pattern - decreasing the heating needs of a construction, and thus, reducing harmful emissions of thermal power plants.

By the time of the loan application to JICA-TSL in 2013, the Company has been developing its business for 6 consecutive years since its establishment, and already holding 28% of market shares.

2. TSL Financing

In order to implement the production expansion and introduction of new advanced technology, the Company required about USD 800 thousand for investment in equipment and about USD 250 thousand for other expenses such as transportation and installment/testing of equipment. With assistance of one of the JICA TSL PFIs, XAC bank, the Company applied for a loan of MNT 1,040 million, which was equivalent to equipment purchase portion of the investment project. However, the Company received loan in amount of MNT 800 million in January 2014.

3. Key success factors

1) High quality raw materials (imports from Korea);
2) Compliance with domestic and international quality standards;
3) Sound marketing strategies;

4) Good financial management;

4. Recent development strategy

Constantly improve the quality of products;

As of today, the Company holds 40% of market shares of domestic construction foam block supply. Since it is hard to export products of the Company to neighboring foreign markets, they should fully concentrate on the domestic market. The Company reported that the quality of products is the main concern of their further development. Therefore, high quality of products is the key to maintain the market leadership.

5. Contribution to Industry

Since its establishment the Company has introduced production of two types of totally new advanced products to the construction material market of Mongolia: (a) "stone painting" panels for construction facade coating and (b) "Black resin" – dark foam blocks for construction thermal isolation. There are about 6 thousand construction material producers and about 60 thousand companies registered in Mongolia. Out of this, the Pyramid Industry Co., Ltd was awarded as one of the Top 50 Producers of Mongolia in 2015 and Top 10 Businesses of Mongolia in 2016.

The Company would like to express to future SME borrowers:

- ✓ Top quality of the product is the key success !

6. Lessons for TSL Project

If possible, equipment purchase credit should be disbursed in USD, but repayment from the borrower should be done in domestic currency;

The Company faced a problem with financing of the project when they received the loan. The loan was disbursed in domestic currency, but they had to buy equipment from abroad, which means they had to convert the loan funds into foreign currency. Since submission of their application to the PFI and approval of the loan there is a significant period of time passed. During this time USD rate has appreciated considerably, and the funds turned insufficient for the equipment purchase at the time of loan disbursement. So the Company had to borrow additional MNT 200 million from XAC Bank for full implementation of the investment project.

On other hand, the Company could not borrow in foreign currency (USD), because their sales were on the local market and in domestic currency (MNT). The exchange rate risk could be much higher during the credit maturity period, which is 5 years in case of Pyramid Industry Co., Ltd.

Therefore, the Company reported that they would like to enable a scheme of conversion of the loan from USD into MNT after disbursement of the loan. In other words, a borrower planning to buy equipment from abroad could receive a loan in USD, and after loan disbursement and equipment purchase convert it to MNT, when the grace period of loan ends and production output starts to be supplied to the domestic market, and the Company has sales in MNT.

SNOW FIELDS CO., LTD.

Exporter of Mongolian cashmere goods

1. Background of the TSL Project

Snow Fields Co., Ltd. was established in 2004 for processing goat cashmere, yak hair and camel wool and production of threads. From the very beginning the Company invested in knitting machines produced by world-class Japanese equipment manufacturer Shima Seiki, and started to produce high quality cashmere and woolen goods for export and for sale on the domestic market.

Over 20 million heads of goats are bred in Mongolia, and every year more than 6.5 thousand tons of high quality cashmere is available on the raw material market. This is 22% of the total world cashmere production. The difference between cost of raw material on the domestic market and price of value-added products on export markets is creating excellent business opportunities.

After 10 years of continuous operations and exports to markets of Japan, Korea, European Union countries and Russia, the Company developed an investment project for construction of production premises. The problem was that the Snow Fields Co., Ltd since the start of its business operated in rental production premises at the Mongol Nekhii Co., Ltd, and for expansion of their production there was not enough space. Also, from the financial point of view it was better to have their own production premises than letting the funds flow to rental payments.

With new production premises the Company has planned to establish a complete value-adding factory with 6 production lines for cashmere hackling, thread spinning, knitting, sewing, and finishing.

2. TSL Financing

With assistance of Khan Bank, in 2014 the Company received two loans with total amount of MNT 1,000 million with 7 years maturity and 18 months grace period for construction of production premises.

3. Key success factors

1) Good raw material market opportunity - natural and good quality raw materials in sufficient volumes;
2) High quality products, enabled by new advanced equipment produced by Shima Seiki manufacturer, Japan;
3) High volumes of production outputs exported to foreign markets, mainly to Japan;
4) Close cooperation with Japanese partners and technical assistance from Japanese producers covering not only business matters, but also technical expertise;

5) Prompt process of TSL disbursement, which contributed to the perfect timing of implementation of the investment project.

It should be mentioned that the basis for financial sustainability of the Company is export access. On the market of Japan the Company cooperates with partners such as Cashmere Plus, Mitsukoshi, Arirang Planning, TY trading, Sakaue and etc. Also, export business relationship with a number of trading partners in Korea, Czech Republic, Denmark, and Russia is maintained.

Another success factor is that they built production premises answering all technologic and utilization requirements of cashmere processing factory. During the planning of production premises the owner of the Company, Mr. Gan-Ulzii visited several times his good partners in Japan namely the Kobe Technological University, and cashmere goods producer companies Toyobushi, Maruzen Uka, and Nakaben in order to take advises and technical expertise. As a result, Mongolia has now very modern cashmere processing factory with excellent equipment and adequate production premises. This factor improves the reputation of the Company and its products among foreign buyers, and as a result, sales are increasing by 10-15% every year. In total, the Company reports that since implementation of the project sales of the Company were increased by 35%.

4. Recent development strategy

a) Improve the quality of raw materials – microns of cashmere;

Mongolian goat produces unique cashmere with thinnest hair in the world, measured in microns. In order to improve more the quality of raw materials and strengthen the Mongolian cashmere brand on the world market, the Company started to herd cashmere-breed red, black and white goats in Dornod and Huvsgul Provinces.

This initiative will continue to contribute to the best quality of Company's end-products, as well as to stability of the raw material supply.

b) Initiation of investment project in cashmere cloth production;

The company has already acquired a land of 4,200 square meters near their production site in order to establish cashmere cloth production factory, and in cooperation with its Japanese partner Nakaben Co., Ltd is going to implement an investment project. Necessary researches and calculations are in process. In October the Japanese partners will visit the Company to make negotiation of future business. The factory will add value to the cashmere and wool threads produced by the Company. The export market of Japan is ensured for the cashmere cloth production by Nakaben Co., Ltd, Japan.

5. Contribution to Industry

Snow Fields Co., Ltd recognizes its mission as "**Production of outstanding World brand products created in Mongolia**".

Besides making continuous efforts for improvement of raw materials quality, The Company pays much attention to education and work skills of employees. The Company has financed, worked out the curriculum and established a knitting engineer and programmer class at the Science and Technology University of Mongolia. The same initiative was conducted at the Vocational Schools, preparing skilled and knowledgeable operators for the knitting industry.

The Company is the official distributor of Japanese world-class knitting equipment producer Shima Seiki in Mongolia. Using this opportunity, the Company runs internship practice works of the students at its factory, and the industry players are thankful to the Company for preparatuion of skilled workers. They admit that employees who completed internship at Snow Fields Co., Ltd are qualitatively better than the normal graduates.

From his experience, Mr. Gan-Ulzii gives the following advice to future SME borrowers:

- ✓ Make a good strategy plan or term-term business plan covering at least three years. Think and plan about where you will be in three years !
- ✓ Invest in good quality in all aspects of the business, covering raw materials, equipment and production premises !
- ✓ Allocate the credit funds only to its planned purposes !

6. Lessons for TSL Project

The lessons from case of Snow Fields Co., Ltd can be summarized as follows:

Cultivate high responsibility and financial discipline;

All organizations in the business environment of the Company such as foreign partners, financial institutions, and state authorities respect responsibility and financial discipline. The work should be done on-time, and payments should made on-time. Good reputation in this matter is the bridge to create mutually beneficial cooperation among partners. Good cooperation with foreign buyers is the basis of success of Snow Fields Co., Ltd.

TSOGTBAT MERGEN CO., LTD.

Tourist camp in Zavkhan Province of Mongolia

1. Background of the TSL Project

Tsogtbat Mergen Co., Ltd is one of the examples of successful implementation of TSL project in the tourism sector.

The Company was established in 2008 to run tourist camp on the shores of the famous Black Lake of Zavkhan, with beautiful untouched nature, which combines desert sands, grasslands, and a gorgeous lake. The camp is distanced from Ulaanbaatar by 1,103 kilometers, located in the Erdenekhairkhan Soum area of Zavkhan Province.

Tourism services can be considered as an export sector: sales to foreign tourists visiting Mongolia bring foreign currency to the country, and tourism companies benefit sales irrespective of economic situation of the country or market circumstances.

At the time of loan application in 2013 the Company was operating a camp with capacity of 40 beds per day, providing good services to their clients with very competitive prices.

However, due to increasing popularity of the tourist camp and attractiveness of the location the camp required to expand its capacity.

2. TSL Financing

With assistance of Khan Bank, in April 2013 the Company was granted with the first loan in amount of MNT 80 million with 8.5 years maturity and 12 months grace period.

The loan was spent for expansion of the tourist camp at the Black Lake, Zavkhan Province, by purchasing additional tourist accommodation – Mongolian national dwellings named "Ger", building 2-store service premises, and purchasing electric generator for the camp.

Again with assistance of Khan Bank, in June 2016 the Company was granted with the second loan in amount of MNT 50 million with maturity of 8 years and 12 months grace period. This loan was also spent for expansion of the camp by purchasing additional Ger dwellings and building some service premises (conference hall) for training and seminar purposes.

3. Key success factors

1) Optimal location with beautiful nature features;
2) Good financial and operational management;

4. Recent development strategy

a) To expand the tourist camp;

Based on ever-growing demand of tourists, an expansion of the tourist camp is planned to increase the capacity and build entertaining features for tourists such as pool with small aqua park and various types of sport fields.

5. Contribution to Industry

The tourist camp of the Company today is one of the largest tourist camps that is able to satisfy standards of foreign tourists. Compared to capacity of 40 beds per day before implementation of the project, the Company has developed its capacity by three times and reached capacity of 120 beds per day due to correct utilization of JICA-TSL.

The Company conveys to future tourism SME projects:

- ✓ Stick to the investment plan !
- ✓ Hospitality and excellent quality services is the key to success !

6. Lessons for TSL Project

Calculate correctly the transportation costs;

Transportation of equipment, construction materials and other staff in case of projects implemented in remote rural areas are considerable part of financing. Moreover, it can cause financial shortages and put the project implementation under risk. So correct calculation of transportation costs is very important from the project implementer side. On other side, in case of remote projects, JICA-TSL could consider to include transportation costs to be financed by TSL funds.

TUSHNEE CO., LTD.

Bakery in Dornod Province of Mongolia

1. Background of the TSL Project

Tushnee Co., Ltd is one of the examples of successful implementation of TSL project in remote rural areas with very limited market volumes.

Tushnee Co., Ltd was established in 1996 in Choibalsan city, the Center of Dornod Province, which is distanced from Ulaanbaatar by 656 kilometers. At the time of loan application the Company was operating a bakery for consecutive 11 years, delivering over 20 types of baked products and ice cream to the local market of Choibalsan city with about 42 thousand residents.

However, the small local market was crowded with competitors: there were operating 17 bakeries only in the Choibalsan city. In order to survive in rough competition, the Company needed to expand its production by building modern production premises, renovate outdated equipment and have a nice café corner near the bakery.

2. TSL Financing

With assistance of Golomt Bank, in August 2007 the Company was granted with a loan in amount of MNT 140 million with 5 years maturity and 12 months grace period, and in August 2010 second loan in amount of MNT 130 million with 8 years maturity and 36 months grace period. These two loans were used for building the new production premises and Kids Café.

The third loan was granted in amount of MNT 350 million in September 2012 with 4 years maturity and 12 months grace period with purpose to expand the existing building of the Company. From this process we can observe the development of the Company, which during the project implementation created real estate and became able to apply for larger credits due sufficiency of collateral assets.

3. Key success factors

1) Personal commitment of owner;
2) Diversification of business;
3) Highly motivated personnel;

The Company pays much attention to its human resource development. The owner, Mrs. Saranchimeg has a strategy to select responsible and committed people, finance their professional trainings and personally teach them on the job place. Not limited by professional skills, the Company is devoted to support its employees in improvement of their livelihoods. For example, with financial support of the Company almost all employees has acquired modern accommodations. Thus, the company has skilled and highly motivated personnel, aimed to bring success to the Company. Above all, personal commitment of the owner plays a vital role in successful operations of the Company.

4. Recent development strategy

Improve product range and quality;

The Company is continuously striving for better quality of its products and healthy food for the population of its homeland Choibalsan city of Dornod Province.

5. Contribution to Industry

The owner Mrs. Saranchimeg recognizes her mission as "**healthy and delicious food for the population of Choibalsan city**".

Besides its delicious bakery products, the Company runs the only café for kids in the Choibalsan city. This place became very popular among adults too because of healthy food produced by original natural vegetables grown in Dornod Province. The Company maintains good cooperation with domestic suppliers of vegetables and other food staff, supporting surrounding community.

From her experience, Mrs. Saranchimeg gives the following advice to future SME borrowers:

- ✓ Get up early and work hard !
- ✓ Good-hearted people make products that are somehow different from similar ones. Give your heart to customers !

6. Lessons for TSL Project

Prognosis of currency exchange rate and overall economic situation made before implementation of the project is vital;

The company has faced problems during implementation of the project after disbursement of the first portion of the loan: economic crisis of 2008 hit the country. MNT started to depreciate against foreign currencies, and the company turned unable to complete the construction of production premises. The owner brings her sincere gratitude to the JICA TSL Office, which was flexible and prompt, and allowed to take additional second loan in order to finish the construction of the production premises.

Diversify your business;

During implementation of the project another economic crisis started in 2015. Sales of the Company has dropped, but the business is still in a good shape due to diversification of the business. A daughter company in construction industry, created in 2014 and ran by son of Mrs. Saranchimeg, has sufficient profits to support the Tushnee Co., Ltd. In such small market as Choibalsan city, the diversification of the business is very important, when risks connected to ups and downs of certain economic sector can be covered by business activities in other sectors.

Appendix 3

Table: Emission Evaluation of ALL EPL

EPL SUB-LOAN INFORMATION					MONITORING INDICATORS																MONITORING INDICATORS											
№	Loan number	Borrower	Project description	EPL priority sector	Electric Energy (kWh/year)				Coal consumption (ton/year)				Dust (ton/year)				SO2 (ton/year)				NOx (ton/year)				CO (ton/year)				CO2 reduction (ton/year)			
					Before Project	After Project	Reduction		Before Project	After Project	Reduction		Before Project	After Project	Reduction		Before Project	After Project	Reduction		Before Project	After Project	Reduction		Before Project	After Project	Reduction		Before Project	After Project	Reduction	
							Rate(%)	Amount			Rate(%)	Amount			Rate(%)	Amount			Rate(%)	Amount			Rate(%)	Amount			Rate(%)	Amount			Rate(%)	Amount
1	Golomt II-1(B)	Shilen khiits LLC	Solar panel assembling	(iii) Renewable energy	2,190,000.00	1,314,000.00	40.0%	876,000.00	180.00	90.00	50.0%	90.00																	243.60	121.80	50.0%	121.80
2	Golomt II-8(B)	Dorniin ilch LLC	HOB factory expansion, HOB manufacturing	(i) HOB					546.00	448.00	17.9%	98.00	4.37	9.86	-125.6%	-5.49	8.74	3.99	54.4%	4.75	2.62	0.85	67.5%	1.77	150.15	30.91	79.4%	119.24	738.96	606.32	17.9%	132.64
3	Golomt II-18(B)	Surt ider LLC	Household heating stoves production factory	(i) Stove					2,400.00	1,360.00	43.3%	1,040.00	12.96	7.34	43.4%	5.62	18.00	10.20	43.3%	7.80	5.76	3.26	43.4%	2.50	55.92	31.68	43.3%	24.24	3,248.16	1,840.62	43.3%	1,407.54
4	TDB II-25(B)	Tara LLC	Sawsand briquette production factory expansion	(ii) Fuel					5,572.00	4,000.00	28.2%	1,572.00	6.68	3.88	41.9%	2.80	12.81	1.44	88.8%	11.37	6.68	1.24	81.4%	5.44	351.04	132.00	62.4%	219.04	7,541.10	5,413.60	28.2%	2,127.50
5	Xac II-8(B)	Protech LLC	Canadian woodworks production factory	(iii) Energy efficiency	36,576.00	16,704.00	54.3%	19,872.00	11.52	5.26	54.3%	6.26																	16.13	7.37	54.3%	8.76
6	Capital II-2(B)	Ekh golomtiin ilch LLC	Small scale high power HOB	(i) HOB					13,871.00	10,195.00	26.5%	3,676.00	91.24	38.15	58.2%	53.09	15.19	6.36	58.2%	8.83	9.36	3.92	58.1%	5.44	121.00	51.02	57.8%	69.98	18,773.00	13,797.90	26.5%	4,975.10
7	Capital II-8(B)	Erdenet chandmani LLC	Waste sand /White dust/recycling project	(iii) Dust recycling									67,307.69	32,307.69	52.0%	35,000.00																
8	Capital II-10(B)	Delger construction LLC	Eco panel factory establishment project	(iii) Energy efficiency	1,226,925.60	395,514.00	67.8%	831,411.60	316.50	113.94	64.0%	202.56																	425.20	153.10	64.0%	272.10
9	Khan II-44(B)	Uv ilch LLC	HOB replacement project	(i) HOB					3,200.00	2,500.00	21.9%	700.00	57.60	27.50	52.3%	30.10	14.72	9.50	35.5%	5.22	3.20	2.75	14.1%	0.45	54.40	80.00	-47.1%	-25.60	4,330.90	3,383.50	21.9%	947.40
10	Xac II-28(B)	Grand electro technokom LLC	Geothermal energy systems project	(iii) Renewable energy	181,440.00	45,360.00	75.0%	136,080.00	27.00	0.00	100.0%	27.00																	232.79	39.49	83.0%	193.30
11	Khan II-60(B)	Undrakh LLC	HOB replacement project	(i) HOB					1,800.00	900.00	50.0%	900.00	57.60	19.80	65.6%	37.80	11.34	5.06	55.4%	6.28	1.22	1.10	10.1%	0.12	46.80	18.70	60.0%	28.10	2,436.12	1,488.74	38.9%	947.38
12	Golomt II-46(B)	Tumen tulguur LLC	Heat insulation material	(iii) Energy efficiency	9,840,000.00	3,280,000.00	66.7%	6,560,000.00	13,360.00	4,800.00	64.1%	8,560.00																	17,946.50	6,447.80	64.1%	11,498.70
13	Capital II-29(B)	Ekas international LLC	Insulated wooden panel project	(iii) Energy efficiency	5,781,600.00	925,056.00	84.0%	4,856,544.00	308.00	0.00	100.0%	308.00																	413.70	0.00	100.0%	413.70
14	Khan II-66 (B)	Duursakh altai LLC	Insulated polystyrene concrete project	(iii) Energy efficiency	1,020,540.00	408,216.00	60.0%	612,324.00	203.00	156.60	22.9%	46.40																	274.70	211.90	22.9%	62.80
15	Golomt II-57 (B)	Arvain ilch LLC	HOB replacement project	(i) HOB					630.00	400.00	36.5%	230.00	11.34	0.26	97.7%	11.08	3.59	0.52	85.5%	3.07	0.25	0.10	61.9%	0.16	67.41	1.24	98.2%	66.17	852.64	541.36	36.5%	311.28
16	Golomt II-58 (B)	Medbar LLC	Insulated concrete (ICF) manufacturing project	(iii) Energy efficiency	491,500.00	245,760.00	50.0%	245,740.00	160.00	80.00	50.0%	80.00																	553.60	163.20	70.5%	390.40
17	Khan II-67(B)	Elbeg dulaan LLC	HOB renovation project	(i) HOB					1,140.00	900.00	21.1%	240.00	4.31	1.70	60.5%	2.61	12.64	1.67	86.8%	10.98	6.94	1.10	84.2%	5.85	288.17	5.83	98.0%	282.34	1,542.88	1,218.06	21.1%	324.82
18	TDB II-46(B)	MNT project LLC	ICF manufacturing	(iii) Energy efficiency	5,367,437.70	4,254,374.60	20.7%	1,113,063.10	200.50	158.10	21.1%	42.40																	280.90	223.10	20.6%	57.80
19	Khan II-71(B)	Epu khairkhan LLC	Felt cover factory expansion project	(iii) Energy efficiency	13,462,500.00	6,731,250.00	50.0%	6,731,250.00	8,975.00	4,308.00	52.0%	4,667.00																	14,360.00	5,115.80	64.4%	9,244.20
20	Golomt II-53(B)	Amid gazar LLC	Tree nursery establishment project	(iii) Carbon capture																												
21	TDB II-47(B)	Khurimt star LLC	Foam panel factory establishment project	(iii) Energy efficiency	9,854,369.30	8,878,014.70	9.9%	976,354.60	368.10	324.00	12.0%	44.10																	515.80	464.00	10.0%	51.80
22	Golomt II-(B)	Uv bayan ulaan LLC	HOB replacement project	(i) HOB					600.00	400.00	33.3%	200.00	10.80	4.40	59.3%	6.40	2.76	1.52	44.9%	1.24	0.60	0.44	26.7%	0.16	10.20	12.80	-25.5%	-2.60	812.04	541.36	33.3%	270.68
23	Khan II-73(B)	Mungut khairkhan LLC	HOB replacement project	(i) HOB					250.00	200.00	20.0%	50.00	4.50	2.20	51.1%	2.30	0.25	0.22	12.0%	0.03	4.25	6.40	-50.6%	-2.15	338.35	270.68	20.0%	67.67	1.15	0.76	33.9%	0.39
24	Capital II-37(B)	L-Boss Trade LLC	Briquette manufacturing factory project	(ii) Fuel					5.00	3.00	40.0%	2.00	6.00	3.00	50.0%	3.00	11.50	4.80	58.3%	6.70	6.00	1.77	70.5%	4.23	315.00	312.00	1.0%	3.00				
25	Khan II-74(B)	Ilfratello LLC	Sawdust briquette manufacturing factory expansion project	(ii) Fuel					1,605.00	1,152.00	28.2%	453.00	1.93	1.12	42.0%	0.81	3.69	0.41	88.9%	3.28	1.93	0.36	81.3%	1.57	101.12	38.02	62.4%	63.10	2,172.21	1,559.12	28.2%	613.09
26	TDB II-50(B)	Novelty LLC	Nanoprotect spray manufacturing project	(iii) nanotechnology																												
27	Khan II-62(B)	Bindermunkh LLC	Sewage tank manufacturing project	(iii) sewage purifying																												
28	Capital II-40(B)	Zooku LLC	Insulated door and window factory expansion project	(iii) Energy efficiency	651,000.00	487,500.00	25.1%	163,500.00	75,000.00	55,500.00	26.0%	19,500.00																	298,500.00	223,500.00	25.1%	75,000.00
29	Capital II-41(B)	Technomarket LLC	Sawdust fuel manufacturing factory establishment project	(ii) Clean fuel					8,440.00	6,058.00	28.2%	2,382.00	10.10	5.80	42.6%	4.30	19.400	2.10	89.2%	17.30	10.10	1.80	82.2%	8.30	531.70	199.90	62.4%	331.80	11,422.60	8,198.80	28.2%	3,223.80
30	Golomt II-62(B)	Nomin tengeriin od LLC	Heat insulated block factory expansion project	(iii) Energy efficiency	7,382,378.40	2,952,951.30	60.0%	4,429,427.10	1,468.40	1,132.80	22.9%	335.60																	1,987.10	1,532.80	22.9%	454.30
31	Golomt II-60(B)	Arvijikh uvs LLC	Insulated light foam block manufacturing project	(iii) Energy efficiency	2,531,101.10	1,012,440.00	60.0%	1,518,661.10	503.40	388.30	22.9%	115.10																	681.20	525.50	22.9%	155.70
32	UB City II-3(B)	Rezin Edlel LLC	Rubber pads factory expansion project	(ⅵ) recycling									31.74	0.00	100.0%	31.74	0.003	0.00	100.0%	0.00					0.14	0.00	100.0%	0.14				
33	TDB II-55(B)	Aniflo LLC	Spray grass manufacturing expansion project	(iii) Carbon capture																												
34	Golomt II-64(B)	Khulgiin Deed LLC	HOB renovation project	(i) HOB					500.00	350.00	30.0%	150.00	9.00	3.90	56.7%	5.10	2.300	1.30	43.5%	1.00	0.50	0.38	24.0%	0.12	8.50	11.20	-31.8%	-2.70	676.70	473.70	30.0%	203.00
35	Xac II-35(B)	Pyramid Industry LLC	Insulated foam panel manufacturing project	(iii) Energy efficiency	9,737.50	3,245.00	66.7%	6,492.50	10,576.60	3,800.00	64.1%	6,776.60																	14,207.60	5,104.00	64.1%	9,103.60
36	Khan II-80(B)	Super Space LLC	Waste fabrics recycling factory establishment project	(ⅵ) recycling																												
37	Xac bank II-37(B)	Ariun bilguun LLC	HOB renovation project	(i) HOB					823.20	602.50	26.8%	220.70	14.80	6.60	55.4%	8.20	3.800	2.30	39.5%	1.50	0.80	0.70	12.5%	0.10	14.00	19.30	-37.9%	-5.30	1,114.20	815.40	26.8%	298.80
38	Xac II-42(A)	Khunnu Sunnu LLC	Briquette factory expansion project	(ii) Fuel					10,000.00	10,000.00	0.0%	0.00	11.46	0.00	100.0%	11.46	11.05	0.00	100.0%	11.05	9.10	8.19	10.0%	0.91	655.30	589.77	10.0%	65.53	35,831.60	35,831.60	0.0%	0.00
39	Capital II-45(B)	Erdem Gaz LLC	Canned gas production factory establishment project	(iii) Energy efficiency	7,700,000.00	0.00	100.0%	7,700,000.00	2,593.36	0.00	100.0%	2,593.36	7.44	0.00	100.0%	7.44					10.04	0.00	100.0%	10.04	0.08	0.00	100.0%	0.08	11,559.07	0.00	100.0%	11,559.07
40	Golomt II-73(B)	Make Green LLC	Tree nursery expansion project	(iii) Other																												
41	TDB II-70(B)	New server LLC	Keramzit factory expansion project	(iii) Other					724.90	559.15	22.9%	165.74																	980.93	756.72	22.9%	224.21
42	Khan II-99 (B)	Mongol Polymer Khooloi LLC	Polymer pipe factory expansion	(ⅵ) recycling									41.86	0.00	100.0%	41.86	0.003	0.00	100.0%	0.00					0.14	0.00	100.0%	0.14				
43	TDB II - 86(B)	MNT project LLC	Foam panel factory expansion project	(iii) Energy efficiency	3,525.00	2,290.00	35.0%	1,235.00	1.82	1.17	35.7%	0.65																				
44	TDB II - 89(B)	Element LLC	Plastic waste recycling factory est. project	(ⅵ) recycling	920.76	767.30	16.7%	153.46	57.60	48.00	16.7%	9.60	0.18	0.15	16.7%	0.03	381.000	317.50	16.7%	63.50	614.40	512.00	16.7%	102.40	53,370.00	44,475.00	16.7%	8,895.00				
45	TDB II - 94(B)	Monscan LLC	Plastic tiles factory est. project	(ⅵ) recycling	8,800.00	6,896.00	21.6%	1,904.00																								
46	TDB II - 95(B)	Manlai guulin LLC	Sawdust briquette factory est. project	(ii) Fuel									5.9	0.015	99.7%	5.89	1.5	0.00	100.0%	1.50	350.60	200.17	42.9%	150.43	9,890.99	7,884.77	20.3%	2,006.22				
			Total		67,740,351.36	30,960,338.90	54.3%	36,780,012.46	166,417.90	110,933.82	33.3%	55,484.07	67,709.50	32,443.37	52.1%	35,266.13	534.28	368.88	31.0%	165.41	1,044.36	746.53	28.5%	297.83	66,370.40	54,164.82	18.4%	12,205.58	454,673.08	320,077.42	29.6%	134,595.66

Source: JICA TSL Project Office

Appendix 4

Financial Performance of PFIs

1. Khan Bank

(1) Outline

Brief History

Khan Bank was established in 1991 as the Agricultural Cooperative Bank, following the dissolution of the former State Bank of Mongolia according to the data of the Bank. Khan Bank assumed most of the assets and businesses of the State Bank in rural Mongolia. Although the Bank was privatized, its business remained heavily influenced by the government. In 1999 it was placed into receivership by the Bank of Mongolia (BoM). In 2000, a restructuring plan was developed under the guidance of World Bank.

The Government of Mongolia assumed ownership and recapitalized the Bank, and an external management team, funded by the United States Agency for International Development (USAID), was brought in to implement the plan.

In 2003 the Bank was privatized through international tender. Sawada Holdings Co., Ltd. acquired 100% of the shares. Subsequently Sawada Holdings sold 40% of the shares to Tavan Bogd Trade Ltd. International Finance Corporation became a shareholder in 2004. In 2006 the Bank's name was officially changed to Khan Bank LLC.

Scope of Business

Khan Bank provides a wide range of financial services. In addition to a full range of loan and deposit products, Khan Bank provides foreign exchange, trade finance, cash management, and international payment services to its commercial customers, including SMEs, corporate, and international institutions.

Branches

Khan Bank operates throughout Mongolia with 537 branches and units in Ulaanbaatar and rural areas, with offices in every province, soum, and border point.

Management

Under the Board, there is the Chief Executive Officer (CEO), First Deputy CEO as Chief Operating Officer and Deputy CEO for Retail Banking. Under the CEO, there are major departments related to lending such as the Corporate Banking Department, the Credit Policy and Regulation Department, the Credit Risk Department. Under the Deputy CEO for Retail Banking, there are departments regarding branch management.

Employees

At year end 2015, the number of staff of Khan Bank was over 5,900, including those on leave. Seventy percent were under the age of 30.

(2) Shareholders

Sawada Holdings Co, Ltd. (SHD) has been the majority shareholder of Khan Bank since March 2003, when it acquired 100% shares of Khan Bank through an international tender. In July 2003 SHD sold 40% of its shares to Tavan Bogd Trade Co., Ltd. In 2008 SHD transferred a portion of its shares to its wholly owned Hong Kong subsidiary, H.S. International (Asia) Limited. SHD owns the majority (54.40%) of Khan Bank directly and indirectly through H.S. International. Hideo Sawada, Chairman of Khan Bank, owned 26.1% of SHD as of December 31, 2015.

The International Finance Corporation (IFC) has been a shareholder of Khan Bank since 2004. The IFC also provides trade facilities and loans to Khan Bank, including senior and subordinated term debt, as well as technical assistance.

Table 1: Shareholders of Khan Bank

Ownership	Share
Sawada Holdings Co Ltd (Tokyo, Japan)	41.30%
H.S. International (Asia) Ltd (Hong Kong)	13.10%
Tavan Bogd Trade Co Ltd (Ulaanbaatar, Mongolia)	22.96%
D. Khulan (Ulaanbaatar, Mongolia)	13.32%
International Finance Corporation	9.32%
Total	100.00%

Source: Khan Bank Annual Report 2015

(3) Financial Situation

Assets and Liquidity

The size of total assets of Khan Bank represents 24% of total banking system assets. Khan Bank significantly increased total assets from MNT 2.8 trillion at the end of 2012 to MNT 4.8 trillion at the end of 2013. Since then, the increase has been slowed down and total assets were MNT 5.1 trillion in 2015.

The share of "loans and advances to customers" was 56.9% in 2015, slightly decreased from 58.1% in 2014, due to the slowdown in the Mongolian economy. The share of "financial investments" increased from 8.7% in 2014 to 16.5% in 2015.

Table 2: Assets of Khan Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Cash and cash equivalents	541,457	646,628	1,385,864	1,131,550	679,590
Mandatory reserves with the Bank of Mongolia	172,471	209,088	346,380	293,847	335,260
Due from other banks	11,225	15,556	88,773	88,740	68,403
Loans and advances to customers	1,377,266	1,731,042	2,446,412	2,971,657	2,913,072
Investments in associates	513	513	513	513	552
Financial investments	66,111	99,931	396,895	444,537	844,891
Fixed assets	62,231	74,107	104,857	121,667	176,056
Other assets	4,470	19,216	31,262	63,563	99,343
Current income tax prepayment	-	389	-	-	-
Total Assets	2,235,743	2,796,470	4,800,956	5,116,075	5,117,165

Source: Khan Bank Annual Report 2015

Liabilities and Equities

Customer accounts (deposits) account for 66% of total liabilities at the end of 2015. The breakdown of deposits is current account 20.2%, demand depots 19.1%, and term deposits 60.7%. On the contrary to a drop of customer accounts' share, the share of other borrowed funds has been gradually increasing as shown in Fig. 10.1.

Total equity has shown a steady increasing trend due to favorable retained earnings. Total capital increased from MNT444 billion in 2014 to MNT565 billion in 2015.

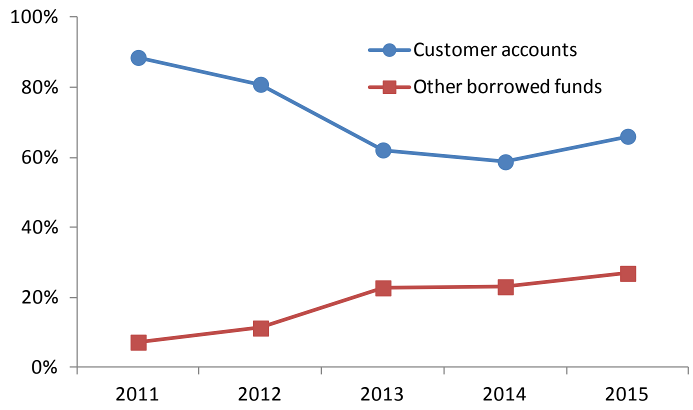
Table 3: Liabilities and Equities of Khan Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Due to other banks	14,466	75,161	509,962	603,985	62,003
Customer accounts	1,812,333	2,073,817	2,773,725	2,744,750	3,005,377
Other borrowed funds	148,369	289,205	1,016,125	1,077,922	1,224,345
Other liabilities	12,259	18,761	25,324	25,397	28,729
Deferred income tax liability	1,130	4,339	4,342	7,193	6,052
Subordinated debt	58,648	103,410	135,885	213,211	225,957
Total Liabilities	2,047,205	2,564,693	4,465,364	4,672,458	4,552,462
Share capital	12,994	13,198	32,995	32,995	52,792

Share premium	13,866	14,141	14,141	14,141	
Revaluation surplus	15,164	14,686	21,211	20,584	19,997
Treasury stock	-	-28,614	-28,614	-28,614	-28,614
Other reserves	121	-	-	-	945
Retained earnings	146,394	218,367	295,859	404,511	519,583
Total Equity	188,539	231,778	335,593	443,617	564,703
Total Liabilities and Equity	2,235,743	2,796,470	4,800,956	5,116,075	5,117,165

Source: Khan Bank Annual Report



Source: Khan Bank Annual Report

Figure1: Share to Total Liabilities

Profit and Loss

Net profit after tax came in 2015 was MNT121 billion, a 12.1% increase over 2014. Net interest income increased by 16.4% in 2015. Higher interest income was partially offset by increased loan loss provisioning (MNT52.2 billion). Total operating expenses increased but at a lower rate than net operating income. At the end of 2015, ROA was 2.4%, while ROE was 23.7%, a slight decline from 2014.

Table 4: Profit and Loss of Khan Bank

Unit: MNT Billion

	2011 YTD	2012 YTD	2013 YTD	2014 YTD	2015 YTD
Interest income	219,386	282,967	433,655	544,095	623,555
Interest expense	93,538	132,994	239,528	302,672	342,502
Net Interest Income	125,848	149,973	194,127	241,423	281,053
Fees and commission income	13,053	17,522	23,808	29,551	33,446
Fees and commission expense	1,300	1,516	2,172	2,810	2,966
Net fees and commission income	11,753	16,006	21,635	26,741	30,479
Other operating income	21,121	17,619	36,993	27,341	34,030
Total operating income	158,722	183,597	252,756	295,505	345,562
Provision for loan impairment	3,040	-1,145	13,697	24,009	52,276
Net operating income	155,683	184,742	239,058	271,496	293,287
Total operating expenses	77,439	97,130	116,857	142,433	156,458
Profit before tax	78,244	87,612	122,201	129,062	136,828
Income tax expense	19,865	16,117	25,463	21,038	15,742
Profit for the period	58,379	71,495	96,739	108,024	121,086

Source: Khan Bank Annual Report

Prudential Ratios

The prudential ratios of Khan Bank are much higher than the minimum requirements. The capital adequacy ratio was 22.6% in 2015 against the minimum prudential requirement of 14.0%. This ratio has been increased recently.

Tier 1 capital adequacy ratio (tier 1 capital as a percentage of risk weighted assets) was 15.6% in 2015 against the minimum prudential ratio requirement of 9.0%. The liquidity ratio in 2015 was 43.1%, a slight decrease from 2014.

Table 5: Trend of Prudential Ratios of Khan Bank

	2011	2012	2013	2014	2015
Capital Adequacy ratio (>14%)	15.4%	16.6%	16.6%	17.2%	22.6%
Tier 1 ratio (>9%)	10.8%	10.8%	11.1%	11.1%	15.6%
Liquidity ratio (>25%)	39.6%	39.3%	47.7%	43.5%	43.1%

Source: Khan Bank Annual Report

Impaired Loan

The ratio of impaired loan to total loans was 7.1% at the end of 2015. As for business lending, this ratio was 16.8% and 49.0% of impaired loan was transferred to impairment provision. The size of impaired loans for consumer lending and agricultural lending was rather small and impairment provision was sufficiently made.

Table 6: Situation of Impaired Loan

Unit: MNT Million

	Business lending	Consumer lending	Agricultural lending	Total	
Total loans and advances to customers	1,163,254	1,549,905	199,912	2,913,072	100.0%
Total neither past due nor impaired	1,045,879	1,546,007	199,919	2,791,805	95.8%
Total past due but not impaired	17,740	8,173	1,023	26,936	0.9%
Impaired loans					
- not past due	64,796	-	-	64,796	2.2%
- 1 to 30 days overdue	12,200	-	-	12,200	0.4%
- 31 to 90 days overdue	18,619	-	-	18,619	0.6%
- 91 to 180 days overdue	21,007	3,576	195	24,778	0.9%
- 181 to 360 days overdue	23,039	5,189	193	28,420	1.0%
- over 360 days overdue	55,892	3,286	131	59,309	2.0%
Total impaired loans	195,552	12,050	519	208,122	7.1%
Less impairment provisions	-95,918	-16,325	-1,549	-113,792	-3.9%

Note: As of the end of 2015
Source: Khan Bank Annual Report

Loan Collateral

Total 75.9% of loans are covered by collateral. The coverage ratio of consumer landing is very low. Unsecured loans mostly consist of pension and salary loans. As for business lending and agricultural lending, the coverage ratio is more than 99%. Real estate properties are popular as collateral.

Table 7: Coverage by Collateral

Unit: MNT Billion

Type of Collateral	Business Lending	Consumer Lending	Agricultural Lending	Total
Secured loans	99.4%	53.7%	99.7%	75.9%
Real estate properties	85.3%	31.1%	10.3%	52.3%
Vehicles	0.5%	6.4%	7.9%	4.0%
Equipment	1.8%	0.1%	0.4%	0.8%
Goods in turnover	4.7%	0.1%	0.0%	2.0%
Other	7.1%	16.3%	81.2%	16.8%
Unsecured loans	0.6%	46.1%	0.3%	24.1%
Total loans and advances to customers	100.0%	100.0%	100.0%	100.0%

Note: As of the end of 2015
Source: Khan Bank Annual Report

(4) Loan Portfolio

The breakdown of total gross loan is 41.6% for business lending, 51.7% for consumer lending and 6.7% for agricultural lending as of the end of 2015. By industrial sector, trade and commerce, construction, mining, and agriculture are major sectors of loans.

Table 8: Breakdown of Lending by Sector

Unit: MNT Billion

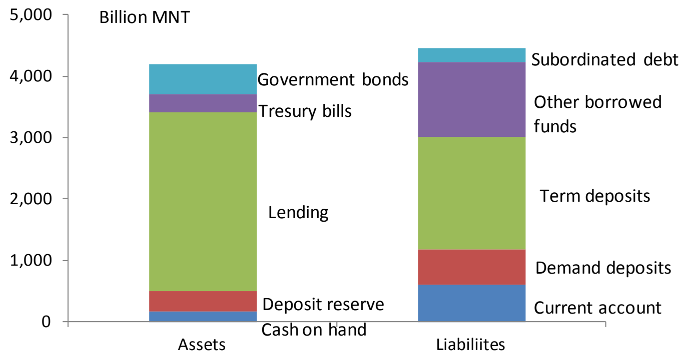
	2014		2015	
	Amount	Share	Amount	Share
Individuals	1,569.5	52%	1,565.9	52%
Trade and commerce	397.0	13%	414.5	14%
Construction	268.6	9%	256.5	8%
Mining	132.0	4%	127.6	4%
Agriculture	118.0	4%	122.9	4%
Real estate	82.2	3%	74.7	2%
Food industry	47.0	1%	54.8	2%
Chemical production	40.7	1%	34.0	1%
Transportation	33.2	1%	23.7	1%
Paper production	29.9	1%	24.9	1%
Metal production	20.3	1%	19.9	1%
Health and social organizations	17.1	1%	21.5	1%
Other	278.0	9%	286.0	9%
Total loans and advances to customers (before impairment)	3,033.5	100%	3,026.9	100%

Source: Khan Bank Annual Report

(5) Funding

In addition to deposits, borrowed funds have become an important source for lending. The size of borrowed funds was MNT1,224 billion at the end of 2015, an increase of 13.6% from the previous year.

The borrowed fund consists of borrowing from foreign financial institutions 61.2%, borrowing from government organization 14.7% and trade finance 14.7%. Borrowing from MOF for JICA's TSL account for 9.9% of Khan Bank's borrowing from government organizations.



Source: Khan Bank Annual Report

Figure 2: Major Items of Assets and Liabilities (As of the end of 2015)

Khan Bank borrows from development financial institutions such as EBRD, FMO, ADB, IFC, OFID and IIB and from IFI and MFIs such as BlueOrchard, Responsibility SICAV (Lux), Credit Suisse Microfinance Fund Management Company, Symbiotics, etc.

Khan Bank also borrows funds from the government organizations to provide policy loans as follows:

Bank of Mongolia loans

(i) Strategic Import Financing Schema (SIFS), Food Price Stabilizaton (FPS), and Construction sector support and apartment price stabilization, and mortgage programs.

(ii) Bank of Mongolia, Term Loan III

Ministry of Food, Agriculture and Light Industry

(i) Small Medium Enterprise Investment Fund

(ii) Small Medium Enterprise Development Fund /Wool & Cashmere loan

Ministry of Finance

(i) Two step loan project for SME development and environmental protection financed by JICA

(ii) Agriculture and Rural Development Project (ADB)

(iii) Private Enterprise Development Fund

(iv) Rural Poverty Reduction Program (International Federations Agricultural Development)

Government Organizations of Aimags (provincial centers)

(i) The Labor and Welfare Service offices at 13 aimags and 1 district provided this fund for the purpose of supporting job creation.

(ii) A loan obtained from the Local Government Office of Orkhon aimag to support local small and middle sized businesses

(iii) Cooperation agreement with Khuvsgul province governors' office to lend to local SME.

Other

(i) Development Bank of Mongolia - Program of supporting export

(ii) Development Bank of Mongolia - SME investment Fund

(iii) Development Bank of Mongolia - Cashmere production

(iv) Development Bank of Mongolia - Industrial support

(v) Microfinance Development Fund

2. Golomt Bank

(1) Outline

Brief History

Golomt bank of Mongolia was established in 1995 as a wholly owned subsidiary of Bodi International LLC. Golomt Bank grew into the leading commercial bank of Mongolia, producing ¼ of the Mongolian national GDP and constituting 20% of Mongolian banking system as of end of 2015. The bank has well-established domestic and international client bases in both corporate and retail market. Worldwide financial magazines such as Global Finance, Euromoney and the Banker named Golomt Bank as the best bank of Mongolia in 2013 and 2014.

It has long been the pioneer among Mongolian banks introducing initiatives to contribute to accelerate Mongolian financial sector development, namely card services, E-banking, 24 hour non-stop banking service, Western Union foreign remittance, Dual Currency card, the very first UnionPay RMB card applicable in not only Chinese territory but worldwide, portable ATM, specially tailored banking application of Smart bank service for android cellular phones, “Self Serving Bank” and ongoing project to issue international Master Card and American Express card with MNT account in cooperation with card issuer giants etc.

Scope of Business

The bank offers complete spectrum of high quality commercial and investment banking services to both domestic and international enterprises and investors reinforcing sound corporate governance and transparency commitments. Traditionally, Golomt Bank focuses on corporate banking. Since 2010 the bank, however, has shifted to retail banking and SME banking, to expand its business and increase its outreach to businesses. Golomt Bank also has a strategy of 50-50 balance between retail loans and SME loans, and corporate loans. As a result of this strategy and expansion, retail loans gradually increased.

Branches

As of 31 December 2015 the Bank had 71 branches within Mongolia. Also, 26 sub-branches along with digital channels including ATMs, Internet and Mobile banking.

Management

Under the Board of Directors, there are Chief Executing Officer, President, Executive Vice President, Chief Operating Officer, Chief Information Officer. The bank has 11 divisions with responsible Vice Presidents: Risk management division, Credit division, Treasury division, Financial management division, Channel management division, Business development division, Investment banking division, Corporate banking division, Custodian banking division, Information technology division and Operations division.

Employees

Golomt Bank has 1,867 employees by the end of 2015.

(2) Shareholders

There are 4 main shareholders, but majority of shares are held by Golomt Financial Group LLC.

- Golomt Financial Group LLC - 83.76%
- Swiss MO - 9.98%
- Trafigura Beheer B.V. - 4.93%
- Employee Stock Option Plan (ESOP) - 1.33%

Golomt Financial Group LLC

Golomt Financial Group LLC is a financial services and investments company founded in 2014 with 100% Mongolian shareholding. The company’s investment objective is long-term capital appreciation and it is invested in Golomt Bank’s common stocks and securities convertible into common stocks.

Swiss-MO Investment A.G.

It is an investment holding company controlled by leading Swiss entrepreneur and philanthropist Urs E. Schwarzenbach. It invested US$20 mm in Golomt Bank in June 2011 for a 9.98%% stake.

Trafigura Beheer B.V.

It is the 3rd largest oil trader and the 2nd largest independent trader in the non-ferrous concentrates market. Trafigura invested US$15.9 mm in Golomt Bank in March 2012 for a 4.93% stake.

Employee Stock Option Plan (ESOP)

Since 2011, ESOP has implemented and served to align employee and shareholder interests. Shareholders granted the right to purchase ordinary shares at discounted price. More than 150 employees have been granted stock options, and a non-governmental organization, Khuvitai Golomt, was established. Currently, the number of shares to be available under the program is no more than 1.33%. In order to participate in the ESOP, an employee must have been employed by the Bank on a full-time basis for at least five years and have met certain other performance criteria.

Golomt Bank also issued preferred shares equal to USD 15 million, which is wholly owned by Mr. Zorigt Munkhchuluun.

In terms of Board structure, one third of Golomt Bank's Board of Directors are independent members, including the representative of ESOP shareholders.

(3) Financial Situation

Assets and Liquidity

Golomt's assets at year-end totaled MNT 3,8 trillion, and representing 17.7 percent of aggregate banking sector assets. Between 2011 and 2015, total assets grown by 78%, but highest amount was in 2014 where total assets reached MNT4 trillion.

Table 9: Assets of Golomt Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Balance Sheet					
Cash and cash equiv.	289.9	426.1	570.7	835.8	687.0
Short-term liquid assets	555.0	620.7	896.6	268.1	354.6
Loans and advances (net)	1,249.3	1,428.0	2,199.2	2461.9	2013.6
Other assets	40.5	52.8	83.1	487.4	749.9
Total assets	2,134.7	2,527.5	3,749.6	4053.2	3805.1

Source: Golomt Bank Annual Reports

In terms of asset composition, Loans and advances (net) accounted the biggest portion of 53% of total assets, followed by other assets (20%) and Cash and cash equivalent (18%). In 2013, loans increased by 54% and then 12% growth in 2014 reaching the highest amount. However, both loans and cash decreased by 18% in 2015 and thus resulted 6% decrease in total assets mainly due to the economic downturn.

Liabilities and Equities

Deposit from customers comprised 60% of total liabilities at the end of 2015. Year 2014 had the highest deposit, liabilities and equity. Although all categories decreased in 2015 except equity categories including retained earnings.

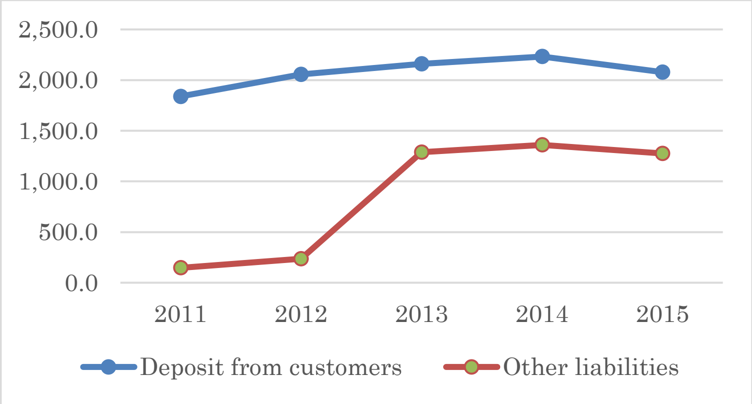
Table 10: Liabilities and Equity of Golomt Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Deposit from customers	1,839.3	2,056.6	2161.4	2232.1	2079.8
Due to banks & Fis	9.5	47.0	26.5	133.3	90.0
Other liabilities	146.8	236.6	1289.8	1359.9	1276.8
Total liabilities	1,995.6	2,340.2	3477.7	3725.3	3446.6
Share capital	46.9	68.2	84.6	96.7	98.8
Other reserves	5.7	2.1	13.8	8.4	12.0
Retained earnings	86.4	117.0	173.5	222.8	247.8
Total equity	139.0	187.3	271.9	327.9	358.6
Total liab. & equity	2,134.6	2,527.5	3749.6	4053.2	3805.2

Source: Golomt Bank Annual Reports

In December 2013, the bank issued preferred shares of MNT16.3 billion to increase the share capital and meet the increased capital adequacy requirement of the BOM.



Source: Golomt Bank Annual Reports

Table 3: Share to total liabilities

Profit and Loss

Net profit after tax of 2015 was MNT26 billion which reduced by 48% compared to 2014. Net interest income also experienced a decrease of 21% in 2015. High loss interest income was partially offset by the increased non-interest income of MNT56.3 billion). Total operating expenses increased by 3% whereas operating profit reduced by 5%. At the end of 2015, ROA was 0.7%, while ROE was 8.7%. Both returns worsened by 50% and 54% respectively compared to 2014. These results indicate that the bank overall financial position is worsening due to economic downturn, stagnation of businesses resulting increased NPL and reduced deposits.

Table 11: Profit and Loss of Golomt Bank

Unit: MNT Million

Income statement indicators	2011	2012	2013	2014	2015
Interest income	165,165	200,245	290,945	338,366	314,830
Interest expenses	(116,240)	(143,127)	(184,701)	(209,312)	(213,295)
Net interest income	48,925	57,118	106,245	129,054	101,534
Net non-interest income	27,163	31,932	59,774	36,197	56,258
Operating profit	76,088	89,050	166,019	165,251	157,792
Operating expenses	(32,515)	(45,419)	(67,116)	(73,068)	(75,362)
Allowance for credit loss	(6,324)	(10,790)	(27,940)	(27,900)	(49,703)
Pre-tax income	37,249	32,841	70,963	64,283	32,726
Tax expenses	(9,022)	(6,694)	(14,106)	(14,455)	(6,742)
Net profit after tax	28,226	26,146	56,857	49,828	25,985

Source: Golomt Bank Annual Reports

Prudential Ratios

Despite the worsening financial performance in 2015, Golomt Bank constantly meets the BOM prudential requirements. The BOM increased the capital adequacy ratio in 2013 from 13% to 14%. All prudential ratios, in particular capital adequacy ratio and liquidity ratio is well above the thresholds. Although still in the good position, the share of single largest borrower exposure (<20%) increased by 15% reaching 18.2%. Consequently, total related party loans to equity ratio worsened by 8%, but still under the threshold. In 2015, the fixed assets ratio increased by 81% and reached 4.7%, but still far away from 8% threshold.

Table 12: Trend of Prudential Ratios of Golomt Bank

Prudential ratios	2011	2012	2013	2014	2015
Capital adequacy ratio > 14%	12.9%	13.3%	16.7%	17.1%	16.6%
Single largest borrower exposure < 20%	19.8%	19.0%	15.9%	15.8%	18.2%
Related party loan to equity < 5%	3.4%	3.5%	3.0%	4.6%	3.9%
Total related party loans to equity < 20%	12.7%	9.5%	8.2%	15.8%	17.0%
Liquidity ratio > 25%	38.9%	41.1%	43.3%	38.2%	38.1%
Fixed assets ratio < 8%	1.5%	1.5%	1.6%	2.6%	4.7%

Source: Golomt Bank Annual Reports

Impaired Loan

The ratio of impaired loan to total loans was 4.5% at the end of 2015. Corporate loan impairment constituted 63% and SME loan impairment accounted for 28%, indicating that private sector stagnation resulted in the loan impairments. The size of impaired loans for consumer lending (6%) and mortgage lending (4%) was rather small. Between 2014 and 2015, amounts written off as uncollectable increased by 9 times for SME loans, 1.6 times for consumer loans and 1.5 times for corporate loans. This illustrates that the economic downturn has seriously affected SME sectors more than others. When comparing the growth of provision for loan impairment as the end of 2015, mortgage lending had highest growth of 2 times despite having small share in total loan impairment, which might indicate that economic difficulties started to affect individuals with mortgage loans.

Table13: Situation of Impaired Loan as of 2015

Unit: MNT thousands

In thousands of MNT	Corporate	Consumer	SME	Mortgage	Total
Total loans &advances to customers	1,164,191,875	197,177,121	554,558,265	622,974,437	2,538,901,698
Total neither past due nor impaired	985,653,058	180,943,764	327,348,188	234,086,263	1,728,031,273
Total past due but not impaired	73,737,008	13,081,058	100,629,773	13,597,801	201,045,640
Impaired loans					-
- 1 to 30 days overdue	25,257,864	-	2,477,420	-	27,735,284
- 31 to 90 days overdue	-	-	-	-	-
- 91 to 180 days overdue	-	-	13,711,995	-	13,711,995
- 181 to 360 days overdue	27,704,265	-	-	-	27,704,265
- over 360 days overdue	93,085,342	-	17,391,442	-	110,476,784
Total impaired loans	146,047,471	-	33,580,857	-	179,628,328
Less impairment provisions	(59,811,263)	(5,412,308)	(26,194,204)	(3,676,679)	(95,094,454)

Source: Golomt Bank Annual Reports

From the structure of loan impairment, consumer and mortgage loans have no impairment, but have MNT26.7 billion of past due. More serious issues are in corporate and SME loan impairments. Corporate lending impairment accounted for 81% of total loan impairment. 64% of corporate loan impairment matured more than 1 year which was very risky and considered as uncollectable loans. This MNT93 billion corporate lending comprised 52% of total loan impairment, which seriously add up NPL of the bank. SME loan impairment with more than 1 year accounted 52% of total SME loan impairment and 10% of total loan impairment. To conclude, business loans are riskier than consumer loans. Among business loans, big corporate loans are much riskier than SME loans in terms of impairment.

Loan Collateral

Despite increasing NPL, most loans except some consumer loans are fully collateralized. In fact, 83.1% of total loan outstanding was collateralized in 2015. Among them, 79.6% of loans were over-collateralized and 20.4% were under-collateralized. When analyzing over-collateralized loans, fair value of collateral was 8 times higher than carrying value of collateral in 2015. This indicates that the bank is still in a good position with its over-collateralized loans despite increasing NPL. The following table shows coverage of collateral by 3 main loan categories. Only consumer loans (79% of total consumer loans) were not collateralized as they were salary and pension loans.

Table 14: Coverage by Collateral

In thousands of MNT	Corporate	Consumer	SME	Mortgage	Total
Loans collateralised by:	100%	21%	100%	100%	94%
Residential real estate	28%	8%	50%	95%	51%
Other real estate	17%	0.3%	7%	0.2%	10%
Tradable securities	12%		3%		6%
Cash deposits	15%	79%	5%	0.2%	10%
Other assets	28%	13%	34%	4%	23%
Unsecured loans		79%			6%
Total loans &advances to customers	100%	100%	100%	100%	100%

Source: Golomt Bank Annual Reports

(4) Loan Portfolio

In terms of sectoral distribution, consumer loans accounted for 21%, manufacturing 19%, mining 15% followed by construction 12% in 2015. Compared with 2014, the biggest reduction occurred in consumer loans (-46%) followed by other loans (-17%) and real estate (-12%). However, mining sector loans increased by 10%.

Table 15: Breakdown of Lending by Sector

Unit: MNT thousand

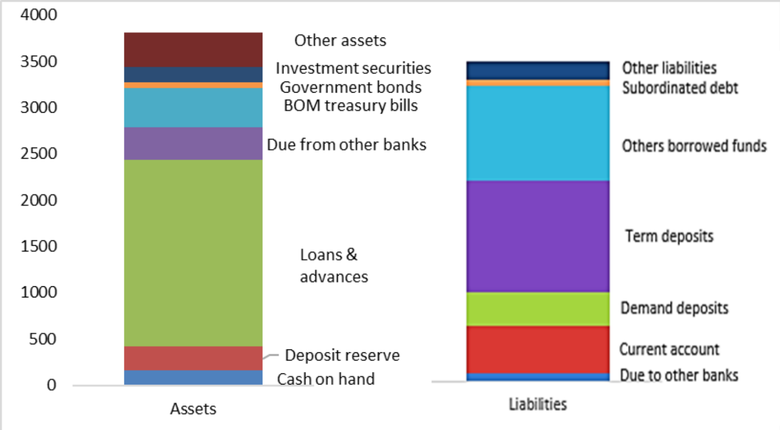
Sectors	2015		2014	
	Amount	Share	Amount	Share
Consumer loans	442,315,383	21%	820,635,083	32%
Manufacturing	405,779,805	19%	392,218,432	15%
Mining & Exploration	317,435,450	15%	264,470,798	10%
Construction	252,836,499	12%	242,971,931	10%
Trade - Whole & Retail	226,603,476	11%	210,326,761	8%
Real estate	84,369,105	4%	98,224,022	4%
Agriculture	63,806,431	3%	64,061,373	3%
Healthcare, education and social service	41,995,462	2%	41,560,829	2%
Other	273,563,630	13%	404,432,469	16%
Total loans and advances to customers (before impairment)	2,108,705,241	100%	2,538,901,698	100%

Source: Golomt Bank Annual Reports

(5) Funding

Current account and deposits are main part of liabilities accounting for 60% of total liabilities. Among them, term deposits hold 35% of total liabilities in 2015. The amount of current account and deposits reduced by 6.8% compared with 2014. In addition to deposits, borrowed funds have become an important source for lending with size of MNT 1 billion (29% of total liabilities).

The borrowed fund consists of borrowed funds under projects 47.2%, borrowing from foreign financial institutions 28.7%, and borrowing from BOM 24.1%. Borrowing from MOF for JICA's TSL account for 4.6% of Golomt Bank's borrowed funds under projects.



Source: Golomt Bank Annual Report

Figure 4: Major Items of Assets and Liabilities (As of the end of 2015), in MNT Billion

Borrowings from other foreign bank of MNT 199 billion represented loan obtained in 2015 from a foreign bank in amount of USD 100,000 thousands with maturity of 18 months. The Bank obtained uncommitted revolving trade credit lines from international banks and financial institutions to fund its trade loans to customers. As of 31 December 2015, Golomt Bank utilised MNT 91 billion of related credit lines and issued loans for the same amount.

Golomt Bank also borrows funds from the government organizations to provide policy loans as follows:

<u>Bank of Mongolia loans</u>

(i) Strategic Import Financing Schema (SIFS), Fuel Pricing Stabilization (SIFS), Food Price Stabilizaton (FPS), and Construction sector support and apartment price stabilization, and mortgage programs.

(ii) Bank of Mongolia, Project loan of KFB bank

<u>Ministry of Food, Agriculture and Light Industry</u>

(i) Small Medium Enterprise Investment Fund

(ii) Small Medium Enterprise Development Fund /Wool & Cashmere loan

<u>Ministry of Finance</u>

(i) Two step loan project for SME development and environmental protection financed by JICA

(ii) Agriculture and Rural Development Project (ADB)

(iii) Private Enterprise Development Project Loan (World Bank)

<u>Government Organizations of Aimags (provincial centers)</u>

(i) The Labor and Welfare Service offices at 13 aimags and 1 district provided this fund for the purpose of supporting job creation.

(ii) A loan obtained from the Local Government Office of Orkhon aimag to support local small and middle sized businesses

(iii) Cooperation agreement with Khuvsgul province governors' office to lend to local SME.

<u>Other</u>

(i) Development Bank of Mongolia - Program of supporting export
(ii) Development Bank of Mongolia - Manufacturing and Processing of Leather Products
(iii) Development Bank of Mongolia - SME investment Fund
(iv) Development Bank of Mongolia - Cashmere production

(v) Development Bank of Mongolia - Industrial support

3. Trade and Development Bank of Mongolia

(1) Outline

Brief History

The Trade and Development Bank of Mongolia (TDB) LLC was established in 1990 separated from the Bank of Mongolia for the privatization of banking business.

Scope of Business

TDB prides itself for its leading position in the universal banking service provider, offering over 130 types of international standard banking products, professional and user friendly banking services.

TDB serves approximately 400 major Mongolian corporations in almost all major sectors. The bank provides various corporate banking services including corporate lending, trade financing syndicated lending and deposit taking through highly qualified staffs.

Branches

As of March 2016, TDB has 60 branches and settlement centers, 208 ATMs and 2211 POS terminals.

Management

Under the Board, there is the Chief Executive Officer (CEO), First Deputy CEO and 6 Deputy CEOs. The corporation consists of 11 departments, i.e., the Corporate Banking Department, Marketing Department, Retail Banking Department, Card Management Department, Branch Management Department, Risk Management Department, Financial Management and Control Department, Legal Department, Corporate Security Department, IT Department and International and Corporate Relation Department, functional units and a variety of committees.

Employees

At the end 2015, the number of staff of TDB was 1,603, increased from 1,532 in 2014.

(2) Shareholders

The TDB Group consists of three companies, TDB, TDB Capital LLC, and TDB Media LLC. The shareholders of TDB Group are as shown in the following table.

Table 16: Shareholders of TDB

Ownership	Share
Globull Investment and Development SCA	65.83%
US Global Investment LLC	7.31%
Goldman Sachs	4.78%
United Banking Corporation LLC	19.95%
Individuals	2.13%
Total	100.00%

As of the end of 2015.
Source: TDB Annual Report 2015

Globull Investment and Development SCA is wholly owned by US Global Investment LLC ("US Global"), which is a consortium owned by Central Asia Mining LLC and Mr. Erdenebileg Doljin (the current Chairman of the Group). US Global Investment LLC also owns approximately 7.31% of the Group. United Banking Corporation LLC is wholly owned by Mr. Tulga Erdenebileg, son of Mr. Erdenebileg Doljin.

(3) Financial Situation

Assets and Liquidity

TDB significantly increased total assets from MNT 5.4 trillion at the end of 2014 to MNT 6.9 trillion in September 2016. The size of “loans and advances to customers” was MNT 3.2 trillion, 46% in 2016. The share of “investment securities” accounts for 22% and that of “cash and cash equivalents” for 16%.

Table 17: Assets of TDB

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016.9	
	Group	Group	Group	Bank	Bank	Bank	Share
Cash and cash equivalents	475.0	444.8	1,090.2	1,053.8	695.0	1,126.4	16%
Investment securities	346.5	459.2	895.5	938.6	1,412.5	1,498.2	22%
Investment in subsidiaries and associates	0.0	0.0	0.0	0.0	37.8	36.2	1%
Loans and advances (net)	1,123.3	1,533.3	2,530.6	2,777.2	2,645.0	3,161.0	46%
Bills purchased under resale agreements	37.0				99.8	124.2	2%
Subordinated loans	7.0	7.0	7.0	4.0	4.0	4.0	0%
Property and equipment (net)	79.1	131.6	186.7	323.1	195.0	330.1	5%
Intangible assets (net)	0.4	0.6	4.3	1.4	1.2	3.4	0%
Investment property	0.0	0.0	0.0	0.0	99.8	99.8	1%
Foreclosed real properties (net)	0.6	0.2	6.1	1.0	1.4	1.3	0%
Current tax assets	0.0	0.0	0.0	0.0		0.3	0%
Other assets	51.8	123.9	403.7	315.8	331.9	468.4	7%
Total assets	2,120.7	2,700.5	5,124.1	5,414.9	5,523.4	6,853.3	100%

Note: As for data before 2013, only consolidated figures of the group are available. Data after 2014 are figures of the bank.
Source: TDB Annual Report

Liabilities and Equities

The size of liabilities of TDB at the end of 2015 was almost same as the previous year with a increase of issued bonds and a drop in deposits. It increased by 24% during 9 months of 2016 due to increased deposits, borrowings and issued bonds. Customer deposits account for 42.1% of total liabilities as of September 2016. The shares of borrowings and debt securities issued were 23.8% and 24.3% respectively.

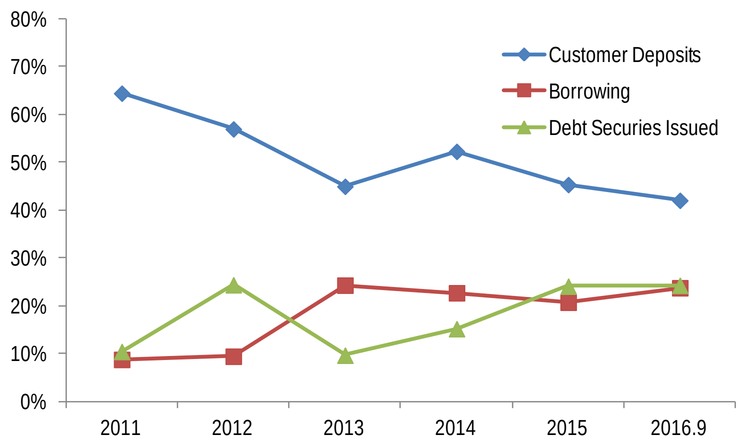
Table 18: Liabilities and Equities of TDB

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016.9	
	Group	Group	Group	Bank	Bank	Bank	Share
Deposits from customers	1,277	1,402	2,140	2,545	2,212	2,548	42.1%
Deposits and placements by banks and other financial institutions	207	38	545	120	113	158	2.6%
Bills sold under repurchase agreements					100	244	4.0%
Borrowings	174	233	1,157	1,107	1,012	1,441	23.8%
Current tax liabilities	2	2	8		4		0.0%
Debt securities issued	207	601	461	741	1,176	1,472	24.3%
Subordinated debt securities issued	42	56	66	75	30	23	0.4%
Other liabilities	73	129	379	278	230	172	2.8%
Total liabilities	**1,981**	**2,461**	**4,755**	**4,867**	**4,876**	**6,058**	100.0%
Share capital	7	17	17	17	50	50	
Share premium	7	19	19	19	19	19	
Treasury shares	-6	-3	-3	-3			
Revaluation reserves	22	44	33	126	134	134	

Accumulated unrealised loss on available-for-sale financial assets					-24	50	
Accumulated unrealised gain on valuation of cash flow hedges					40	64	
Retained earnings	109	162	302	389	428	479	
Non-controlling interests			2				
Total equity	**139**	**240**	**369**	**548**	**647**	**795**	
Total liabilities and equity	**2,121**	**2,700**	**5,124**	**5,415**	**5,523**	**6,853**	

Note: As for data before 2013, only consolidated figures of the group are available. Data after 2014 are figures of the bank.
Source: TDB Annual Report



Note: As for data before 2013, only consolidated figures of the group are available. Data after 2014 are figures of the bank.
Source: TDB Annual Report 2015

Figure 5: Share to Total Liabilities of TDB

Profit and Loss

Net profit after tax in 2013 was MNT193 billion as the whole group. However, the profit of the bank segment has continued to decrease to MNT 89 billion in 2014 and MNT 50 in 2015. The decreasing operating and increasing operating expense were major reasons of the decrease in profitability.

Table 19: Profit and Loss of TDB

Unit: MNT Billion

	2011 Group	2012 Group	2013 Group	2014 Bank	2015 Bank
Interest income	143.5	213.3	321.4	444.5	532.9
Interest expense	-95.4	-137.4	-200.7	-297.4	-359.6
Net interest income	48.1	75.9	120.7	147.1	173.3
Net fee and commission income	12.1	16.4	21.5	26.8	28.8
Other operating income (loss), net	14.3	12.0	68.9	26.1	-19.0
Net non-interest income	26.4	28.4	90.4	52.9	9.8
Operating income	74.5	104.3	211.2	200.1	183.1
Operating expense	-20.1	-32.9	-44.5	-65.8	-84.9
Provision for impairment losses	-3.1	-6.6	-8.3	-44.7	-47.0
Profit before tax	51.4	77.9	158.4	89.6	51.2
Income tax expense	-9.3	-14.8	-19.2	-0.3	-1.1
Net profit for the year	42.1	63.1	139.3	89.3	50.1

Note: As for data before 2013, only consolidated figures of the group are available. Data after 2014 are figures of the bank.
Source: TDB Annual Report

Prudential Ratios

The prudential ratios of TDB satisfy the requirements of BOM. However, the capital adequacy ratio of 15.2% and the tier 1 capital adequacy ratio of 10.2% just barely exceed the requirements.

Table 20: Trend of Prudential Ratios of TDB

	2010	2011	2012	2013	2014	2015	2016.9
Capital Adequacy ratio (>14%)	10.20%	8.18%	9.97%	11.62%	13.00%	16.29%	15.22%
Tier 1 Capital Adequacy ratio (>9%)	16.29%	12.67%	15.12%	15.07%	19.03%	11.95%	10.15%
Liquidity ratio (>25%)	67.00%	41.93%	37.17%	42.26%	41.51%	44.00%	39.44%

Note: As for data before 2013, only consolidated figures of the group are available. Data after 2014 are figures of the bank.
Source: TDB Annual Report

Impaired Loan

The loans categorized as impaired loans have been increasing because of Mongol's economic recession, especially the mining and construction sectors. ratio of non-performing loan was 6.3% at the end of 2015, increased from 1.1% in 2013 and 4.0% in 2014.

Table 21: Situation of Impaired Loans

Unit: MNT Billion

	2013	2014	2015
Carrying amount	2,530.6	2,777.2	2,645.0
Performing	2,494.3	2,559.9	2,343.2
In arrears	27.0	162.5	225.8
Non-performing loans:			
a) Substandard	11.3	78.5	83.3
b) Doubtful	4.3	20.9	76.8
c) Loss	11.7	14.1	13.9
Gross amount	2,548.6	2,835.9	2,743.1
Allowance	-18.0	-58.7	98.1
Net carrying amount	2,530.6	2,777.2	2,645.0

Note: As of the end of year
Source: TDB Annual Report

Loan Collateral

The impaired loans as of the end of 2015 are covered by collateral as shown in the following table.

Table 22: Situation of Impaired Loans

Loan Category	Gross Amount (MNT Billion)	Collateral (MNT Billion)	Coverage (%)
In arrears	225.8	192.6	85.3
Substandard	83.3	61.6	73.9
Doubtful	76.8	38	49.5
Loss	13.9	-	-

Note: As of the end of 2015
Source: TDB Annual Report

(4) Loan Portfolio

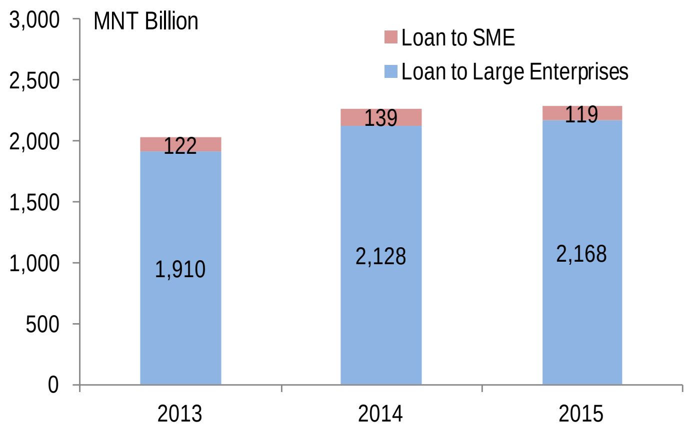
TDB defines it customer segments as follows:

Table 23: Customer Segment of TDB

Segment	Definition
Corporate Banking	Loan amount: Greater than MNT 3 billion, or Borrower's sales amount: Greater than MNT 6 billion
SME Banking	Loan amount: Between MNT 350 million and MNT 3 billion, or Borrower's sales amount: Between MNT 1.5 billion to MNT 6.0 billion
Retail Banking	Loan amount: Less than MNT 350 million, and Borrower's sales amount: Less than MNT 1.5 billion

Note: In addition, there are the investment and international banking segment and the treasury segment.
Source: TDB Annual Report

The characteristic of TDB's lending is a concentration to large enterprises. The size of loans to SMEs is approximately 6% of that of loans to large enterprises.



Source: TDB Annual Report

Figure 6: Breakdown of Loans by Size of Borrower

By sector, the construction, trading and mining sectors account for 50% of total loan outstanding as of the end of 2015.

Table 24: Loan Outstanding of TDB by Sector

Sector	Amount (MNT Billion)	Share (%)
Construction	531.6	20.1
Trading	432.6	16.4
Mining and quarrying	357.4	13.5
Manufacturing	254.6	9.6
Mortgage	249.2	9.4
Hotel, restaurant and tourism	179.3	6.8
Financial services	166.8	6.3
Petrol import and trade	114.9	4.3
Payment card	96.8	3.7
Transportation	62.5	2.4
Health	21.0	0.8
Saving collateralized	20.8	0.8

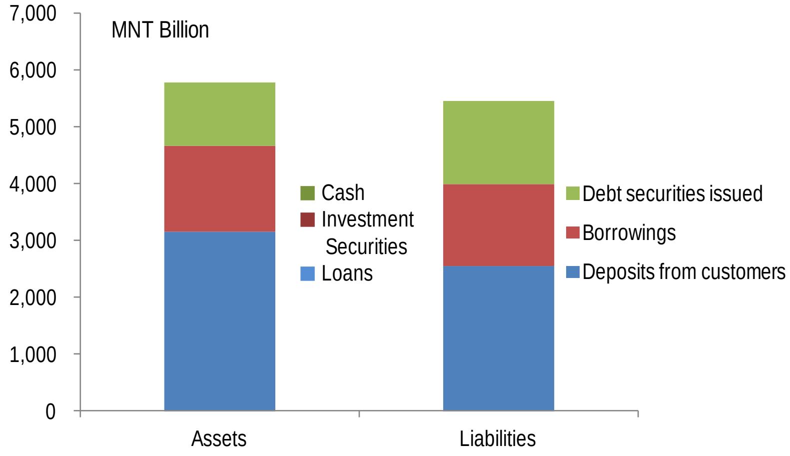
Agriculture	15.0	0.6
Electricity and thermal energy	6.2	0.2
Education	3.2	0.1
Others	133.1	5.0
Total	2,645.0	100.0

Note: As of the end of 2015
Source: TDB Annual Report

TDB has provided a subordinated loan of MNT 4 billion to UB City Bank which bears a fixed interest of 8% per annum and is to be fully repaid in September 2017.

(5) Funding

The size of loans slightly exceeds that of deposits. TDB actively raise funds through borrowing and bond issuance.



Source: TDB Annual Report

Figure 7: Major Items of Assets and Liabilities (As of the end of 2015)

TDB borrows from domestic and international financial institutions. The borrowing from the Development Bank of Mongolia and BOM account for 30% of total. These borrowings are for the provision of program loans for price stabilization, housing development, SME development, etc. The borrowing for JICA TSL through the Ministry of Finance accounts for approximately 2% of total.

Table 25: Borrowings of TDB

Source		Amount (MNT Billion)
1	Cargill Financial Services International, Inc	170.2
2	Development Bank of Mongolia	168.2
3	Mortgage Financing Programme by BOM	132.0
4	TDB Syndicated Facility	78.7
5	Commerzbank AG	62.0
6	Cargill TSF Asia Pte.Ltd	49.5
7	OPEC Fund for International Development	49.2

8	Bank of Mongolia	45.9
9	Sumitomo Mitsui Banking Corporation	45.1
10	SME Fund, Ministry of Industry	39.8
11	Japan International Cooperation Agency	24.1
12	Russian Agricultural Bank	24.0
13	Netherlands Development Finance Company	16.6
14	Export-Import Bank of Korea	14.2
15	Banca Popolare Di Sondrio	13.4
	Other	79.4
Total		1,012.4

Source: TDB Annual Report

TDB issued debt notes on the international capital market in 2007, 2010, 2012 and 2014. Most recently, in MY2015, TDB issued senior unsecured noted of USD 500 million under the Global Medium Term Note Programme guaranteed by BOM at the Singapore Stock Exchange Market.

4. Xac Bank

(1) Outline

Brief History

Xac Bank was established by a merger of the two largest non-bank financial institutions (NBFI) in Mongolia, Goviin Ekhlel LLC and X.A.C LLC in late 2001. Goviin Ekhlel was originally established as an NBFI serving SMEs by Mercy Corps in 1999 with funding from USAID. X.A.C LLC was established as NBFI serving microloans under the Micro Start Mongolia Project under UNDP in 1998. Xac Bank is the flagship subsidy of TenGer Financial Group, which was established as the first holding company in Mongolia in 2001 and initially called as X.A.C.-GE Group. While the bank has expanded its business toward SME and corporate clients as a commercial bank, the bank has continuously worked on microfinance under support of the international financial institutions including IFC and EBRD. The bank, along with Tenger Financial Group, has been also expanding its business coverage both domestically and internationally. For instance, TenGer Financial Group expanded its operation by investing directly to Molbulak Microfinance Institution in Kirgystan.

Scope of Business

Xac Bank provides all services indicated in the Banking Law. It has a strategic policy to promote SME and corporate clients in addition to individuals and micro enterprises. Along with this strategic policy, the bank divided Corporate Banking Division into two divisions in 2012, namely Small and Medium Enterprises (SME) Division and Corporate Clients Division, in order to provide the services fit for each client type.

Branches

The bank has 86 branches in UB and all aimags.

Management

The Executive management is composed of 11 Mongolian and one foreign executives. They are CEO, President of the bank, Chief Retail Banking Officer, Chief Financial Officer, Chief Operation Officer, Chief Credit Officer, Chief Business Development Officer, Chief Human Resource Officer, Chief Security Officer, Chief Investor Relations and Corporate Affair Officer, Chief Counsel and Compliance Officer and Chief Information Officer.

Employees

Xac bank has 1,649 employees of which 1,429 are full-time employees.

(2) Shareholders

Xac Bank is a wholly-owned subsidiary of TenGer Financial Group. TenGer Financial Group has international financial institutions, local and foreign reputable companies, investment funds, non-government organizations and individuals as its shareholders and is currently the only company in the banking and financial sector of Mongolia with such a diverse shareholding structure shown below.

Table 26: Shareholding structure

Owner	Share
Mongolyn Alt /MAK/ Corporation	20.00%
IFC	17.17%
ORIX	16.81%
EBRD	12.91%
National Bank of Canada	10.52%
Ronoc Partners	10.15%
Mongolia Financial Services	6.63%
Triodos Fair Share Fund	3.73%
Open Society Forum	1.59%
UB Rotary Club	0.30%
Bold Magvan	0.10%
Ganbold Chuluun	0.09%
Total	100.00%

Board of Directors has 9 directors and Chairman. Mr. Ganbold Chuluun serves as Chairman on the board since 2003. Besides Chairman, the Board has Executive Director, 5 non-executive directors (three foreigners) and 3 independent non-executive directors (two foreigners).

(3) Financial Situation

Assets and Liquidity

The size of total assets of Xac Bank represents 9% of total banking system assets. The bank significantly increased (68% growth) total assets from MNT 1.1 trillion at the end of 2013 to MNT 1.8 trillion at the end of 2013. Since then, the increase has been slowed down and total assets were MNT 1.9 trillion in 2015.

The share of “loans and advances to customers” was 60.5% in 2015, slightly decreased from 63.4% in 2014, due to the slowdown in the Mongolian economy. The share of “financial investments” increased from 10.6% in 2014 to 20.4% in 2015.

Table 27: Assets of Xac Bank

Unit: MNT Billion

ASSETS	2011	2012	2013	2014	2015
Cash and balances with central bank	114.3	174.5	238.6	187.8	183.9
Due from banks	39.5	142.6	121.8	138.4	99.1
Reverse repurchase agreements	-	3.5	30.0	152.8	10.0
Financial investment	99.3	88.7	345.7	220.8	395.4
Loans and advances to customers	535.9	630.9	1,029.5	1,313.7	1,171.3
Fixed assets	19.1	25.0	29.6	31.2	34.8
Other assets	9.4	11.8	15.3	25.8	38.2
Current income tax prepayment	-	0.7	1.0	2.3	3.4
TOTAL ASSETS	817.5	1,077.7	1,811.5	2,072.8	1,936.1

Source: Xac Bank Annual Reports

Liabilities and Equities

Customer accounts (deposits) account for 50% of total liabilities at the end of 2015, however the size reduced by 20% from 2014. The size of customer accounts has constantly increased and has grown by 143% since 2011. The share of other borrowed funds dramatically increased in 2013 and was same sizes in 2013 and 2014 with customer accounts. But the size lowered in 2015 as shown in Figure 10.5.

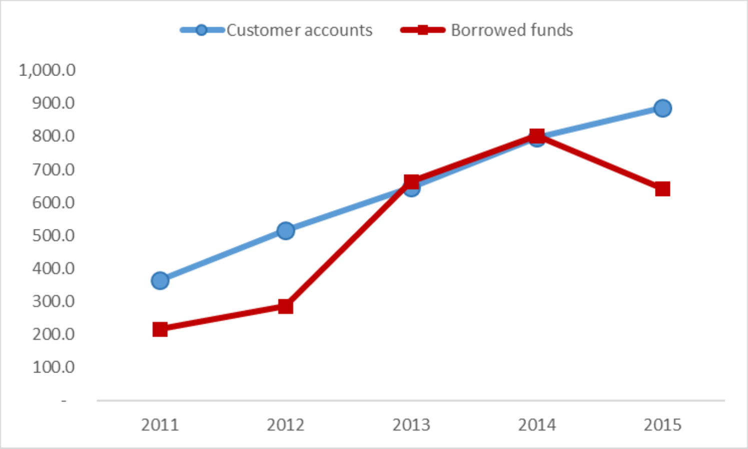
Total equity has shown a steady increasing trend due to favorable retained earnings. Total equity increased from MNT133.9 billion in 2014 to MNT156.3 billion in 2015.

Table 28: Liabilities and Equities of Xac Bank

Unit: MNT Billion

LIABILITIES	2011	2012	2013	2014	2015
Due to banks	62.5	55.9	141.7	34.3	20.7
Repurchase agreements	48.8	63.0	162.4	179.7	100.3
Customer accounts	365.3	516.0	644.5	797.7	886.3
Borrowed funds	217.1	286.1	664.4	803.6	643.2
Subordinated loans	37.0	48.9	58.6	97.8	104.2
Other liabilities	4.3	10.0	17.7	25.8	25.1
TOTAL LIABILITIES	735.0	979.9	1,689.3	1,938.9	1,779.8
EQUITY ATTRIBUTABLE					
Ordinary shares	20.4	20.4	20.4	20.4	55.3
Share premium	35.0	35.0	35.0	35.0	-
Other reserves	10.5	10.5	10.5	10.5	10.5
Retained profits	16.7	32.0	56.3	68.0	90.5
TOTAL EQUITY	82.6	97.8	122.2	133.9	156.3
TOTAL LIABILITIES AND EQUITY	817.6	1,077.7	1,811.5	2,072.8	1,936.1

Source: Xac Bank Annual Report



Source: Xac Bank Annual Report

Figure 8: Share to Total Liabilities

Profit and Loss

Net profit after tax came in 2015 was MNT22.5 billion, a 94% increase over 2014. This growth mainly supported by growth in interest income (16%), net operating income (19%), profit before tax (103%) and decrease in provision for loan impairment (37%). Net trading loss of MNT27.6 billion and net operating loss of MNT11 billion contributed to worsened other operating income. Total operating expenses reduced by 0.9%. At the end of 2015, ROA was 1.2% (0.6% increased from 2014), while ROE was 15.6% which increased by 6.6% from 2014.

Table 29: Profit and Loss of Xac Bank

Unit: MNT Billion

Category	2011	2012	2013	2014	2015
Interest income	93.3	128.0	181	238.5	277.6
Interest expense	(48.0)	(68.0)	(100.3)	(141.1)	(145.2)
Net Interest Income	45.3	60.0	80.7	97.4	132.4
Fees and commission income	1.6	3.2	5.8	7.7	8.5
Fees and commission expense	(0.5)	(0.6)	(0.8)	(1.0)	(1.5)
Net fees and commission income	1.1	2.7	5.0	6.7	7.0
Other operating income	1.9	2.8	6.7	(7.8)	(38.6)
Total operating income	48.2	65.5	92.4	96.3	100.8
Provision for loan impairment	(2.6)	(2.4)	(9.7)	(29.9)	(21.8)
Net operating income	45.6	63.0	82.7	66.4	79.0
Total operating expenses	(30.6)	(44.1)	(54.1)	(55.1)	(54.6)
Amortisation of deferred grants	1.1	1.3	1.3	0.9	0.4
Profit before tax	16.1	20.2	29.9	12.2	24.8
Income tax expense	(4.0)	(4.9)	(5.5)	(0.6)	(2.3)
Profit for the period	12.1	15.2	24.4	11.6	22.5

Source: Xac Bank Annual Reports

Prudential Ratios

The prudential ratios of Xac Bank are much higher than the minimum requirements. The capital adequacy ratio was 20.6% in 2015 against the minimum prudential requirement of 14%. This ratio has been increased in 2014. The liquidity ratio in 2015 was 38.7%, a slight incrase from 2014. Loan to deposit ratio improved by 19% due to increased customer account and reduced loans and advance. However, NPL ratio worsened in 2015 reached 6.1% which is increased by 65% from 2014. Single borrower and related party exposures were still under BOM requirements.

Table 30: Trend of Prudential Ratios of Xac Bank

Unit: Percentage

Prudential ratios	2011	2012	2013	2014	2015
Captal adequacy ratio >14%	20.8	20.4	16.2	17	20.6
Liquidity ratio >25%			43.8	37.2	38.7
Loan to deposit	146.7	122.3	164	171.5	139
NPL ratio	1.2	1.3	1.4	3.7	6.1
Single borrower exposure <20%	4.7	7.1	12.4	11.2	10.6
Related party loan exposure			8.2	10.7	10.3

Source: Xac Bank Annual Reports

Impaired Loan

Provisions for loan impairment calculated for 6 loan products: SME, mortgage, micro business, consumer, financial lease and others. The share of SME loans was the biggest (72%) followed by micro business (11%). Xac bank actively worked to recover impaired loans for each category and MNT 26.9 billion loans were recovered in 2015 which was 4 times higher than of 2014. Loans changed to impairment in 2015 increased by 36% reaching MNT 47.5 billion. Total provision for loan impairment by the end of 2015 increased by 42% and amounted for MNT 68.2 billion which was 5.6% of total loan and advances to customers.

Table 31: Loan impairments of 2014 and 2015

Unit: MNT thousands

In thousands of MNT	SME	Mortgage	Micro business	Consumer	Financial lease	Others	Total
Provision for loan impairment at 1 January 2014	15,841,586	651,405	812,787	880,065	204,249	78,824	18,468,916
(Recovery of)/provision for impairment during the year	(4,071,429)	(272,173)	(317,716)	(411,597)	(67,368)	(32,227)	(5,172,510)
Change for the year	28,844,157	1,176,711	2,312,248	1,407,654	374,401	833,836	34,949,007
Amounts written off during the year as uncollectible	(2)	(11,222)	(56,162)	(39,859)	(5,710)	(11,210)	(124,165)
Provision for loan impairment at 31 December 2014	40,614,312	1,544,721	2,751,157	1,836,263	505,572	869,223	48,121,248
Provision for loan impairment at 1 January 2015	40,614,312	1,544,721	2,751,157	1,836,263	505,572	869,223	48,121,248
(Recovery of)/provision for impairment during the year	(23,646,704)	(517,349)	(1,128,654)	(662,796)	(166,287)	(780,795)	(26,902,585)
Change for the year	32,300,072	3,171,942	6,222,174	3,077,165	687,461	2,025,115	47,483,929
Amounts written off during the year as uncollectible	(128,171)	(16,048)	(143,612)	(144,669)	(97,536)	(1,280)	(531,316)
Provision for loan impairment at 31 December 2015	49,139,509	4,183,266	7,701,065	4,105,963	929,210	2,112,263	68,171,276

Source: Xac Bank Annual Report

Loan Collateral

The amount and type of collateral required depends on the assessment of the credit risk of the borrower or counter party and the type of loan granted. Xac bank follows the collateral guidelines set by the Credit Management Committee in determining the type and value of collateral to be obtained. The main types of collateral obtained are as follows:

(i) For small business, consumer, agricultural, SME and employee loans -cash, guarantees, securities and real estate properties, chattels, inventory, etc.
(ii) For mortgage loans -mortgages on residential properties and vehicles.
(iii) For wholesale loans -cash, equities and real estate properties.
(iv) For deposit backed loans -cash deposit.

The Bank performs physical inspection of the collateral and regularly monitors the market value of collateral, requests additional collateral in accordance with underlying agreement, and monitors the market value of collateral obtained during its review of adequacy of the allowance for impairment losses.

Of the total aggregate amount of gross past due but not impaired loans and advances to customers, the fair value of collateral that the Bank held as at 31 December 2015 was MNT 226,1 million (2014: MNT 155 million).

(4) Loan Portfolio

In terms of sectoral distribution, trade loans accounted for 24%, manufacturing 18%, mortgage 14% followed by service sector loans 12% in 2015. Compared with 2014, major growths occurred for agricultural loans (39%), loans to staff (64%) and deposit backed (19%). All other sectoral loans declined: construction, loans to key management and other loans decreased by 36%; mortgage by 19%; mining by 17%; and consumption by 16%. Consequently, total loans reduced by 9% in 2015.

Table 32: Breakdown of Lending by Sector

Unit: MNT thousand

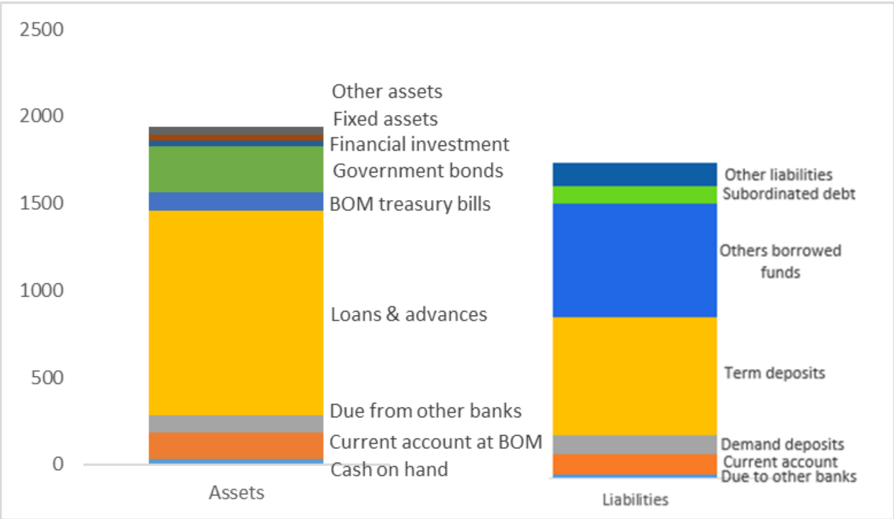
Sectors	2014		2015	
	Amount	Share	Amount	Share
Manufacturing	215,311,310	16%	227,271,619	18%
Mining & Exploration	17,134,711	1%	14,285,039	1%
Construction	99,753,180	7%	63,909,196	5%
Trade - Whole & Retail	312,112,759	23%	297,764,750	24%
Deposit backed	82,380,202	6%	100,426,394	8%
Mortgage	220,233,804	16%	177,307,450	14%
Agriculture	21,831,129	2%	30,358,547	2%
Consumption	134,270,861	10%	112,569,112	9%
Loan to staff	12,989,060	1%	21,331,556	2%
Loans to key management	2,018,373	0%	1,298,699	0%
Service	174,132,449	13%	148,466,128	12%
Other	69,651,066	5%	44,472,092	4%
Total loans	1,361,818,904	100%	1,239,460,582	100%

Source: Xac Bank Annual Report

(5) Funding

Current account and deposits accounted for 50%, including current accounts of 6%, demand deposits of 6% and term deposits of 38%. In addition to current accounts and deposits, borrowed funds have become an important source for lending. The size of borrowed funds was MNT 643.2 billion (36%) at the end of 2015, a decrease of 20% from the previous year.

The borrowed fund consists of borrowing from foreign financial institutions 69.2%, borrowing from government organization 30.1% and other company 7.1%. Borrowing from MOF for JICA's TSL account for 6.1% of Xac Bank's borrowing from government organizations



Source: Xac Bank Annual Report

Figure 9: Major Items of Assets and Liabilities (As of the end of 2015)

Xac Bank borrows from development financial institutions such as EBRD, FMO, ADB, OFID, Microfinance Enhance Facility S.A., SICAV-SIF, Global Climate Partnership Fund, Development Bank of Austria, Micro, Small and Medium Enterprises Bonds SA and others.

Xac Bank also borrows funds from the government organizations to provide policy loans as follows:

<u>Bank of Mongolia loans</u>

(i) Strategic Import Financing Schema (SIFS), Food Price Stabilizaton (FPS), and Construction sector support and apartment price stabilization, and mortgage programs.

(ii) Bank of Mongolia, Term Loan III

<u>Ministry of Food, Agriculture and Light Industry</u>

(i) Small Medium Enterprise Investment Fund

(ii) Small Medium Enterprise Development Fund /Wool & Cashmere loan

<u>Ministry of Finance and others</u>

(i) Two step loan project for SME development and environmental protection financed by JICA

(ii) Agriculture and Rural Development Project (ADB)

(iii) Employment Creation Support Fund

(iv) Rural Poverty Reduction Program (International Federations Agricultural Development)

(v) Micro Finance Development Fund

5. Capitron Bank

(1) Outline

Brief History

Capitron Bank was established in 2001 and merged successfully with the Inter Bank of Mongolia in 2006.

Scope of Business

Capitron Bank provides most financial services indicated in the Banking law. In addition to a full range of loan and deposit products, foreign exchange, trade finance, cash management, and international payment services to its commercial customers, including SMEs, corporate and individuals.

Branches

Capitron Bank has 31 branches in economically developed regions, such as Ulaanbaatar, Darkhan and Erdenet cities, and Selenge, Bayan-Ulgii, Dornogobi and Umnugobi aimags.

Management

Board of Directors consists of 5 directors including chairman.

Employees

The bank has 270 full-time employees.

(2) Shareholders

This bank is owned by three Mongolians: D. Erdenerbayar (holding 44.4% shares), Bat-Erdene (17.2%), P. Munkhsaikhan (17.8%) and Capitron Bank Ltd (20.67%). The bank has 7 departments (Asset management, Risk management, Corporate banking, Consumer banking, Financial management and monitoring, Operation, Administration) and 2 divisions (Business development and IT) under the CEO, First Deputy of CEO and Deputy of CEO.

(3) Financial Situation

Assets and Liquidity

The bank's assets at year-end totaled MNT 181.8 billion, and representing 0.8 percent of aggregate banking sector assets. Between 2011 and 2015, total assets grown by 47%, but highest amount was in 2013 where total assets reached MNT 204.4 billion.

Table 33: Assets of Capitron Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Balance Sheet					
Cash and cash equiv.	16.5	18.1	41.2	36.0	29.1
Short-term liquid assets	11.0	18.8	30.3	7.9	29.4
Loans and advances (net)	69.7	63.6	109.9	118.9	89.2
Other assets	26.7	20.4	23.0	21.3	34.1
Total assets	123.9	120.9	204.4	184.1	181.8

Source: Capitron Bank Annual Reports

In terms of asset composition, Loans and advances (net) accounted the biggest portion of 49% of total assets, followed by other assets (19%). Both Cash and cash equivalent and Short-term liquid assets accounted for 16% of total assets. In 2013, loans increased by 73% and then 8% growth in 2014 and then reduced by 25% in 2015.

Liabilities and Equities

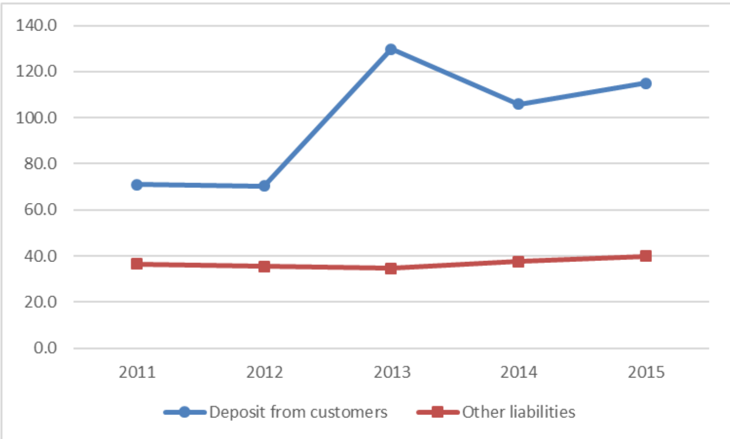
Deposit from customers comprised 70% of total liabilities at the end of 2015. Year 2013 had the highest deposit and liabilities. Although deposit from customers, other liabilities and share capital slightly increased in 2015, loss (negative retained earnings) was the highest in 2015.

Table 34: Liabilities and Equity of Capitron Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Deposit from customers	70.9	70.3	129.7	105.8	115.0
Due to banks & Fis	4.5	0.5	19.0	19.3	9.0
Other liabilities	36.6	35.4	34.6	37.6	39.9
Total liabilities	112.0	106.2	183.3	162.7	163.9
Share capital	8.0	8.0	16.0	20.5	30.0
Other reserves	3.3	5.2	5.2	2.8	2.8
Retained earnings	0.6	1.5	-0.1	-2.0	-14.8
Total equity	11.9	14.7	21.1	21.3	18.0
Total liab. & equity	123.9	120.9	204.4	184.0	181.9

Source: Capitron Bank Annual Reports



Source: Capitron Bank Annual Reports

Figure 10: Share to Total Liabilities

Profit and Loss

Net profits after tax in 2014 and 2015 was negative. Loss increased by 42% and reached MNT 2.6 billion. This loss mainly caused by increase in interest expense (11%), allowance for impairment losses (8 times increase) and net operating expenses (53%). At the end of 2015, ROA was negative 1.5% (worsened by 43% from 2014), while ROE was negative 15% which deteriorated by 68% from 2014.

Table 35: Profit and loss of Capitron bank

Category	2011	2012	2013	2014	2015
Interest income	11.6	9.4	14.6	18.9	20.1
Interest expense	(8.4)	(9.4)	(10.7)	(13.9)	(15.4)
Net Interest Income	3.2	(0.02)	3.9	5.0	4.7
Total non-interest income	1.0	1.2	2.9	1.9	3.6
Net operating income	4.2	1.2	6.8	6.9	8.3
Total operating expenses	(3.4)	(4.3)	(7.2)	(7.9)	(8.3)
Profit before allowances for impairment losses	0.8	(3.1)	(0.4)	(1.0)	(0.1)
Allowances for impairment losses	(1.0)	2.4	0.0	(1.2)	(11.1)
Operating profit	(0.2)	(0.7)	(0.4)	(2.3)	(11.2)
Non-profit income	1.1	3.8	2.2	0.4	8.5
Non-operating expenses	(0.3)	(0.3)	(0.4)	(0.2)	(0.3)
Profit before tax	0.6	2.8	1.3	-2.0	-3.0
Income tax expense	(0.01)	(0.3)	(0.1)	0.1	0.4
Profit for the period	0.6	2.5	1.3	-1.9	-2.6

Source: Capitron Bank Annual Reports

Prudential Ratios

Not all prudential ratio information is available from Capitron bank annual reports. The bank constantly meets the BOM requirements on capital adequacy ratio and liquidity ratio. Compares with some banks, Capitron bank loan to deposit ratio was relatively low until 2014. By 2015, loan to deposit ratio was 103%. NPL ratio has a warning sign as non-performing loan was critically increased in 2015. NPL increased by 81% in 2015.

Table 36: Prudential ratios of Capitron bank

Prudential ratios	2011	2012	2013	2014	2015
Captal adequacy ratio >14%	12.0%	17.2%	17.1%	15.9%	16.1%
Liquidity ratio >25%	28.9%	34.8%	37.7%	31.8%	37.4%
Loan to deposit	98%	90%	85%	112%	103%
NPL ratio	10.9%	9.6%	7.6%	7.4%	13.4%

Source: Capitron Bank Annual Reports

Impaired Loan

The quality of loan was quickly deteriorating in last 2 years. By the end of 2015, provision for loan impairment increased by 100.2% than 2014. Although provision was significantly reduced in 2015 50 MNT 46.7 billion, amounts written of during the year hugely increased to negative MNT 37.2 billion.

Table 37: Loan impairments of 2014 and 2015

Unit: MNT thousands

In thousands of MNT	Loan	In thousands of MNT	Loan
Provision for loan impairment at 1 January 2014	8,958,202	Provision for loan impairment at 1 January 2015	9,503,232
(Recovery of)/provision for impairment during the year	552,084	(Recovery of)/provision for impairment during the year	46,680,411
Amounts written off during the year as uncollectible	(7,054)	Amounts written off during the year as uncollectible	(37,160,978)
Provision for loan impairment at 31 December 2014	9,503,232	Provision for loan impairment at 31 December 2015	19,022,665

Source: Capitron Bank Annual Report

(4) Loan Portfolio

In terms of sectoral distribution, real estate accounted for 17%, manufacturing 16%, consumption 15% followed by construction sector loans 14% in 2015. Compared with 2014, major growths occurred for construction (58%) and health and education sector loans (24%), while biggest decrease experienced in mining (-61%), manufacturing (-39%), trade (-26%) and agriculture (-25%). Consequently, total loans outstanding reduced by 16% in 2015.

Table 38: Breakdown of Lending by Sector

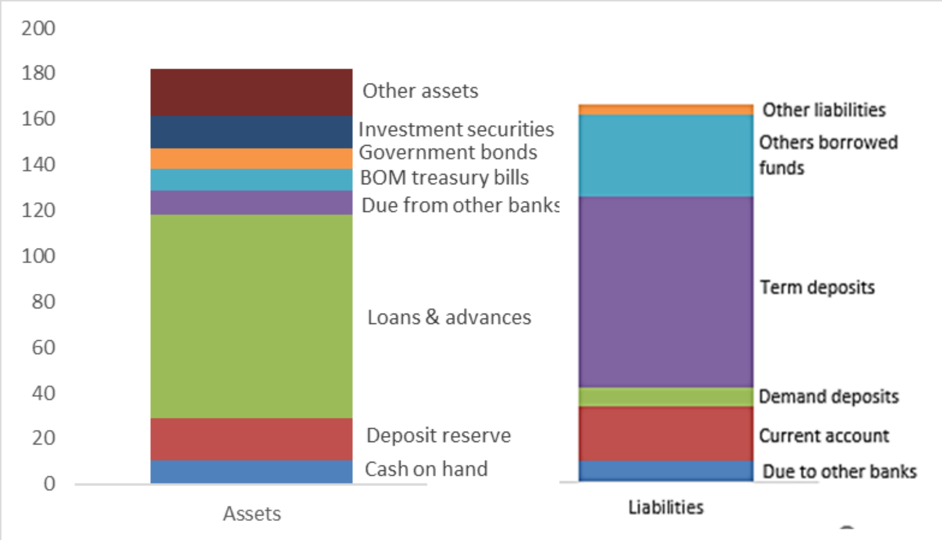
Unit: MNT million

Sectors	2014		2015	
	Amount	Share	Amount	Share
Manufacturing	28,259	22%	17,247	16%
Mining & Exploration	8,263	6%	3,224	3%
Construction	9,325	7%	14,748	14%
Electricity & water supply	3,518	3%	3,678	3%
Trade - Whole & Retail	18,081	14%	13,300	12%
Real estate	19,424	15%	18,509	17%
Agriculture	11,046	9%	8,320	8%
Transport	2,620	2%	2,586	2%
Health, education	1,739	1%	2,157	2%
Mortgage	2,665	2%	2,338	2%
Consumption	16,821	13%	16,624	15%
Service	4,959	4%	4,032	4%
Other	1,641	1%	1,450	1%
Total loans	128,361	100%	108,213	100%

Source: Capitron Bank Annual Reports

(5) Funding

Current account and deposits are main part of liabilities accounting for 70% of total liabilities. Among them, term deposits hold 51% of total liabilities in 2015. The amount of current account and deposits increased by 9% compared with 2014. In addition to deposits, borrowed funds have become an important source for lending with size of MNT 35.9 billion (22% of total liabilities).



Source: Capitron Bank Annual Report

Figure 11: Major Items of Assets and Liabilities (As of the end of 2015), in MNT Billion

Capitron bank borrows funds from the government organizations to provide policy loans such as BOM, Ministry of Finance, TSL, SME Development Fund, Mongolian Ipotek Corporation and Development Bank of Mongolia. JICA TSL loan accounted for 40% of others borrowed funds.

6. Capital Bank

(1) Outline

Brief History

The Industrial Shareholding Bank was established in 1990 by 16 state and private factories, business entities and was renamed to the Innovation Bank in 1998. In February 2003, the name of bank was changed to Capital Bank.

Scope of Business

Capital Bank extends banking service to 500.0000 corporate and individual customers. Capital Bank aims to become a leading SME bank in Mongolia. The vision of Capital Bank is “To be nature-friendly “Green E-Bank” that supports small and medium sized enterprises.”

Branches

Capital Bank have totally 90 branches and settlement centers (39 branches and settlement centers in Ulaanbaatar and 51 branches and settlement centers in rural areas) as of the end of 2015.

Management

Under the Board, there is the Chief Executive Officer (CEO), 2 Deputy CEOs, and 11 departments. The chairman of the board is Mr. Batbayar Tuguu, and CEO is Mr. Ariunbold Agvaanjamba. The operational departments are the Branch Management Department, Corporate Banking Department, SME Department, and Business Development Department.

Employees

At the end 2015, the number of staff of Capital Bank was 634, increased from 535 in 2014.

(2) Shareholders

The shareholders of Capital Bank are Bishrelt Holding LLC (99.9%) and Tavan Bogd LLC (0.1%). The Brishrelt Holding is one of the largest groups in Mongolia with 14 subsidiary companies in trade and service sectors.

(3) Financial Situation

Assets and Liquidity

Capital Bank decreased total assets from MNT 817 billion at the end of 2014 to MNT 746 billion in 2015. Capital Bank significantly increased the outstanding of loans and advances; on the contrary, it decreased cash/balances with the central bank and financial investments to be held until maturity during the same period.

Table 39: Assets of Capital Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Cash and balances with the central bank	39.8	34.3	77.7	78.0	29.6
Due from banks	7.4	23.7	33.7	67.1	4.0
Derivative financial instrument		35.7	12.8	16.6	
Financial investments – available-for-sale	0.8	0.8	18.6	9.7	26.8
Financial investments – held-to-maturity	27.3	8.1	57.9	99.1	22.8
Investment in an associate	0.0	0.0		0.5	0.5
Loans and advances to customers	124.4	198.1	311.0	490.8	544.8
Property, plant and equipment	9.3	18.9	31.8	49.4	64.8
Intangible assets	3.3	3.1	2.4	2.0	7.6
Other assets	2.5	2.8	2.8	2.5	30.7
Assets held for sale	5.7		6.3	1.7	14.2
Prepaid tax	0.0	0.1	0.1	0.0	0.0
Deferred tax asset		0.1	0.0	0.0	0.0
Total assets	220.5	325.6	554.9	817.4	745.6

Source: Capital Bank Annual Report

Liabilities and Equities

Total equity has been steadily increasing because of generation of profit every year. Total liabilities decreased by 11% to MNT 662 billion in 2015. Deposits and borrowing stayed stable but due to banks drastically dropped from MNT 131 billion at the end of 2014 to MNT 32 billion in the next year. Customer deposits account for 52% of total liabilities and borrowing for 40% as of the end of 2015.

Table 40: Liabilities and Equities of Capital Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Due to banks	11.4	50.9	74.6	130.8	31.9
Repurchase agreements	12.9	7.6		39.3	8.8
Due to customers	112.7	114.4	226.2	325.0	346.6

Borrowed funds	64.0	92.3	208.7	250.0	262.5
Derivative financial instrument		34.3	2.3		0.0
Other liabilities	2.1	2.2	1.7	1.4	10.8
Corporate income tax payable	0.0	0.0	0.0	0.5	0.1
Deferred tax liability	0.0		0.4	0.9	1.6
Total Liabilities	203.2	301.7	513.9	747.9	662.3
Ordinary shares	16.0	22.0	33.0	33.0	53.0
Other components of equity	0.1	0.4	4.4	23.1	15.9
Retained profits	1.2	1.6	3.7	13.5	14.4
Total Equity	17.2	23.9	41.0	69.6	83.3
Total Liabilities and Equity	220.5	325.6	554.9	817.4	745.6

Source: Capital Bank Annual Report

Profit and Loss

Total operating income of Capital Bank was decreased by 22% to MNT 26.8 billion in 2015. The main reason was an increase of interest expenses which were much more than that of interest income. Net operating income was MNT 22.3 billion after credit loss expenses of MNT 4.5 billion. As a result, profit after tax in 2015 decreased by 90% from the previous year to MNT 0.9 billion.

Table 41 Profit and Loss of Capital Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Interest and similar income	15.8	28.0	35.7	71.1	76.6
Interest and similar expenses	-12.5	-21.7	-27.8	-47.8	-60.4
Net interest income	3.3	6.2	8.0	23.3	16.2
Fees and commission income	1.4	1.3	1.2	2.1	2.8
Fees and commission expenses	-0.1	-0.2	-0.3	-0.2	-0.2
Net fees and commission income	1.3	1.1	0.9	1.9	2.7
Net trading income	0.5	2.4	11.9	9.1	7.8
Other income	0.2	0.7	0.0		0.2
Total operating income	5.3	10.5	20.8	34.3	26.8
Credit loss expense	-0.1	-1.5	-0.0	-4.4	-4.5
Net operating income	5.2	8.3	20.8	29.9	22.3
Operating expenses	-5.0	-7.6	-17.9	-18.5	-21.0
Non-operating expense	0.0	0.0	0.0		-0.3
Share of loss in an associate	0.0	0.0		-0.0	-0.0
Profit before tax	0.2	0.7	2.8	11.3	1.0
Income tax expense	-0.0	0.0	-0.1	-2.4	-0.1
Profit after tax	0.2	0.7	2.7	8.9	0.9

Source: Capital Bank Annual Report

Prudential Ratios

The recent figures of prudential ratios of Capital Bank are not available in the disclosure information of the bank.

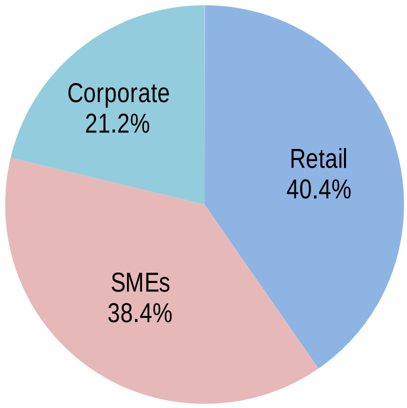
Table 42: Trend of Prudential Ratios of Capital Bank

	2010	2011	2012	2013	2014	2015
Capital Adequacy ratio (>14%)	17.43%	14.81%	13.44%	14.33%	16.00%	N.A.
Tier 1 ratio (>9%)	17.39%	14.77%	13.41%	14.31%	N.A.	N.A.
Liquidity ratio (>25%)			25.20%	35.08%	33.30%	N.A.
			4.24%	2.59%	N.A.	N.A.

Source: Capital Bank Annual Report

(4) Loan Portfolio

Total loan portfolio of Capital Bank is comprised of 40.35% to retail, 38.43% to SMEs, 31.22% to corporate bank customers.



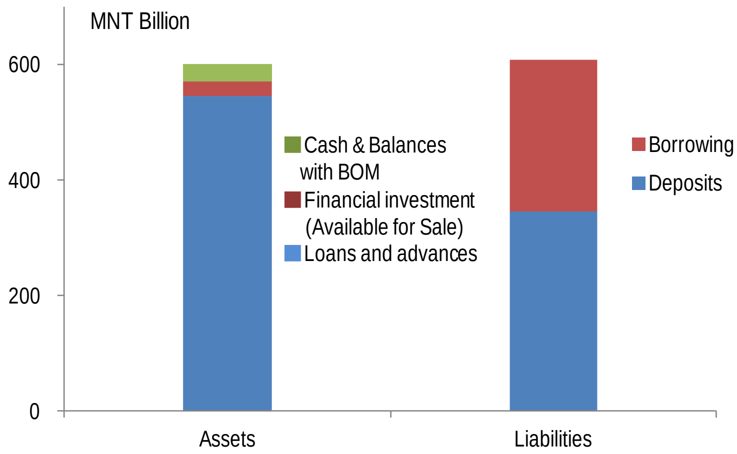
Note: As of the end of 2015
Source: Capital Bank Annual Report

Figure 12: Loan Portfolio of Capital Bank

The information of non-performing loan ratio and collateral is not available in the disclosure information of Capital Bank.

(5) Funding

As the following figure shows, both deposits and borrowings loans and advances are important source of loans and advances of Captital Bank



Note: As of the end of 2015
Source: TDB Annual Report

Figure 13: Major Items of Assets and Liabilities of Capital Bank

Capital Bank provides various loans with the funds from the government through SME Development Fund, the Development Bank of Mongolia and other funds, and international financial institutions such as World Bank, JICA, IFAD, etc.

7. Ulaanbaatar City Bank

(1) Outline

Brief History

The Ulaanbaatar City Bank (UB City Bank) was established by the Ulaanbaatar Fund Public Enterprise in 1998.

Scope of Business

As a commercial bank, UB City Bank provides a broad range of banking and financial services to individual and corporate clients.

Branches

The number of branches and units was 29 in 2015.

Management

The Board of Directors of Ulaanbaatar City Bank consists of the Chairman, Mr. D.Batjargal (Chairman), and other four directors. Under the CEO, Ms. Ms A.Enkhmend, there are 7 departments, 6 divisions and 2 units in addition to 3 committees.

Employees

As of end of 2014, UB City Bank employed 352 employees, 45% of which work at the Headquarters and the rest at branches and settlements.

(2) Shareholders

The owner of UB City Bank is Mr. Doljin Erdenebileg who is the chairman of TDB.

Table 43: Shareholders of UB City Bank

Ownership	Share
D.Erdenebileg	99.99%
D.Batjargal	0.01%
Total	100.00%

Source: UB Bank Website (http://www.ubcbank.mn/)

(3) Financial Situation

Assets and Liquidity

The total assets of UB City Bank decreased by 14% during the first 9 months in 2016. The typical changes in recent years are an increase in “balances with BOM” and decreases in “loans and advances” and “bills and securities”, and “deposits with other banks.” The loans and advances account for only 47%, less than half of total assets as of September 2016.

Table 44: Assets of UB City Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016.6
Cash in hand	3.4	6.7	9.1	8.8	8.7	12.1

Balances with BOM	64.5	42.4	140.5	215.6	255.6	318.9
Demand and time deposits with other bank and financial institutions	25.0	37.2	177.8	67.5	57.9	23.2
Bills and Securities	60.5	27.8		230.0	133.0	19.6
Loans and advances	280.9	286.5	543.7	645.8	612.0	580.7
Other real estate owned						0.1
Fixed Assets	7.8	14.4	33.8	39.8	46.6	40.8
Intangible assets	0.4	0.6	0.6	0.7	0.7	0.9
Long term investment	9.7	58.2	288.5	244.6	173.2	195.2
Other assets	4.7	58.6	20.1	19.0	156.9	48.1
Total asset	456.9	532.3	1,214.1	1,471.8	1,444.6	1,239.5

Source: UB City Bank Annual Report

Liabilities and Equities

Customer deposits account for 66% of total liabilities as of September 2016. During the first 9 months in 2016, customer deposits increased by MNT 96 billion. On the contrary, liabilities to other banks and bills sold under repurchase agreements decreased by MNT 150 billion and MNT 131 billion respectively in the same period.

Table 45: Liabilities and Equities of UB City Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015	2016.6
Current/Deposit accounts from customers	257.9	206.5	477.8	701.5	657.4	753.3
Liabilities to other bank and financial institutions			568.2	186.6	343.8	193.5
Bills sold under repurchase agreements			54.0	152.5	130.6	
Other sources payable	49.7	44.6	40.7	333.6	70.1	151.2
Subordinated debt		4.0	4.0	4.0	4.0	0.0
Other liabilities	7.8	66.2	17.2	22.9	157.9	44.4
Total liabilities	422.2	495.7	1,161.8	1,401.1	1,364.1	1,142.4
Share capital	8.0	8.0	16.0	16.0	40.0	45.0
Revaluation surplus	6.2	7.3	9.7	11.3	12.0	14.3
Retained earnings	16.5	21.4	26.6	43.4	28.4	33.8
Social development fund	0.0	0.0	0.0	0.0	0.0	0.0
Subordinated debt securities issued	4.0				4.0	4.0
Total capital	34.7	36.6	52.3	70.8	80.5	97.1
Total Liabilities and Capital	456.9	532.3	1,214.1	1,471.8	1,444.6	1,239.5

Source: UB City Bank Annual Report

Profit and Loss

Net profit after tax in 2015 was MNT9.1 billion, a 46% decrease compared with 2014. The net interes income and net operating income increased by 25% and 37% respectively. However, the provision for loan losses of MNT 17.9 billion deteriorated the profit before tax.

Table 46: Profit and Loss of UB City Bank

Unit: MNT Billion

	2011	**2012**	**2013**	**2014**	**2015**
Interest income	31.5	37.4	74.6	117.1	134.8
Interest expense	-19.6	-23.1	-43.0	-82.1	-90.9
Net interest income	11.9	14.3	31.7	35.0	43.9

Operating profit (loss)	-0.2	-1.7	-2.9	-9.8	-7.9
Foreign exchange trading net gain (loss)	2.7	1.6	0.4	-1.8	4.5
Service fees and commissions	1.2	1.2	2.5	3.5	2.8
Other income	1.7	0.0	0.0	5.4	10.1
Net non-interest income (expense)	5.8	4.6	0.1	-2.7	0.5
Net operating income	17.7	18.9	31.7	32.3	44.4
Operating expense	-4.4	-5.6	-9.0	-14.3	-16.4
Profit before Provision for loan losses	13.2	13.4	22.8	18.1	28.0
Provision for loan losses	-1.5	-8.6	-10.1	-3.0	-17.9
Operating profit from principal activities	11.8	4.7	12.7	15.1	10.1
Non operating income	0.0	0.2	0.8	1.8	0.8
Non operating expense	-0.2	-0.1	-0.1	-0.1	-0.2
Profit before tax	11.6	4.8	13.4	16.8	9.1
Income tax expense	-2.0	-0.1	0.0	0.0	0.0
Net Profit after Tax	9.6	4.7	13.4	16.8	9.1

Source: UB City Bank Annual Report

Prudential Ratios

The prudential ratios of UB City Bank sufficiently satisfy the requirements of BOM. However, all the indicators, i.e., capital adequacy ratio, tier 1 capital adequacy ratio and liquidity ration, have tended to decrease in recent years.

Table 47: Trend of Prudential Ratios of TDB

	2014	2015	2016.9
Capital Adequacy ratio (>14%)	18.80%	16.60%	15.58%
Tier 1 ratio (>9%)	15.00%	13.50%	12.68%
Liquidity ratio (>25%)	60.00%	49.20%	44.20%

Source: UB City Bank Annual Report

Impaired Loan and Collateral

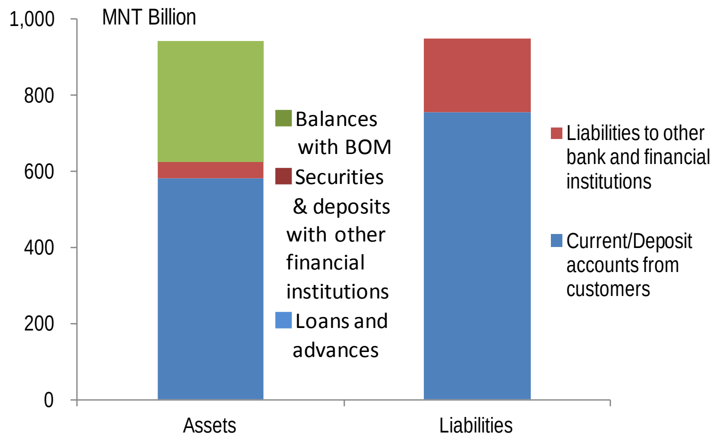
The non-performing loan ration of UB City Bank was 1% at the end of 2015. However, the ratio increased to 1.97% as of the end of August 2016. The information of collateral of UB City Bank is not available in the disclosure information provided by the bank.

(4) Loan Portfolio

The loan portfolio of UB City Bank is 31% for business loan, 40% for mortgages loan, and 29% for consumer loan as of the end of 2015.

(5) Funding

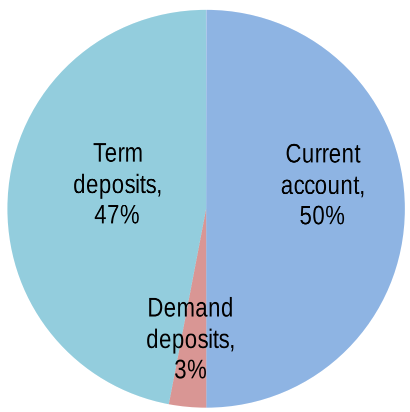
As shown in the following figure, the size of deposits exceeds that of loans and advances. The major source of funding for loans is deposits from customers at UB City Bank.



Note: As of the end of September 2016
Source: UB City Bank Annual Report

Figure 14: Major Items of Assets and Liabilities of UB City Bank

The composition of deposits is as shown in the following figure.



Note: As of the end of 2015
Source: UB City Bank Annual Report

Figure 15: Breakdown of Deposits of UB City Bank

In addition to ordinary business loans, UB City Bank provides program loans for 10 programs with the funds of the Mongolian government, Central Bank of Mongolia, and Development bank of Mongolia.

8. State Bank

(1) Outline

Brief History

State Bank is a state-owned commercial bank in Mongolia licensed by the central bank (BOM). It is a limited liability company as well, and therefore, is subject to both the Banking Law and Company Law like other commercial banks in Mongolia.

State Bank was established as a state-owned bank in 2009. The background of the establishment was the continuous bankruptcy of Anod Bank (the fourth largest bank in Mongolia at that time) and Zoos Bank in 2008. In order to manage the assets and liabilities of these two failed banks, GOM established a new state-owned bank (State Bank) to succeed the assets of the two failed banks with additional financial support from GOM in 2009. In July 2013, State Bank also merged another failed bank, Savings Bank.

<u>Scope of Business</u>

State Bank provides a wide range of financial services. In addition to a full range of loan and deposit products, foreign exchange, trade finance, cash management, and international payment services to its commercial customers, including SMEs, corporate, and international institutions. The bank is the main bank for public sector organizations, social insurance and social welfare allowance disbursements. Therefore, most people have current accounts in State Bank.

<u>Branches</u>

State Bank has 540 branches, of which 86 branches in UB city and 454 branches in all rural areas.

<u>Management</u>

Board of Directors has 9 members including Chiarman, six members from Cabinet Secretariat, 3 members from Ministry of Finance, Ministry of Justice, State Property Committee and two independent members.

Management team consists of General director, First deputy general director, 2 Deputy general director, Chief financial officer, Chief operations officer, Chief production development officer, Chief business operations officer, Chief corporate affairs & Treasury officer and 16 departments.

<u>Employees</u>

The Bank has 3,800 staff serving for 2.7 million customers.

(2) Shareholders

State Bank is a fully state-owned commercial bank in Mongolia.

(3) Financial Situation

<u>Assets and Liquidity</u>

The size of total assets of State Bank represents 7.9% of total banking system assets. State Bank significantly increased total assets from MNT 57.6 billion at the end of 2012 to MNT 331.9 billion at the end of 2013. Since then, the increase has been slowed down and total assets were MNT 1.7 billion in 2015.

The share of “loans and advances to customers” was 54% in 2015. It reduced by 14% of 2014 due to the slowdown in the Mongolian economy. The share of “financial investments” increased from 13% in 2014 to 16% in 2015. Most assets reduced in 2015. The biggest decline occurred in cash (-36%), due from other banks (-26%), other assets (-22%) and loans (-14%). These decreases resulted in 16% reduction in total assets.

Table 48: Assets of State Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Balance Sheet					
Cash and cash equiv.	28.6	57.6	331.9	465.7	298.1
Due from other banks	16.7	10.9	36.5	143.5	106.0
Other short term liquid assets	56.2	0.1	0.6	0.1	0.4
Loans and advances (net)	102.2	181.0	942.2	1,070.0	924.5
Financial investments	14.9	49.4	355.0	261.9	279.9
Fixed assets	11.3	11.2	60.0	74.6	79.2
Other assets	1.7	3.6	26.1	19.0	14.9
Total assets	**231.6**	**313.8**	**1,752.3**	**2,034.8**	**1,703.0**

Source: State Bank Annual Reports

Liabilities and Equities

Deposit from customers comprised 75% of total liabilities at the end of 2015. Year 2014 had the highest deposit, due to banks and liabilities. Although all categories decreased in 2015 except equity categories including retained earnings. Retained earnings 1.9 times compared with 2014 retained earnings.

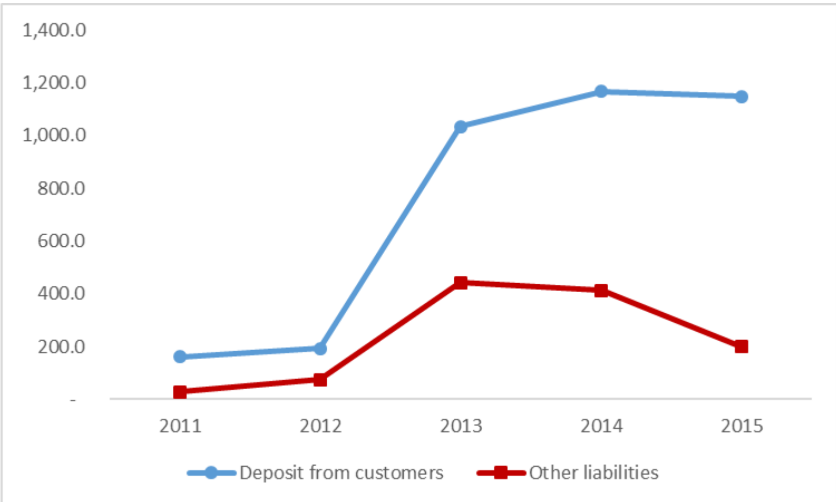
Table 49: Liabilities and Equity of Golomt Bank

Unit: MNT Billion

	2011	2012	2013	2014	2015
Deposit from customers	160.4	193.9	1,034.2	1,167.2	1,149.5
Due to banks & Fis	10.0	17.1	144.1	303.0	184.4
Other liabilities	28.6	74.5	441.6	413.0	199.6
Total liabilities	199.0	285.5	1,619.9	1,883.2	1,533.5
Share capital	28.0	28.0	113.0	113.0	113.0
Other reserves	0.2	1.1	13.8	24.8	16.7
Retained earnings	4.5	(0.8)	5.4	13.8	39.8
Total equity	32.7	28.3	132.2	151.6	169.5
Total liab. & equity	231.7	313.8	1,752.1	2,034.8	1,703.0

Source: State Bank Annual Reports

In 2013, the bank increased its share capital to MNT 113 billion to meet the increased capital adequacy requirement of the BOM.



Source: State Bank Annual Reports

Figure 16: Share to total liabilities

Profit and Loss

Net profit after tax was MNT 13.9 billion in 2015, a 28% decrease over 2014. Net interest income decreased by 1% in 2015. Net non-interest revenue increased by 24%, allowance for credit loss increased significantly, and thus resulted in 26% reduction in pre-tax income. At the end of 2015, ROA was 0.8%, while ROE was 8% which is 5% lower than 2014.

Table 50: Profit and Loss of State Bank

Unit: MNT Billion

Income statement indicators	2011	2012	2013	2014	2015
Interest revenue	22.5	30.0	96.7	213.8	217.5
Interest expenses	(14.1)	(16.8)	(62.3)	(138.7)	(143.4)
Net interest revenue	8.4	13.2	34.4	75.1	74.1
Net non-interest revenue	1.9	0.5	8.0	13.2	16.4
Operating profit	10.3	14.9	48.9	93.8	95.7
Operating expenses	(6.4)	(11.7)	(36.5)	(74.3)	(71.1)
Allowance for credit loss	(0.3)	(1.9)	(5.7)	(0.3)	(10.4)
Pre-tax income	4.7	1.30	6.7	19.2	14.2
Tax expenses	(0.3)	(0.03)	0.4	0.1	(0.3)
After-tax income	**4.4**	**1.27**	**7.1**	**19.3**	**13.9**

Source: State Bank Annual Reports

Prudential Ratios

Despite the worsening financial performance in 2015, State Bank constantly meets the BOM prudential requirements. The BOM increased the capital adequacy ratio in 2013 from 13% to 14.3% and further increase to 17% in 2015. Capital adequacy ratio and liquidity ratio is well above the thresholds. NPL ratio is worsening but still low.

Table 51: Trend of Prudential Ratios of State Bank

Indicators	**2011**	**2012**	**2013**	**2014**	**2015**
Total assets	313.8	1,230.11	1,752.18	2,034.81	1,703.0
Loan portfolio	184.35	770.19	941.86	1,067.58	929.2
Total deposits	280.1	1,110.04	1,554.64	1,845.30	1,526.6
Shareholder's equity	28.33	70.07	132.19	151.51	169.5
Net profit	1.24	-1.04	7.04	19.32	13.9
NPL ratio in total assets	0.70%	0.50%	0.70%	0.50%	1.1%
NPL ratio in loan portfolio	1.10%	1.50%	1.30%	1.00%	2.1%
Capital adequacy ratio /> 12%/	15.60%	13.00%	14.30%	15.12%	17.1%
Liquidity ratio >25%	41.30%	28.60%	44.00%	42.34%	44%

Source: State Bank Annual Reports

Impaired Loan

Provisions for loan impairment calculated for 4 loan products: business loan, consumer loan, mortgage and agricultural. The share of business loans was the biggest (86%) followed by consumer loan (7%) and mortgage (7%). State bank actively worked to recover impaired loans for each category and MNT 10.1 billion loans were recovered in 2015 which was 20.6% higher than of 2014. Loans changed to impairment in 2015 increased by 21% reaching MNT 19.8 billion. Total provision for loan impairment by the end of 2015 increased by 104% and amounted for MNT 19.1 billion which was 2.1% of total loan and advances to customers.

Table 52: Loan impairments of 2014 and 2015

Unit: MNT million

In MNT million	Business loan	Consumer loan	Mortgage	Agricultural	Total
Provision for loan impairment at 1 January 2014	8,775.7	394.3	264.0	29.8	9,463.8
(Recovery of)/provision for impairment during the year	(7,232.9)	(951.8)	(98.9)	(65.5)	(8,349.1)
Change for the year	4,265.3	3,215.5	386.2	414.0	8,281.0
Provision for loan impairment at 31 December 2014	5,808.1	2,658.0	551.3	378.3	9,395.7
Provision for loan impairment at 1 January 2015	5,808.1	2,658.0	551.3	378.3	9,395.7
(Recovery of)/provision for impairment during the year	(3,768.8)	(5,240.3)	(261.3)	(798.8)	(10,069.2)
Change for the year	14,326.3	3,921.8	1,104.9	458.2	19,811.2
Provision for loan impairment at 31 December 2015	16,365.6	1,339.5	1,394.9	37.7	19,137.7

Source: State Bank Annual Report

Loan Collateral

The fair value of the collateral that the Bank holds relating to loans individually determined to be impaired as at 31 December 2015 amounts to MNT 56,3 billion (2014: MNT 48 billion). These values are estimated by management based on the latest available information.

The amount and type of collateral required depends on the assessment of the credit risk of the borrower or counterparty and the type of loan granted. The main types of collateral obtained are as follows:

(i) corporate lending: charges over real-estate properties, inventories, plants and equipment, machineries and vehicles;
(ii) small business lending: charges over real estate properties and inventories;
(iii) consumer lending: charges over automobiles and assignment of income; and charges over real estate properties;
(iv) residential mortgages: mortgages over residential properties.

The Bank also obtains guarantees from parent companies for loans to their subsidiaries and personal guarantees from the main shareholders for the limited liability entities but the potential benefits are not included in the above. The Bank regularly monitors the market value of collateral and requests additional collateral when necessary in accordance with the underlying agreement.

(4) Loan Portfolio

In terms of sectoral distribution, consumer loans accounted for 82% followed by agricultural loan of 6%. Other sectors accounts for very small shares. Compared with 2014, the biggest reduction occurred in transportation and communication (-67%) followed by finance (-51%), trade (-44%), electricity (-43%) and mining (-36%). Only other loans increased by 78%. Consequently, total loans decreased by 13%.

Table 53: Breakdown of Lending by Sector

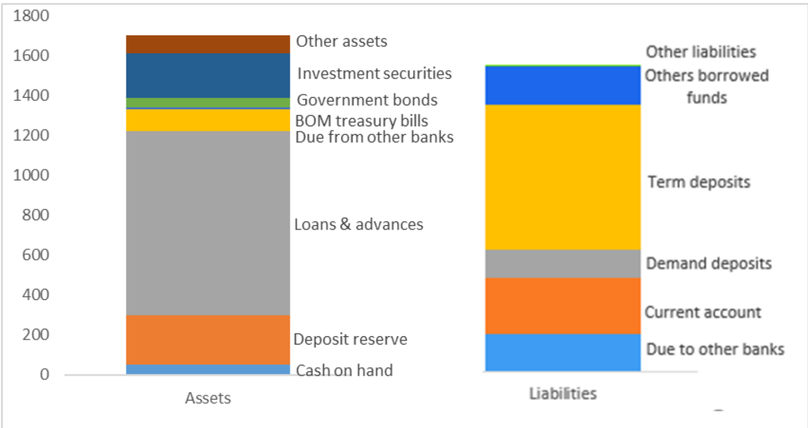
Unit: MNT million

Sectors	2014		2015	
	Amount	Share	Amount	Share
Consumer loans	856,785.2	79%	772,023.4	82%
Manufacturing	29,795.7	3%	27,585.7	3%
Mining & Exploration	2,596.9	0%	1,671.7	0%
Construction	62,622.3	6%	45,105.7	5%
Trade - Whole & Retail	14,432.6	1%	8,022.6	1%
Electricity & Oil	5,514.9	1%	3,162.6	0%
Real estate	7,159.1	1%	6,266.0	1%
Finance	4,535.1	0%	2,219.6	0%
Agriculture	67,411.8	6%	53,048.6	6%
Transport & Communication	8,717.5	1%	2,891.3	0%
Tourism	3,547.8	0%	3,359.6	0%
Healthcare, education and social service	12,709.8	1%	11,831.5	1%
Other	3,585.9	0%	6,396.9	1%
Total loans and advances to customers (before impairment)	1,079,414.6	100%	943,585.2	100%

Source: State Bank Annual Reports

(5) Funding

Current account and deposits are main part of liabilities accounting for 75% of total liabilities. Among them, term deposits hold 47% of total liabilities in 2015. The amount of current account and deposits reduced by 1.5% compared with 2014. In addition to deposits, borrowed funds have become an important source for lending with size of MNT 192.7 billion (13% of total liabilities).



Source: State Bank Annual Report

Figure 17: Major Items of Assets and Liabilities (As of the end of 2015), in MNT Billion

State Bank borrows from development financial institutions such as ADB and Mortgage Financing Corporation.

State Bank also borrows funds from the government organizations to provide policy loans such as BOM, Ministry of Finance, TSL, SME Development Fund, Mongolian Ipotek Corporation and Development Bank of Mongolia.