Microfinance Regulation and Supervision in Mongolia

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ABOUT THE SERIES

The *Essays on Regulation and Supervision* series has been commissioned for the Microfinance Regulation and Supervision Resource Center, funded by the Consultative Group to Assist the Poor (CGAP) and implemented by the IRIS Center. These essays are intended to provide additional insights and perspectives on the experiences of microfinance institutions, regulators, donors, and others regarding specific microfinance legal and regulatory environments.

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INTRODUCTION

Mongolia is one of the most successful cases of the deepening and broadening of access to financial services in the world.[1] The extremely high rate of financial services penetration has been achieved in only 9 years – without doubt one of the fastest rates of success observed anywhere in the world whether it be in a "developed" country or a "developing" country. These achievements are especially significant given that Mongolia has the 4th lowest population density in the world —with half of its population living in rural remote areas—and is ranked 116 out of 177 countries in the United Nations Human Development Index.

1. Source: United Nations World Population Prospects (2004 revision). Data are for 2005.

This penetration has included[2]:

- Number of households per bank branch office – 760
- Number of households per financial institution – 511[3]
- Percentage of on-time performing loans – 92.4%
- Percentage of population with savings accounts –15.7%
- Percentage of the 16 commercial banks significantly involved in productive micro credit – 43.7%
- Percentage of all villages and townships with at least one commercial bank providing microfinance services – 100%
- Percentage of all herder households with loans outstanding – 72%
- Percentage of all villages and townships with at least two commercial banks providing microfinance services – 77%

2. The following data are from Bank of Mongolia (Spring 2007).

3. This number is based upon inclusion of 970 Savings and Credit Unions (SCU). However, only 380-400 SCUs are currently operating.

Access for low-income people—through both consumer and productive credit, access to savings, insurance, leasing, transfers and payments, and other financial services—has been achieved primarily through "mainstream" institutions (licensed financial institutions such as banks, cooperatives, and non-bank financial institutions). The scale of outreach of not-for-profit government projects, NGOs, and donor interventions has been insignificant. Many of these have caused market distortions and/or have been failures at a huge cost to both Mongolian and international taxpayers (as measured by CGAP standards of disclosure and performance). [4]

4. See Consultative Group to Assist the Poor, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions (2003).

Despite a significant number of initial challenges, microfinance in Mongolia has achieved superb success since the beginning of the "microfinance revolution" in the summer of 1998. At that time, Mongolia was characterized by:

- A financial sector that was in deep turmoil; the majority of banks were insolvent.
- One of the lowest savings rates in the world.

- The lack of an appropriate legal environment (tax regime, financial sector, justice system, etc.).
- An unstable macroeconomic climate.
- Multiple failures of donor-led microfinance initiatives.
- Large, nationwide on-going natural disasters in agricultural areas and for livestock.
- A lack of institutional capacity in the NGO, private, and public sectors to promote and sustain both microfinance and overall financial services.

Currently, the largest providers of financial services for the poor in Mongolia are full-service banks. The institutional and financial sustainability of these banks meet world-class standards of excellence in performance, transparency, and governance.

One might assume that the great successes of the "microfinance revolution" in Mongolia were fostered through the creation of a specific microfinance enabling environment at the very beginning. This assumption is false:

- There is not now—nor has there been in the past—a specific National Policy on microfinance.
- There are no specific laws that directly relate to microfinance institutions, their creation, or their licensing.
- There are no specific tax breaks or other fiscal incentives for microfinance.
- There is no specific regulatory or supervisory regime for microfinance.
- There are no provisions in any law or policy that encourage or motivate microfinance innovation or the role of NGOs in microfinance.
- There is a near-complete absence of any laws, regulations, or policies related to consumer education, financial literacy, or financial consumer protection.

Mongolia's success without the existence of a specific enabling environment for microfinance seems to defy the on-going global trend of both developed and developing countries investing significant financial, institutional, and human resources into the creation of pro-poor financial sector enabling environments.

This paper attempts to undertake an objective analysis of the current state of the financial sector legal and regulatory environment, its strengths and weaknesses, and possible future options for improvement. This paper concludes that despite the successes of the Mongolian microfinance revolution, specific laws and regulations are perhaps required in five primary areas:

- Diversification of financial services for the poor (new forms of insurance,[5] productive leasing, etc).
- Support for the access of the poorest of the poor to mainstream services through innovations and new legal forms of local community groups.
- Analysis of fiscal incentives, legal reform, promotion, and education for savings (with far-ranging, long-term benefits for the macro-economy, financial institution growth, individual household welfare, and debt capacity).
- The overall protection and education of all consumers of financial services.
- The creation of legal forms for second-tier support institutions such as apex financial institutions, private credit bureaus, and rating agencies.

5. Mongolia is a world leader in the piloting of pro-poor agricultural insurance, specifically index-based livestock insurance.

We leave it to the readers to analyze and come to their own conclusions on whether the resolution of these above areas can best be resolved through specific pro-poor policies and laws, or simply through further improvement in the overall financial sector legal and regulatory framework.

The views and opinions expressed in this paper are solely those of the author and do not reflect government or donor opinions or viewpoints.

Supervision and Regulation of Microfinance Service Providers

Microfinance Service Providers

In Mongolia, there is neither an official definition of "microfinance" nor any policies, laws, or regulations specifically designed to create an enabling environment for microfinance. Instead, microfinance is regulated by the same banking and financial laws and regulations that govern the mainstream financial system.

According to the Mongolian laws and regulations, all financial operations are divided into two parts: banking and non-banking financial operations.

The Central Bank of Mongolia (Bank of Mongolia - BoM) is responsible for the licensing, supervision, and regulation of banks.

The Financial Regulatory Commission of Mongolia (FRC), established in January 2006, is under the direct supervision of the Parliament of Mongolia. The FRC is the regulatory body for all non-bank financial activities in Mongolia, namely insurance and stock exchange markets, non-bank financial institutions, savings and credit cooperatives, and others.

The banking sector has stabilized and strengthened since the 1990s banking crisis. The number of securities market participants, non-bank financial institutions, insurance companies, and savings and credit cooperatives has increased rapidly in the last few years. In Mongolia, there is a significant difference between the level of development of the non-bank financial sector and the banking sector. Therefore, the establishment of the FRC was seen as a key requirement to strengthen and develop the overall financial system.

The providers of microfinance services in Mongolia range from individual money lenders to commercial banks. **Commercial banks** are by far the largest providers of financial services (leasing, loans, savings, transfers, and payments) to the poor. Private and state-owned, for-profit and non-profit, and member-based and investor-owned legal entities are all involved in microfinance in Mongolia.

Savings and credit unions, which are regulated by the Cooperatives Law, provide a limited number of financial services to their members.

NGOs, individuals, and government and donor projects are legally prohibited from providing financial services. However, there are many NGOs and individuals engaged in such operations; they are classified in this essay as "Informal Providers."

Money lenders are defined as individuals who provide loans to any other legal person, both professionally and non-professionally. Traders, for instance, sell commodities to clients on credit. Cooperatives other than SCUs—such as livestock, production, service, and marketing cooperatives—are also involved in providing lending services. The main activities of the cooperatives are buying and selling members' products, selling commodities, and providing technical and financial services to members. In the majority of cases, these cooperatives do not charge interest on loans. The lending funds come from other business, fees, and member savings. NGO and government and donor projects depend on funds from the government and donors; they provide these loans to support household livelihoods and poverty reduction efforts for specific target groups and project areas.

Permission to Provide Microfinance Services

According to the Mongolian legislation, banking and non-banking financial services may only be carried out by authorized for-profit legal entities. This requirement was established in order to protect consumers' assets, ensure long-term sustainable operation, and maintain the stability of the overall financial sector. The only non-profit legal entities permitted to provide financial services are SCUs. SCUs are allowed to provide such services because they provide services only to their members, not to the public; and because SCUs are not large enough to affect the stability of the financial sector.

There is no regulation for informal providers because they are not allowed to provide financial services. Most of the informal providers are not-for-profit legal entities and individuals. The government and donor projects operate without legal entity rights and obligations.

Licensing and Registration of Microfinance Service Providers

Formal microfinance providers such as banks, NBFIs, and SCUs are all required to acquire licenses in order to provide banking and other financial services.

The Central Bank of Mongolia is the body authorized to license banks to provide banking services, which include the following: taking deposits; providing loans, transaction services, and guarantees to third parties; purchasing and selling precious metals and stones; taking valuables into custody; conducting foreign exchange and transaction services; issuing, buying, and selling securities; and providing investment and financial consultancy.

Once a bank has been permitted to provide banking and financial services, no other permissions are required to provide microfinance services.

The FRC provides licenses to all financial institutions except banks. NBFIs are not authorized to take deposits from the public. SCUs are only allowed to provide loans to—and mobilize deposits from—members.

In order to receive a license, financial institutions need to meet certain requirements with respect to minimum capital, management qualifications, technology, and security (depending on the institution). There is no minimum capital requirement for SCUs, but they are required to have a minimum of 20 members.

The minimum capital should be fully liquid (cash only) and may not include loans from other financial institutions. The applicants must also provide an explanation of the source of their fund resources. Bank supervisors have found it difficult to verify whether or not their resources are "clean," because during the 1990s banking crisis, people used to keep their money at home; most business transactions in Mongolia had been carried out in cash.

The following table shows the changes in the minimum capital requirement for financial institutions and the number of households per financial institution. Currently, there may be too many financial institutions in Mongolia.

	1997	1999	2001	2004	2006
Minimum Capital Bank Requirement	MNT 400 million	MNT 1 billion	MNT 2 billion	MNT 4 billion	MNT 8 billion
Number of households per bank (including all branches and units)	Not available	Not available	1040	871	760

	1999	2001	2003	2006
Minimum Capital Requirement of NBFI	Ulaanbaatar – MNT 10 million Rural area – MNT 1 million	Ulaanbaatar – MNT 30 million. Other cities[6] – MNT 10 million Rural area – MNT 1 million	Cities – MNT 100 million Rural – MNT 1 million	Ulaanbaatar – MNT 200 million Other cities – MNT 100 million Aimags[7] – MNT 10 million
Number of households per NBFI (including all branches and units)	Not available	3179 households (NBFI -24 SCU – 135 Financial leasing -1 Insurance – 16)	847.4 households (NBFI – 88 SCU – 586 Financial leasing – 1 Insurance – 16)	532.5 households (NBFI – 163 SCU – 970[8] Insurance – 16 Stock exchange broker companies – 28 Foreign currency exchange units - 57

Until 2006, the provision of financial services in rural areas was dominated by the former state agriculture bank, now privatized and called Khan Bank. In 2006, the private Mongol Post Bank began an aggressive rural expansion program. In the year 2000, fewer than 0.5% of all herders had loans. 7 years later, however, approximately 72% of all herders have active loans.[9] This is highly significant for the nation's economy, as agriculture accounts for 40% of GDP.

To receive a license, financial institutions also have to have an experienced Board of Directors and Executive Director with banking and financial sector knowledge. Directors and Officers should not have unpaid debts, criminal records, or any conflicts of interest. The current law on cooperatives does not establish professional management requirements for SCUs, because they are member-based, self-regulated organizations. Now that the FRC has been charged with supervising SCUs, however, it might establish such requirements.

Informal providers are legally prohibited from engaging in lending services. Despite this prohibition, there are many NGOs, money lenders, and projects providing financial services to the poor. Both donors and the government of Mongolia are

6. Other cities include Erdenet and Darhan, smaller cities than the capital, Ulaanbaatar.

7. The territory of Mongolia divides administratively into Aimags and a capital city; Aimags subdivide into Soums; Soums into Baghs; the capital city subdivides into Districts; and Districts into Khoroos.

8. Only half of SCUs are operating. Currently, 117 SCUs have received an operational license from the FRC, which predicts that the number of licensed SCUs could increase to 380-400.

9. This number does not adjust for double and triple borrowings in a household. The lack of a credit bureau at the village level in Mongolia continues to be a gap that poses systemic risk.

increasingly discouraging these NGOs and projects in favor of mainstream solutions, since some informal providers have considerably disrupted the market by lending at subsidized interest rates, engaging in non-transparent operations, and delivering the message that it is acceptable practice not to repay loans. However, the Government of Mongolia and the main supervisory bodies (BoM and FRC) are not necessarily inclined to prohibit their illegal operations because they help to alleviate poverty and aim to improve the livelihood of the highly vulnerable and very poor households. These households lack access to financial services because formal providers cannot reach them.

Prudential Regulations for Microfinance Service Providers

In order to provide banking and non-bank financial services, banks must comply with four main ratio requirements of prudential regulation, set by the BoM and FRC:

1. Capital adequacy
2. Loan risk
3. Liquidity
4. Foreign exchange ratio

The current prudential regulations do not monitor the outreach and depth of microfinance services, but they do assist in evaluating the overall institutional risk.

All prudential ratios more or less conform to BIS standards. All formal providers (Banks, NBFIs, and SCUs) are required to establish a loss provisioning fund for a variety of different assets, which include loans, receivables, securities, guarantees, letters of credit, and seized collateral in order to meet the capital adequacy ratio. These requirements are applicable to non-deposit-taking institutions (NBFIs) as well. NBFIs are—and will continue to be—regulated because:

1. The total assets of NBFIs accounted for 2.5-3.2% of total financial sector assets in the last 3 years. This percentage is predicted to increase.
2. As mentioned earlier, most of the businesses in Mongolia perform only cash transactions, so it is difficult to verify these businesses' accounts. Some regulators fear that NBFIs are being funded with bank funds. Therefore, some believe that NBFIs should be regulated to protect the banking sector.
3. Supervisors suspect that some of the NBFIs have taken deposits from the public under the so-called "trust" service.

Within the last 5 years, the number of SCUs has increased over 7 times. Most SCUs do not have stringent criteria for membership. Most members are only interested in financial services, because SCUs provide much easier access to financial services than banks. Although SCU loan interest rates were often much higher than banks' rates, the number of members was increasing rapidly. In addition, some SCUs set the deposit rates too high, resulting in bankruptcy. As a result, BoM had to take emergency action and included SCUs under prudential regulation in 2003. Since 2003, SCUs have had to create loss provisioning funds for all assets, just like banks and NBFIs.

The prudential regulation for SCUs is being amended to approximate the World Council of Credit Unions' (WOCCU) PEARLS evaluation system for the following reasons:

1. The not-for-profit legal form does not fit with the guidelines of traditional prudential regulation.
2. When the Supervisors from the BoM developed the prudential regulation in 2002, they did not have any experience or knowledge on how to supervise SCUs because they had not been properly trained. The FRC recognized this and saw that the PEARLS system was the best for member-based institutions. As a result, the regulatory framework was redesigned and approved in February 2007.[10]

Mongolia is dependent upon imports because the national industries failed after state privatization in the 1990s. Excluding last year, the foreign exchange rate has always been unstable. This is why managing foreign exchange rate risk is considered to be one of the main prudential concerns in Mongolia.

In order to meet the liquidity ratio, banks must deposit reserve funds in the BoM. The reserve fund rate for banks was reduced in March 2007 from 14% to as low as 5%—depending upon the bank's features and characteristics—in order to encourage banks to use additional resources, improve their competitiveness, and introduce new products and services.

NBFIs are not required to establish reserve funds because they do not take deposits from the public. Since February 2007, however, SCUs have been required to create a reserve fund using at least 10% of their annual net profit.

There are two types of limitations on risk concentration:

1. A limitation on the amount of loans to individuals and related groups.
2. A limitation on the amount of loans to the Executive Director, Board of Directors, staff, and their related borrowers.

All types of movable, immovable, and intangible assets can be pledged. Immovable assets, however, are protected by legislation and may only be claimed through court proceedings if the borrower fails to repay the loan.

Microfinance Policy

As mentioned before, Mongolia lacks a specific microfinance policy. Microfinance is regulated under the general financial sector policy. The main regulatory policies are based upon

10. The reasons why the supervisory bodies decided to supervise the SCUs will be explained in greater detail later in the essay.

market economy rules. There are no risk concentration limitations with respect to geographic or sectoral diversification. There are no laws or regulations that require certain types of licensed financial institutions to target certain types of customers or markets. All institutions are free to choose their respective markets and products.

The BOM provides guidelines and the methodology for calculating interest rates on deposits and loans, but interest rates are not regulated and there are no interest rate ceilings. Due to the rapid development and expansion of the geographical coverage of SCUs, banks have decreased their interest rates on loans, increased their deposit rates, expanded their services in rural areas, offered new products, and begun to operate more efficiently. Currently, nearly half of all commercial banks are engaged in microfinance.

The tremendous success of microfinance in Mongolia is also accompanied by increases in certain risks. Recent research conducted by the Central Bank of Mongolia clearly demonstrates an increasing trend of double and triple borrowing by low-income households and micro-entrepreneurs. This poses a credit risk for both consumers and financial institutions, as well as systemic risk for the overall sector.

The Credit Information Bureau (CIB) was established in 1996 by the BoM. The CIB operated and tracked information manually until 2001. Today, they have a computerized management information system (MIS), but the database provides only loan, borrower, and collateral-related information; these data do not track types of loan products and services, interest and service fees, or how many loans have been provided in urban or rural areas. CIB operations are carried out by only two full-time officers.

All commercial banks and NBFIs are required to report credit information to the CIB. The CIB does not yet track SCUs' credit information because SCUs have only recently begun to be regulated by the state supervisory body. The BoM did not predict that microfinance would develop in Mongolia when it established the Credit Information Bureau. As a result, the current database does not provide efficient information on micro credit. The main microfinance providers, XacBank and Khan Bank, have had difficulty reporting credit information because they have a larger number of loans than other banks and NBFIs.

As the FRC is still a newly-established organization, it lacks a credit information bureau for financial service providers. No other private- or public-sector credit bureaus currently exist.

Protection of Consumers of Microfinance Services

There are no microfinance-specific consumer protection rules; this issue is addressed through general financial sector laws and regulations. In addition to prudential regulation by the BoM and FRC, consumer protection is addressed through regulations regarding the transparency of financial institutions, internal and external supervision, and good governance.

Disclosure

According to the Civil Code, banking law, and BoM regulations, banks and authorized financial service providers must publicly disclose their financial performance. Every year, one can see all banks' and most NBFIs' external audits and company-verified financial statements printed on paper. From these statements, one can get the general picture of their financial performance, but one cannot determine whether, for example, the financial institutions charged the publicly-announced interest rate or if they added different kinds of commissions, fees, and charges.

Reporting

Supervisory bodies require that all financial institutions submit financial statements on a monthly basis for off-site monitoring. The reporting system does not, however, include the evaluation of the outreach and depth of microfinance services. In addition, there is no system for monitoring or evaluating the performance and outreach of informal providers.

Deposit Insurance

There is no deposit insurance law. A draft law has been submitted to the government and is pending discussion by the Parliament.

Governance and Internal Supervision

All changes in Board members, Executive Directors, and shareholders must be reviewed by the BoM. The BoM also recommends that banks develop guidelines with respect to good governance and internal supervision. Similar requirements likely will be applied to SCUs and other financial institutions, but such requirements are still under consideration by the FRC.

Supervision of SCUs

SCUs are the only not-for-profit, member-based, self-regulated organizations supervised by the State, which has taken over supervision because the members have not taken responsibility for internal supervision. This has occurred because most members are interested only in services and hold very low shares of institutional capital. In addition, members have lacked sufficient knowledge and education about SCUs. The FRC has developed a new Law on Savings and Credit Unions that clarifies both the main duties and rights of members, Directors, and managers; and permitted and prohibited activities. The FRC should concentrate on improving the capacity of the SCUs and their members to supervise their cooperatives and assets, and to monitor the operations of the supervisory committee.

SCUs are allowed to mobilize savings from members only. There is a limitation on public announcements promoting the mobilization of deposits by SCUs.

Rating and Auditing

There is no rating agency operation offered by the State or the private sector.

Not all local audit companies provide the same quality of auditing. This is because the system of penalties and accountability for public notaries and audit companies is not fully functional.

The Main Factors Leading to Crisis and Success

How could Mongolia have achieved so much success in so little time without a national microfinance policy or any specialized regulation and legislation? Given Mongolia's recent failures with SCUs, this success is even more surprising. This section discusses the mistakes that led to the Savings and Credit Unions crisis, as well as the factors that led to Mongolia's eventual success in increasing access to microfinance services.

Microfinance Development in Mongolia Was Not Always a Success

Early efforts in the 1990s to promote microfinance failed. These failures included the establishment of government-owned banks, all of which became insolvent and were liquidated. Failed institutions included the Agriculture Bank of Mongolia (now Khan Bank), the Cooperative Bank, Grameen-Style NGO replicators, early savings and loan cooperatives, several attempts at second-tier credit union modalities, and a large number of donor- and government-led poverty lending projects.

The Savings and Credit Union (SCU) movement started in 1996. By the end of 2006, the number of registered SCUs had increased to 970. Of these, only 380-400 operate actively. As of today, 117 SCUs have received a license from the FRC.

In the last 3 years, many SCUs have become insolvent or declared bankruptcy. 25 of these SCUs (with 8,903 members) have lost the equivalent of USD 58.1 million in member funds.[11] While the police and other state-related organizations are taking various actions, people have started to lose their trust in SCUs and NBFIs as microfinance providers.

Many different organizations have conducted research and

11. This translates into an average loss of over USD 6,525 per member. The reason why this figure is so high is because many people sold their houses, some borrowed money from banks and deposited the proceeds in high-yielding SCU accounts, and even some big businesspeople invested money in SCUs.

brought forward ideas as to why so many people have lost their money. The National Legal Research and Information Center conducted a broad survey and concluded that there were three categories of insolvent or bankrupt cooperatives:

1. Cooperatives that were established with the sole purpose of cheating people. They stole their money and then fled (usually to another country).

2. Cooperatives that unethically used member deposits to finance different business activities—such as purchasing and building properties—and that later couldn't meet liquidity requirements.

3. Cooperatives that may have been operating reasonably well but, because of moral hazard and contagion, lost the confidence of their members. This resulted in a run on deposits (starting a downward cycle of loss of liquidity and income).

In the case of the 25 SCUs mentioned above, from the start they had the intent to cheat people. Why so many people were cheated is an interesting question. Were there not enough established financial institutions that could serve those people? Why were so many SCUs established in such a short period of time? Many have concluded that the people who were cheated did not have enough knowledge and education, and that they wanted to earn easy money by receiving a high deposit interest rate. While I agree with these conclusions, there was such a high demand for lending services because banks and NBFIs were serving only clients who had immovable collateral. Most SCU members joined even though their loan interest rates were high because banks work so slowly, require so many papers, and many banks do not accept movable assets as collateral. In addition, many SCU customers believed that banks only serve the rich.

This example also demonstrates how much cash people keep on hand. Even though Mongolia has such a small population and a large number of financial institutions, there is still a high demand for efficient, fair, and transparent microfinance services.

In December 2002, an amendment to the Cooperative Law prohibited the public promotion of loans and deposit products. Unfortunately, many SCUs did not comply with this law because the sanctions and penalties were so weak; these SCUs continued to publicly promote their services and continued to pay the penalties. The Central Bank issued several warning declarations to these SCUs, but the promotion of SCU services continued until recently.

The cooperative law was renewed in 1996. The law was written according to international standards. It provided more opportunity for members to decide all issues, including internal supervision, elections, voting, and dividend sharing. No external supervision was established. Cooperatives were permitted to establish an Association and a second-tier apex organization as well. The law also made clear that SCUs were not-for-profit organizations and should only serve their members.

The main factors that led to the SCU crisis include the legislation and the SCUs' institutional capacity. They may be summarized as follows:

Internal Factors	**External Factors**
There was no member training and no general understanding of SCU operations. There were also low levels of economic knowledge and education.	One of the main mistakes was that the law did not state the minimum and maximum share capital requirements per member. Members who were interested in loans invested small amounts of money because they did not care about the cooperative's operations. Members who had more money and were interested in making a profit invested in high percentages, and usually the operations were carried out by the bigger investors. Of course, the bigger investors had no desire to build the capacity of other members to supervise them.
The majority of the members are interested only in financial services, and a minority of members are interested only in dividends from their share capital.	The law did not state clearly that the members' share capital and deposits should be used only to provide loans for members, not to finance other businesses.
No internal supervision system; no operational transparency.	The law did not require annual external audits. It required auditing for tax purposes only if assets reached MNT 30 million (equivalent to about USD 26,000 at the current exchange rate). No specialized or experienced auditors were registered and/or trained.
Non-professional human resources and weak financial management.	The State registration office operates under the supervision of the Ministry of Finance. It is in charge of reviewing the founders' agreement and bylaws of each organization. If the agreement and bylaws comply with the relevant legislation, the office registers the organization and provides it with legal entity status. In practice, the State registration office has never properly enforced the legislation on legal entities; it has registered many SCUs even though their bylaws were illegal.
	Two SCU National Associations and one second-tier apex organization were established. Unfortunately, they did not provide substantial support, training, and advocacy. They also did not lead the SCUs towards international best practices and principles.
	The government of Mongolia declared the year 2005 as the "Year of Cooperatives" without any national policy to develop the cooperatives, and with holes in the Cooperatives Law.
	In 2002, an amendment to the Cooperatives Law restricting SCUs from advertising and mobilizing savings from the public was passed. Despite this regulation, cooperatives continued advertising almost every day on TV channels

	and newspapers until recently. There was no monitoring or implementation of this legal restriction. The sanctions and penalties were too weak; the SCUs earned more income from their illegal advertisements than the amount that they were penalized.
	According to the amendment to the Cooperatives Law in 2004, the Central Bank was authorized to supervise the SCUs. Subsequently, the Central Bank approved prudential ratio regulations for SCUs. However, the cooperatives were already in a downward spiral. According to this law (which is now being rewritten) the Central Bank has the right to supervise—but not to terminate—SCU operations.

Microfinance in Mongolia Today

It is difficult to understand the development of microfinance in Mongolia without discussing XacBank and Khan Bank. XacBank and Khan Bank are the primary providers of Microfinance in Mongolia.[12]

12. For further information, go to: www.xacbank.org and www.khanbank.com.

XacBank

XacBank started its operations as a UNDP-funded project to provide micro credit for the poor. The project was implemented very successfully. Most projects are discontinued after a certain period, once the intended tasks are completed. However, it would have been a pity to discontinue the project, since the demand for its services was so high. Instead, the project was restructured into a legal entity and received the first NBFI license from the Central Bank; it then gradually transferred to pure private ownership. The Xac NBFI continued its operations and received its bank license from the Central Bank in 1999. The institution became a fully licensed bank in the year 2000.

It is impossible to talk about all of its successes here, but in May 2006, XacBank received an "A" rating from Planet Rating, a global microfinance rating agency.

The following are some of the key factors that led to the success of XacBank:

Internal Factors	**External Factors**
Mixed ownership structure. The shareholders of XacBank consist of for-profit, not-for-profit, local, and international legal entities and individuals.	Constantly provided with international donor support and technical assistance.
Demand-driven products and services combined with high-quality customer training and consultancy.	Direct supervision from Central Bank of Mongolia since its establishment.

Good governance and transparent operations.	
Strong human resources policy and constant training; young and energetic management team and staff.	
Has followed international microfinance "best practice" guidelines and standards in its day-to-day operations from the start, even though supervisory bodies have not required this.	

Khan Bank

Khan Bank is the only bank to have established branches in every province and town in the nation. Distinguishing features of Khan Bank include:

1. Prior to privatization, it was owned completely by the state. The government could not manage the bank efficiently; it almost went bankrupt. The Government of Mongolia and Central Bank jointly reinvested and then privatized the institution. After privatizing and restructuring its operations, Development Alternatives, Inc. (DAI)[13] assumed responsibility for its daily management.
2. Khan Bank has the largest number of branches because it was previously owned by the government.[14] The bank provides payment and transaction operations related to the state budget. Khan Bank receives state budget resources and delivers payments for salaries of civil servants and pensioners.

13. DAI is a for-profit international development firm based in Bethesda, Maryland, USA. For more information, see www.dai.com.

14. Most of Khan Bank's branches already existed prior to privatization.

The common factors leading to the success of these two microfinance providers are:

1. Both occupied the market earlier than the other microfinance providers.
2. Both provide demand-driven products and services.
3. Both have operated under the direct supervision of the Central Bank of Mongolia since their establishment.
4. Both organize regular human resources trainings.
5. Both have received significant amounts of international donor support and technical assistance.
6. The last and perhaps most important factor is that both closely follow international principles and guidelines for prudential and transparent banking, even when it is not required by the Central Bank.

It should also be noted that other mainstream financial institutions have now aggressively entered into the microfinance market. One of the most notable entrants is the Mongol Post

Bank. After only one year of strategic effort, microfinance now comprises 70% of Mongol Post's total portfolio. The bank has quickly become the 2nd largest microfinance provider in rural areas (overshadowing XacBank). In addition, four insurance companies are now providing index-based insurance to herders. A large number of banks and NBFIs are now engaged in micro-leasing. Finally, Khan Bank, XacBank, and Mongol Post Bank have partnered with ADRA International[15] to provide non-collateralized lending to self-help groups and individuals who do not possess sufficient collateral.

Conclusion

Microfinance operations are distinct from other banking and financial operations because of the type of customers that they serve: poor people who would not normally gain access to the traditional banking system. What is most important to microfinance operations is to be loyal to the social mission of serving the poor and to have good leaders that understand this goal. It is also important to operate according to international microfinance best practice standards. A favorable legal and regulatory environment will encourage microfinance development. However, a favorable legal environment cannot compensate for a lack of either good governance or leaders that are loyal to serving the poor. XacBank achieved success because all of these components were in place.

XacBank and Khan Bank followed international best practices and guidelines from the start, even though the supervisory bodies did not require it. These standards are higher than the prudential regulatory requirements that were set by the Central Bank. So even though there was no specialized supervisory regulation of microfinance in Mongolia, there was also no conflict between international MF guidelines and BoM regulations. There is an old Mongolian saying that says, essentially, that the one who starts off right finishes first. In other words, it is always easier to start correctly than to fix mistakes afterwards. Why should we have to learn from our own mistakes when we have an opportunity to learn from best practice?

In order to provide long-term, sustainable operations, microfinance institutions need to provide fair, transparent, efficient, and demand-driven services to their customers. In the beginning of the year 2000, commercial banks never believed that providing microfinance could be profitable or that poor people would be able to repay their loans. Currently, however, nearly half of all commercial banks and almost all NBFIs and SCUs provide microfinance. The growth of the SCUs showed that there was a significant demand for efficient, fair, and transparent services.

Microfinance customers are distinct from other financial customers. They are often highly vulnerable to shocks in the market and in the home. They have little to no liquid savings, a minimum of pledgeable collateral, and generally low levels of financial literacy. As a consequence, microfinance customers are comparatively more vulnerable to unethical, non-transparent, or inappropriately-designed financial services, and their consumer rights are often violated.

Regulators and law enforcement agencies should focus more on consumer protection, rather than just focusing on institutional capacity building:

1. Regulations should mandate that institutions deliver complete and accurate information to clients. For example, all financial institutions in Mongolia announce their interest rates, but they never disclose their service fees, commissions, and all other charges. The financial institution salespeople never explain the terms and conditions of their services (including penalties) in language that less-educated people can understand.
2. The client's personal information should be kept confidential. Currently, the banking law allows for access to a client's personal information upon the request of the taxation and customs office. The banking and tax laws should be amended to include this right to confidentiality. This should be implemented by the financial institutions and enforced by the regulators.
3. Public advocacy, education, and training should be organized by the NGOs and State supervisory regulators. Educating MFI clients about their rights and MFIs' obligations will empower clients to protect their rights and demand fair services. In the longer term, consumer education should also benefit regulators by reducing their supervisory burden, as MFIs will be forced to properly serve customers in order to survive.
4. If financial institutions break the law, the sanctions and penalties have to be strong enough to discourage further violations.

In order to improve the environment for microfinance, what should we do? Should we amend the current laws and regulations, develop a national microfinance policy, or adopt a new law on microfinance? If we lack both (i) the human resources with the necessary microfinance knowledge; and (ii) the experience and the capacity to implement and enforce the law, then we are better off without separate laws and regulations.

Without any microfinance-specific laws and regulations, Mongolian MFIs have demonstrated excellent success that compares favorably with MFIs worldwide. Weak areas include: governance; internal controls; interest rate disclosure; consumer education; financial privacy; limited licensing options for informal groups (see below); lack of opportunity to develop a private-sector credit bureau; lack of rating agency; inadequate sanctions and penalties; and insufficient capacity and training of supervisors. These issues can be resolved through inclusive financial reform by amending some related laws and adopting some resolutions by the BoM and FRC. These resolutions will benefit not only microfinance clients but also other clients of banking and financial institutions.

The following resolutions or amendments to the laws and regulations should be considered:

1. The main supervisory regulatory policy, based on market economy rules, should be kept as it is now so long as financial institutions and clients are both benefiting.
2. Since the number of microfinance providers has increased, supervisory bodies must train supervisors to better understand microfinance, with or without support of international donors and NGOs (if they lack financial resources).
3. Supervisory bodies should consider providing the private sector with opportunities to establish the following: a rating agency; a credit information bureau; and a second-tier apex organization under their direct supervision, in order to intensify the demand-driven operation of financial institutions, especially if the state has limited financial and human resources. These institutions can begin with a temporary license, which can be converted into a full license or revoked, depending upon performance.
4. Authorized bodies that provide licenses to financial institutions should consider providing limited licenses to self-help groups, NGOs, and projects in order to support the innovation of financial services.
5. Audit companies should be rated, licensed, and specialized in various areas.