FINANCIAL ANALYSIS

A. Introduction

1. Financial analysis for the Supporting the Credit Guarantee System for Economic Diversification and Employment Project was conducted following the Asian Development Bank (ADB) guidelines in Financial Management and Analysis of Projects[1] and Financial Due Diligence—A Methodology Note.[2] The analysis undertook a financial evaluation, an assessment of financial management, and due diligence on financial intermediaries.[3]

B. Financial Evaluation

2. The Credit Guarantee Fund of Mongolia (CGFM) was assessed against covenants for suitability to access the project and was found to be substantially in compliance (Table 1).

Table 1: Credit Guarantee Fund of Mongolia Compliance with ADB Covenants

Covenants	Criteria	CGFM Status[a]
Capital adequacy ratio (%)	Over 12.0	100.0
Nonperforming loans as percentage of total loan (%)	Under 5.0	1.5
Adequate credit and risk management policies and systems	Yes/No	Yes
Compliance with prudential regulations including:	Yes/No	Yes
a. Maximum leverage (multiple)	10 x	4.2 x
b. Expected credit risk claims' coverage (%)	100.0	100.0
Satisfactory results from an independent audit (per ADB)	Yes/No	Yes
Acceptable corporate and financial governance (per ADB)	Yes/No	Yes
Sound business strategy (per ADB)	Yes/No	Yes
Autonomy in guarantee issuance and pricing	Yes/No	Yes
Board and credit committee composition consistent with best practice standards and acceptable to ADB	Yes/No	Yes
New capital to be accepted only if its use is unrestricted	Yes/No	Yes
Financial soundness, including liquidity and profitability (per ADB)	Yes/No	Yes
a. Profitability in the last 2 completed fiscal years (FY2014, FY2013)	>0.0	Yes
b. Current assets to current liabilities (multiple)	>1.2 x	No current liabilities

[a] As of 30 June 2015 (CGFM Fiscal Year is January to December).
> Greater than.
X Multiple.
Source: Asian Development Bank.

3. Due diligence was performed of the CGFM during project preparations. The CGFM was assessed in seven areas: legal framework, corporate governance, financial management, risk management, management information system (MIS), products, and the education CGFM provides to small and medium-sized enterprises (SMEs).[4] Overall results were favorable, but practices must be improved in some areas. The legal framework of the CGFM must be enhanced to address weaknesses in corporate governance and more clearly define its capital structure. It must also address the participation of the CGFM in the proceeds from liquidation of any excess collateral obtained by participating financial institutions (PFI) for subloans to SMEs. From a corporate governance perspective, the CGFM must transfer the current supervisory

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1 ADB. 2005. *Financial Management and Analysis of Projects*. Manila.
2 ADB. 2009. *Financial Due Diligence—A Methodology Note*. Manila.
3 Financial Management Assessment (accessible from the list of linked documents in Appendix 1 of the report and recommendation of the President).
4 Details of the assessment of the financial management, risk management, and MIS are in Due Diligence of CGFM and Roadmap (accessible from the list of supplementary documents in Appendix 2 of the report and recommendation of the President). More information on education may also be found in the same document.

board's audit-like functions to an internal audit unit; deliver corporate governance training for founders, board directors, and management; enhance transparency of practices, and institute strategic planning. It is also crucial that the CGFM design new products[5] that have various guarantee coverage levels and to also consider development of a range of guarantee products. Collection and foreclosure processes regarding the enforceability of guarantees associated with nonperforming loans (NPL) must be strengthened. Risk management practices should also be better defined and an independent unit created. Finally, CGFM needs to coordinate its various training and capacity-building programs for SMEs better to achieve a greater impact at a lower cost. Coordination should include other development partners and with government and nongovernment organizations in Mongolia regarding their existing SME training programs.

4. To fully address weaknesses identified in the assessment, technical assistance (TA)[6] will be attached to the project to build the CGFM's capacity.[7] The TA will improve the CGFM's financial management, risk management, governance, and operations. The credit guarantee system's legal framework will be revised to support operation of private sector guarantee entities. The CGFM's legal framework will be reviewed and amendments will be proposed. A road map developed during project preparatory TA will guide improvements under the project.

C. Financial Management Assessment

5. The assessment found that the Ministry of Finance (MOF), which will serve as the executing agency, has adequate financial management capacity. It also found that, overall; the CGFM is capable of managing the project financially. Adequate financial management controls are in place, but the fund's financial management practices could be strengthened.[8] Financial management would be made more effective by the use of new enhanced management reporting tools and reports. Creation of long-term budgeting with links to strategic objectives is needed. Financial management policies and procedures could be refined to allocate responsibilities more clearly. Key indicators could be specified to monitor performance. The assessment also found that the risk management function needs to be strengthened, and that better regulatory and operational risk policies should be drafted. Greater technical capacity is needed to enhance credit assessment and portfolio analysis. New credit policies and manuals should be drafted with clearer sector appetite statements. Improving MIS capability and functionality, and developing a suite of new portfolio and oversight reports will also increase financial management effectiveness.

D. Financial Sustainability Assessment

6. CGFM's financial performance for the period 2012-2014 is in Table 2. Declines in assets and equity reflect MNT depreciation against the US dollar over this period. The assessment

[5] New sector products could consider the following higher credit guarantee levels for SME borrowers: (i) 90% for start-ups (i.e. new or less than 3 years of operation) with proposed new employment and loan tenors of 5 or more years; (ii) 85% for firms run by women entrepreneurs; (iii) 80% for agricultural, micro, and home businesses and tenors longer than 5 years; (iv) 75% for firms in the export sector, proposed new employment, and tenors above 5 years; (v) 75% for firms outside Mongolia's capital and tenors exceeding 5 years; and (vi) 70% for other sectors and tenors of more than 5 years.

[6] Attached Technical Assistance (accessible from the list of linked documents in Appendix 1 of the report and recommendation of the President).

[7] As of 30 June 2015, CGFM issued 364 guarantees for MNT24.4 billion with an average tenor of 43 months and a NPL ratio of 1.52%.

[8] See Due Diligence of CGFM and Roadmap (accessible from the list of supplementary documents in Appendix 2 of the report and recommendation of the President) for a complete list.

considered the impact of the additional funding from the project on CGFM. Overall, the assessment found that CGFM is capable to absorb the impact from the project and meet loan covenant criteria. The assessment considered the impact of the ADB loan on CGFM capital requirements (Table 3: Equity requirements based on 5 year growth projections), the impact of additional fees earned to support additional operational needs (Table 4: Product fee sensitivity analysis), and NPL increases (Table 5: Nonperforming loan sensitivity analysis).

Table 2: Key Financial Ratios and Figures for Credit Guarantee Fund of Mongolia

Figure/Ratio	Formula	FY2014	FY2013	FY2012
Capital Adequacy				
Assets ($)		3,071,751	3,232,350	3,628,849
Equity ($)		3,071,650	3,232,350	3,626,543
Capital adequacy ratio (%)	Capital / Assets	100.00	100.00	99.90
Profitability				
Return on Equity (%)	Net Income / Total Equity	8.27	5.88	(0.09)
Cost to Income Ratio (%)	Total Cost / Total Revenues	57.10	55.50	137.70
Liquidity				
Liabilities ($)		101	0.00	2,306
Current Liability Coverage	Current Assets / Current Liabilities	333.00 x	NA	15.60 x
Growth Rates				
Assets (%)	Increase from previous year	9.23	6.18	n/a

X Multiple.
Source: Asian Development Bank.

Table 3: Equity Requirements Based on Five Year Growth Projections[a]

Portfolio, Income, or Expense	Required equity at 5.0% growth rate ($)	Required equity at 12.6% growth rate ($)	Required equity at 15.0% growth rate ($)
Current portfolio growth in 5-year time frame (growth rate %)	14,960,077	19,815,676	21,526,231
Drawdown of funds from ADB (through MOF)	60,000,000	60,000,000	60,000,000
Cumulative guarantee portfolio by end of year 5	74,960,077	79,815,676	81,526,231
Income (5-year time frame)			
Projected growth in fees on current CGFM portfolio	3,328,343	4,158,040	4,448,033
Projected fees on new products funded by ADB loan	4,380,000	4,380,000	4,380,000
Interest earned on time deposits (average 6%)	13,140,000	13,140,000	13,140,000
Estimated Income	20,848,343	21,678,040	21,968,033
Expenditure items for CGFM (5-year time frame)			
Projected growth in expenses on current CGFM portfolio	1,901,496	2,375,505	2,541,179
Expenditure on new ADB-funded portfolio	2,190,000	2,190,000	2,190,000
NPL charge on the total portfolio (average annual charge)	5,740,155	5,963,910	6,039,663
Loan costs: direct loan cost (0.8964% on drawn loan funds)	1,963,116	1,963,116	1,963,116
Loan costs: commitment charge on undrawn funds (0.15%)	121,500	121,500	121,500
Funding costs: MOF fee on loan funds (2% after year 3)	2,400,000	2,400,000	2,400,000
Estimated expenditures	14,316,267	15,014,031	15,255,458
New annual inflow/(outflow) of resources	6,532,076	6,664,009	6,712,575
Equity as at 31 December 2014	2,973,121	2,973,121	2,973,121
Contribution from ADB project and normal CGFM fees	6,532,076	6,664,009	6,712,575
Maximum available equity at end of year 5	9,505,197	9,637,130	9,685,696
Maximum supported guarantee portfolio at 10 times equity	95,051,970	96,371,300	96,856,960
Required additional equity contribution within 5-year time frame	0	0	0

[a] Using exchange rate of MNT 1,950 = $1.
Source: Asian Development Bank.

Table 4: Product Fee Sensitivity Analysis[a]

Portfolio, Income, or Expense	Estimated @ 1% fees on new products ($)	Estimated @ 2% fees on new products ($)	Estimated @ 3% fees on new products ($)
Estimate of size of current portfolio at end loan cycle	93,438,199	93,438,199	93,438,199
Drawdown of loan from ADB (through MOF)	60,000,000	60,000,000	60,000,000
CGFM income sources			
Growth in fees on current portfolio	38,463,113	38,463,113	38,463,113
Fees on new products	7,890,000	15,780,000	23,670,000
Deposit interest earned (average 6%)	47,340,000	47,340,000	47,340,000
Estimated Income	93,693,113	101,583,113	109,473,113
Expenditure items for CGFM			
Projected NPL charge on the total portfolio (average annual charge)	30,461,541	30,461,541	30,461,541
Loan costs: direct loan cost (0.8964% on drawn funds)	7,072,596	7,072,596	7,072,596
Loan costs: commitment charge on undrawn loan (0.15%)	121,500	121,500	121,500
Project funding costs: MOF fee on funds (2% after 3-year grace period)	13,800,000	13,800,000	13,800,000
NPL charge on the total portfolio (average annual charge)	30,461,541	30,461,541	30,461,541
Estimated expenditures	81,320,890	81,320,890	81,320,890
New annual inflow/outflow of resources to the CGFM	12,372,223	20,262,223	28,152,223

[a] Using exchange rate of MNT 1,950 = $ 1.
NPL = Non performing loan.
Source: Asian Development Bank.

Table 5: Nonperforming Loan Sensitivity Analysis[a]

Portfolio, Income, or Expense	Current NPL at 1.52% ($)	1% NPL over initial 5-years ($)	2% NPL over initial 5-years ($)	3% NPL over initial 5-years ($)
Current portfolio at end ADB loan tenor	12,118,232	93,438,199	93,438,199	93,438,199
Drawdown of funds from ADB over 5 years	0	60,000,000	60,000,000	60,000,000
CGFM income sources				
Growth in fees on current CGFM portfolio	608,422	38,463,113	38,463,113	38,463,113
Fees on new products	0	15,780,000	15,780,000	15,780,000
Interest earned on deposits (average 6%)	0	47,340,000	47,340,000	47,340,000
Estimated Income	608,422	101,583,113	101,583,113	101,583,113
Expenditure items for CGFM				
Growth in expenses	327,737	21,975,253	21,975,253	21,975,253
Growth in expenditure on new portfolio	0	7,890,000	7,890,000	7,890,000
Projected NPL charge on the total portfolio (annual charge currently running at 1.52%)	184,537	15,230,770	30,461,541	45,692,312
ADB loan cost (0.8964% on drawn funds)	0	7,072,596	7,072,596	7,072,596
Commitment charge (0.15%)	0	121,500	121,500	121,500
MOF fee on funds (2% after 3-year grace)	0	13,800,000	13,800,000	13,800,000
Estimated expenditures	512,274	66,090,119	81,320,890	96,551,661
Annual inflow/outflow to CGFM	96,148	35,492,994	20,262,223	5,031,452

[a] Using exchange rate of MNT 1,950 = $ 1.
Source: Asian Development Bank.

E. Due Diligence of Financial Intermediaries

7. Due diligence was performed on all 10 PFIs[9] that submitted expressions of interest to ADB. Table 6 outlines the status of each of the 10 PFIs against the PFI primary selection criteria agreed between ADB, CGFM and MOF. In summary, 7 of 10 banks were in compliance. PFIs not in full compliance can still participate if they make a plan to address weaknesses within a time deemed reasonable by ADB. The assessment found that the project's implementation arrangements will deliver adequate financial management. Due diligence found that a sufficient number of PFIs are qualified to be financial intermediaries for the financing phase.

Table 6: Participating Financial Institution Compliance with Key Covenants

ADB Financial Covenants	Benchmark	Bank A	Bank B	Bank C	Bank D	Bank E	Bank F	Bank G	Bank H	Bank I	Bank J
Capital adequacy ratio (%)	Over 12	14.56	15.93	13.36	17.06	17.23	17.00	14.89	15.21	19.17	18.75
NPLs (loans 90 days past due) as share of total loans (%)	Under 5	0.13	11.17 [a]	10.15 [a]	11.25 [a]	1.59	1.98	2.86	0.19	4.00	3.48
Prior experience of at least 3 years in SME lending & microcredit	Yes/No	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Profitability in each of the last 2 completed fiscal years	Yes/No	Y	N	N	Y	Y	Y	Y	Y	Y	Y
Audited financial statements for at least 3 years	Yes/No	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Compliance with all prudential requirements of the Bank of Mongolia	Yes/No	Y	Y	N	Y	Y	Y	Y	Y	Y	Y

[a] non-compliant according to benchmark requirement.
Source: Asian Development Bank.

8. PFIs were also assessed against other criteria including if: (i) their corporate, financial, and governance practices were acceptable to ADB; (ii) they had adequate credit and risk management policies and operating systems that were acceptable to ADB; (iii) they had a track record of running a successful SME program or had demonstrated the capacity to reach a performance level acceptable to ADB within the next 12 months; (iv) they had what ADB considered to be satisfactory and transparent accounting, management information, and internal audit systems; and (v) they had the capability to provide sufficient, clear, and timely ongoing information on SME subloan performance. While the assessment found the majority of the PFIs reviewed to be in compliance, some issues were identified that are systemic throughout the banking sector. For example, technical accounting knowledge is lacking and understanding and implementation of risk management policies and independent units needs to be enhanced. Further, their exposures to specific sectors (e.g., mining) could impact the performance of their loan portfolios and foreign exchange rate movements could impact their repayment of loans denominated in foreign currencies. PFIs were aware of these weaknesses and the need for improvements. Outreach support will be provided by the CGFM, supported by the TA, and will address needs in SME education, credit risk underwriting, and financial reporting. ADB will make a final selection of PFIs for the project with MOF and CGFM prior to loan effectiveness. The CGFM and MOF will monitor each PFI's compliance with the eligibility criteria and report to ADB on compliance status.

[9] PFIs submitted expressions of interest to ADB for participation in the Supporting the Credit Guarantee System for Economic Diversification and Employment Project. These were evaluated according to predetermined selection criteria. Details are in Eligibility Criteria for PFIs and Due Diligence Reports of PFIs (accessible from the list of supplementary documents in Appendix 2 of the report and recommendation of the President).