



SUMMARY PROCEDURE

FOR OFFICIAL USE ONLY

R129-15
5 November 2015

Proposed Loan and Technical Assistance Grant Supporting the Credit Guarantee System for Economic Diversification and Employment Project (Mongolia)

1. The Report and Recommendation of the President (RRP: MON 48015-002) on the proposed loan and technical assistance grant to Mongolia for the Supporting the Credit Guarantee System for Economic Diversification and Employment Project is circulated herewith.
2. This Report and Recommendation should be read with *Country Operations Business Plan: Mongolia, 2015*, which was circulated to the Board on 20 August 2015 (DOC.IN.273-15).
3. In the absence of any request for discussion and in the absence of a sufficient number of abstentions or oppositions (which should be communicated to The Secretary by the close of business on 27 November 2015), the recommendation in paragraph 29 of the paper will be deemed to have been approved, to be so recorded in the minutes of a subsequent Board meeting. Any notified abstentions or oppositions will also be recorded in the minutes.

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Report and Recommendation of the President to the Board of Directors

Project Number: 48015-002
November 2015

Proposed Loan and Technical Assistance Grant Mongolia: Supporting the Credit Guarantee System for Economic Diversification and Employment Project

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 5 October 2015)

Currency unit	–	tugrik (MNT)
MNT1.00	=	\$0.00050138
\$1.00	=	MNT1,994.50

ABBREVIATIONS

ADB	–	Asian Development Bank
CGFM	–	Credit Guarantee Fund of Mongolia
ESMS	–	environmental and social management system
MOF	–	Ministry of Finance
PAM	–	project administration manual
PFI	–	participating financial institution
PIU	–	project implementation unit
SLA	–	subsidiary loan agreement
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

NOTE

In this report, “\$” refers to US dollars.

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PROJECT AT A GLANCE

1. Basic Data		Project Number: 48015-002	
Project Name	Supporting the Credit Guarantee System for Economic Diversification and Employment Project	Department /Division	EARD/EAPF
Country Borrower	Mongolia Mongolia	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Small and medium enterprise finance and leasing		60.80
		Total	60.80
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Public financial governance	Some gender elements (SGE) ✓	
Partnerships (PAR)	International finance institutions (IFI) Official cofinancing		
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Nation-wide	High
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: B Involuntary Resettlement: FI-C Indigenous Peoples: FI-C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		60.80	
Sovereign Project loan: Ordinary capital resources		60.00	
Sovereign Capacity development technical assistance: Technical Assistance Special Fund		0.80	
Cofinancing		0.00	
None		0.00	
Counterpart		30.03	
Project Sponsor		21.90	
Government		8.13	
Total		90.83	
9. Effective Development Cooperation			
Use of country procurement systems		No	
Use of country public financial management systems		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to Mongolia for the Supporting the Credit Guarantee System for Economic Diversification and Employment Project.¹ The report also describes the proposed technical assistance (TA) for the Supporting the Credit Guarantee System for Economic Diversification and Employment Project, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.

2. The project aims to improve the access of Mongolia's small and medium-sized enterprises (SMEs) to finance to sustain their businesses and thereby foster growth, diversify the economy, lessen its dependence on the mining sector, and create jobs. The TA will improve the quality of the Credit Guarantee Fund of Mongolia (CGFM) and the country's credit guarantee system. The government has asked the Asian Development Bank (ADB) to support commercial banks' lending to SMEs by backing CGFM credit guarantees.² The project will expand the financing for SMEs in sectors not related to mining.

II. THE PROJECT

A. Rationale

3. **Development problems and opportunities.** The mining sector accounts for about 25% of gross domestic product, and this makes the country highly vulnerable to swings in global commodity prices. Although micro, small, and medium-sized enterprises make up 90% of registered businesses and provide about 50% of all jobs, up to 90% of the country's 36,800 SMEs do not have regular access to finance from banks. This limits their chances to grow and their ability to make their full potential contribution to the economy and employment. Their access to lending is impaired by their lack of currently recognized collateral, high rates on long-term bank loans they need from banks, and the banks' own liquidity constraints on the long-term lending.³ Other issues are the country's inadequate credit information base, the burdensome requirements SMEs face when applying for credit, the SMEs' poor understanding of financial management, and underdeveloped loan underwriting capabilities at the banks.⁴ Two-thirds of SMEs are engaged in the manufacturing sector, particularly food production, followed by construction materials and garments. With proper access to finance, SMEs, can help economic diversification by increasing leather production, tourism, and other consumer services.

4. SMEs must often either borrow collateral to pledge when seeking loans or get no financing from banks for their investment needs and growth. Providing collateral is even more problematic for SMEs run by women as their businesses tend to be smaller than those run by men, and therefore have fewer pledgeable assets. Mongolia has an ownership and liens' register for immovable property but there is no system to secure interests on movable assets.⁵

¹ The design and monitoring framework is in Appendix 1.

² The CGFM is a state-owned enterprise established in 2012. Members include the Ministry of Finance, the Ministry of Labor, the Ministry of Industry, the Financial Regulatory Commission, the National Chamber of Commerce and Industry, and the Mongolian Employers Federation. The government has provided all of the capital. As of year-end 2014, CGFM had \$3.1 million in assets.

³ The term "long-term" or "longer-term" used in this document refers to loans with a 5-year maturity or longer.

⁴ The Bank of Mongolia operates a credit registry. A credit information bureau established in 2009 by the Mongolian Bankers Association with the support of the United States Agency for International Development is not operational.

⁵ On 25 March 2014, the International Finance Corporation signed a cooperation agreement with the Ministry of Justice to reform the secured transaction system and to establish a proper legal framework for secured transactions through a new law on pledging, an online registry for movable property, and awareness raising and training for industry professionals.

This generally limits the collateral accepted by banks to real estate. Weak standards for appraising assets reduce the credibility of these valuations of collateral. SMEs need loans on terms longer than those now available for their capital investments, but the banks do not have the matching long-term funding sources to lend with those maturities due in part to an underdeveloped long-term deposit market. To match their short-term deposits, banks mainly make only short-term loans to SMEs. They also try to make these loans in US dollars to help balance their open foreign currency positions. Foreign currency loan rates are also lower than the annual 16% rates generally available for local currency loans, and the rates of 22%–26% available to SMEs. This ignores the inability of most SMEs to generate enough foreign currency to repay these loans. As a result, the national chamber of commerce and industry has reported a rising number of SME bankruptcies brought on by having to service loans in US dollars.

5. The government established the CGFM in November 2012 to help SMEs overcome the obstacles posed by collateral issues to gaining finance. Operations began in April 2013, and 10 of the country's 13 banks now participate in the program, along with 6 nonbank financial institutions. Its overall effect on the economy has been limited as the fund's potential impact is held back by its size, having only one basic guarantee product, and a lack of operational capacity and expertise. SMEs are not using credit guarantees as much as they could for several reasons. Many potential borrowers are unaware of the program, and the CGFM marketing is weak. SMEs also lack financial management knowledge needed to apply for loans. While the CGFM can support SME access to finance by offering guarantees, no law specifically governs the operations of a private guarantee system offering an alternative to the government-run CGFM. Despite the barriers, on average each guarantee issued has helped SMEs create jobs.

6. **Government plans and linkage with country partnership strategy.** The project is consistent with Mongolia's national development strategy, which is based on the Millennium Development Goals, and with an SME development program the government has adopted for 2014–2016.⁶ It is in line with ADB's interim country partnership strategy for Mongolia for 2014–2016, which made development of the finance sector a new priority.⁷ Finance sector development was reconfirmed as one of ADB's core areas of operation by the 2014 Midterm Review of Strategy 2020.⁸ The project will build on previous and ongoing ADB lending programs that included support for strengthening financial regulation and governance, expanding access to credit, enhancing the role of the nonbank finance sector, and increasing the availability of savings and credit services in rural areas and among the poor.⁹ The project is an extension of ADB's SME onlending programs,¹⁰ as well as its TA work in microfinance, mobile and branchless banking, and regulatory and supervisory frameworks.¹¹

⁶ Government of Mongolia. 2008. *Millennium Development Goal-Based Comprehensive National Development Strategy of Mongolia (State Great Hural, Resolution No. 12, 2008)*. Ulaanbaatar; Government of Mongolia. Ministry of Labor. 2013. *SME Development Program*. Ulaanbaatar.

⁷ ADB. 2014. *Interim Country Partnership Strategy: Mongolia, 2014–2016*. Manila.

⁸ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

⁹ ADB. 2005. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Mongolia for the Financial Regulation and Governance Program*. Manila (Loan 2218-MON); ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Mongolia for the Rural Finance Program*. Manila (Loan 1848-MON); ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Mongolia for the Rural Finance Program*. Manila (Loan 1848-MON).

¹⁰ ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Khan Bank for Supporting Micro, Small, and Medium-Sized Enterprises Project in Mongolia*. Manila (Loan 7410-MON); ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loans to XacBank and TenGer Financial Group for Supporting Micro, Small, Medium-Sized Enterprises and Leasing Finance Project in Mongolia*. Manila (Loan 7401-MON).

¹¹ ADB. 2000. *Technical Assistance to Mongolia for Rural Finance*. Manila (TA 3397-MON); ADB. 2009. *Technical Assistance to Mongolia for Transformational Mobile Banking Services*. Manila (TA 7479-MON); ADB. 2009.

7. **Development partners and lessons.** Among Mongolia's development partners, only the Japan International Cooperation Agency has provided the CGFM with support. It has provided limited periodic training and has proposed placing a volunteer credit guarantee expert at the fund. Development partner assistance in the SME sector has focused mainly on supporting SME capacity development and providing financing for private enterprises with no or limited access to finance. Much of this assistance has been aimed at lowering the high cost of loans by offering SMEs concessional rates. It has not addressed the issues related to the SMEs' inability to provide collateral currently acceptable to the banks from which they seek loans or the lack of availability from banks of long-term funding because their deposit base is only under 1 year. Despite an increasing number of development partners active in SME development and financing, programs have shown that these issues and limited access to affordable long-term finance continue to constrain SME growth.

B. Impact and Outcome

8. The impact will be increased job creation in economic sectors not related to mining. The outcome will be an expansion of access to finance for SMEs.

C. Outputs

9. **Output 1: Longer-term financing for small and medium-sized enterprises increased.** Up to \$60 million of ADB funding will be made available under the proposed financial intermediation loan to enable participating financial institutions (PFIs) to make long-term loans denominated in local currency to SMEs for eligible subprojects. In addition, the project will back the introduction of new guarantee products by the CGFM to support up to \$432 million of SME subprojects. This is expected to create as many as 13,200 jobs over the 18-year ADB loan period.¹² Output 1 will be delivered by (i) helping PFIs mitigate maturity mismatches by making time deposits in PFIs to fund a portion of their loans to qualified SME borrowers, and (ii) CGFM guarantees for a portion of the credit risk these loans pose. New credit guarantee products designed to help low-income groups in rural areas and women entrepreneurs access the credit guarantee will be established.¹³ The CGFM will carry out awareness-raising and outreach programs to make women and the rural poor aware of the credit guarantee system.

10. **Output 2: A longer-term bank deposit market developed.** The funding from the local currency time deposits placed by the CGFM in the PFIs will help establish a market for 5-year deposits, since it will build confidence in the safety and pricing of local currency deposits and encourage the private sector to mobilize savings for lending with longer maturities. CGFM will use market-based rates for time deposits consistent with existing funding from the government,

Technical Assistance to Mongolia for Policy and Institutional Support for Banking Sector Systemic Risk Management. Manila (TA 7397-MON).

¹² According to regulation, CGFM may issue guarantees totaling a maximum value of 10 times its capital base. It is projected that the capital base can reach \$9 million, reflecting current capital and proposed additional government injection and thereby allowing for \$90 million of guarantees to be issued. Assuming that PFIs will lend only 75% of the borrowing SMEs' total project costs, \$90 million in guarantees could support \$120 million of SME subprojects at one time, before considering recycling. Economic analysis shows that 13,200 jobs may be created and loan funds may be recycled 3.6 times during the project. This would support \$432 million in SME subprojects. As of 30 June 2015, the CGFM had issued 364 guarantees for MNT24.4 billion supporting MNT59.7 billion of gross loans, with an average 43-month tenor. These guarantees created 1,210 new jobs. PFIs will include commercial banks only.

¹³ This project defines women-run businesses as businesses that meet at least one of three criteria—i.e., that (i) at least 50% of ownership is controlled by women, (ii) at least 60% of senior managers are women, or (iii) at least 50% of the registered contractual employees are women. ADB. 2014. *Gender Toolkit for Micro, Small, and Medium-Sized Enterprise Finance and Development.* Manila.

bilateral development partners and multinational organizations. The CGFM time deposits in PFIs will require the CGFM to issue new guarantee products, such as guarantees targeting women entrepreneurs, rural-based SMEs, and SMEs that will create non-mining sector jobs, to support loans to qualified SME borrowers. The loan repayments will be recycled during the term of the ADB loan to support new SME loans.

D. Investment and Financing Plans

11. The project is estimated to cost \$90 million (Table 1). The government has requested a loan of \$60 million from ADB's ordinary capital resources to help finance the project. Project financing (Table 2) reflects sources contributed by PFIs from the private sector and the CGFM to partially fund credit-guaranteed SME subprojects in addition to the ADB loan. The loan will have an 18-year term, including a grace period of 12 years, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year (the interest and other charges during implementation to be capitalized in the loan), and such other terms and conditions set forth in the draft loan and project agreements.¹⁴ The loan will have principal repayments in regular semiannual installments over the last 6 years of the loan, and interest will be repaid semiannually with interest and commitment fees capitalized up to the allocation amount in Table 1.¹⁵ All payment and repayment obligations of Mongolia under the ADB loan are independent of the performance of the CGFM under the subsidiary loan agreement (SLA) with the Ministry of Finance (MOF), of PFIs under the relevant time deposit agreements, of SME borrowers under the relevant SME loan agreements, as well as of any conversion or hedging risk borne by Mongolia in the conversions of the ADB loan into tugrik or reconversion to US dollars.

Table 1: Project Investment Plan
(\$ million)

Item	Total
A. Cost^a	
Loans to eligible SME subprojects	88.63
B. Financing Charges During Implementation^b	1.37
Total (A+B)	90.00

SME = small and medium-sized enterprise

^a Refers to time deposits funded by the Asian Development Bank (ADB) loan and the Credit Guarantee Fund of Mongolia cofunding, plus participating financial institutions' funding contribution.

^b Includes interest and commitment charges estimated for a 3-year period computed for ADB's ordinary capital resources (OCR) loan at the 3-year US dollar fixed swap rate, plus an effective contractual spread of 0.5% and maturity premium of 0.1%. Commitment charges for an OCR loan are 0.15% per year to be charged on the undisbursed loan amount.

Source: Asian Development Bank estimates.

¹⁴ Interest includes a maturity premium of 10 basis points. This is based on the loan terms and the government's choice of repayment option and dates.

¹⁵ A 12-year grace period is necessary to allow the CGFM to recycle ADB loan proceeds approximately 3.6 times during its 18-year term. This will be done by supporting the placement of new, recurring time deposits linked to guarantees issued for new loans to qualified SME borrowers. The grace period will also enable the project to support long-term SME loans for capital investments. Interest and commitment fees will be capitalized up to the allocation amount to allow for the retention of profits by the CGFM due to lower initial financing charges that will support the buildup of the capital base and give the fund additional capacity to issue guarantees through leverage.

Table 2: Financing Plan

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank		
Ordinary capital resources (loan)	60.0	66.7
Private sector ^a	21.9	24.3
Government of Mongolia ^b	8.1	9.0
Total	90.0	100.0

^a The amount is the overall loans not funded from Asian Development Bank and Credit Guarantee Fund of Mongolia resources reflecting sources contributed by participating financial institutions to partially fund credit-guaranteed loans to small and medium-sized enterprises.

^b Comprises \$8.1 million of current capital and additional proposed capital to come from either a proposed additional capital injection by the Government of Mongolia or the retention of the excess of revenues less costs available at the Credit Guarantee Fund of Mongolia, net of required holdback of 10% according to supervisor regulations. The government will finance local taxes and duties that may be due under the project.

Source: Asian Development Bank estimates.

E. Implementation Arrangements

12. The MOF will be the executing agency, and the CGFM will be the implementing agency. ADB loan proceeds will be drawn down by the MOF from the imprest account, based on the estimate of the amount of the time deposits the CGFM is to place with PFIs during the next 6 months.¹⁶ ADB loan proceeds are expected to be fully drawn down by the end of the 5-year implementation period and possibly sooner, depending on how quickly the CGFM issues new guarantees. Upon receipt of the ADB loan proceeds through periodic drawdowns, the MOF will convert the proceeds into tugrik and relend the converted amount to the CGFM under an SLA that is satisfactory to ADB.¹⁷ Upon receipt, the CGFM will immediately deposit these funds into a subaccount that will be used to place time deposits in the PFIs that meet the selection criteria agreed by the MOF, the CGFM, and ADB, and have received guarantees from the CGFM for SME loans for eligible subprojects. Time deposit and guarantee agreements between the CGFM and PFIs will be approved by ADB. Each PFI will use the time deposit proceeds and guarantees received to issue new market-based, floating, or fixed-rate tugrik loans, leases, and other forms of finance to eligible SMEs for eligible subprojects. When the time deposits mature, the proceeds will be deposited in an escrow account under the name of the CGFM at a PFI approved by ADB for recycling into new time deposits.¹⁸

¹⁶ The volume of time deposits placed in a PFI will be linked to the level of the guarantees the CGFM issues for loans to eligible SME borrowers by the PFI. Only loans to eligible SME borrowers that use new CGFM guarantee products will be eligible to receive partial ADB loan funding. Time deposits will be placed in PFIs at maturities equal to the principal amortization schedule of the underlying portfolio of SME loans in annual maturity increments until the level of the guarantees the CGFM issued for loans to eligible SME borrowers by each PFI to SMEs is reached. Time deposits have maturities of up to 5 years. If the principal amortization schedule for the portfolio of SME loans reflects tenors of longer than 5 years, all remaining amortizations beyond 5 years will be combined into a 5-year time deposit and then, at the 5-year maturity, the time deposits will be rolled over into new time deposits to cover the remaining portfolio amortization schedule through the final maturity of the portfolio of SME loans, as described in the project administration manual (PAM). Cofunding from the CGFM will be placed in PFIs on the same terms and conditions as deposits using ADB loan funds. Time deposits placed by the CGFM in PFIs will pay a market-based rate in line with the government and other development agencies' loan financing programs, as determined by ADB from time to time and detailed in the PAM. The initial rate will be set by ADB and, after 3 years, be reset by ADB in line with the government and other development agencies' loan financing programs.

¹⁷ For the first 3 years of the ADB loan, MOF will charge the CGFM an interest rate of up to 1% on the balance of the ADB loan disbursed to the CGFM in tugrik in the SLA. After year 3, MOF may charge CGFM under the SLA on the disbursed ADB loan balance a maximum of the pass-through rate of interest charged by ADB, plus up to 0.5%. MOF may additionally charge CGFM under the SLA up to 0.15% on the undisbursed balance of the ADB loan. The repayment period of the SLA will be consistent with the ADB loan.

¹⁸ The interest rate on escrow account balances will be at market rates with a maturity of no more than 1 month.

13. **Qualified participating financial institutions.** To be eligible to participate, each PFI must: (i) be deemed by ADB as having satisfactory operations for at least 5 years; (ii) submit documentation establishing at least 5 years of experience in SME or microcredit lending; (iii) demonstrate to ADB its track record of running a successful SME program; (iv) have corporate, financial, and governance practices that are acceptable to ADB; (v) have adequate credit and risk management policies, and operating systems acceptable to ADB; (vi) have satisfactory and transparent accounting, management information system, and internal audit system as determined by ADB; (vii) satisfy ADB's due diligence requirements for integrity, antimoney laundering, and counterfinancing of terrorism, and put in place antimoney laundering, and counterfinancing of terrorism controls, and measures to implement such controls, in each case acceptable to ADB; (viii) establish an environmental and social management system (ESMS) acceptable to ADB, and appoint qualified staff to implement the ESMS for screening prospective qualified SME subprojects in accordance with ADB's Safeguard Policy Statement (2009) and the requirements set forth in the project administration manual (PAM) to the satisfaction of ADB; and (ix) obtain relevant approvals for new CGFM guarantee products for SME loans that will be provided to qualified SME borrowers for qualified SME subprojects, and sign the relevant master guarantee agreement, approved by ADB.¹⁹

14. In addition, each PFI will need to meet other eligibility criteria at all times. It must (i) comply fully with capital adequacy ratios and all other prudential requirements mandated by the Bank of Mongolia; (ii) have loans overdue by 90 days or more comprising less than 8% of its total loan portfolio; (iii) have operating profit after tax in its most recently completed fiscal year; and (iv) have its financial accounts audited annually by an external auditor, with its audit results determined satisfactory by ADB. PFIs that do not meet all eligibility criteria at selection may still participate if they agree to implement measures to achieve full compliance within 12 months of signing the master guarantee agreement with the CGFM. If a PFI does not fully comply within 12 months of this signing, it will not be permitted to participate in the project. The CGFM will notify ADB of this promptly and exercise its rights under the time deposit and guarantee agreements in consultation with ADB. A final selection of PFIs will be made jointly by ADB, the MOF, and the CGFM based on due diligence reports and the PFI eligibility criteria agreed in the loan and project agreements.

15. **Qualified borrowers, loans, and subprojects.** A qualified SME borrower will (i) be an SME according to the definition stipulated in Mongolia's law governing SMEs, (ii) not be engaged in any prohibited investment activities on the extended prohibited investment activities list attached to the loan and project agreements, (iii) comply with Mongolia's applicable laws and regulations, and (iv) meet credit and other risk-related criteria determined and applied by the PFI and the CGFM.²⁰ Each qualified SME loan will (i) be used by a qualified SME borrower for a qualified subproject; (ii) be denominated in tugrik; (iii) have a market-based interest rate; (iv) be at least partially guaranteed by a new guarantee product issued by the CGFM; and (v) have at least 5-year maturity, which is consistent with lending for capital investments. Up to 15% of the gross amount provided to the CGFM under the subsidiary loan agreement may be used at any given time for SME loans that have a repayment period or tenor of less than 5 years.

16. A project steering committee will be established to monitor project status and support coordination. It will be chaired by the MOF and include representatives of the CGFM and the Ministry of Industry. A project implementation unit (PIU) will be established in the CGFM to support, review, and report on project implementation. The PIU will monitor each PFI's

¹⁹ Project Administration Manual (accessible from the list of linked documents in Appendix 2).

²⁰ Prohibited Investment Activities List (accessible from the list of linked documents in Appendix 2).

compliance with the PFI eligibility criteria, submit status reports to ADB, and notify ADB if any PFI fails to comply. The CGFM will exercise its rights under the time deposit and guarantee agreements in consultation with ADB. All procurement of goods and civil works for the SME subprojects will be subject to and governed by applicable provisions of ADB's Procurement Guidelines (2015, as amended from time to time). The implementation arrangements are summarized in Table 3 and described in detail in the PAM.

Table 3: Implementation Arrangements

Aspects	Arrangements
Implementation period	April 2016–March 2021
Estimated project completion date	31 March 2021 (estimated ADB loan closing: 31 October 2021)
Management	
(i) Oversight body	Project steering committee Ministry of Finance (chair) Ministry of Industry (member) CGFM (member)
(ii) Executing agency	Ministry of Finance
(iii) Key implementing agency	CGFM
(iv) Implementation unit	CGFM project implementation unit (3 staff)
Consulting services for technical assistance	55 person-months \$0.83 million
Disbursement	The loan proceeds will be disbursed in accordance with ADB's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time) and detailed arrangements agreed between the government and ADB.

ADB = Asian Development Bank, CGFM = Credit Guarantee Fund of Mongolia.

Source: Asian Development Bank.

III. TECHNICAL ASSISTANCE

17. The TA will be implemented over 24 months and is expected to start by 31 March 2016 and to be completed by 31 March 2018. The quality of the CGFM and the credit guarantee system will be improved and the TA will build operational, governance, and risk management capacity at the CGFM and enhance its product set. It will help reform the credit guarantee system framework by drafting laws and regulations to enable a private credit guarantee system to develop. The CGFM's legal framework will be reviewed under the TA to strengthen governance mechanisms and support public transparency. The MOF will be the executing agency. ADB will consider the current and planned activities of other development partners when finalizing the arrangements for the TA.²¹ The TA will use a road map created by the project preparatory TA.²² The TA is estimated to cost \$0.83 million, of which \$0.80 million will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-V).²³ TA consultants will be selected in accordance with ADB's Guidelines on the Use of Consultants (2013, as amended from time to time). TA resources will be disbursed in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time).

IV. DUE DILIGENCE

18. Due diligence found the project to be financially viable, economically sustainable, and in compliance with Mongolia's laws. It supports social and gender development, and incorporates environmental safeguards.

²¹ The Japan International Cooperation Agency has been implementing a two-step loan project since 2012 to provide lending and capacity development to PFIs supporting SMEs and also supports the CGFM (para. 7).

²² ADB provided project preparatory TA to Mongolia for Supporting the Credit Guarantee System for Economic Diversification and Employment Project (TA 8792).

²³ Under P48015-003.

A. Economic and Financial

19. The key economic benefit is job creation. The project is economically viable. Its estimated economic internal rate of return of 21.1% exceeds the 12.0% economic opportunity capital cost. Sensitivity analysis tested the robustness of economic viability under three scenarios: a reduction in the projected jobs to be created per guarantee issued, a reduction in the envisioned incremental wage gains, and a 1-year delay in project start. The testing resulted in economic internal rates of return of 15.7%–20.4%, confirming viability. Financial due diligence showed that the CGFM met all loan covenants. The CGFM's financial capacity was subjected to sensitivity analysis to assess its ability to meet equity requirements and the cofinancing ratio in the event of adverse changes in the growth rate in guarantee issuance, the fees charged for guarantees, and the ratio of nonperforming loans. The analysis showed that the CGFM can comply with loan covenants during the ADB loan term under all scenarios.²⁴

B. Governance

20. **Credit Guarantee Fund of Mongolia.** An assessment established that the CGFM has the ability to manage the project financially.²⁵ ADB will have approval of the CGFM's selection of a PIU staff that has suitable skills and is familiar with the government and ADB requirements on disbursements and social and environmental safeguards. Adequate financial management controls are in place, but financial management practices require some strengthening (footnote 25). These are its legal framework, governance, financial management, risk management, information systems, and SME educational program. The CGFM needs to enhance its financial management reporting tools and reports and its long-term budgeting, as well as budget links to strategic objectives. Risk management should be reinforced, and better regulatory and operational risk policies drafted. The CGFM credit guarantee assessment and portfolio analysis skills require improvement. Due diligence rated the premitigation risk moderate, and the concerns identified will be addressed through the associated TA during project implementation (para. 17). ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the MOF and the CGFM. The policy requirements and supplementary measures are described in the PAM.

21. **Participating financial institutions.** Due diligence was carried out for all 10 candidate PFIs that submitted expressions of interest.²⁶ ADB reviewed the PFIs' credit, operational, and counterparty risks, as well as their risk mitigation processes. Seven of these PFIs met all of the eligibility criteria (paras. 13-14).²⁷ The three PFI candidates that did not qualify may still participate if they agree to implement measures to meet all criteria within a reasonable period. Shortcomings in PFIs related to social, gender, and environmental safeguards will be addressed through the training to be provided under the TA. The CGFM will monitor the PFIs to ensure that SME loans finance activities that are consistent with ADB's Safeguard Policy Statement and other loan qualification criteria, including ADB's extended prohibited investment activities list. Auditing procedures will meet ADB requirements. The CGFM will prepare annual audited consolidated statements on the use of funds by the PFIs and will provide ADB with quarterly statements to show that the ADB loan funds are used for the purposes intended by the project.

²⁴ Loan Agreement (accessible from the list of linked documents in Appendix 2).

²⁵ A detailed diagnostic report, recommendations, and a road map are contained in Due Diligence of Credit Guarantee Fund of Mongolia and Road Map (accessible from the list of linked documents in Appendix 2).

²⁶ Eligibility Criteria for Participating Financial Institutions and Due Diligence Reports of Participating Financial Institutions (accessible from the list of linked documents in Appendix 2).

²⁷ Full details of PFI due diligence results can be found in Financial Analysis and Due Diligence Reports of Participating Financial Institutions (accessible from the list of linked documents in Appendix 2).

22. **Ministry of Finance.** Financial management assessments for ADB-funded projects have judged the MOF to be able to act as an executing agency.²⁸ Due diligence for this project established that the MOF has sufficient financial management capabilities and is familiar with ADB requirements on disbursements and social and environmental safeguards.

C. Poverty, Social, and Gender

23. **Socioeconomic and gender impacts.** The project will not have a direct effect on income growth or poverty reduction, but it will create jobs and its indirect impacts on living standards and the well-being of the Mongolian population will be substantial. As the project will improve access to finance for SME entrepreneurs who are likely to include women, as well as employment opportunities for women in the SME sector, the project's proposed gender category is some gender elements. The project steering committee and the PIU will ensure that the principles of gender equity aimed at increasing benefits for women are consistent with ADB's Policy on Gender and Development (1998) and are followed during project implementation. The expected economic, social, and gender impacts are described in detail in the PAM. Action will be taken to ensure that SMEs benefiting from loans comply with national labor standards.

D. Safeguards

24. The project will help put arrangements into place at the MOF, the CGFM, and the PFIs to ensure that the loans qualified SME borrowers will comply with ADB's Safeguard Policy Statement; Mongolia's labor, environmental, health, safety, and social laws and regulations; and the restrictions of the extended prohibited investment activities list.²⁹ Before the first disbursement of the ADB loan, the CGFM will be required to establish an ESMS acceptable to ADB and appoint qualified officers to implement it. The ESMS will be used to screen and categorize the potential environmental, indigenous peoples, or involuntary resettlement impacts of any proposed SME subproject before it is approved for a credit guarantee.

25. **Social safeguards.** The project is classified FI and treated as category C for involuntary resettlement and for indigenous peoples impacts under ADB's Safeguard Policy Statement. Project activities will affect no ethnic minority communities or indigenous peoples nor involve involuntary resettlement. No proposed subproject that can be classified as category A or B for involuntary resettlement or indigenous peoples' safeguards will be approved.

26. **Environment.** The project is classified FI and treated as category B for environment. The project will have mainly positive environmental benefits, since the support it will provide for SMEs will be closely screened to eliminate potential adverse environmental impacts and will help diversify the economy away from overdependence on mining-related activities, which often have negative effects on the environment. An ESMS was prepared for the PFIs that includes elements of an environmental assessment and review framework. The PFIs will use the framework for due diligence to establish whether proposed subprojects meet Mongolia's environmental protection and environmental impact assessment laws, and the requirements of ADB's Safeguard Policy Statement. The ESMS screening procedures include a brief climate risk assessment that will be applied to every subproject. Based on the proposed loan activities, no significant adverse environmental impacts are expected, and risk is considered low. Only subprojects treated as category B or C for environment will be supported by the PFIs under ADB's project and loan. The potential impacts of any category B subprojects will be mitigated

²⁸ ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Administration of Technical Assistance Grant for Additional Financing to Mongolia for the Agriculture and Rural Development Project*. Manila.

²⁹ The project will comply with information and disclosure requirements of ADB's Safeguard Policy Statement.

through implementation and monitoring that has been prescribed by the generic environmental management plans that will be an agreed part of loan approval by concerned PFI.

E. Risks and Mitigating Measures

27. The overall project risk rating is moderate and project benefits are expected to outweigh the costs and the risks. Major risks and mitigating measures are summarized in Table 4 and described in detail in the risk assessment and risk management plan.³⁰

Table 4: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Economic instability could negatively affect the PFIs' willingness to lend to SMEs and damage the ability of SMEs to repay.	The TA will enhance the credit risk management and underwriting capacity of the CGFM to ensure that the SMEs to be issued guarantees are financially sound. Criteria and practices will be communicated to the PFIs to help them screen the viability of subprojects more effectively.
Weaknesses in the CGFM's governance, internal controls, and financial management could affect implementation of the project.	The TA linked with the loan will support improvements in financial management, governance, and the operational and risk management capacity of the CGFM during the first 2 years of the project. Amendments will be proposed to strengthen the current law governing the CGFM.
SMEs may not be aware of the availability of credit guarantees affecting demand for long-term loans.	The CGFM will market new guarantee products with longer tenors than those currently available and help educate SMEs on the benefits of aligning their long-term investment needs with long-term finance.
PFIs may not want to avail of credit guarantees because they have a poor perception of the CGFM.	CGFM will hold regular outreach and create a marketing program to promote use of guarantee products. The project steering committee will support the promotion of the credit guarantee system.

CGFM = Credit Guarantee Fund of Mongolia, PFI = participating financial institution, SMEs = small and medium-sized enterprises.

Source: Asian Development Bank.

V. ASSURANCES AND CONDITIONS

28. The government and the CGFM have assured ADB that implementation of the project will conform to applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, labor, procurement, consulting services, and disbursement as described in the PAM and loan documents. The government and the CGFM have agreed with ADB on certain covenants for the project, set forth in the loan and project agreements. These include loan disbursement conditions requiring that (i) an ESMS acceptable to ADB be established by the CGFM, (ii) the SLA be entered into between the MOF and the CGFM, and that it be satisfactory to ADB, and (iii) a template time deposit agreement acceptable to ADB be in place.

VI. RECOMMENDATION

29. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank and, acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve the loan of \$60,000,000 to Mongolia for the Supporting the Credit Guarantee System for Economic Diversification and Employment Project, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 18 years, including a grace period of 12 years with interest and commitment fees capitalized up to 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and project agreements presented to the Board.

Stephen P. Groff
Vice-President

3 November 2015

³⁰ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned withJob creation in nonmining-related sectors increased (SME Development Program, 2014–2016)^a

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Outcome SMEs' access to finance expanded	By 2021 a. Mix of rural SME loan accounts opened increases to 20.0% of total accounts opened (2011 baseline: 17.3%) b. Loan accounts opened by SMEs run by women account for half of all SME loan accounts opened ^b (2014 baseline: 46.0%) c. Number of active enterprises with fewer than 50 employees increases at a 10% average annual rate during 2016–2021 (Baseline: 8.8% average annual increase during 2006–2014)	a. World Bank global financial inclusion database b. PFI reports c. World Bank global financial inclusion database and Mongolian Year Book (National Statistics Office of Mongolia)	Economic instability negatively affects the willingness of financial institutions to make loans to SMEs
Outputs 1. Longer-term financing for SMEs increased ^c	1a. At least three new credit guarantee products are issued by the CGFM, including at least one that supports women entrepreneurs, by the end of 2018 (2014 baseline: 1 product) 1b. At least \$58.63 million of funding is channeled to PFIs using CGFM guarantees by the end of 2021 (2015 baseline: 0)	1a. Project monitoring reports, CGFM reports 1b. Project monitoring reports; reports from the CGFM, PFIs, and the MOF	The legal amendments and new laws and regulations needed for the CGFM are delayed.
2. A longer-term bank deposit market developed	2a. At least four PFIs participating in the CGFM program regularly offer tugrik time deposits with maturities of at least 5 years by 2021 (2015 baseline: 0)	2a. Project monitoring reports; reports from the CGFM, PFIs, and the MOF	

<p>3. Quality of the CGFM and the country's credit guarantee system improved^d</p>	<p>3a. Two new procedures on risk management and financial management adopted and implemented by the CGFM by the end of 2017 (2015 baseline: 2 procedures)</p> <p>3b. The government adopts amendments to enhance the legal framework supporting the credit guarantee system, including support for a private guarantee system, by the end of 2016. (2015 baseline: 0)</p> <p>3c. CGFM drafts marketing program and action plan and implements them jointly with regional CGFM representatives and PFIs by the end of 2017 (2015 baseline: none)</p> <p>3d. CGFM management information system enables the collection, reporting, and analysis of gender-disaggregated data on the number of guarantees and loans issued, types and sizes of loans, and repayment status of loans by the end of 2017. (2015 baseline: No data available)</p>	<p>3a. Project monitoring reports; reports from the CGFM, the MOF, and the MOI</p> <p>3b. Project monitoring reports; reports from the CGFM, the MOF, and the MOI</p> <p>3c. Project monitoring report, CGFM</p> <p>3d. Project monitoring report, CGFM</p>	
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Key Activities with Milestones

1. Longer-term financing for SMEs increased

- 1.1 Prepare new credit guarantee service agreements between the CGFM and PFIs to be signed by the end of 2016
- 1.2 Hold training for CGFM and PFI staff on financial, environmental, and social safeguards, and gender and labor issues by the end of 2016
- 1.3 Establish and implement environmental and social management system for screening subprojects by the end of 2016
- 1.4 Design new marketing program for CGFM products and services to SMEs, with emphasis on areas outside of the capital, by the end of 2017
- 1.5 Create new guarantee products tailored to needs of men and women entrepreneurs and SMEs outside the capital by the end of 2018

2. A longer-term bank deposit market developed

- 2.1 Draft new time deposit agreements between the CGFM and PFIs for placement of funds into PFIs by end of 2016
- 2.2 Place first time deposits in PFIs by the end of 2016

<p>3. Quality of CGFM and the credit guarantee system improved</p> <p>3.1 Conclude consultations with all stakeholders regarding government amendment of the law on the CGFM, and prepare a legal and regulatory framework for government approval on the operation of a private credit guarantee system by end of 2016</p> <p>3.2 Develop and implement operational, governance, and risk management capacity of the CGFM by the end of 2016</p> <p>3.3 Enhance the CGFM management information and risk management systems by issuing expressions of interest for new system needs and beginning vendor work by the end of 2017</p> <p>3.4 Begin regular outreach training for CGFM regional representatives and in provinces on the guarantee program, products, environmental and social safeguards, labor standards, and gender support by the end of 2017</p>
<p>Inputs</p> <p>Project loan: Asian Development Bank: \$60 million Government of Mongolia and private sector: \$30 million</p> <p>Technical assistance: Asian Development Bank: \$800,000 Technical Assistance Special Fund (TASF-V)</p> <p>Note: The government will also finance the equivalent of counterpart costs in kind. This will include providing adequate counterpart staff, office facilities, office supplies, secretarial assistance, domestic transport and accommodation for counterpart staff, and communication facilities for consultants.</p>
<p>Assumptions for Partner Financing Not applicable.</p>

CGFM = Credit Guarantee Fund of Mongolia, MOF = Ministry of Finance, MOI = Ministry of Industry, PFI = participating financial institution, SMEs = small and medium-sized enterprises.

^a Introduced by the Ministry of Labor on 28 November 2013 and subsequently became the responsibility of the MOI at its founding in 2014.

^b This project defines women-run businesses as businesses that meet at least one of three criteria—i.e., that (i) at least 50% of ownership is controlled by women, (ii) at least 60% of senior managers are women, or (iii) at least 50% of the registered contractual employees are women. ADB. 2014. *Gender Toolkit for Micro, Small, and Medium-Sized Enterprise Finance and Development*. Manila.

^c The term “longer-term” refers to loans with 5-year maturity or longer.

^d Supported by the technical assistance for Supporting the Credit Guarantee System for Economic Diversification and Employment Project.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=48015-002-3>

1. Loan Agreement
2. Project Agreement
3. Sector Assessment (Summary): Small and Medium-Sized Enterprises
4. Project Administration Manual
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Attached Technical Assistance
8. Financial Analysis
9. Economic Analysis
10. Country Economic Indicators
11. Summary Poverty Reduction and Social Strategy
12. Environmental and Social Management System Arrangements
13. Risk Assessment and Risk Management Plan

Supplementary Documents

14. Prohibited Investment Activities List
15. Due Diligence and Financial Management Assessment of the Credit Guarantee Fund of Mongolia¹
16. Eligibility Criteria for Participating Financial Institutions
17. Due Diligence Reports of Participating Financial Institutions¹

¹ Not available to the public as per ADB's Public Communication Policy 2011.