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FINANCIAL SECTOR ASSESSMENT

MONGOLIA

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EAST ASIA AND PACIFIC REGION VICE PRESIDENCY
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This Financial Sector Assessment (FSA) summarizes the key findings and recommendations of the Financial Sector Assessment Program (FSAP) Development Module for Mongolia, based on the World Bank mission[1] that visited Ulaanbaatar from January 22-February 4, 2012. The main focus of the mission was to examine opportunities for expanding access to finance (particularly for small- and medium-enterprise sector), developing the domestic capital market, and strengthening the housing finance market.

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GLOSSARY

Exchange Rate (as of February 2, 2012)
MNT 1 = US$ 0.000735294
US$ 1 = MNT 1360

ALM	Asset-liability management
APR	Annual percentage rate
ARM	Adjustable-rate mortgage
ATM	Automatic teller machine
BOM	Bank of Mongolia (central bank)
CAR	Capital Adequacy Ratio
CIB	Credit Information Bureau
CSD	Central Securities Depository
DTI ratio	Debt-to-income ratio
EAP	East Asia and Pacific region
ETT	Erdenes Tavan Tolgoi (mine project)
FRC	Financial Regulatory Commission
FRM	Fixed-rate mortgage
FSAP	Financial Sector Assessment Program
GDP	Gross domestic product
GoM	Government of Mongolia
HF	Housing finance
HOA	Homeowners' Association
ICT	Information communication technology
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IPCCN	Interbank Payment Card Centralized Network
IPO	Initial public offering
IT	Information technology
KYC	Know your customer
LSEG	London Stock Exchange Group
LTV ratio	Loan-to-value ratio
MDF	Microfinance Development Fund
MHFC	Mongolian Housing Finance Corporation
MICPA	Mongolian Institute of Chartered Public Accountants
MIK	Mongolian Mortgage Corporation
MMLF	Mortgage market liquidity facility
MNT	Mongolian Tughrik
MOF	Ministry of Finance
MOJ	Ministry of Justice
MOU	Memorandum of understanding
MSE	Mongolian Stock Exchange
MSME	Micro, small and medium enterprise
NPC	National Payment Council
NSO	National Statistical Office of Mongolia
NBFI	Nonbank financial institution
NPL	Nonperforming loans
OT	Oyu Tolgoi (mine project)
OTC	Over-the-counter
POS	Point-of-sale
POB	Point-of-banking
PPP	Public-private partnership
REE	Residential energy efficiency
REIT	Real estate investment trust
RMBS	Residential mortgage-backed securities
ROSC	Report on Observance of Standards and Codes
SCC	Savings and credit cooperative
SCH	Securities Clearinghouse
SIPR	State Immovable Property Registry
SME	Small and medium enterprise
SPC	State Property Committee
SSHF	Small-scale housing finance

EXECUTIVE SUMMARY

Owing primarily to extensive investment in new mining projects, Mongolia's economy is on a path of very rapid long-term growth. At the same time, prospects for the economy are overshadowed by the recurrent risk of overheating, fuelled by expansionary fiscal policy, volatile global commodity prices, and rising capital flows. Coordination of fiscal, monetary, and exchange rate policy agendas and properly enforced micro- and macro supervision measures will be essential to maintaining inclusive growth and financial sector stability.

Despite a severe banking crisis in 2008-2009, Mongolia's financial sector assets have nearly tripled in size since the last Financial Sector Assessment in 2007. However, there is still large potential to deepen and broaden financial intermediation to channel the gains of the resource boom toward productive investments. In light of this opportunity, the authorities have requested the World Bank to conduct an FSAP Development Module to examine specifically access to financial services (with the focus on SMEs), capital markets, and housing finance, and to make recommendations for key policy reforms.

While financial intermediation in Mongolia has been growing fast, access to finance remains a critical constraint for enterprises, and especially for small and medium enterprises (SMEs). Improving access to financial services will require strengthening the legal and regulatory framework and financial infrastructure, including the secured transactions framework, creditor rights and insolvency regime, credit information sharing system, platform for technology-based banking products, regulation and supervision of nonbank financial institutions, and consumer protection in financial services. In designing programs to enhance SME access to finance, authorities are advised to consider risk-sharing mechanisms, such as partial credit guarantees and TA for improving SMEs' borrowing capacity, as opposed to directed lending schemes.

Improvements in the institutional, regulatory and supervisory framework are required to achieve Mongolia's ambitious plan for developing the domestic capital market. An immediate priority is the enactment of a new Securities Market Law consistent with international good practice. The Financial Regulatory Commission, as supervisor of the non-bank financial sector, needs greater human and financial resources, and the Mongolian Stock Exchange and market intermediaries need to invest substantially in skills and capacity. Improving the function of government bond markets is also vital to develop a reference yield curve. One of the most important ingredients for a strong domestic capital market is a diversified institutional investor base, and the regulatory agencies need to provide an enabling environment to develop the insurance and pensions sectors and to attract institutional investors.

Strengthening the housing finance market is another area of high priority, as the rapidly urbanizing population raises demand for housing far beyond the current supply. To avoid a real estate bubble and keep mortgage lending in balance with housing supply, banks and regulatory authorities are advised to: adopt a conservative approach to mortgage lending, further enable property modernization, and allow for the expansion of small-scale housing finance for lower-income groups. The housing finance market also needs a stronger mortgage market liquidity facility to provide long-term funding. Finally, publicly-funded, subsidized housing programs, such as the "100,000 Apartments" Program, need to be carefully planned and

implemented, so that the desired social objective is achieved with minimal distortion to the broader housing finance market.

Table 1. Key Findings and Policy Recommendations

Finding	Recommendation	Timing[2]	Priority[3]
General enabling environment			
Volatile macroeconomic environment and high inflation inhibits long-term investment	Pursue sound mix of fiscal, monetary, and exchange rate policies to maintain macroeconomic stability and curb inflation	ST	H
Indications of build-up of systemic risks in the banking system	Preserve stability of the banking system through the combination of micro- and macro supervision measures consistently enforced by BOM	ST	H
Insufficient resources and capacity for supervision of securities markets, NBFIs and SCCs	Strengthen supervisory and financial resources and legal protection of FRC to enable more effective supervision	MT	H
Improving access to financial services			
Banks' funding constraints limit provision of long-term credit, particularly for SMEs	Improve competition in the banking sector through encouraging entry of reputable foreign banks with more sustainable funding, skills, and wider product range	LT	M
No effective registration and enforcement for security interests over movable assets	Improve legal and regulatory framework for secured transactions, establish a modern movable collateral registry	MT	M
Limited financial instruments available for SMEs	Revise the leasing law and consider preferential tax treatment for leasing transactions	MT	M
	Review legal framework for contracts assigning receivables with a view to the development of factoring	MT	M
Inadequate legal framework and enforcement for creditor rights, insolvency, and bankruptcy	Amend the insolvency legislation to make it consistent with international standards	ST	M
	Strengthen court capacity to handle commercial matters and consider the creation of commercial courts	MT	M
Implementing regulations are needed for the new law on credit information	Issue license and regulations to enable operations of private credit information bureau	ST	H
Mobile banking has a potential for fast and low-cost delivery of financial services to remote and rural areas	Create a national platform to improve inter-connectivity and service delivery, reduce the cost of maintaining and using mobile banking services, and improve customer security	MT	H
Inadequate regulatory and institutional framework for financial consumer protection	Adopt the time-bound action plan for improvement of consumer protection framework in financial sector	MT	M
Lack of efficient risk sharing mechanisms for SME finance	Adopt regulations for effective operation of Credit Guarantee Fund	ST	H
Strengthening capital markets			
Legal and supervisory framework and practices insufficient to	Enact the new Securities Market Law and accompanying regulations consistent with international	ST	H

[2] ST, short term, indicates action can be undertaken in 0-6 months. MT, medium term, indicates 6 months-1 year. LT, long term, indicates 1+ years.
[3] Priority: High (H), Medium (M), Low (L).

support a modern securities market	(IOSCO) principles		
	FRC should take action against breaches of corporate governance and non-disclosures of material information by listed companies	ST	H
	Efficiently allocate regulatory resources by relying on market-based price mechanism for IPOs	ST	H
Undeveloped contractual savings sector limits domestic investment in the capital markets	Assess demand dynamics in equity and bond markets, including any regulatory constraints, with a view to widening the investor base and attracting foreign institutional investors	MT	M
	Enhance quality and reliability of financial information of listed entities	MT	H
Government bond market is undeveloped and has not played its role to provide benchmark pricing for credit risks	Improve debt issuance strategy to support the risk-free yield curve	MT	H
	Build a central repository of information relating to the issuance, outstanding amount and terms of corporate bonds	MT	M
	Review the suitability of using the MSE auction system for primary issuance of government bonds and the feasibility of introducing a primary dealer system	MT	M
Improving housing finance			
Emerging misbalance in housing demand/mortgage lending as compared to current volumes of new housing construction	Support increase of volume of residential construction through alleviating bottlenecks in physical infrastructure for housing	LT	M
	Strengthen the legal and regulatory regime to promote bank lending for existing residential property maintenance and modernization	MT	M
	Reduce risk of retail-developer finance by strengthening borrower-developer contractual framework and developing structure like real estate investment trust for construction finance	MT	H
Institutional, regulatory and supervisory framework for efficient housing finance still under-developed	Consolidate and automate registration of property rights for land and buildings	ST	H
	Improve consumer disclosure rules, standards for real property appraisals, and supervision of real estate agent industry	ST	H
Financial system lacks sufficient diversified and long-term sources for mortgage funding	Strengthen institutional and governance capacity of MIK, and review its mix of products and business strategy	MT	M
	Adopt laws on securitization and covered bonds, and enact relevant regulations	ST	M
Large-scale subsidized housing program envisioned by GoM lacks clear design and implementation mechanism, and can potentially distort housing finance market	Adopt a clear strategy for program design and implementation, considering, inter alia, infrastructure and construction aspects, governance and transparency of execution process, funding constraints, household eligibility criteria, and mechanism for monitoring and evaluation	ST	H

I. Macroeconomic Environment and Financial Sector Landscape

1. **Mongolia's economy has embarked on a very high, long-term growth trajectory**, driven primarily by extensive investment in new mining projects, including the largest copper deposit in Asia and the world's largest coking coal deposit, and proximity to Asian markets.

Mongolia's real GDP is expected to grow at an average annual rate of 16 percent for the 2011-2013 period and to accelerate further in the years following.

2. **Mongolia's massive economic growth has contributed to a demographic transition in the country.** While the share of rural, primarily nomadic, population remains large at 47 percent, many are seeking new opportunities in the capital, and the population of Ulaanbaatar has more than doubled since 2000. The population is also very young compared to the region and to post-socialist neighbors: about 70 percent of the population is below the age of 35 years.

3. **The growth prospects are overshadowed by recurrent risk of overheating,** fuelled by expansionary fiscal policy, volatile global commodity prices, and rising capital inflows. Fiscal spending increased by 50 percent in real terms in 2011, and a 32 percent increase is envisioned for 2012. As a result of structural factors and expansionary policies, consumer price inflation reached 11.1 percent in 2011, and is expected to remain in double digits in the near- to medium-term. Further aggravating the inflation problem, Mongolia's open economy is prone to a high degree of price and exchange rate volatility, due to its dependence on imported fuel and foodstuffs, and its commodity-dominated export structure.

4. **Against this backdrop, financial intermediation in Mongolia has grown rapidly since 2007 but remains highly volatile,** mirroring the boom-and-bust nature of the economic cycle. Although the banking sector assets nearly tripled from US$2.4 billion to US$6.8 billion at end-2011, the system went through a severe crisis and credit crunch in 2008-2009. Since late 2009, renewed economic growth and strong capital inflows have resulted in an extended period of accelerated credit growth.

5. **The financial sector is dominated by the banking sector, accounting for 96 percent of financial sector assets** (Table 2). The system comprises 14 commercial banks, of which 13 are private domestic banks, and one is a state-owned bank; banks are supervised by the Bank of Mongolia (the central bank). The banking system is highly concentrated, with the top 3 banks accounting for about 70 percent of market share, and the top 5 banks accounting for over 86 percent. A very small portion of financial sector assets is held by nonbank financial institutions that are supervised by the Financial Regulatory Commission (FRC).

6. **To realize fully its economic potential, Mongolia needs to build a diversified, efficient and stable financial system, capable of intermediating both on a large scale and in specific market segments**. Due to its focus on the development agenda, and specifically on access to finance for the SME sector, capital markets development, and housing finance market development, this report does not address financial sector stability issues[4]. It must be noted, however, that preserving stability and preventing the build-up of risks in the financial (especially banking) system through the combination of properly enforced micro- and macro supervision measures is an absolute pre-requisite for sustainable development of the three above-mentioned market segments. This is also contingent upon the authorities' ability to maintain a stable

[4] The IMF undertook a Financial Sector Assessment Program Stability Module mission to Mongolia from November 8-19, 2010. The findings of the mission are summarized in the IMF's Financial Sector Stability Assessment for Mongolia, dated March 3, 2011, and available at: www.imf.org/mongolia.

macroeconomic environment through a mix of sound and properly coordinated fiscal, monetary and exchange rate policies.

Table 2. Structure of the Financial Sector, 2008-2011

		Dec-08			Dec-09			Dec-10			Dec-11	
	Number	Assets (bn MNT)	Percent of Total Assets	Number	Assets (bn MNT)	Percent of Total Assets	Number	Assets (bn MNT)	Percent of Total Assets	Number	Assets (bn MNT)	Percent of Total Assets
Commercial Banks	16	3,527	95.7%	15	4,215	95.5%	14	6,214	96.3%	14	9,223	96.4%
Private	16	3,527	95.7%	14	4,078	92.5%	13	6,034	93.5%	13	8,991	94.0%
State-Owned	0	0	0%	1	137	3.1%	1	180	2.8%	1	232	2.4%
Nonbanks	403	159	4.3%	459	195	4.4%	465	237	3.7%	467	340	3.6%
Insurance companies	16	34	0.9%	18	41	0.9%	16	46	0.7%	17	77	0.8%
Life	1	1	0.0%	1	1	0.0%	1	1	0.0%	1	3	0.0%
Non-Life	15	33	0.9%	17	40	0.9%	15	45	0.7%	16	74	0.8%
Savings and Credit Cooperatives	209	32	0.9%	217	45	1.0%	179	49	0.8%	170	59	0.6%
NBFIs	132	79	2.1%	177	97	2.2%	182	129	2.0%	192	189	2.0%
Securities firms/broker firms	46	14	0.4%	47	13	0.3%	88	14	0.2%	88	14	0.1%
TOTAL FINANCIAL SYSTEM	419	3,686	100%	474	4,410	100%	479	6,451	100.00%	481	9,563	100.00%

Source: Bank of Mongolia and Financial Regulatory Commission

II. ACCESS TO FINANCIAL SERVICES

A. Status of Access to Finance

7. **Financial intermediation in Mongolia has grown significantly in recent years; credit and deposit penetration are on par with the average in the East Asia and the Pacific (EAP) region.** Bank credit increased on average by 47 percent in 2006-2008, although banks virtually stopped lending in late 2008 due to the crisis. Credit growth resumed in late 2009 as the economy rebounded strongly, and in 2011 credit grew substantially by more than 70 percent yoy. Deposits have also grown rapidly after the crisis, by an average of 53 percent in 2010 and 2011. At end-2010, credit to the private sector accounted for 49 percent of GDP and deposits for 60 percent of GDP, compared to an average of 52 percent and 63 percent in the EAP region, respectively. Credit by nonbank financial institutions (NBFIs) and savings and credit cooperatives (SCCs) has also increased, although it accounts for a small share (about 3 percent) of total financial sector lending, as NBFIs and SCCs remain small and underdeveloped.

8. **Bank lending is growing rapidly to both households and corporates, including SMEs.** About a third of total loans are to households, which have increased by about 80 percent yoy in 2011. Corporate loans account for 66 percent of total loans and have increased by more than 70 percent yoy in 2011. The bulk of bank lending is concentrated in Ulaanbaatar, and in five sectors of the economy—trade, construction, real estate, mining, and manufacturing—that account for 65 percent of total lending. At end-2011, 19 percent of total bank lending was to entrepreneurs and SMEs. Bank credit to SMEs has more than doubled from 2008 to 2011, to about US$735 million at end-2011.

9. **While financial intermediation has been growing fast, enterprise surveys and industry players suggest that access to finance remains a top constraint for firms, and especially for SMEs.** The World Bank's Enterprise Survey[5] shows that access to finance is the most important constraint among the top-10 constraints as reported by firms. More than 30 percent of firms in Mongolia perceive access to finance as the biggest problem to their operations (higher than the average of 17 percent in the EAP region).

10. **Access to finance is particularly constrained for SMEs, which are also more sensitive to an unstable macroeconomic environment, characterized by high inflation and exchange rate fluctuations.** Loan terms and conditions for SMEs are characterized by high interest rates, short maturities of loans that are inadequate to meet investment needs, relatively small loan sizes, and predominantly immoveable collateral-based lending requirements. Encouraging the entry of foreign banks could improve competition in the banking sector, as well as bring more sophisticated credit appraisal techniques and longer term funding. In the meantime, the SME sector would benefit from business development services to improve management skills and financial reporting.

11. **There are limited financial instruments for SMEs in Mongolia.** Mongolian banks predominantly offer loans, deposit and savings products, and some trade financing to SMEs. There is no factoring, there is very limited leasing, and equity finance is not available. Leasing remains underdeveloped, with an estimated leasing penetration rate[6] of about 2-3 percent. Leasing companies providing financial leasing are not currently regulated and supervised. Factoring is not present in Mongolia, although it is allowed in the legal framework covering banks and NBFIs. To encourage the growth of factoring and leasing, the authorities are advised to: (i) provide tax incentives in the leasing law that would encourage the development of the industry; (ii) review the legal framework governing contracts between parties and assignment of receivables to ensure that the current framework is adequate for the development of factoring; and (iii) provide education to SMEs about financial products.

12. **Nonbank financial institutions and savings and credit cooperatives remain small, but could play an important role in expanding access to finance to SMEs and microenterprises, especially during economic downturns.** SCCs provide savings and loan services to low-income and rural households. Lending by SCCs has more than doubled from US$14 million in 2007 to US$33 million in 2011. SCCs may accept deposits and provide loans only to their members. NBFIs provide a variety of financial services: loans, payment guarantee, currency exchange, remittances, factoring, leasing, short-term investment, trust funds, and electronic payments. Between 2007 and 2011, lending by NBFIs more than tripled, from US$26 million to US$79 million, and accounted for up to 8 percent of total SME credit in 2011. However, they face significant funding constraints that limit their growth—they are not allowed to take deposits and are thus mainly dependent on their capital base and borrowings from banks and foreign institutions to fund loans.

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[5] http://www.enterprisesurveys.org/

[6] Penetration rate is measured as annual leasing volume divided by gross fixed capital formation.

13. **The Financial Regulatory Commission, as the regulator and supervisor of NBFIs and SCCs, is encouraged to take further measures to promote the sector's growth, while efficiently allocating supervisory resources**. As noted also in the capital markets section, the FRC needs major investments in staff, technology and capacity to handle its broad and increasing responsibilities. It might also consider streamlining prudential requirements for non-deposit taking NBFIs, and categorizing NBFIs and SCCs by size and risk in order to allocate supervisory resources accordingly.

B. Secured Transactions, Insolvency, and Bankruptcy Framework

14. **Access to credit in Mongolia is adversely affected by a number of problems in the legal framework**.[7] In particular, there are important issues in the design and functioning of secured transactions, in the enforcement of claims, and in the judicial and administrative institutions supporting the bankruptcy and insolvency regime.

15. **A modern secured transactions framework allows for pledging of movable assets by borrowers, and its essential elements include:** (i) a wide scope of movable assets that can be taken as security; (ii) clear priority rules over competing interests; (iii) a central electronic security interest registration system; and (iv) effective and low-cost enforcement of the security interest. In Mongolia, a Pledge Law has not yet been approved, there is no centralized movable assets registry (rather there are several specialized registries), and awareness about movable assets financing is limited. Improvements in the legal and regulatory framework, establishment of a single, centralized movable collateral registry, and training for borrowers and lenders should be a high priority in Mongolia. An effective secured transactions regime would facilitate lending to SMEs, which typically have a wide range of movable assets and limited immovable assets.

16. **Enforcement of creditor rights also presents important challenges in the Mongolian legal environment**, as enforcement of court decisions is often more difficult than obtaining the judgment itself. The enforcement of claims is severely affected by debtors' delaying tactics, weaknesses in the Bailiff's Office, inefficiencies in the rules for valuation of immovable assets, and irregularities at auctions. In this context, authorities are recommended to finalize the enforcement regime and allow for out-of-court enforcement of security interests and a streamlined court enforcement regime.

17. **The legislative framework does not facilitate enterprise workouts or restructurings by encouraging lending to or investment in viable distressed enterprises.** The legal framework should be amended to provide favorable tax treatment with respect to losses or write-offs, to guide negotiation of restructuring agreements for financial institutions, and to provide an instrument whereby informal agreements can be easily converted into binding insolvency plans. In addition, the bankruptcy legislation has proved inadequate, and bankruptcy procedures are hardly ever used, since secured creditors stand to lose significantly from the process. Virtually all procedures are liquidations.

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[7] More detailed analysis will be provided in the Insolvency and Creditor Rights ROSC report, currently being finalized by the World Bank.

18. **Completing reform of the insolvency regime will be vital to improving conditions for SME finance.** The new legislation should aim at preserving the value of distressed businesses, integrating more closely the insolvency regime and the commercial and corporate laws, aligning the law of Mongolia with international standards, allowing for a speedy transformation of an informal restructuring agreement into an insolvency plan, and setting guidelines for cross-border insolvencies.

19. **Putting secured transaction, bankruptcy and insolvency laws into practice will require effective courts**, and this seems to be another major bottleneck. High case-loads, lack of judicial specialization, and lack of rigorous standards or supervision of insolvency representatives, are challenges which authorities will need to address to ensure that there is adequate judicial capacity.

C. Credit Information Systems

20. **The credit registry at the BOM has broadened its database to include information of all borrowers in the country.** The BOM currently provides an improved credit information service to banks and participating NBFIs, free of charge, and the quality of data is deemed adequate by the market. In addition, a private credit information bureau (CIB) has been established by commercial banks, but it is not yet operational. According to the new Credit Information Law (enacted in December 2011), the private CIB will need to receive an operating license from the BOM. It will build a credit database with information reported by lending institutions (banks, NBFIs, and SCCs), and state agencies on a contractual basis, and will provide additional services like credit scoring and credit rating.

21. **To put in place a balanced framework for the operation of the entire credit information system, the BOM should promptly issue implementing regulations** prescribed in the Credit Information Law. In particular, the regulations should specify: (i) detailed requirements for collecting credit information and using, storing, protecting and transferring it, as well as setting the service fees; (ii) a code of ethics; (iii) rules for refusal, suspension and termination of CIB license; and (iv) the process of reorganization or liquidation. It is essential that the BOM puts in place a reasonable framework for the exchange of information between the BOM registry and the licensed credit bureau. The BOM's supervisory process for the private CIB should be further developed. Also, the legal and regulatory framework should be further developed to protect the rights of the data subjects to correct information.

E. Use of Technology to Promote Access to Finance

22. **The use of modern technologies has grown fast in recent years, with support by the authorities.** The BOM took an active role in promoting the use of debit and credit cards by establishing a national platform for card processing. In 2009, the BOM approved the legal framework for a consolidated card clearing and settlement system, including licensing of its participants. In early 2010, the Interbank Payment Card Centralized Network started operations with the BOM and nine commercial banks as system participants. As of mid-2011, the card service network offers 410 ATMs, 4,956 POS terminals and 2,076 POB terminals shared by all participants. By mid-2011, there were over 2 million card holders in Mongolia, of which about one quarter are active users. The BOM plans to broaden the national platform for electronic

payment instruments by extending the infrastructure needed for the use of cards in smaller cities and rural areas, and it is introducing a national chip-based credit card.

23. **Banks are increasingly using mobile banking as a low-cost delivery channel, particularly in remote and rural areas.** In the past two years, mobile banking has expanded greatly, with nine banks and a number of NBFIs providing mobile banking services. Mobile phone banking is supported by four operators, and banks are effectively limited to contacts with clients served by one operator. Internet banking is also a new, fast-growing product. Government initiatives such as the e-Mongolia National Program are increasing internet awareness and usage throughout the country. The BOM is encouraged to take the lead in establishing a national platform for internet and mobile phone banking services that can introduce better standards and reduce costs, allow entrance of qualified non-bank institutions, and improve customer security.

E. Consumer Protection and Financial Literacy[8]

24. **Consumer protection and financial literacy are critical to ensuring confidence in the financial system and increasing financial inclusion**. Given the rapid pace of the development of the financial sector in Mongolia, and technological innovations that create new risks for consumers, consumer protection and financial literacy become particularly important. For example, it appears to be a common practice in Mongolia to quote interest rates on a monthly—rather than annual percentage rate—basis. Large banks have set up their internal complaint mechanisms to address consumer complaints, but there is no independent financial ombudsman scheme. There is a general consumer protection law in Mongolia, but no specific financial consumer protection law. The institutional framework for financial consumer protection is not clear, and specific consumer protection provisions need to be enacted in laws and regulations. An improved consumer protection framework should: (i) protect against unfair or deceptive practices; (ii) improve transparency through disclosure and plain language requirements for products and pricing, in a way that allows consumers to easily compare offers of financial products; and (iii) establish an efficient and fair mechanism for resolving customer complaints and disputes.

F. Government Policies and Programs Related to Access to Finance

25. **Aiming to increase the number and productivity of SMEs, improve the sector's competitiveness, and promote business capability, the GoM is allocating greater resources to programs promoting SME lending.** The SME Credit Program is currently the largest government initiative, which channels subsidized, longer-term credit through banks to qualifying SMEs pre-screened by provincial councils. Given the considerable fiscal cost (around 3 percent of GDP in 2011), the GOM is strongly advised to conduct an independent evaluation of the effectiveness of the program to date, measuring its outreach, additionality and sustainability.

26. **Going forward, the authorities may consider less costly, market-based mechanisms, that will involve risk-sharing with financial institutions, and avoid the distortions**

[8] More detailed findings and recommendations on this subject will be presented in the World Bank's Consumer Protection and Financial Literacy Review, which is expected to be completed by fall 2012.

associated with subsidized lending. A Credit Guarantee Fund (CGF) is being established as a public-private partnership to issue guarantees to banks and NBFIs for loans primarily to SME-manufacturers. In order for the new CGF to be effective, it will be important to put in place a regulatory framework that ensures that the CGF is sound, has adequate initial capitalization, carefully defines its target beneficiaries, offers additionality, and that participating financial institutions practice strong credit risk management.

III. Strengthening Capital Markets

A. Current State of Capital Markets

27. **With a financial market dominated by the banking sector, the undeveloped capital market is ill-equipped to support the growth momentum that the country aspires to over the next 10 years.** The nonbank financial sector constitutes less than 4 percent of the total assets in the financial sector, with capital markets contributing less than 1 percent. Instruments available for long-term investment remain limited, and the growth of both the retail and institutional investor bases have lagged. The bond markets remains quite small.

28. **Over the past two years, there has been a growing appreciation by the authorities of the need for a well-diversified financial market, which can meet the demand of savers and investors in a cost-effective way.** A major milestone is the strategy to modernize the Mongolian Stock Exchange (MSE), supported through a strategic partnership with the London Stock Exchange Group (LSEG), signed in December 2010. The project's goal is to establish the Mongolian capital market as a world-class market, with the MSE operating according to internationally accepted standards and participating as one of LSEG's key partners in Asia. During the first phase of the project, LSEG will collaborate with MSE on the modernization of the MSE, the Securities Clearing House (SCH) and the Central Securities Depository (CSD), with the view to eventual privatization of the MSE.

29. **The growth momentum in the domestic economy was reflected in the impressive performance indicators of the MSE.** The price indices, market capitalization, and number of transactions have risen rapidly over the past two years. By end-2011, the market capitalization of MSE increased by MNT 794.6 billion or by 58 percent compared to 2010, reaching MNT 2.2 trillion (US$1.6 billion). The price indices and turnover levels of the MSE surged in 2009-2011, with the MSE becoming one of the best-performing emerging stock markets in the world.[9]

30. **Nonetheless, the Mongolian stock market is still very small and illiquid.** The ratio of stock market capitalization to GDP was merely 16 percent at its peak in 2010.[10] Listed companies are still few in number and small in size, and turnover is among the lowest compared to other emerging market peers. Deepening capital markets requires implementation of a comprehensive, prioritized reform program that should set the stage for expanding the supply of securities. Key areas for reform are detailed below.

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[9] The TOP-20 index of the MSE rose by 46.9 percent in 2011.

[10] For comparison, Sri Lanka's market capitalization is 40 percent of GDP and Indonesia's market capitalization is 50 percent of GDP.

B. Improving the Regulatory Framework

31. **Modernizing the legal and regulatory framework is a critical prerequisite for deepening the capital market in Mongolia.** A new Securities Markets Law (SML) is being drafted, which seeks to align the framework for securities regulation in Mongolia with international best standards. In particular, the new SML is expected to facilitate the introduction of new and innovative products, such as depository receipts, and to facilitate cross-listings on the MSE. It is important that a quality law is enacted soon, addressing, inter alia, the following critical policy issues: (i) clarifying the roles of the FRC and the MSE, particularly in relation to listings; (ii) incorporating a market-based due diligence system by qualified valuation experts; (iii) introducing a sponsor system to support IPO listing on MSE to enhance due diligence; (iv) reviewing FRC's internal systems and processes to ensure that appropriate checks and balances operate on its supervisory judgments; and (v) introducing a "Know Your Customer" (KYC) obligation on regulated entities that provide investment advice to clients.

C. Improving Supervisory Effectiveness

32. **The FRC must have sufficient financial resources and operational autonomy commensurate with its expanding responsibilities to effectively meet the complexity and challenges in supervising the capital markets.** The FRC faces the multiple challenges of filling the gaps in the legal framework, and strengthening the regulatory, supervisory, governance, internal control, and accounting and auditing processes. With the rapid modernization of the capital markets, the FRC will need: (i) enhanced operational independence; (ii) a reasonable level of human and financial resources (for example, by allowing FRC to retain the fees it collects and to share a small percentage of clearing fees from sales and purchase transactions that are effected on the stock exchange); and (iii) stronger statutory protection for its staff against legal actions brought against them in the course of the discharge of their statutory functions.

D. Modernizing Market Infrastructure

33. **The commitment of the authorities to the modernization of market infrastructure for the securities markets is highly commendable.** A modern, automated surveillance, trading and settlement system to be shared by MSE, SCH, CSD, and the FRC is being installed in the MSE. However a market readiness assessment by an independent professional firm is critically important. A settlement guarantee mechanism[11] appears to be absent from the design of the new system; this is important to mitigate settlement risk, and should be combined with appropriate capital standards for intermediaries. Also, the system should detail the roles and responsibilities of all market participants and relevant stakeholders to minimize uncertainties.

E. Strengthening Domestic Bond and Equity Markets

34. **There has been some progress in government debt management since 2008, and a number of important reforms have been initiated**, but significant improvements are still required to develop a robust, local-currency bond market. The MOF has no predetermined

[11] The FSAP team was informed by the LSEG representative in MSE that there is a very preliminary proposal for settlement guarantee mechanism that is being discussed with the FRC.

auction schedule and issues government bonds through the MSE on an irregular basis. To-date government bonds worth US$171 million have been issued. There is no comprehensive bonds database available, and pricing of recent government bond issues does not appear to have been market-based. As such, the market lacks a reference yield curve. Weaknesses in the government bond market are impeding the development of corporate bond and derivatives markets that are very small at only US$11 million in issues to date. Most Mongolian companies prefer to seek financing either from banks or abroad.

35. **In addition to fiscal objectives, public debt management needs to have market development and liquidity objectives in mind**. To improve transparency and the ability of market participants to plan and absorb the government's funding requirement, the Debt Management Office should consider publishing quarterly updates of the auction calendar, announcing its intentions for the quarter in terms of specific volumes and tenors to be auctioned. The GoM should reconsider the suitability of using the MSE auction system for primary issuance of government and corporate bonds, and consider the feasibility of introducing a primary dealer system. The design of government bonds should be standardized and their issuance concentrated in a limited number of popular, benchmark maturities.

36. **In the equity market, growth is hampered by a lack of large and quality issuers, a poor valuation process, weak capital market intermediaries, a narrow investor base, and a limited product range.** A major challenge for the MSE is that there are very few large, "blue chip" listings.[12] Most Mongolian companies do not disclose their earnings with an adequate degree of transparency and accuracy,[13] making valuation difficult. Although the government has contributed to the growth of the MSE by privatizing state-owned assets through listings, it has applied pre-determined valuations and admitted many poor-performing firms with inadequate financial disclosure. Most capital market intermediaries are poorly capitalized, inactive, or unable to effectively intermediate between savers and the capital market.[14] Also, a low equity culture and a low level of investor literacy have further deterred investor confidence in the stock market.

37. **In order to attract quality issuers to list on the MSE, FRC will need to ensure that key elements of the legal and institutional framework are in place, and should allow for a market-based price discovery process.** Further, FRC should provide a framework that facilitates foreign listings or dual listings, and it should allow for a broader product range from MSE, including depository receipts.

F. Developing a Sound Institutional Investor Base

38. **One of the most important dimensions of domestic capital market development in Mongolia is the need to develop a diversified institutional investor base**, including mutual

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[12] Only six of the listed companies have market capitalization that is over US$5 million.
[13] According to the MSE 2010 Annual Report, only 151 listed companies submitted their annual financial statements in 2010, and only 159 listed companies announced to shareholders the convening of annual general meetings.
[14] Of the 88 broker-dealers licensed in Mongolia, one company carries out more than 50 percent of total transaction volumes on MSE.

and investment funds and other contractual savings institutions, such as pension funds and insurance companies. They provide an institutional framework for long-term capital accumulation and act as a stable source of demand for long-term debt securities and equity investments. The insurance and pensions sectors and other contractual savings institutions are not developed in Mongolia, and they have insignificant investments in equities and bond instruments. Individual investors comprise 99.8 percent of the total number of accounts maintained in the CSD. However, it should be pointed out that more than 60 percent of these accounts are dormant and are not traded.

39. **Developing a sound investor base will require: (i) creating the conditions for a more active role of banks in the growth of institutional investors**; (ii) ensuring that regulations of commercial banks, insurance and pensions are consistent with the expansion of capital markets to private enterprises; and (iii) monitoring eventual regulatory arbitrage opportunities created by the fast-growing wealth management products. Efforts to build a strong investor protection system and improve public awareness and investor education should complement market development efforts.

40. **The regulatory system must adequately address corporate governance and disclosure, especially financial disclosure** to ensure the quality of price discovery. The accounting and auditing standards that underpin financial disclosure are crucial to build this credibility.

G. Building Capacity of Regulators, MSE and Market Intermediaries

41. **Capacity of the FRC, MSE and market participants needs substantial strengthening to meet the challenges and sophistication that come with capital market development.** Systematic training should also be planned for each level of member staff of the FRC, MSE and SCH to keep up with developments and new products in the marketplace. With the clearing and settlement system moving from a pre-settlement system to T+3, it is imperative for a risk-based supervisory approach and the requisite skill sets to be built for the staff of FRC, MSE and SCH.

42. **Finally, it is important that proper attention is given to prioritization of the reform measures going forward.** In this regard, a roadmap for the next five years of capital market development in Mongolia would be very useful to document the relevant challenges and ensure better coordination between stakeholders.

IV. Strengthening the Housing Finance Market

A. Overview of the Housing Finance Market

43. **After a severe crisis in 2008-2009, the Mongolian housing finance market has recovered very rapidly**, with portfolio outstanding increasing by 190 percent to US$482 million between 2009 and 2011. This represents 8 percent of 2010 GDP and 12 percent of the 2011 banking sector loan book. The average mortgage loan amount for originations in 2011 was MNT 32 million (US$24,000), and the average loan-to-value (LTV) ratio is 70 percent. Most lending is concentrated in and around Ulaanbaatar.

44. **At the same time that demand for housing finance is growing fast, the housing stock and critical infrastructure are under-developed.** Housing stock in Ulaanbaatar is comprised of semi-formal, traditional ger (or yurt) districts, where almost half of the city population lives, and formal housing, consisting primarily of older block houses. In the meantime, the supply of new homes is limited given the short construction season and critical bottlenecks in housing infrastructure, such as power and heating. In this environment, Housing prices have risen sharply over the past two years, particularly in 2011, when house price appreciation for apartments typically purchased with mortgage loans was 36.7 percent.

45. **A number of weaknesses hamper sustainable growth in the housing finance market, with the majority of recommendations from the 2007 FSAP remaining relevant.** Even though the Law on Mortgage has been adopted, lenders report that foreclosure court cases take several years with little certainty; market participants report gaps in legal enforcement, in part due to weak judicial capacity; real estate brokerage and appraisal sectors appear to lack adequate supervision and capacity. The local banks have limited access to longer-term funding to finance mortgage loans, and the secondary mortgage market is very small.

46. **As the Mongolian mortgage market grows, and the government pursues an ambitious social housing agenda, there is an urgent need for a holistic sector approach.** First, there is a need to better balance housing supply and demand, which requires the authorities to focus on prudent mortgage lending standards and supervision, as well as on provision of power and utility infrastructure and zoned land. Second, it will be important to ensure effective implementation of ongoing and planned public housing finance programs, with a focus on minimizing mortgage market distortions channeling resources in a transparent manner to low-income segments of population. Third, it will be important for authorities to consider facilitating better balance in the composition of mortgage funding, through developing a functioning market liquidity facility.

B. Balancing Housing Finance Supply and Demand

47. **In order to prevent overheating of the real estate sector, the authorities should seek to re-balance supply and demand of housing.** On the supply-side, GoM is advised to support the increase of volume of residential construction by focusing on provision of power and utility infrastructure, particularly in the context of larger-scale projects. On the demand side, BOM is advised to continuously monitor and refine prudential regulation for banks' mortgage loans, for example, by calibrating prudential requirements for mortgages collateralized by pre-2000 buildings, for multiple loans held by the same borrower, etc. In addition, in order to provide a foundation for sustainable mortgage market development, the capacity, quality and efficiency of operations of the State Immovable Property Registry (SIPR) should be enhanced.

C. Strengthening Publicly-Funded Housing Programs

48. **GoM pursues an ambitious publicly-funded social housing agenda to address the social and environmental challenges resulting from the country's housing shortage.** The largest such program to date, "100,000 units", has been announced in 2011 and its details are currently being formalized. Mongolian Housing Finance Corporation, a state-owned financial institution, serves as the main implementing vehicle for such programs. MHFC provides

mortgage loans on heavily subsidized terms, as well as developer finance for housing construction. By late 2011, MHFC accumulated over 25 percent of the total outstanding mortgage loan portfolio.

49. **Similar to subsidized housing schemes elsewhere, Mongolia's recent initiatives carry two key risks:** (i) potential market distortion as private lenders are forced to compete with subsidized loans carrying below-market interest rates; and (ii) implementation inefficiencies, resulting from inadeqauate supervision, reporting, transparency, and governance of state-funded programs. The Mongolian housing market presents specific challenges due to its rather small size and severe infrastructure constraints.

50. Prior to the start of implementation of the "100,000 unit" Program, the GOM needs to develop a detailed implementation strategy addressing: stringent governance, transparency, and safeguards requirements for Program administrator; mechanism for investments in required housing infrastructure, zoning and local construction capacity; carefully designed eligibility criteria for beneficiaries; yearly funding allocations correlated with available supply of new housing; and regular independent monitoring and evaluation of program results.

D. Improving Mortgage Funding Structure

51. **Banks' capacity to deliver housing finance in a prudent and sustainable manner is affected by the shortage of longer-term funding.** The total liquidity provided in 2011 through Mongolian Mortgage Company (MIK), a private mortgage intermediary, amounted to just 1 percent of originations. Market participants report that MIK's cost of funds is not competitive with high yields on deposits; that MIK's business model based on an "asset swap" technique is no longer relevant to Mongolia; and that limited availability of funding at MIK makes provision of liquidity to lenders inconsistent in volume and timing.

52. **It is recommended that the authorities and the banking community critically reassess MIK's business model, with a goal to develop a functional and relevant mortgage market liquidity facility,** by enhancing its corporate governance to the level of current international practices; providing specific regulatory preferences to MIK debt instruments, supporting domestic issuance of MIK mortgage-backed securities; and providing a defined amount and term of sovereign guarantees of MIK debt with a clear sunset provision.