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KHAN BANK, THE AGRICULTURAL BANK OF MONGOLIA

John Gutin
Robin Young (ed.)

January 2005

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Accelerated Microenterprise Advancement Project

This summary case study was prepared by John Gutin of DAI and edited by Robin Young of DAI and is based on the case study, "The Agricultural Bank of Mongolia," by Jay Dyer, J. Peter Morrow, and Robin Young, prepared for the World Bank-sponsored Scaling Up Poverty Reduction Conference, Shanghai, China, 2004. Data from other sources are referenced throughout the paper.

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John Gutin, M.S., is an Associate with the Banking and Financial Services Group at Development Alternatives, Inc.

Robin Young, M.B.A., is a Senior Development Specialist with Development Alternatives, Inc.

Development Alternatives, Inc. is an economic development firm based in Bethesda, Maryland.

DAI
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1 Introduction

Today, the Agricultural Bank of Mongolia, now known as Khan Bank,[1] is an institution best described by superlatives. It is the leading provider of financial services to rural Mongolia (with the largest rural branch network), one of the largest taxpayers in Mongolia, and the most profitable of the 16 major Mongolian banks, based on return on equity (ROE).[2] But just five years ago, Ag Bank was in receivership and facing possible liquidation after more than a decade of political interference, mismanagement, loan losses, and numerous brushes with insolvency. Many in the international community felt the Bank could never operate sustainably and should be closed. However, the Ag Bank's role in providing crucial financial services to Mongolia's vast rural areas meant that closing it would have had a catastrophic impact on the rural economy and the economy as a whole. Instead, an enlightened partnership between the Government of Mongolia (GoM) and the donor community recognized and leveraged the Bank's latent assets, namely its extensive rural branch network franchise and corresponding access to a large and underserved market. Ag Bank's subsequent rapid turnaround and successful privatization highlights the potential of commercially-oriented microfinance to transform even the most troubled state-owned banks into sustainable providers of financial services while also maintaining rural outreach.

[1] In 2003, the abbreviated name "Khan Bank" was adopted for the Bank's English-language publications and marketing activities. In this paper, Ag Bank is used when discussing historical aspects of the Bank and Khan Bank when referring to the post reform and current situation.

[2] Agricultural Bank of Mongolia 2003 Annual Report and audited financial statements.

2 Context

2.1 The Economic and Demographic Context

Mongolia has a total population of approximately 2.4 million people and is divided into 21 aimags (provinces), each subdivided into 15-20 soums (administrative districts). The three largest cities in Mongolia (Ulaanbataar, Darkhan, and Erdenet) are separate urban aimags, but approximately 60 percent of the population lives in one of the 19 rural aimags. Herding, the traditional Mongolian way of life, remains the primary occupation of the rural population along with small-scale agriculture and very little value-added economic activity occurs outside the urban centers.

Although the Government has only recently embraced political and economic liberalization, it has made real progress toward achieving macroeconomic stability and an open economy with an eye towards economic growth and poverty reduction. The country is poised to benefit from an enlarging private sector, particularly the potential of small- and medium-sized enterprises to increase employment and reduce poverty.[3]

While the loss of Soviet financial and technical support in 1990-1991 triggered a serious contraction of gross domestic product (GDP) and soaring triple-digit inflation, growth resumed by 1994 and inflation has since stabilized at well below 10 percent.[4] Mongolia recorded economic growth of 5.5 percent in 2003 based on strong agricultural performance and a growing services sector,[5] and increasing incomes have improved the overall quality of life for the population.

However, poverty persists in Mongolia despite the recent economic buoyancy. Per capita GDP is roughly US$477 and more than one third of the population lives below the income poverty line.[6] Although Mongolia has the world's lowest population density and is still a generally rural society, rapidly increasing urbanization is magnifying urban-rural inequalities and straining limited urban resources. In 2003, Mongolia ranked 117th on the United Nations Development Program's (UNDP) Human Development Index,[7] ahead of only 58 countries, and the severity and depth of poverty has actually increased since the transition to a market-oriented economy, with reforms contributing to a widening income gap between rich and poor.

3 UNDP Human Development Report, Mongolia 2003, p. 2.
4 World Bank Mongolia Country Brief, p.1
5 Asian Development Bank Mongolia Country Strategy and Program Update 2005-2006, p. 1.
6 World Bank Mongolia Country Brief, p. 4. (income poverty defined as the percentage of a population whose income is less than US$1/day).
7 UNDP Human Development Report 2003.

2.2 The Banking Sector

During the Communist era, Mongolia relied on a mono-bank system in which lending was dictated by political considerations and commercial credit was not available. After the 1990 market economy transition, the Government initiated a divestiture of the financial system, creating a two-tiered banking system comprised of a new Central Bank and five commercial banks spun off of the former State Bank.

However, the Government failed to adhere to market principles and directed these new "commercial" banks to make political loans to poorly performing state enterprises.[8] The continued political meddling combined with the banks' inherent institutional weaknesses, inherited portfolios of non-performing loans (NPLs), an inadequate legal and regulatory framework, and general macroeconomic problems severely damaged the solvency and stability of the banking system.

Liquidity crises resulted in 1994, and again in 1996, as the commercial banks were unable to meet prudential standards set by the Bank of Mongolia. On the heels of yet another crisis, the Bank of Mongolia introduced a strengthened regulatory framework and new supervisory measures for the banking sector in 1998, including new minimum capital requirements, increased weighted capital adequacy ratio, and improved reporting and disclosure requirements.[9]

Although the reforms did eliminate some smaller problem banks (two banks had their licenses revoked, and seven banks did not meet the new minimum capital requirement) the larger banks remained unstable, with the Government still directly involved in six and retaining a controlling interest in three. By 1999, three large banks were insolvent, including the Ag Bank, and trust in the banking system was decimated.

However, the structural reorganization and renewed commercial orientation of the banking sector, along with a corresponding broader range of customer-focused products and services, an overall improved quality of lending, and a stabilized macroeconomic environment, have drawn Mongolians back into the banking system. Capital inflows have been renewed over the past several years and volumes of loans and deposits have been growing across the sector.[10] In May 2002, the banking system was twice as large as at the end of 1999, based on overall assets.

2.3 The Microfinance Market

Until relatively recently, microfinance in Mongolia was the exclusive domain of Government and donor projects and other non-commercial operations. Even today, more than 60 donor-funded NGOs are engaged in microfinance in Mongolia.

8 Asian Development Bank, 2003 Performance Audit Report on Financial Sector Program in Mongolia, p. 1
9 The prudential norms subsequently were revised and strengthened in line with international standards. For example, the risk weighted capital adequacy ratio is now 10 percent.
10 Bank of Mongolia Annual Report, 2002, p. 25.

However, the repeated banking crises and ensuing reforms of the mid-1990s re-oriented the focus of the formal financial sector toward the untapped potential of low-income and rural households, and especially the microentrepreneurs in the informal sector that by some estimates contribute as much as 30 percent of Mongolia's overall GDP, with about 60 percent of GDP derived from the rural sector as a whole.[11]

Today, the largest source of funds for microfinance activities is the domestic market rather than donor investments, although donors such as the Asian Development Bank (ADB), the World Bank, and the European Bank for Reconstruction and Development (EBRD) are still very active in the sector. According to a survey by the Bank of Mongolia, 15 percent of the Mongolian population had an active micro loan from a mainstream regulated lender in 2002, as compared to just 1 percent in 1998. The same survey recorded a 760 percent increase in loans to rural borrowers in the 12 months between December 2001 and 2002.[12] Nonetheless, of the 16 major banks operating in Mongolia, only three—Khan Bank, Post Bank, and XAC Bank—have a significant rural presence.

There are several explanations for this relative lack of rural market penetration by the banking sector. For one, while the latent demand for microfinance services in rural areas is clearly large, Mongolia's low population density and low levels of rural economic activity mean that the demand for financial services is also highly dispersed and uneven. Moreover, there are marked differences between the rural and urban markets, and rural financial service providers have specific problems to contend with, including seasonal fluctuations in demand, little available collateral security, and the high cost of serving the low-density rural areas. This may explain why only banks with existing infrastructure and capacity, like Khan Bank and Post Bank, have leveraged the potential of the rural microfinance niche.

11 UNDP, 2002 Sub-Sector Review of Micro-finance in Mongolia, p. 8.
12 UNDP, 2002 Sub-Sector Review of Micro-finance in Mongolia, p. 18.

3 The Model

3.1 History

The Ag Bank was established in 1991 as the Agricultural Cooperative Bank from the assets of the former State Bank, with the specific goal of serving the agricultural sector. The Bank was initially owned by state agricultural cooperatives, which were later broken apart into private agricultural enterprises.

The Ag Bank inherited a massive structure from the State Bank, including 326 rural branches and settlement centers employing more than 2,600 people, demand deposits of MNT 2.2 billion, and loan debts of MNT 2.3 billion.[13] Although Ag Bank paid monthly interest on the deposits at a rate set by the Bank of Mongolia, the loan portfolio generated no interest income. These loans turned to passive assets on the books and laid the basis for ensuing losses.

Within a short period of time, the Bank's owners, the agriculture enterprises, and the Government directed it to widen the scope of its operations and make larger loans such that by 1996 the Ag Bank's liquidity and financial position had deteriorated to the point where it became necessary for the Bank of Mongolia to appoint a receiver. The ADB concluded that the main causes of Ag Bank's poor financial condition were the inherited nonperforming loans and politically directed loans, and financed the placement of Government bonds to replace the bad debts.

However, there was no accompanying shift in business strategy or institutional restructuring, and by 1999 the Ag Bank was once again in receivership, this time due to poor management. Two other large commercial banks in similarly poor financial condition were closed. However, by virtue of the Ag Bank's critical role in the provision of financial services to rural Mongolians, it was granted a stay of execution.

3.2 The Turnaround

Instead, a restructuring plan was implemented by USAID, the World Bank, the Government, and others by which the Government once again became 100 percent owner of the Bank through a capital infusion using Government bonds and cash. USAID agreed to provide funds for an outside management contract, while the Government agreed to provide this outside manager with full authority to manage the institution free from political or other interference. A contract was signed with Development Alternatives, Inc. (DAI) of Bethesda, Maryland, USA, to manage the Bank, and in July 2000, a team led by Chief Executive Officer J. Peter Morrow arrived in Mongolia. DAI staff and advisors provided technical

13 Ag Bank Information Memorandum, p. 6.

support as the team set the agenda for the turnaround and transformed the Bank. By agreement among all parties, the mission of the turnaround was to: (1) restore financial soundness to the Bank; (2) bring financial services to the country's rural population; and (3) prepare the Bank to operate independently and be privatized.

By all of the measures above, the turnaround has been a resounding success. With the necessary political, financial, and structural support in place, the management team developed a new lending program, converted payment services into deposits, created an extensive marketing program to improve the Bank's image and attract clients, implemented strong controls through new policies and procedures, built a more effective management structure, and significantly increased training activities.

Within four months, the Bank was breaking even, quickly thereafter began to generate profits, and now is completely self-sustaining. In terms of outreach, the Bank reaches 98 percent of the rural communities in Mongolia with 354 offices in the countryside. And in January 2003, the Government received three viable bids for the Bank, all from strong and fully qualified private sector buyers. H.S. Securities of Japan was the highest bidder at US$6.85 million, and retained DAI to continue to provide management to the Bank, a contract that is entirely financed by Bank income.[14]

3.3 Product Strategy

Key to the Bank's turnaround and current success has been the successful development and implementation of new products throughout the country. The new product approach was to quickly pilot products and then rapidly expand the delivery countrywide, rather than focusing on quick saturation at each branch. This strategy effectively leveraged the Ag Bank's unmatched market access via the existing branch network to rapidly reach the economies of scale necessary for profitability.

The current menu of credit and deposit products is carefully tailored to be responsive to the unique demands of the market, is diversified by geographic area, and has evolved with changing market needs. This careful product design demonstrates that financial products can be delivered gainfully even in scarcely populated and poor areas if they truly meet the needs of customers. For example, the Bank's herder loans were specifically designed to meet the unique needs of nomadic Mongolian herders. Available on terms of up to one year, they help cover living and operating expenses in the months when herders are not generating income or wish to purchase herd-related goods. Because herders have substantial cash at certain times of the year, penetration of the herder market with comprehensive training and banking services is a priority.

Although Khan Bank's main product focus has always been on rural Mongolia, its successes there have laid the foundation for substantial growth and new services for all Mongolians. From the core micro and small business product, the line has now expanded to

[14] In mid 2004, DAI also became a minority share-holder.

medium enterprise, pensioner, payroll deduction, and agricultural loans, and the Bank is currently piloting mortgage loans.

By recognizing the informal lending sector as a real competitor, and providing a service that encourages borrowers to successfully move into the formal financial system, Khan Bank has created a new kind of bank borrower. Individuals who do not qualify for the Bank's small business loans often use a consumer loan to get started in a new venture.

Thus, the right products create burgeoning demand, leading to repeat, larger loans, and demand for other products and services, resulting in cost recovery, and sustainability, and finally profitability across the product line. As a result, families and businesses are able to borrow more money at better terms and lower costs, while outreach to the rural poor continues to be deep.

The following tables summarize Khan Bank's loan and deposit portfolio:

Table 1: Loans (as of February 2004)

Loan Product	Date Product Launched	Total Number of Loans Disbursed	Total Value of Loans Disbursed ($000s)*	Total Number of Loans Outstanding	Total Value of Loans Outstanding ($000s)*	Average Loan Outstanding ($)
Micro & Small	Nov. 2000	80,835	98,780	13,485	19,135	1,419
Small & Med.	May 2001	3,300	15,555	1,633	8,184	5,011
Pensioners	May 2001	628,431	36,912	72,277	5,003	69
Herders	Aug. 2001	31,373	20,753	9,449	6,819	722
Payroll Based	Oct. 2001	132,784	34,177	30,539	6,654	218
Crop	May 2002	1,483	746	148	89	604
Mortgage	April 2003	770	3,752	696	3,144	4,518
Total		**878,976**	**210,674**	**128,227**	**49,028**	**382**

Table 2: Deposits (as of February 2004)

Deposit Category	Outstanding Balance (US$000s)	Percent of Total Outstanding Balance	Number of Depositors	Percent of Total Depositors	Average Account Balance (US$)
Organizations	15,849	20.99	14,354	3.80	1,104
Current	12,024	15.92	14,318	3.79	840
Time	2,823	3.74	22	0.01	128,347
Demand	1,001	1.33	14	0.00	71,471
Individuals	59,667	79.01	363,070	96.20	164
Current	2,044	2.71	266,875	70.71	8
Time	47,265	62.59	39,971	10.59	1,182
Demand	10,358	13.72	56,224	14.90	184
Total	**75,515**	**100.00**	**377,424**	**100.00**	**200**

Table 3: Deposit Evolution (converted to US$000s)*

Deposit Category	12/31/03		12/31/02		12/31/01		12/31/00	
Businesses	9,730	13.2%	9,798	22%	8,117	33%	3,663	28%
Government	4,293	6.7%	8,207	18%	8,570	35%	6,712	52%
Individuals	50,225	80.1%	27,028	60%	7,752	32%	2,520	20%
Total	**64,248**	**100%**	**45,034**	**100%**	**24,439**	**100%**	**12,896**	**100%**

*Note: Most loans and deposits are in the local currency, tugrug, and converted here to U.S. dollars at the exchange rate of 1,174.

3.4 Financial Performance

The financial performance of the Ag Bank has been remarkable by most measures. In terms of profitability, return on equity (ROE) was 52.3 percent in 2002,[15] more than twice the overall banking industry's average ROE of approximately 23 percent in the same year,[16] and asset growth also outpaced the industry. Although ROE fell to 42.9 percent in 2003, the Bank remained the most profitable in Mongolia based on both ROE and a Return on Assets of 2.8 percent, and it was the second most profitable bank overall.[17]

These high returns reflect the Bank's efficiencies in lending, as well as the increasing proportion of total income derived from fees (31 percent in 2003 compared to 29 percent in 2002). This trend is especially noteworthy, since fee income may be increasingly important as competition for quality loans increases in Ag Bank's core rural markets.

Profits have grown from accumulated losses of US$5.2 million in 1999 to a current monthly pre-tax average profit of US$300,000, and the institution is now entirely self sustaining. From a cost recovery perspective, the value of the Bank has increased so much that it could have easily paid for the cost of the turnaround by the value that was created: earnings in just 2003 were close to the entire cost of the three-year, donor-financed turnaround.

In terms of loan volume and outreach, the Bank disbursed 878,000 loans between late 2000 and February 2004, and as of February 2004, 128,227 loans were outstanding for a portfolio of almost US$50 million while maintaining an arrears rate consistently below 2 percent, with US$75.5 million in 377,424 deposit accounts.

Moreover, the small average outstanding loan size of US$382 reflects deep rural outreach, where 90 percent of all Ag Bank's lending takes place. Indeed, one the Bank's greatest assets is the branch network comprising 379 points of service throughout Mongolia, much greater than any of the other 16 banks operating in the country. The Bank's 354 offices

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15 Agricultural Bank of Mongolia Annual Report and audited financial statements, 2002, p. 26.
16 Bank of Mongolia Annual Report 2002, p. 67.
17 Agricultural Bank of Mongolia Annual Report and audited financial statements, 2003, p. 6.

in the countryside effectively reach 98 percent of rural communities, with one out of every two Mongolian households using Khan Bank.

Aside from the large impact of its loan and deposit activity, the opening of 110 new branches and creation of more than 1,000 well-paying jobs has boosted the economies of many communities. In addition, Khan Bank—previously a cash drain on the Government—is now one of the largest taxpayers in Mongolia.

H.S. Securities, the new owner of the Bank, has stated that it wants to continue to expand based on the Bank's target markets. It will be investing millions of dollars more into the Bank to continue the outreach and market penetration. Since privatization, the Bank has continued to grow rapidly, practically doubling the loan portfolio from US$24.7 to US$49 million during the first year. This was supported by a 110 percent capital increase, from MNT 3.9 billion to MNT 8.2 billion (US$3.32 million to US$6.98 million at the exchange rates for early 2004), through reinvesting all earnings and a fresh capital injection from H.S. Securities of US$2 million. This commitment and financial capacity is the best assurance that access to these financial services throughout the country will continue.

Although the evidence points to a bright future for Khan Bank in the near term, some potential challenges merit concern. For one, the Bank has benefited greatly from the limited competition it faces in rural areas, allowing for high effective interest rates on its loans and some of the highest net interest margins[18] among the commercial banks offering microfinance. These high margins have contributed significantly to the impressive ROE and overall profitability of the past two years. However, increasing competition has already contributed to lower effective rates, with the highest rate in 2003 at 48 percent per annum, as compared to 72 percent in 2002, and the trend is almost certainly for rates to fall even further. In fact, the UNDP estimates that the average effective interest rate charged by the principle microfinance banks, including Ag Bank, fell by nearly half between 1999 and 2002.[19] The challenge will be to fine-tune product costing and pricing capabilities to ensure financial sustainability as the downward trend in rates continues.

Also, while the Bank's interest income increased more than 66 percent in 2003 as compared to 2002, due to increased loan volume, overall expenditures increased significantly due to rising interest expense on consumer deposits as well as increased provisions for loan losses. Rising capital expenditures will undoubtedly put additional pressure on future profitability as the bank seeks to expand the branch network in Ulaanbaatar and elsewhere, with all of the associated increases in administrative and operational expenses.

Finally, the high rates of return on equity of the past two years are partly attributable to the Bank's relatively low capital base compared to internationally accepted prudential norms. The Bank of Mongolia has not implemented the Basel Accord, though the Ag Bank is held to a standard of a 5 percent core capital adequacy ratio and 10 percent risk-weighted capital ratio. Even so, the capital base has grown from zero to approximately US$7 million

[18] NIM is calculated on nominal interest rate charged on loans less the average interest rate on time deposits.
[19] UNDP, 2002 Sub-Sector Review of Micro-finance in Mongolia, p. 33.

since the turnaround began. If the loan book continues its aggressive growth, leverage and capital adequacy could become pertinent issues.

4 Lessons and Conclusions

It is challenging to turn around a troubled state-owned “dinosaur” bank, but Khan Ag Bank proves this challenge can be met, even under the most difficult circumstances.

Like many state-owned rural banks, Ag Bank was under very strong pressure to serve the Government’s political needs. Thus, a critical part of the restructuring plan was to insulate the Bank from political interference. The agreements between the Government of Mongolia, the Central Bank, the World Bank, and USAID effectively prevented Government interference in the Ag Bank’s operations, other than continuing Central Bank supervision and monitoring. Absolutely zero tolerance was given to politicians locally or nationally who tried to influence the Bank’s lending. Because the USAID-funded outside management team was given full authority for the Bank, it was easier to build this firewall.

The human element also is crucial. The competencies of the independent management team were vital for developing an improved credit and operating culture based on operating discipline and service innovation, and for the rapid rollout of new products and services. Decisions had to be reached and implemented quickly, and it was critical to deploy individuals with relevant outside experience who were not beholden to domestic political interests. The team brought together experiences, knowledge, and management skills from work in similar economic contexts, as well as extensive U.S. banking experience.

However, effective Bank management does not occur in a vacuum. The Ag Bank turnaround was necessarily a joint effort between expatriates and local professionals, both at the executive and branch level. The managers recruited a Mongolian executive team with important technical, cultural, and market knowledge, while Ag Bank’s existing well-trained and disciplined rural branch staff were key to the successful rollout of new products and services. Although the staff were not used to thinking strategically, they quickly grasped new products and marketing approaches, and had invaluable knowledge of their local markets.

Finally, the convergence of all of these pieces made possible the lynchpin of the Bank’s success: the new product strategy. Khan Bank proves that financial intermediaries can profitably service low-income markets if the product offerings are right. Even where per capita incomes are low, the experience has proven that there is a large market for the right kind of deposit and credit products, even if the interest rates and fees are relatively high.

Low-income market segments will pay for the right products and good service. But if the lending products do not adequately meet the needs of the business and match their ability to service certain levels of debt, a large dropout rate will occur. Thus, the products (including the delivery and services attached to them) must grow and develop to reflect accurately the needs of the market.

With a low operating cost basis and good returns from lending, Ag Bank was able to generate the profits to reinvest in physical and human infrastructure and make the Bank sustainable, while still providing the needed services to the underserved market. The process evolved into a “virtuous cycle” driven by the strong demand, as well as unmet need, for the new services.

Thus, the Khan Bank experience stands in contrast to the commonly held view that state-owned “dinosaur” banks cannot be turned around and successfully privatized. There are undoubtedly other cases where, despite a poor history and state sector culture, latent but strong franchise value in a branch network or customer flow can be capitalized into profits and sustainability.

U.S. Agency for International Development
Microenterprise Division
1300 Pennsylvania Ave. NW.
Washington, DC 20523-2100

Telephone: 202-712-0030
Fax: 202-216-3228
Website: www.microLINKS.org

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