

CASE STUDIES

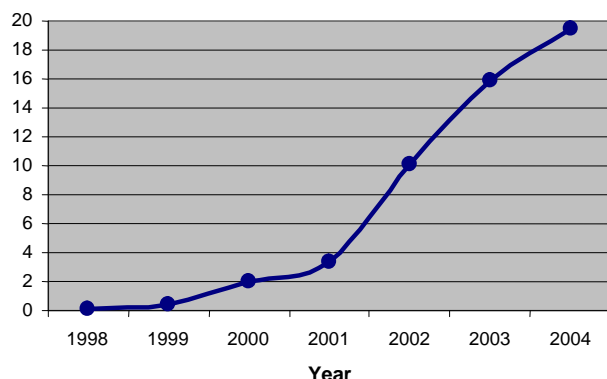
XAC Bank: From the Liability Side of the Balance Sheet

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In September and October 1998, two NGOs working within the Mongolia MicroStart Project made their first microcredit loans. A year later, in October 1999, these organizations and four other NGOs participating in the MicroStart project consolidated their operations to create the first non-bank financial institution (NBFI) in Mongolia, known as X.A.C. Co. Ltd. Somewhat incredibly, after just two years of operating as an NBFI, the company transformed again, merging with another NBFI, Goviin Ekhlel Ltd., to create XacBank, which received a full banking license from the Central Bank on December 27, 2001.

XacBank (pronounced "HassBank") soon became one of only three financial institutions to have a national presence, with at least one branch in each of Mongolia's 21 provinces. Although it is classified as a young institution by the *MicroBanking Bulletin*, it has 506 staff working in 36 branches and a portfolio of US\$ 20 million, with an average loan of US\$ 635. It serves more than 32,000 borrowers and 40,000 depositors. The latter have savings of nearly US\$ 14 million.³⁰

Figure 1: Total Assets (Millions USD)



XacBank's short and remarkable history has been described in other publications, but the tale has generally been told from the perspective of asset management. This article, by contrast, describes the equally interesting and important evolution of the bank's liability and capital structure: specifically, how XacBank's unusual and impressive growth has been financed and what the implications of this strategy are for the bank's future.

³⁰ These figures were as of December 31, 2004.

We explore this question with a focus on three aspects of XacBank's approach in particular: 1) the use of mergers and transformation as fundraising strategies; 2) the early and determined pursuit of commercial capital; and 3) the decision to eschew the short-term advantages of international capital for a longer-term strategy, albeit initially more expensive, emphasizing local private capital.

Overview of the "Other" Side of the Balance Sheet: Liabilities

The two Mongolian NGOs that came together to form X.A.C. Co. Ltd. were funded by MicroStart grants.³¹ Since this funding was limited to a maximum capital grant of US\$ 150,000 per institution, the newly formed company was forced almost immediately to seek additional sources of capital to cover its operational expenses and to finance portfolio growth. The initial solution was to invite four other MicroStart-funded NGOs to become shareholders in the company by investing their MicroStart grants.³² This decision was made, in part, due to a lack of liquidity in the Mongolian banking system and the difficulty of obtaining loans from the local market.

From 1998 to mid-2000, XAC had no commercial liabilities, and through the end of the year 2000, it continued to be financed almost entirely by donor subsidies. Since 2001, however, direct grant funding has been minimal, with contributions from the Consultative Group to Assist the Poor (CGAP) in 2001 and the International Finance Corporation of the World Bank Group (IFC) in 2002 amounting to US\$ 250,000. By October 2002, just four years after its first loans were made, XAC's transition to commercial capital was, to a large extent, complete.

³¹ The two NGOs with microcredit operations were the Mongolian Women's Federation (MWF) and the Liberal Women's Brain Pool (LEOS). X.A.C. (an acronym meaning "Golden Fund for Development" in Mongolian) was created in May 1999 to serve as the central credit office for the NGO lending activities.

³² The four NGOs were the Mongolian Open Society Institute (an affiliate of the Soros Foundation), the National Association of Mongolian Agricultural Cooperatives (NAMAC), the Local Governance Development Fund (LGDF), and The Rotary Club of Ulaanbaatar. These four NGOs joined X.A.C. Co. Ltd. as part of its transformation from a private company to an NBFI in October 1999.

As early as July 1999, key stakeholders including both the UNDP Technical Advisor and XAC's Executive Director articulated a need to seek additional investments, not only to finance growth, but also to inject additional knowledge, skills and a commercial edge to balance the then-current ownership's strong social orientation.³³

XAC developed a highly structured approach to finding new investors. Its search began with a plan that included funding objectives by volume of funding and type of investor. The ideal investor would be one committed to the XAC mission, but also capable of balancing social mission with strong commercial experience. International social investment funds were considered but not pursued, as XAC's capital needs were not large enough at the time to warrant their interest, and because XAC believed it could find conventional, local, private investors. This strategy kept the "universe" of potential investors much larger than it is for many MFIs that seek only socially motivated investors.

XAC's search for new investment was aided by MicroStart, which undertook an unpublished, structured survey (likely the first ever) of investment funds serving MFIs. From this, the institution was able to identify international funders of all types (not just equity) and to structure a plan for attracting them. The plan included, among other things, specific preparations for attracting investors (e.g., improved transparency and reporting), and improvements in investor-search capacity (e.g., improved investor relations skills) and negotiation ability. It also included a dedicated budget for expenses related to the search for funding, on an activity-by-activity basis. This budget was detailed, taking into account, for example, the cost of hosting investors undertaking informational and due diligence meetings (an estimated US\$ 6,000 per visit).

In May 2000, XAC negotiated its first commercial loan from a local bank with an effective rate of 43.6 percent.³⁴ By July 2000, it had piqued the interest of several international institutional investors, including Triodos, the IFC, the Asian Development Bank, the European Bank for Reconstruction and Development, the Kreditanstalt fuer Wiederaufbau (KfW, Germany's state-owned development bank) and the Soros Foundation. At the end of that year, Triodos Bank made a US\$ 400,000 convertible loan in local currency.

³³ Clark, Heather and Maria Paula Carvajal, "Appraisal Document for MicroStart Mongolia", UNDP/SUM, July 1999.

³⁴ Reille, Xavier, "Appraisal Document for XAC Mongolia", CGAP, August 2000.

Figure 2: XAC Bank – Milestone Events

June 1997: MicroStart signs operating agreement in Mongolia

September 1998: First loan made

May 1999: NBF1 transformation plan approved

September 1999: NBF1 license granted

April 2000: Bank transformation plan approved

May 2000: First local bank bridge loan is obtained

September 2000: Approached Goviin Ekhlel's management and merger discussions initiated

December 2000 : First convertible loan from an international investor (Tridos)

October 2001: Merger agreement signed with Mercy Corps – principal shareholder of Goviin Ekhlel

December 2001: Bank license received

December 2002: More than US\$ 5.8 million in deposits are mobilized

December 2003: Quantity of debt sourced locally exceeds that sourced internationally

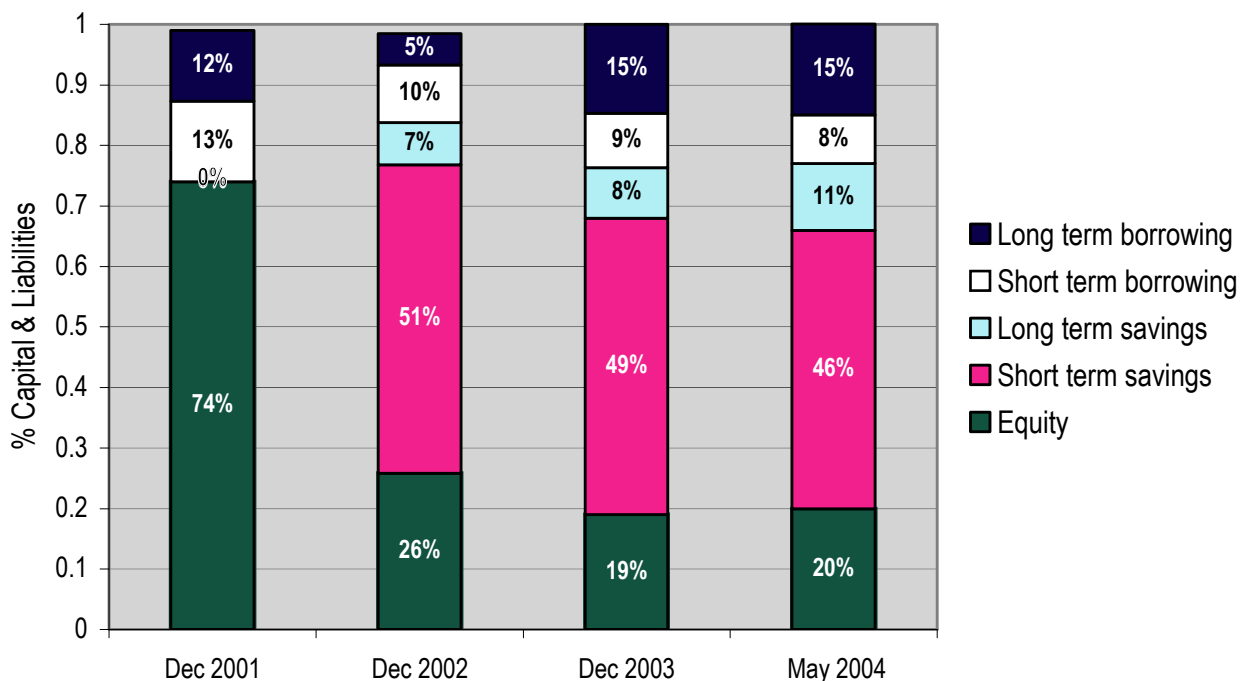
March 2004: Three local companies buy shares in the bank

In 2001, XAC obtained the financing it needed to meet the Central Bank's MNT 2 billion or US\$ 1.785 million minimum capital requirement for a banking license by merging with Goviin Ekhlel Co. Ltd., the second-largest non-bank financial institution in the country. Also in 2001, XAC issued short-term (6-month) commercial notes, privately placed by a local commercial bank.

With its transformation to commercial bank status in late 2002, XacBank was able to diversify its funding sources significantly (see Figures 3 and 4).

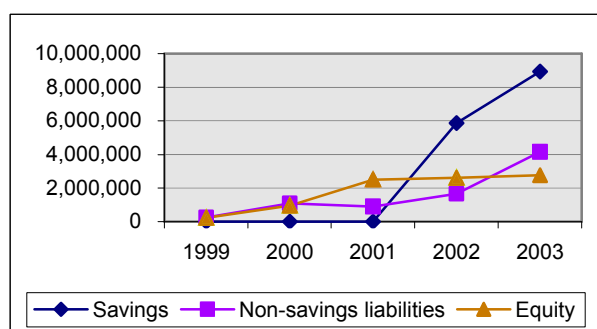
By 2002, the bank had successfully negotiated loans from the IFC, Deutsche Bank Microcredit Development Fund, and the Dexia Micro-Credit Fund as well as from a government agency, the Employment Generation Support Fund, and Anod Bank (a local financial institution).

Figure 3: XAC Bank Capital and Liability Structure (2001 – 2004)



XacBank began mobilizing savings in 2002, and by the end of that year, was financing approximately 58 percent of its assets through public savings. As shown in Figure Three, that percentage remained constant to the end of 2003 (accompanying asset growth of 57 percent). Throughout 2002 and 2003, XacBank continued to borrow from both local and international financial institutions, although by the end of 2003, it was sourcing more funds locally than internationally, mostly via term savings.

Figure 4: XAC Funding Structure (1999 – 2003)



By May 2004, XacBank's debt-to-equity ratio had grown from less than 1:1 in 2001 to over 4:1. As of December 2004, portfolio-at-risk greater than one day (PAR > 1) was 1 percent, return-on-equity (ROE) was 22 percent, and return-on-assets (ROA) was 3.81 percent. These statistics are not unusual for commercial banks with microfinance operations.

Considering the rural and national nature of XacBank's market, its statistics also compare fairly well with other large Asian MFIs, which, as reported in the *MicroBanking Bulletin*, have ROEs averaging 31 percent and ROAs averaging 4.5 percent (*MicroBanking Bulletin* Issue No. 9, July 2003).

Mergers, Transformations and Private Capital

At least four important factors have contributed to the success of XacBank's financing strategy:

1. A market-oriented approach;
2. A deliberate preference for developing long-term domestic funding relationships;
3. An early commitment to transparency; and
4. A demonstrated ability and willingness to distribute profits.

A Market-Oriented Approach

From its inception, XacBank paid great attention to the demands of the market. This was largely out of necessity since, in a country with only 2.3 million inhabitants and a population density of just 1.5 people per square kilometer, the potential market for microcredit was estimated to be only 77,000 clients strong.

Faced with such a small market, XAC was urged by MicroStart to think beyond its core microcredit

market and to adopt a “vertical” (inclusive) marketing strategy. Unlike other MFIs that could rely on large, almost limitless urban markets, XAC began thinking early on about a range of products suitable for micro-, small- and even medium-sized businesses, not only in urban markets but also in suburban and rural markets where 60 percent of the Mongolian population lives. Today XacBank offers 12 credit products, 6 deposit products, and a range of other services including funds transfers, foreign exchange and micro-leasing.

Box 1: Mission and Vision

XacBank Mission

First, to contribute to Mongolia’s socioeconomic development by providing access to comprehensive financial services to all citizens and legal entities, including those who are normally excluded, e.g. low-income and remote rural households. Second, but equally important, to maximize the value of shareholders’ investment, while creating a profitable and sustainable financial institution.

Vision

XacBank will be a dynamic leader serving the marginalized citizens of Mongolia, with the most innovative and transparent banking services, supplied in a professional and sustainable manner. The Bank will use technology together with personalized customer service to grow its market share and support the development of micro- and small business in Mongolia.

In 2000, when XAC’s first savings product was being developed, the impact of the product was expected to be marginal, with only 1.3 percent of total assets to be financed by deposits as of December 2002 (Reille, 2000). Planners were conservative in their projections, given the need to obtain a banking license and to develop and test savings. During the first year of savings mobilization, XacBank vastly exceeded these targets, but deposits were mainly current accounts and time deposits from corporate clients, which proved to be highly unstable and sensitive to interest rates.

After reviewing its strategy at the end of 2002, XacBank shifted its focus to attracting savings from individuals, which were viewed as a less competitive and more stable market. It invested in research and product development that resulted in a range of products that were appropriate for this market. The bank then made sure that the market knew about these developments through an effective promotion strategy.

In less than two years, XacBank introduced a total of six savings products, including an innovative children’s saving account that significantly increased the total funds mobilized and attracted a large number of depositors, though it also reduced the average deposit amount, from US\$ 306 at the end of 2002 to US\$ 175 as of May 2004. As a result, XacBank was financing 71 percent of its total assets with deposits by the end of 2004.

XacBank was able to achieve this rapid deposit mobilization by paying attention to what the market wanted and responding to those demands with appropriately designed products. Also, by merging with Goviin Ekhlél, which already had a loyal clientele of small- and medium-sized enterprises (SME), XacBank gained a more diverse and ready-made market faster than it could have as a single institution entering one market segment at a time. Goviin also brought more than just equity and market; it brought complementary products and skills to XacBank. Together, the two institutions were able to achieve nationwide reach and capture the vertical target market they were looking for (i.e., ranging from micro-businesses to SME to consumers).

Figure 5: Paying the Price to Access Domestic Funds

	2003		2002	
	Rates (%)	Amount (MNT'000)	Rates (%)	Amount (MNT'000)
Placement from financial institutions			18%	400,000
Deposits from customers	3.6% - 18%	10,012,172	3.6% - 20.1%	6,180,013
Loans from local financial institutions	12% - 15%	1,680,000	15%	280,000
Loans from foreign financial institutions	2% - 7.22%	1,197,200	5.34% - 9.37%	1,153,125
Loans from government agencies	5.5% - 6%	856,245	6%	245,000
Other liabilities	-	849,571	-	166,790

Source: XacBank Annual Report 2003.

Choosing Domestic Over International Sources

Attracting deposits has come at a fairly high price. In fact, XacBank is paying interest rates on long-term deposits that are likely higher than what it could attract from international social-investment funds. Foreign-exchange risk premiums associated with international funding is approximately 4 to 5 percent. This means there is a spread of 2-5 percent between, on the one hand, XacBank's average cost of locally denominated funds (15%), and on the other, the average cost of social investment funding which is around 6 to 9 percent in US\$.

Given that over 11 percent, or about US\$ 4 million, of the bank's long-term funding is term deposits with prices much higher than the average cost of funds, the bank is clearly paying a high price for local funds. The focus on local funding is strategic given that most social investment funds, for which the bank would surely be eligible, provide funding at a much cheaper rate than 15 percent. It is strategic because while local funding may be more expensive in the short term, it has many long-term advantages. Local currency deposit collection as the main source of funding is universally recognized as the most important source of funding. It is more abundant than international funds; it tends to be stable, particularly savings and demand accounts; and it provides cross-selling opportunities that are consistent with and supportive of the bank's vertical-loan market-penetration strategy. The strategy is also mission-oriented because access to reliable savings services is crucial to the poor, regardless of whether they borrow from the bank or not. The motivation to deposit savings is an important new element in the mindset of people who have just made a transition from a socialist system to a market-oriented one.

Local currency funding also keeps the bank's exposure to foreign exchange risk at manageable levels. At year end 2003, foreign-currency-denominated accounts were about 20 percent of assets and around the same for liabilities (stricter limits on foreign currency exposure than required by the Bank of Mongolia). Unable to hedge international loans due to its relatively small size and the cost of hedging instruments, XacBank limited its exposure, unlike many other MFIs that have been seduced by simplistic price comparison.

Transparency

An early commitment to transparency helped XacBank raise investors' familiarity with the institution and their confidence in it, giving them the information they needed to make risk-return decisions. The bank insisted on full-scale, Financial Accounting Standard (FAS) audits beginning in 1998. Box 3 shows a full list of the steps

XacBank has taken demonstrating its commitment to transparency.

Box 3: Transparency at XacBank

- Installment repayment reports are posted on branch walls;
- The names of clients for whom loans are approved are posted at branches;
- Branches are run as profit centers and receive monthly overall performance records of all other branches, as well as the consolidated report for the organization as a whole;
- Staff are tested for internal job vacancies and required to submit an application form for new positions developed as the organization grows;
- Financial audits are conducted yearly;
- Procedures audits are conducted yearly (by an external, internationally recognized financial audit company);
- Internal audits are conducted continually (internal, but reporting directly to the Board and General Assembly);
- Client satisfaction surveys are conducted yearly;
- Central Bank supervision is continual, at all branch offices and central office
- CAMEL rating of 1.6 for 2004;
- Due-diligence is conducted for each international commercial investment, technical assistance grant, etc.
- CGAP-format appraisals are conducted yearly;
- Tax inspections are conducted continually;
- Social welfare inspections are continual, at all branch offices and the central office;
- Donor monitoring is quarterly and annual (UNDP);
- MIX Market and *MicroBanking Bulletin* participation: five-diamond transparency grade;
- PlanetRating A-, positive September 2004;
- Quarterly management reports through website;
- Printed annual reports with accompanying audit notes.

Commitment to Profit Distribution

XacBank has paid dividends four times to its shareholders over the last six years, including a small dividend to X.A.C. Co. Ltd.'s NGO owners in 1999. The impulse for early dividend payment stemmed partially from the fact that the originating NGOs

viewed XAC as a source of income for their non-financial activities. Initially, XAC's structure gave the NGOs responsibility for the development and management of "quasi independent" branches. As "owners" of branches, the NGOs treated their branches as profit centers, creating an early and positive tension between the goals and needs of the overall institution and the interests of NGO branch owners. Such an arrangement appears to have simulated the tension between private-sector ownership of companies in which owners look to extract income from their investments.

Early dividends may not have been the *major* attraction for new private investors, but it had positive residual impact on the institution. Private capital investors, unlike international development investors, like to see return on their investments, or at the least strong promise of income in the not-too-distant future. Investors like to know that NGO-majority owners will not always vote to invest retained earnings solely into poverty-alleviation efforts.

Dividends are all the more critical given the relative lack of liquidity (in some cases almost complete lack thereof) typically characterizing MFI shares. That XacBank has paid out dividends in 2002, 2003 and 2004 totaling US\$ 550,000, of which 20 percent was cash and the balance was stock, shows a commitment to sharing earnings that will likely prove important in the next round of fund-raising (the Central Bank has increased the minimum capital adequacy requirement from US\$ 3.75 million to US\$ 7.1 million, or from MNT 4 billion to 8 billion). XacBank paid out a stock dividend of US\$ 234,000 or MNT 262 million on profits of US\$ 246,000 or MNT 276 million in 2003 and the bank's Board is currently discussing a 2005 dividend strategy, as part of a plan to provide returns for shareholders in this way, until more liquid markets for trading equity can be established.

The Payoff: Domestic Private-Sector Equity Investment. The Result: Financing Growth

In the words of XacBank's CEO, Ganhuyag Chuluun, "We knew from the beginning that we wanted to grow...and from the beginning we set out to access commercial funds." The bank's early funding strategy helped lay a foundation for future financing. Indeed, when the Bank of Mongolia earlier raised the minimum capital requirement for banks from US\$ 1.88 million to US\$ 3.75 million, or MNT 2 billion to 4 billion, XacBank was able to do what few MFIs – even those in larger and more sophisticated capital markets – have been able to do. It attracted significant investment from new shareholders, all of whom were local, privately-owned, commercial

entities. The Tuusin Group, operating in many different industries but mostly manufacturing and freight-forwarding, now owns 13 percent of the bank through its stake in the holding company XAC-GE, while Monnis Group International (a mining, engineering and construction company) owns 4 percent under the same arrangement. CYDAN Credit Union, a local financial institution, invested directly in the bank. In January of 2005, one of these private investors exited from XacBank through a sale of shares to other shareholders.

**Figure 6: XacBank Ownership Structure
Year End 2004**

Owner	Percentage Shares
XAC-GE	93.7
Mercy Corps (42.1%) *	
Six NGOs (40.6%) *	
Tuusin Group (13.4%)	
Monnis Group (3.9%)	
Others	9.6
Individuals (3)	
Financial Institutions (4)	
XacBank Employee Fund	
Donated capital	

Conclusion

XacBank is well on its way to having a liability structure similar to that of mature small banks, with about 85 to 90 percent of funding sourced through local deposits. Its liability strategy has been and continues to be well-calibrated to manage long-term funding costs, effectively serving the interests of both long-term institutional growth and ownership income. XacBank's successful integration of profit- and mission-maximization goals makes it an enviable institution and one that serves as a model for others.

The bank anticipates additional financing needs of about MNT 30 billion (US\$ 27 million) over the next three years. The plan is to raise MNT 5 billion from equity investments and retained earnings, 8 billion MNT from domestic and international lenders and MNT 17 billion from deposits. No problem, says Ganhuyag Chuluun, the CEO: when it comes to XacBank's prospects for attracting international investors, "it's a question of when, not if."

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