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MONGOLIA
Government Financial Sector Reform Program
(2000 – 2010)

Mid-Term Review Report

In spring 2000 the Government of Mongolia adopted a "Long-Term Vision and Medium Term Strategy for Financial Sector Reform and Development in 2000-2010," and implemented the Medium Term Strategy in 2001–2004 under the framework of the Bank's FSAC and ADB's FSPL II. In 2004–2005, a Bank team carried out a series of reviews to take stock of the progress made, and identify the remaining as well as emerging challenges. The reviews enjoyed support and coordination from the Ministry of Finance, the Bank of Mongolia and various financial institutions in Mongolia. The data used for the reviews were mainly those at the end of 2004, some were as recent as June 2005 and beyond. The main findings and recommendations of the reviews are summarized in this report, which serves as an Issues Paper for Bank management and staff working on or interested in Mongolia.

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EXECUTIVE SUMMARY

1. Mongolia suffered back-to-back financial crises in the 1990s. A large part of the economy went back to in-kind transactions. The consequent fiscal cost of banking system stabilization and restructuring was sizeable. The biggest challenge faced by the Government of Mongolia in early 2000 was whether the country could break the vicious cycle, and regain the momentum for financial sector development. Under the parallel programs of World Bank's Financial Sector Adjustment Credit (FSAC) and ADB's Second Financial Sector Program Loan (FSPL II), the government adopted for the first time the "Long-Term Vision, Medium-Term Strategy and Policies for the Financial Sector Reform Program" and largely realized the medium-term targets established under the Bank/ADB programs in 2001–2004

2. By 2005 the landscape of Mongolia's financial sector was quite different. All (but one) of the banks were held by local businessmen and/or foreign investors. The assets of the three largest banks as a percentage of total banking assets declined from over 80 percent in 1999 after the third financial crisis, to below 50 percent. Financial sector assets expanded rapidly from accounting for less than 30 percent of GDP in 1999 to over 60 percent. The expansion was largely funded by an equally high-speed increase of deposits. Non-Performing Loans (NPLs) as a percentage of total loans were maintained at a single-digit level, and the banking system as a whole was solvent. Bank branch networks reached all *aimegs* (provinces), where basic banking services were interrupted five years ago. Non-Bank Financial Institutions, such as finance companies and savings and credit cooperatives mushroomed.

3. Mongolia was ahead of the other transition economies of East Asia (e.g. China and Vietnam) in a number of important areas. The small economy liberalized the interest rate and foreign exchange regimes in the early 1990s. A 2002 IMF assessment found that the country's overall standard for banking supervision fully complied or largely complied with a number of important Basel Core Principles. Monetary and financial data published on a regular basis by the Bank of Mongolia (BOM, the central bank) were considered as generally compatible to the recommendations of IMF's General Data Dissemination System in terms of coverage, periodicity and timeliness. Mongolian banks that focused on microfinance gained a reputation of adopting the key principles of microfinance and were at par with the latest trends of international microfinance practices. In terms of financing private sector growth, domestic credit to the private sector as a percentage of GDP reached 30 percent (2003), which was close to that of lower-middle-income countries, and more than doubles that of low-income countries. The government had reason to feel upbeat, but was faced with two major challenges: maintaining financial sector stability and improving access to finance.

Financial sector stability

4. ***The system has recovered from back-to-back crises of 1990s, but remains fundamentally fragile.*** The financial system registered fast recovery and expansion in

2001 – 2005. Exponential expansion of loan portfolios in consecutive years usually leads to higher default risks, especially for a system with weak financial discipline and prudential controls. Impaired assets continues to be a major threat to financial sector stability. The official data revealed that in 2003, NPLs started to grow faster than performing loans. Considering the weaknesses of credit risk management, and of financial accounting and reporting, the share of impaired assets could be much higher. Banks' profit margins were narrowing, and the system's capital base increased at a much slower pace than its loan portfolio. It should be noted that these problems emerged in a period of economic boom which could quickly slide into a slump, given the vulnerability of the small, open economy to terms of trade shocks.

5. **Mongolia has established a set of basic laws and regulations governing the financial sector, but major loopholes continue to exist**. In many important areas, such as consolidated supervision, prompt corrective action, central bank governance, corporate governance of commercial banks, regulation and supervision of finance companies and savings and credit cooperatives, the legal and regulatory framework has a long way to go to reach a level of international best practices. Furthermore, weak enforcement of prudential regulation and supervision has limited the Bank of Mongolia's ability to take timely and adequate actions to address the problems which could threaten financial stability. Weak enforcement is mainly a result of the lack of: (a) skills and expertise for risk-based supervision; (b) well-designed and coordinated supervision work program; (c) reliable data; (d) appropriate central bank governance structure; and (e) strong political will. This problem could serve as a reminder that opaque conditions exist, shadowing the reported financial situation of the banks.

6. ***The government needs to be prepared for systemic distress.*** Based on the results of the mid-term reviews using data up to June 2005, the Bank team recommends that the government would need to develop and adopt a contingency plan to deal with systemic distress which could strike at the least expected time. While the government and the BOM gained experience in the past, the next financial crisis will be much more difficult to handle, given the higher level of financial deepening and the broader outreach of the sector. The contingency plan should clearly assign responsibilities, and spell out procedures, for first-time response to a major bank run or bank liquidity problem within the central bank and between the BOM and other key government agencies (e.g. MOF).

7. ***Banking regulation and supervision continue to demand strengthening.*** The Bank team recommends that the government consider including further amendments of the Law on Central Bank in the legislative work program of the Parliament in the near future, in order to establish an appropriate governance structure of BOM. The Bank team proposes a dozen recommendations to strengthen BOM governance. Establishment of a "balances and checks" framework with clearly separated management and governing bodies could make a difference. So would be adoption of a "two-step" system for nominating and confirming the central bank governor and members of the governing and policy boards. People with direct conflict of interest, such as representative(s) from the chamber of commerce or an industry association, should not sit on the central bank's supervisory board.

8. In addition, BOM should consider establishing a "Ladder of Enforcement" which should include the expanded PCA system, and a range of formal and informal enforcement actions. The government and the BOM should give top priority to the strengthening of corporate governance at commercial banks, especially in the areas of: (a) composition, fiduciary duty and responsibility of the governing board; (b) disclosure of conflict of interest by main owners and top executives; and (c) the role of external audits. The central bank should also require all commercial banks to establish a basic risk management framework in accordance with the Basel Committee's recommendations.

9. ***Sector consolidation is needed.*** Mongolia was overbanked for a population of less than 3 million and an economy of just over US$ 1 billion (2004 real GDP). This aggravated the problem of weak institutional capacity for regulation and supervision. To encourage system consolidation, BOM raised the requirement of minimum capital for commercial banks and finance companies, but the impact was minimal. The central bank should consider re-licensing those banks with highly concentrated borrower base as finance companies, to facilitate sector consolidation and better competition among banks with a broader clientele base. It was also important for BOM to verify the continuous availability and sources of commercial banks' capital, and to effectively enforce market entry and exit regulations.

10. ***Developing a basic legal and regulatory framework for NBFIs should be a high priority.*** Lax market entry policies led to the exponential growth of the NBFIs sector in Mongolia, in particular that of savings and credit cooperatives. Because of the loopholes in the legal and regulatory framework for NBFIs, these financial institutions have operated like commercial banks, but are not subject to the same magnitude of supervision. While these institutions only accounted for less than 10 percent of financial sector assets (2004), their problems could affect a large portion of small depositors. The Bank team recommends that the legal and regulatory framework be strengthened to prohibit finance companies and savings and credit cooperatives from taking the general public's deposits, and to prevent pyramid schemes from snowballing into widespread banking system distress. A trust law governing the rights and obligations of the parties to a trust should be adopted to remove the loophole which allows finance companies to document deposit from the general public as "trust" accounts. Laws and regulations on savings and credit cooperatives and NGOs should be developed or revised to clearly define the nature and business scope of these not-for-profit organizations. The oversight capacity of the newly established Financial Regulatory Commission would need substantial strengthening. First of all, the government should factor in adequate allocation for the FRC in its annual budget, so that the sector regulator could recruit a core team of qualified staff and develop the basic information technology to support its operation. Another priority for FRC's institutional capacity building will be the development and adoption of a set of basic operational principles and procedures in accordance with international practices.

Access to finance

11. ***Access to finance has improved but is still limited.*** Despite progress made in financial deepening and expansion of banking networks, access to finance remains a key

constraint to improved investment climate for private sector development. What financial institutions provide cannot keep up with the increased demand for funding for business start-ups and the growth in household consumption. The clientele base of Mongolian banks is very narrow. The fifty largest borrowers accounted for over half of the banking system's loan portfolio (2004). Some small banks only serve a few dozen borrowers. The conventional wisdom in Ulaanbaatar holds that the high interest rates is the binding constraint to limited access to finance. The nominal interest rate in Mongolia remained at a double-digit level in 2000 - 2005. However, both the nominal and real interest rates began to decline at a faster pace, with the latter declining faster due to accelerated inflation in 2004. By 2005, nominal *Togrog* and US dollar lending rates declined by more than 46 percent from their peak of 2000. If non-performing loans were excluded from the calculation of the effective interest rate, the average ex-post lending rate of *Togrog* loans (15%) was only half of the ex-ante rate in 2004. Even with high lending rates, banks net interest margin (7.7%) in 2004 was normal compared to that of the East and Central Asian countries (7.5%).

12. ***Credit (debt repayment) culture is weak.*** Many structural and institutional weaknesses have contributed to the rigidity of the high interest rate, noticeably among them: a) high NPLs, low operating efficiency and weak corporate governance of banks; (b) poor credit (debt repayment) culture on the part of borrowers; and (c) underdeveloped market infrastructure (e.g. financial accounting and reporting, assets appraisal, and collateral repossession and disposal). The mid-term reviews found that many borrowers had a leverage ratio exceeding 80 percent, and often shifted debts among seemingly unrelated businesses owned by them. Their lenders either did not have proper documentation of the loans and appropriate risk management regimes, or worse, colluded with them. The Banking Law prohibits defaulters to own banks or hold executive positions in banks, but there are no legal restrictions preventing big defaulters from running for high-profile public offices.

13. ***Financing products are predominantly short-term loans.*** This was reported as a key impediment to access to finance in various surveys. Because of the rudimentary level of financial intermediation, Mongolian banks have adopted a conservative approach toward maturity transformation. The 2004 BOM data showed that over 90 percent of loans had a maturity of less than one year, which were funded by deposits of the same short maturities. The same approach is used for managing foreign currency exposures, which accounted for over 40 percent of total assets (2004). A limited gap analysis of selected banks by the Bank team found that there was no material mismatch in either loan/deposit maturities or foreign currency assets/liabilities. Compared to its East Asian neighbors, Mongolia has a low national savings rate (18% - 2004). Banks have not spent as much effort on developing new savings products as they do on expanding the loan portfolio.

14. ***Improvement of access to finance should not be limited to availability of loans.*** The term "access to finance" covers a wide range of subjects, such as the legal and regulatory environment, spatial distribution of financial institutions, availability of funding for borrowers in the form of loans or other commercial products, quality of

payment services, variety of savings products, and financial sector infrastructure. At a time when banks would need to build up capital to cushion for financial distress and invest in new products, exerting political pressure to force down the interest rate could be a dangerous policy. The Bank team proposes a number of recommendations on the strengthening of the legal and cultural environment for improved access to finance, as a more appropriate option, which should be considered together with the recommendations on achieving and maintaining financial stability.

15. ***Strengthened business environment for credit institutions will contribute to improved access to finance.*** To facilitate the development of a sound debt repayment culture, the relevant laws should be amended to disallow large (in particular current) defaulters to pursue high-profile public offices, and to encourage reinvestment of profits into companies. As a result of the amendments to the Civil Code and other relevant laws in 2005, certain default cases could be resolved out of court, but permitting out of court settlement is not adequate. The laws should also: a) define evidence of ownership for different forms of collateral, appropriate conveyance for each form of collateral and methods for perfecting security interest in collateral; and b) establish the priority of liens. Otherwise, difficulties in the repossession and disposal of defaulters' collateral would affect the financial institutions' ability to charge lower lending rates, as they would have to factor in the likelihood of loss recovery when pricing loans.

16. ***Further improvement of sector infrastructure will contribute to improved access to finance.*** This should feature high in the government's new medium-term strategy. A system of automated registries of ownership, liens and satisfaction of liens could be installed in the immovable property registration. A movable property registration system should be established on the basis of the police department's vehicle registrar. In parallel, a pilot program for liabilities insurance should be designed and implemented. While Mongolia has adopted International Accounting and Auditing Standards, few companies maintain IAS compatible accounts, and there is a paucity of qualified accountants and auditors. Consideration should be given to require companies above a certain sales (turnover) threshold to present independently audited financial statements compatible to IAS when they borrow from a credit institution.

17. ***An enabling legal environment for commercial instruments of longer-term financing will contribute to improved access to finance.*** In the short to medium term, it will be difficult and too risky for Mongolian banks to extend their loan maturities beyond their capacity to support maturity transformation. The capital market, a major source of long-term funding in more developed markets, is at an embryonic stage and will take time to develop in Mongolia. Meanwhile, proven commercial instruments for longer-term financing, such as factoring and financial leasing, are not utilized. A couple of local financial institutions started to experiment with financial leasing for equipment rentals in 2004 - 2005, but could not benefit fully from it, because the existing laws do not have proper provisions on accounting and tax treatment of financial leasing. Neither did the banks' clients benefit fully from the new product, because it was more like a 12-month term loan. The financial leasing law under preparation should adopt the international

practices on maximum maturity and minimum price of a lease contract, so that Mongolian firms could enjoy the full benefits of more standard financial leasing products.

18. ***New instruments for savings mobilization will contribute to improved access to finance.*** Mongolian banks should develop new savings products to attract more stable and longer-term deposits (e.g. retail certificates of deposits). Finance companies should be allowed to use money market instruments (e.g. jumbo CDs and money market deposit accounts) to fund their operations, so that they would not have to resort to legal arbitrage for funding. An increasingly important source of funding for economic growth is remittances from migrant workers and other Mongolians working and living abroad. Monthly remittances from abroad were estimated at US$15–20 million (2004–2005), mostly brought in via informal channels. As a business strategy to extend outreach and diversify funding sources, banks should develop new savings products or establish new business relations with foreign financial institutions, to provide services for the transfer and safekeeping of remittances.

Conclusion

19. In conclusion, commendable progress was made in 2001 – 2005, toward establishing a sound, efficient and diversified financial sector as envisaged in the government's 2000 Long-Term Vision, but Mongolia's financial sector remained fragile. It could continue to strengthen and improve on a fast track toward a healthy and well-governed system capable of providing efficient financial services in a competitive environment; or it could see the progress made in the first five years (2000–2005) severely eroded in a relatively short period. **Financial stability and market-based development of access to finance should remain top priorities in both the Bank's country assistance strategy and the government's poverty reduction and sector development strategy**. The key lessons learned in the 1990s summarized by the government in March 2000 are still valid; that is, the development of a sound financial system depends on the following crucial factors:

- Strong financial discipline, sound corporate governance and practices, and effective prudential regulation and supervision in the financial system.
- An appropriate legal framework and operational structures that support contract enforcement and protection of private property.
- The State refraining from intervening in the allocation of financial resources and the management of financial institutions.

INTRODUCTION

1. Mongolia endured unprecedented banking crises in 1994, 1996 and 1998-99, which resulted in financial disintermediation, stagnant economic growth and worsened livelihood, especially for the poor and in the rural areas. NPLs level shot up to 50 percent, while M2 dropped to 24 percent of GDP in 1999. Out of 27 banks licensed in 1990–2000, 15 were closed by 2000. Each time the crisis hit, the government had to rush to put in place a stabilization program supported by donors. The fiscal cost was sizeable. Measured by direct budget expenditures, the cost of the crises for the government amounted to 8.5 percent of GDP.[1] This did not include the government's borrowing from the International Financial Institutions (IFIs) for the purpose of funding the stabilization and restructuring programs.

2. In March 2000 in the aftermath of the 1998-99 financial crisis, the government adopted a "Long-Term Vision, Medium-Term Strategy and Policies for the Financial Sector Reform Program" (Long-Term Vision), which summarized the key lessons learned from the banking crises of the 1990s, and laid out a vision for developing a sound, efficient and diversified financial sector in Mongolia in 2000–2010.[2] This strategy paper was developed after extensive exchange of views with key stakeholders, including members of Parliament from both sides of the aisle and the international and bilateral donors. Around the same time, the World Bank staff carried out a Financial Sector Review which provided the analytical basis for the Financial Sector Adjustment Credit program (FSAC) to support the implementation of the government's long-term vision and medium-term strategy.[3] The government subsequently implemented the FSAC program of banking sector stabilization, consolidation and privatization in 2001-2004. ADB's FSPL II focused on the development of the NBFIs

3. By 2005, Mongolia's financial sector was on a fast track of expansion in assets, variety of institutions, and number of customers. Thanks to high commodity prices abroad and rapid economic growth at home, demand was rising for financing businesses growth, residential housing and household consumption. There was an outcry for longer term lending and eased loan terms and conditions. Meanwhile, there were signs of underestimation of impaired assets and capital, squeezed profit margin and increased operational risk, which might threaten the stability and soundness of the financial system. Enforcement of prudential regulation and supervision remained weak, and NFBIs were operating largely in a void of effective oversight. Mongolia's financial sector was at a crossroads. It could continue to strengthen and improve on a fast track toward a healthy and well-governed system capable of providing efficient financial services in a competitive environment. On the other hand, the impressive achievements toward the

[1] 2001 GDP. The cost of crises that could be measured includes recapitalization, write-offs of government deposits, and issuance of Bank Restructuring Bonds to underpin non-government deposits in failed banks and interest payments of the BR Bonds.

[2] Government of Mongolia, Letter of Development Policy, Long-Term Vision, Medium-Term Strategy and Policies for the Financial Sector Reform Program, dated March 29, 2000.

[3] See Report on Mongolia Financial Sector Review dated October 31, 1999, and the Memorandum of the President for the FSAC dated March 29, 2000.

Long-Term Vision could be gravely eroded in a relatively short period, or wiped out overnight because the system remained fundamentally fragile.

4. Against this backdrop, the Bank's task team carried out a series of studies and case analysis, in order to take stock of the progress made, identify priority areas for Bank assistance strategy, and provide inputs to the government for the formulation of a new medium-term sector development strategy.[4] The reviews enjoyed support and coordination from the Ministry of Finance, the Bank of Mongolia and various financial institutions in Mongolia. This report is a result of these reviews. Section I introduces sector structure and business environment; Section II presents a limited analysis of banking system soundness; Section III is an overview of financial sector regulation and supervision; Section IV discusses issues related to BOM governance; and Section V summarizes lessons learned in micro- and rural- finance in Mongolia. Challenges and recommendations are discussed at the end of each section. Annex 1 reproduces the key lessons learned and the long-term vision from the government's 2000 policy statement; Annex 2 contains more information on BOM's prudential regulations and IMF's assessment; and Annex 3 is the list of staff and consultants who contributed to the mid-term reviews. The statistical Appendices substantiate the analysis of the report. Data used for the reviews were mainly those at the end of 2004, some were as recent as June 2005 and beyond.

Section I – Sector Structure and Environment

5. *Market size and structure.* Fifteen years after the beginning of economic transition, the landscape of Mongolia's financial sector is very different from the mono-bank system which served as the State's cashier in the old planned economy. The interest rate and exchange rate regimes are among the most liberalized in the East/Southeast Asian region. **The once heavily state-dominated banking sector with high level of concentration and no penetration by foreign investors has been transformed into a more dynamic system with relatively equal private sector players**. Financial intermediation has been significantly deepened as a result of the structural changes and a recovery of public confidence in the banking sector. **In terms of financing private sector investment, Mongolia is close to the level of lower-middle-income countries** and more than doubled that of low-income countries (30% of 2003 GDP).[5]

Table 1: Financial deepening and openness

	1999	2004
Largest 3 banks assets as a percentage of banking sector assets	81	49
Public bank assets as a percentage of banking sector assets	72	5
Foreign owned bank assets as a percentage of banking sector assets	Nil	40
Financial sector assets as a percentage of GDP	20	60
Cash outside the system as a percentage of M2	40	18
Credit to private sector as a percentage of total loan	41	89

[4] A group of Bank staff and consultants have contributed to this report, and their works/inputs are listed in Annex 3.
[5] See Table 9 in the Appendices for comparisons between Mongolia's and other financial systems.

Nominal GDP (MNT billions)	925	1808
Total banking sector assets (MNT billions)	181	1,072
Mongolian togrog per US dollar	1022	1185

Source: BOM.

6. The financial sector is composed of:

(a) The Bank of Mongolia (BOM)
(b) The Financial Regulatory Commission
(c) Five first tier commercial banks
(d) Ten second tier banks
(e) Two locally incorporated Russian banks
(f) Over 140 Non-Bank Financial Institutions (NBFIs),
(g) Two dozen insurance companies,
(h) Over to 400 active Savings and Credit Cooperatives (SCCs).

7. The Bank of Mongolia (BOM) is the country's regulator of the banking system. It has enjoyed relatively high degree of autonomy by law in formulating and implementing monetary and exchange rate policies, managing the country's foreign currency reserves, and in prudential regulation and supervision. Before January 2006, the BOM was also responsible for the regulation and supervision of NBFIs; the Ministry of Finance (MOF) was to provide oversight for SCCs and insurance companies; and the Securities Regulatory Commission the entry and exit of securities markets and the securities houses. In January 2006, the government established a new, sector-wide regulatory agency –Financial Regulatory Commission (FRC) – which is responsible for all financial institutions except for commercial banks.

8. Foreign investors from the United States, Japan and Switzerland hold controlling shares in two of the five largest domestic banks, and those from Belgium, China, Japan, Russia and UK established joint-venture or wholly-owned NBFIs in Mongolia. ADB and the Bank's private investment arm IFC are minority owners of the Trade and Development Bank (TDB, the largest bank); and IFC also hold minority interests in the Agriculture Bank (KHAN Bank, the largest microfinance bank). The rest of the domestic financial institutions are owned by individual businessmen and/or privately held companies.

9. **Commercial banks remain predominant**, accounting for 73 percent of total assets (2004). Mongolia banks offer basic lending and deposit products, and payment services. An increasing number of banks have also issued consumer cards (debit and credit cards). **Short maturities and loan concentrations characterize the balance sheet** of commercial banks, as shown by the following 2004 data: [6]

- Ninety-eight percent of loans and deposits had a maturity of less than 12 months.

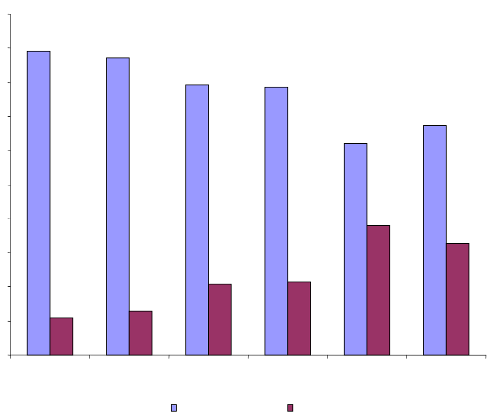
[6] See Appendices Table 3, 6 and 8 for more information.

- Thirty-five percent of total loans were provided to traders (both wholesale and retail), 19 percent to borrowers in manufacturing business, and the rest are quite dispersed.
- Loans in foreign currency amounted to 43 percent of total loans, matched by deposits in foreign current accounting for 46 percent of total deposits.
- The system's average exposure to 20 largest borrowers was over 30 percent

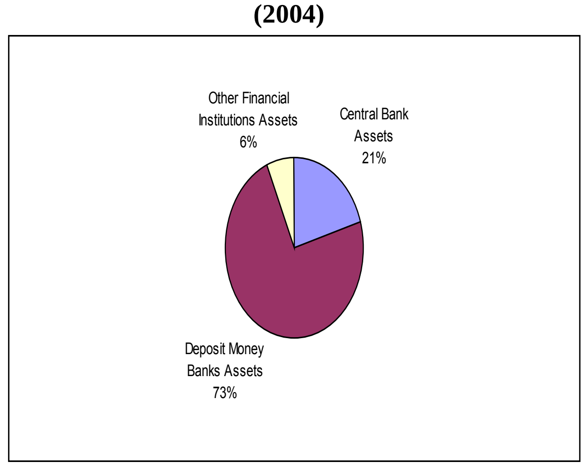
10. **The NBFIs together with the SCCs have experienced highest growth in number** in recent years, but their share of the financial sector assets accounted for less than 3 and 5 percent, respectively (2004). The NBFIs are permitted to engage in (a) lending, (b) factoring, (c) financial leasing, (d) guarantees, (e) payment instruments, (f) electronic payments and remittance, (g) foreign currency exchange, (h) investment and financial consultancy. Most of the NBFIs are licensed to conduct lending. Only two percent of NBFIs are incorporated as financial leasing companies, but over 15 percent as foreign currency exchange shops. There were over 800 SCCs registered at the Public Registrar, but only half of them were active (2005). **The stock market, a by-product of the 1991-92 mass privatization programs, has been dormant**. Although 375 companies are listed at the Mongolian Stock Exchange (MSE), they are held by a much smaller group of business families. Issuance of Treasury bills accounted for 85 percent of transactions of the MSE, and market capitalization was merely 2 percent of GDP (2004).

Graph 1: Changes in Mongolia Financial Sector Structure

First Five Banks Share (1999 – 2004)



Banking System Share in Total Financial Assets (2004)



Source: BOM and Staff estimates.

11. *Legal and regulatory framework*. **Mongolia has established a body of basic laws for banking and financial services**, including the Law on Central Bank, the Banking Law of Mongolia, the Law on Non-Bank Financial Activities, The Securities Law of Mongolia, the Law on Financial Regulatory Commission, and the laws on Negotiable Bills; Deposits, Loans and Banking; Currency Settlements; and Treasury. The central bank and banking laws were improved in 2001 - 2005 through several amendments. Main legislative work underway included the draft law on deposit

insurance, the draft law on financial leasing and the draft law on savings and credit unions (2005).

12. The Civil Codes and a number of other laws govern commercial contracts and company bankruptcy. However, the laws and regulations have yet to clearly spell out procedures, requirements and remedies for the protection of private property rights and the enforcement of commercial contracts. Bankruptcy procedures are cumbersome and lengthy. According to the Bank's 2004 "Doing Business Indicators", a typical insolvent Mongolian firm might remain open for four years, as compared to the regional average of 2.8 years. Mongolia's court system was among the weakest in the region. Procedures governing the parties in dispute, or between them and the court, were complex and redundant. Duration of dispute resolution process was above the regional average and three to four times longer than in Korea and Singapore.[7]

13. *Market infrastructure*. **Payments in Mongolia are made mainly through cash, but the uses of non-cash instruments are catching up**. Five banks issued debit/credit cards and the number of cardholders in large cities jumped to over 240,000 (2004). The BOM operates a net-based, end-of-day interbank clearing and settlement system. Payment orders from the Ministry of Finance on a paper basis were also processed through this system before 2006. With the recovery of economic growth and stabilization of the banking system, the volume and value of transactions processed by the BOM payments system registered high growth.

Table 2: Payment system development

	2000	2005
Average # of transactions processed per day	2,823	9,327
Average value per transaction processed in MNT millions	1.76	3.20
Six main participating banks share as a % of total transaction volume	90.6	82.8
MOF's share as a % of total transaction volume	n.a.	24.5

Source: BOM

14. As a response to the pressure on the existing payments system and to meet the economy's rising demand for timely, reliable and safe clearing and settlement of financial transactions, a separate clearing house and switch system was developed by the BOM under the Bank's Financial Capacity Building Project (FCDP). This system went live in February 2006, and started to clear low value transactions (most of MOF transactions belong to this category), thus enabling the BOM to transform the current end-of-day, net-based payment system into a Real Time Gross Settlement system (RTGS) for high value transactions. The new system would also serve as a common platform for processing transactions generated by consumer cards issued by different banks. The establishment of the RTGS system would help the BOM to better manage its settlement exposure risk. **Parallel to system upgrading, the central bank should revise/adopt the regulations on interbank payments to fully comply with the BIS Core Principles for Systemically Important Payment Systems**.

[7] Please visit www.doingbusiness.org for detailed and more updated information.

15. Mongolia's Accounting Law adopted the International Accounting Standards (IAS) in early 1990s, and all the large banks engage external auditors to audit their financial statements in accordance with IAS. But **few companies in real sector maintain IAS compatible accounts**. **There is a paucity of well-trained accountants, and audits are often flawed**. Assisted by the Bank, the Government adopted the International Standards for Auditing (ISA) issued by International Federation of Accountants (IFAC), and translated the ISA into Mongolian language (2004). While the adoption of ISA might improve audit quality, there is an urgent need to develop a cadre of competent private sector auditors.

16. The Immovable Property Registration Agency (IPRA) is another component of the basic financial sector infrastructure established in the 1990s. Borrowers are required by law to register their business premises and residential houses at IPRA and present the evidence of registration when applying for secured loans at banks. A third element of the financial sector infrastructure, BOM's Credit Information Bureau (CIB) was upgraded under the Bank's Private Sector Development Credit (PSDC I). This is an on-line system, covering basic information (positive and negative) of company and individual borrowers. For both the systems, **data reliability and evidence verification have been a problem**.

17. *Credit culture*. **Mongolia would need to develop a credit culture where contracts are honored and defaulters penalized**. Based on a limited review of selected banks' loan files by the Bank team, Mongolian borrowers appear to have high leverage ratio, that is, their equity is very low in relation to their debt. In many cases, the borrower's own capital was less than 10% of the debt, or even in the negative zone. Low equity to debt ratio leaves a borrower with little cushions when his business projections fail to materialize or the market goes down. Since the businessman does not have much of his own money to lose, he may simply abandon a failing venture rather then making a second try. He may also become too willing to take on large risk without any good business strategy. **Mongolian banks usually mitigate this type of risk by charging a high lending rate**, but are increasingly blamed for businesses' high funding costs. Defaulters, especially those with good connections or influence, often walk away from a loan he can no longer service, but continue to be able to borrow from banks. As a typical Mongolian businessman is likely to own more than one unrelated business, one way for this businessman to secure fresh funding is to shift loans among his businesses. Banks seem to have either overlooked the issue, or worse, are in collusion with such borrowers. Lack of consolidated information on borrowers in BOM's credit information system and from the business licensing authorities make it more difficult for a bank to find out the scheme early on.

18. The loopholes in the legal framework are another cause for the weak credit culture. Although the Commercial Banking Law does not allow defaulters to own a bank or become a bank executive, there is no similar legal provision to prevent defaulters from running for public office or being appointed to important government positions. On paper, financial institutions can settle with their borrowers outside the court system under certain circumstances after the amendment of relevant laws in 2005, but the out-of-court process might be equally difficult due to the lack of a set of legal definitions and

enforcement mechanisms governing the repossession and disposal of collateral by banks. For cases that are subject to court jurisdiction, failing to appear on the court date, a common tactic employed by borrowers without suffering any penalty or disciplinary action, could prolong the court proceeding for months and even years. Judges are said to be unfamiliar with commercial laws and have frequently ruled in favor of defaulters. Disposal of assets under bankruptcy could take as long as four years. On the part of the banks, inadequate collateral documentation, either due to negligence, difficulty in verifying evidence, or collusion with borrowers, has contributed to the prolonged process.

19. *Interest rate*. The interest rate is determined by market forces. **The general interest rate level remains high, but has shown a declining trend from its 2000 peak**. Nominal *Togrog* and US dollar lending rates declined by more than 46 percent by 2005. The gap between what banks could afford to charge and what borrowers wanted to receive has become a high-profile political issue, and pressure on BOM to impose an administrative cap on lending rates is building up.

Table 3: Interest rates

	2000	**2005**
Domestic currency lending rate (%)		
Nominal	34.7	28.3
Real	21.0	18.8
Nominal Foreign currency lending rate (%)	25.8	14.8
Inflation rate (%)	13.7	9.5

Source: BOM

20. *Challenges and Recommendations***.** The financial sector structure became more stable and diversified in 2001 - 2005, but several fundamental structural problems threaten the system stability and development. **Mongolia is over-banked** for a population of less than 3 million and an economy of just over US$1.1 billion (2005 real GDP). This is particularly true when one considers the limited supervision capacity and the dearth of banking and accounting skills. In the past, over-banking was an Ulaanbaatar (national capital) phenomenon, but it is becoming a problem in the scarcely populated rural areas, where a county with one to two thousand residents might have several branches of different banks and a few NBFIs and SCCs. There has been an augment that an increased number of financial institutions would enhance competition. This is questionable when many financial institutions act more like owners' internal financiers. In addition, there is a well-known tradeoff between gains from competition and those from the economy of scale. Because of the over-banking problem, Mongolia's banking system is less efficient than many of its peers. Mongolia's number of banks per 100,000 people (0.69) was much higher than the low-income countries' average (0.13). Consolidation is necessary. Although it is difficult to pin down an "optimal" number of banks**,** a system of fewer viable banks with adequate branch network would be more manageable while ensuring fair competition and improved access to finance. The same could be said for NBFIs and insurance companies.

21. BOM recognized the over-banking problem, and tried to reduce the number of banks by raising the requirement for minimum statutory capital twice in 2001 - 2005. The central bank expected that most of the banks would meet the new minimum capital

requirement of MNT 8 billion by March 2006. However, the sources of the new capital might not be adequately reported. In some cases, it was not clear whether the fresh funding injection was a loan to the borrower or an investment for a bank's permanent capital base. **It is important for BOM to verify the continuous availability and sources of the new funding, and to effectively enforce market entry and exit regulations**. There should be no more licensing for banks owned by individuals or family businesses. In the absence of effective market disciplines, such owners should not be allowed to have access to the public's deposits.

22. In the early 2000s, the authorities, including BOM, encouraged the establishment of NBFIs and SCCs, in hopes of increasing competition and bringing down the interest rate. While these financial institutions helped to broaden the access to finance for the poor in a limited way, their impact on the interest rate could not be ascertained. As a matter of fact, many SCCs raised deposit rates from time to time to compete with the banks for funding, making the general interest rate level more unlikely to go down, as commercial banks' margins were squeezed. In October 2005, BOM raised the minimum required paid-in capital of NBFIs. This is a welcoming step toward strengthening the regulatory framework for NBFIs, but its impact on the over-banking problem remains to be seen.

23. Improvement of the society's credit or debt repayment culture should be a long-term goal of the government. While recent legal amendments could help to improve debt recovery process, the laws and regulations would still need to clearly spell out the principles and procedures on creation of security interest, perfection of security interest, and execution of security interest over pledged collateral. **The government should consider amending the existing laws and regulations** to:

- (i) Prohibit large defaulters from running for public office and taking senior government positions.
- (ii) Require all companies with a turnover above a specified amount to present IAS compatible financial statements audited by independent auditors to their creditors.
- (iii) Provide tax incentives for retaining or reinvesting profits in the company.
- (iv) Define evidence of ownership for different forms of collateral, appropriate conveyance for each form of collateral and methods for perfecting security interest in collateral.
- (v) Adopt procedures for establishing the priority of liens.
- (vi) Train judges in commercial laws governing contracts, companies, debt recovery and bankruptcy.
- (vii) Establish an economic court (or a separate sub-system in the civil court) which will also be responsible for small claims cases.

24. **Market infrastructure could be further developed with practical and incremental improvements**. A system of automated registries of ownership, liens and satisfaction of liens could enhance the services of the immovable property registration. A movable property registration system could be established on the basis of the current

vehicle registration regime managed by the police department, to be complemented by the development of liabilities insurance. Mongolian banks have yet to see sharing of credit information as a win-win case. On the other hand, CIB would need to improve its services, so that banks could see more benefit from sharing reliable and timely credit information among them.

Section II – Banking System Analysis

25. ***CAMEL analysis*.** In order to have a feel of banking system soundness (or lack of it), the Bank team carried out a CAMEL analysis using BOM data at the end of 2004. CAMEL analysis is a useful tool, however, **the results of the analysis should be interpreted with caution due to the legal, regulatory and institutional constraints discussed in this report**. [8]

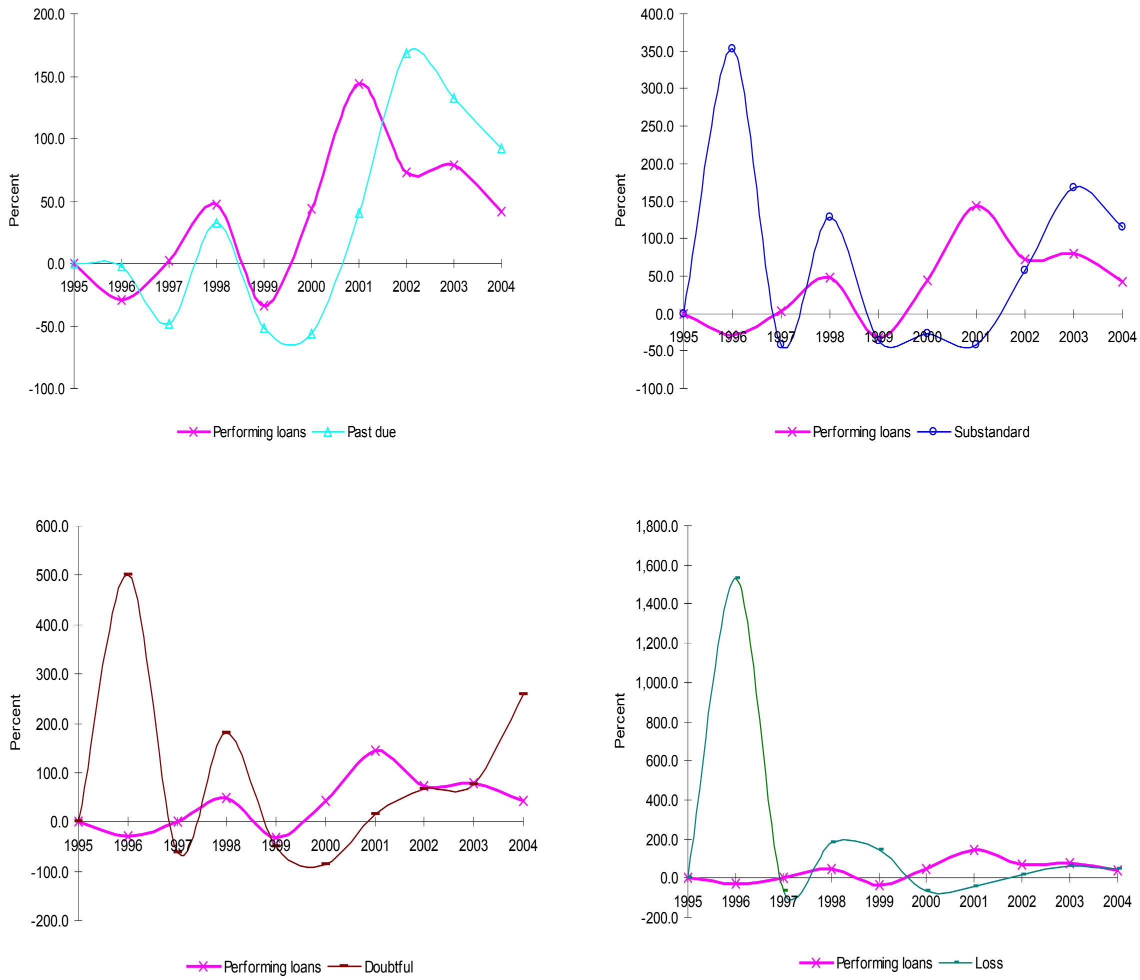
26. Capital adequacy. The adequacy and availability of capital ultimately determine the robustness of financial institutions to sustain large losses. The banking system's capital to risk-weighted assets appeared to be adequate (20%) and the Tier 1 capital ratio increased by 56 percent in the last three years. However, the leverage ratio, which measures the extent as to how much assets is financed by a bank's own capital, was rising as **assets expansion outpaced capital increase in the last five years**.

27. Assets quality. Threats to the solvency of Mongolian banks largely derive from impairment of assets. The reform measures of the last five years improved banks' balance sheet. Performing loans as a percentage of total loans rose from 45 percent in 1999 to about 90 percent in 2004.[9] However, no system can withstand for long two to three digit credit expansion without suffering substantial increases in NPLs. An analysis of the change patterns of non-current loans (including past-dues) revealed a more serious situation than what was captured by official reports. **Starting from 2002, increases in past-due loans outpaced those in performing loans. As more past-due loans were downward-rated, the growth of substandard and doubtful loans exceeded that of performing loans in 2003, and by 2004, the amount of loans classified as loss were rising faster than that of performing loans**. It should also be noted that although the BOM used the standard, five-category, assets classification system, loan classifications usually did not account for the market value of collateral due to the lack of reliable information. Assets quality might be further impaired if the booming housing market collapses, as most of collateral were in the form of residential apartments and/or business premises.

[8] CAMEL stands for **C**apital adequacy, **A**ssets quality, **M**anagement, **E**arnings power, **L**iabilities. They are widely used by supervisors in more developed economies to assess the credit rating of banks.

[9] Before January 2005, NPLs included those classified as past-due, substandard, doubtful and loss. Since then, NPL statistics composed by the BOM do not include past-due loans. The term performing loans in this note is the same as current loans and does not include past-due loans.

Figure 2: Percentage changes of NPLs



Source: BOM and Staff calculations.

28. Management: This indicator in the CAMEL system tests the adequacy of the banks' management systems, including the decision making process, and the procedures of business planning, budgeting and performance measurement. It also assesses the effectiveness of internal control, such as whether transactions are properly executed and adequately recorded in accordance with IAS. **Management appeared to be one of the most lagging areas in Mongolia's banking system**. Management was executed through a top-down approach. There were all kinds of executive directives, but no well-established operational structures for effective internal control and audits. Standardized operational policies, job descriptions, performance targets and evaluation were alien concepts. A few banks, often the foreign managed ones, started to prepare for adopting internal cost accounting and performance measurement. There was no clear indication that careful market research preceded a bank's decision to provide a new product or service. Most of the Mongolian banks were targeting any financial product/service/market which was perceived as profitable at the moment, without regard for the business' sustainability and the bank's own strengths and weaknesses.

29. Earnings power. The profitability of Mongolian banks as measured by return on average assets and return on average equity was higher than those banks operating in an environment of controlled interest rate regime (e.g. Chinese banks). However, **the declining trend of profit margin would accelerate, given the downward pressure on lending rates, increased operating expenses, and rising NPLs**. While the ex ante interest rate appeared high (over 30% for local currency loans), the ex post lending rate (when NPLs outstanding were excluded) was halved by 15 percent. It was estimated that the NPLs could account for a 50 percent reduction in Mongolian banks' gross profit margin. Mongolian banks' source of income was limited to interest earning assets, which were basically composed of loans and Central Bank Bills (CBBs). Interest spread between deposits and loans continued to shrink due to competition pressure. Meanwhile, BOM's policy and heated competition between banks for CBBs were putting the yield of the central bank paper down. On the other hand, rapid rise of operating expenses of the banks had yet to be reversed due to rapid expansion of branch network and heavy investment in fixed assets (expensive IT systems and elegant office buildings). Non-interest incomes were almost negligible on Mongolian banks income statements, while these incomes, such as those from insurance, investment, mutual fund and annuity products and services, contribute significantly to commercial banks' earnings in more developed markets.

30. Liabilities. Mongolian banks' liabilities were composed of short-term (< 1 year) deposits from households and companies, of which current account and demand deposits amounted to over 40 percent. **Assets/Liability management capacity was rudimentary, and most banks did not have a risk management framework**. The main approach of assets and liability management was to maintain high liquidity, and the average system-wide liquidity was kept in the range of 30-40 percent for years. Excessive liquidity might spur banks to seek high risk borrowers, given limited investment opportunities. It also hurt banks' earnings power. Gap analysis as part of the due diligence for the selection of participating banks under the PSDC II project found no material mismatch of maturity or currencies. But only a couple of banks started to monitor their risks and positions on a daily basis and regularly evaluate counterparty risk. Many banks did not have standard procedures on foreign exchange trading and counterparty risk. **Risk management of off-balance sheet exposures, such as guarantees, letter of credit (L/Cs) and derivatives, were segmented and often not adequately reported**. The widely reported multi-dollar L/C case involving three banks demonstrated that even a relatively better managed bank had yet to adopt an effective risk management system.

31. *System-wide financials*. Based on the above analysis, **the system as a whole appeared to have weathered a period of dramatic growth quite well**. In particular, the foreign investor controlled banks managed by international teams were well capitalized and could act as anchors in troubled times. Accelerated formal and informal capital inflows from neighboring countries, including remittances from overseas migrant workers, helped to smooth out borrowers' cash flows, and thus banks' loan portfolio quality. However, **there was an identifiable weakening in the banks' capital base to withstand shocks**, from the runaway NPL level and reckless OBS exposures which

might not be adequately reported or had been hidden. The Risk Weighted Capital Adequacy Ratio (RWCAR) declined from a record high of 27 percent in 2000 to 20 percent in 2004. The system's average profitability also declined from the early 2000s. Although NPL share as a percentage of total loans declined from a peak of 50 percent in late 1990s to 10 percent in 2004 (and over 8 percent in 2005), NPLs increased at a higher pace than performing loans during 2002–2004, according to the official reports. The banking system as whole appeared to have made adequate provisioning against loan loss, but some weak banks fell short of the BOM requirement. Of the three banks involved in the L/C case, only one bank made a meager general provisioning (1%) against the exposures. It was also questionable whether Mongolian banks made adequate or any provisioning at all against possible capital erosion as a result of OBS exposures. It should be noted that the loan quality decline was taking place in a relatively stable macro environment with record high GDP growth. **Assets quality would further deteriorate if the economy takes a downturn**.

Table 4: Banking system capitalization and profitability

	2000	2004
Capital adequacy as a percentage of risk-weighted assets	27	20
Banking capital as a percentage of assets	7.5	8.1
Liquidity as a percentage of liabilities	55	41
Foreign exchange exposure as a percentage of capital	29	34
Non-Performing Loans as a percentage to total loans	24	10
Return on Assets (%)	4.2	1.6
Return on Equity (%)	20.6	14.5

Source: BOM.

32. *Corporate governance*. As a result of the implementation of the Bank's FSAC program in the early 2000s, banking privatization was almost completed, except for that of Savings Bank, which is on the government's privatization program. The majority owner of Trade and Development Bank (TDB), the largest bank, and of Agricultural Bank (KHAN Bank), the largest microfinance and rural finance bank, are foreign investors, and the rest local companies and/or individual businessmen. Minority shareholders usually include a handful of companies/individuals that have extensive business relations with the majority owner. In some banks, managers and employees are also small minority owners. The Banking Law provides for the general meeting of shareholders as the supreme authority of a bank, and the next authority specified in the law is the board of directors, whose members have to be shareholders. In reality, since **there is no well-diversified shareholder base**, the supreme authority of a bank is vested with a very small number of closely-connected majority owners (in some cases a single businessman). There are exceptions: IFC hold minority interest in TDB (jointly with ADB) and KHAN Bank, and appear to have a greater say in these banks than a typical minority shareholder in a local bank.

33. Mongolian banks' clientele base is quite narrow and their credit risk exposure highly concentrated. **The system average of the exposure to the twenty largest borrowers was 36 percent** in 2004, and that of the exposure to the fifty largest borrowers was close to 55 percent. If the 16 banks for which loan exposure information was available were ranked in terms of their exposure to the twenty largest borrowers, the

banks in the top quartile had a large borrower expose of 68 to 99 percent.[10] Only two leading microfinance banks (KHAN Bank and Xac Bank) had an exposure of less than 10 percent. In terms of loan exposure to the fifty largest borrowers, all the banks (except for the two microfinance banks) had an exposure of at least 46 percent. It appears that self-dealing among owners' business partners and extended family members might be a problem. The Banking Law defines "related person," and BOM regulations set forth lending limits to related persons and to single borrowers or a single group of related borrowers. However, enforcement of these regulations is difficult because **there is no mandatory disclosure of conflict of interest by shareholders and executives**. The lack of consolidated information in business registration also make it difficult to ascertain a bank's exposures to a single borrower or to related parties.

34. The organizational structure of a typical Mongolian bank is quite flat, and responsibility for lines of business often scatters around the institution. The main owner and the senior managers are deeply involved in the daily business management. The board of directors in these banks is actually the executive body, usually composed of the president, her deputies and core department heads. **Lines of responsibilities and accountabilities are not defined and documented**. Strategic goals and corporate values are not clearly stated, and there is no procedure to ensure that staff understood and committed themselves to these goals and values. Except for banks which have received substantial donor support for institutional development, local banks have yet to realize that an appropriate organizational structure was crucial to a bank's operational efficiency and risk control.

35. The independence of external auditors is crucial for financial market integrity, and therefore, is an important corporate governance principle. In Mongolia, a businessman could own a bank and its auditor at the same time. **Most of the local auditing firms are affiliated to businessmen/groups which might hold direct or indirect interest in the financial institutions**. Presence of international auditors in the local market is limited due to cost concerns. In October 2005, E&Y withdrew from Mongolia, although it continued to be the auditor for three large banks (TDB, Golomt Bank and KHAN Bank).[11] Mongolia Institute of Certified Public Accountants (MICPT, an affiliate of the MOF) is the reviewer of auditing firms' license including those involved in financial institutions audits. BOM no longer has the right to review the qualifications of banks' auditors. In cases where the auditor raised a material issue, it was not clear whether the issue was thoroughly discussed at management meetings and promptly addressed. In one known case, the bank management removed a qualifying comment from the auditor's opinion before including it in the bank's annual report. Outside Mongolia, altering auditor's opinion may be criminal. However, in the Mongolian bank's case, it seemed that neither the authorities nor the auditor took any corrective action.

[10] Information on loan exposure is not available for Menatep Mongolia.
[11] It should be noted that E&Y Mongolia was the auditor for two of the three banks involved in the multi-dollar L/C case, but signed off the audit reports in a couple of years without identifying the problem related to the large off-balance-sheet exposures.

36. *Challenges and recommendations*. **Mongolia's banking system has recovered from the aftermath of the financial crises, but remain vulnerable to shocks in the medium term**. This is first due to the economy's dependence on external trade, in particular, the copper and gold markets. Sharp changes in economic dynamics impair assets quality and dry up system liquidity, as evidenced in the previous financial crisis. The authorities and the regulators should factor in the cyclical nature of the economy and its vulnerability to external shocks when formulating and implementing financial sector policies.

37. With the caveat of data quality problem, the CAMEL analysis based on official supervision returns revealed a trend of a weakening capital base. Considering the existence of underreporting and/or mis-presentation of assets at risk and off-balance-sheet exposures, **it is crucial that banks maintain a strong capital base to weather adverse conditions**. The capital adequacy requirements should reflect the risks that banks undertake. While there is a tradeoff between capital level and efficiency, the CAR of 10 percent appeared to be inadequate, given the risks faced by the banks and their weak capacity for risk management. In addition, the government should not impose interest rate restrictions that would constrain banks' ability to reinvest profit in order to build up their capital base.

38. If focus on CAR helped to stabilize the banking system in the past, it alone would not be adequate in a more diversified market. **One critical area that should be assessed is the operational risk**. The Basel Banking Committee defines the operational risk as "the risk of direct and indirect loss resulting from inadequate or failed internal processes, people and systems or from external events."[12] As the L/C case revealed, banks could suffer huge capital losses because they do not have an effective framework (operational policies and procedures, centralized functions and staffing, automated systems, etc.) to manage credit, liquidity and contingent liability exposures, although a few Mongolian banks have started to establish/strengthen a risk management framework.[13]

39. In order to build on the progress made in 2001 - 2005, and maintain the momentum in financial sector development, **the Bank team recommends that BOM consider**:

(i) Carrying out a special inspection of each problem bank, including an in-depth portfolio review and an operational risk assessment, together with international specialists.
(ii) Taking prompt and adequate actions to address the problems identified in the special inspection.
(iii) Raising the prudential requirement for risk weighted capital adequacy ratio, so that the banks would have a better cushion to absorb losses.

[12] Basel Committee on Banking Supervision, Consultative Paper, Operational Risk, January 2001.
[13] TDB, Golomt Bank, Mongol Post Bank and Zoos Bank were beneficiaries of Bank technical assistance in this area. KHAN Bank was strengthening its risk management framework under the foreign management team.

(iv) Requiring all commercial banks to establish/strengthen a basic risk management framework in accordance with Basel Committee's recommendations.
(v) Enhancing supervision capacity for assessing operational risk.

40. While BOM has some experience in dealing with systemic distress, the next crisis could be more difficult to handle because of the rapid expansion (both in magnitude and depth) of the sector. Spontaneous reactions could fall short of stabilizing the situation and stopping further hemorrhage. **The government should develop and adopt a contingency plan for crisis management**, including specific procedures and responsibility assignments within the central bank, and between the central bank and the other key government agencies (e.g. MOF), in case an unexpected event triggers a systemic distress.

41. **The lack of financial discipline and risk control, or in other words, inadequate corporate governance, is a major cause of past financial crises**, and continue to affect access to finance and financial intermediation in Mongolia. BOM reportedly issued "Corporate Governance Guidelines" in 2004, but has yet to use its persuasion power to ensure the implementation of the guidelines. BOM should consider:

(i) Carrying out a public awareness campaign about the importance of banking corporate governance.
(ii) Requiring the banks to formalize their strategic objectives and corporate values, and adopt procedures and a code of conduct (professional ethics).
(iii) Training central bank supervisors and commercial banks' board members, so that they become familiar with the international best practices of corporate governance, and understand the stated corporate objectives and values.
(iv) Encouraging banks to centralize by the lines of business and better define lines of responsibilities and accountabilities.

42. Given the fact that most of the banks are small in size with relatively light overheads, it might be over-shooting to require banks to establish multiple boards and committees. However, these privately held banks would still need to establish an appropriate governance structure, because banks are depositories of the public's monies, and therefore have the obligation to ensure the safety of the monies, in addition to maximizing shareholder value. **The government and BOM should give top priority to the strengthening of corporate governance at commercial banks, especially in the areas of: (a) composition, fiduciary duty and responsibility of the governing board; (b) disclosure of conflict of interest; and (c) role of external audits**. More specifically, the government should consider further amending the Banking Law to:

(i) Require the majority of board members to be non-executives, allow non-shareholders to sit on the board, and clearly define the fiduciary duty and responsibilities of the board, so that appropriate oversight can be exercised by individuals not involved in daily management of a bank.

(ii) Require the full disclosure of conflict of interest regarding bank shareholders and senior managers.
(iii) Require any loan to a borrower directly or indirectly related to a shareholder, a director or a bank officer to be fully documented, approved by a majority of the board of directors and covered with a corresponding board resolution, and reported to the central bank on a regular basis.
(iv) Apply the disclosure requirements to persons and entities that may be considered in some form of "conglomerate" based on a percentage of direct and related ownership or beneficial interest in a borrowing or guaranteeing company.
(v) Require public disclosure of a bank's: size, membership, qualifications and committees of the governing board, responsibilities, reporting lines, qualifications and experience of senior management, organizational chart, and remuneration policies.
(vi) Prohibit auditing firms under the same owner of a financial institution to conduct audits of the institution.

43. In addition, the government should consider reinstating BOM's authority to "certify" local auditing firms as qualified auditors for financial institutions based on independent professional review and in consultation with MICPA. BOM should require banks to report their actions to address issues raised by the external auditors, and adopt a mandatory "rotation program" for bank auditors, to maintain an arm's length business relationship between the auditor and a bank's management.

Section III – Financial Sector Regulation and Supervision

44. *Commercial banking system*. In 2001 - 2005, with assistance from the IFIs, including the Bank's FSAC program, the government amended the banking and central bank laws and BOM regulations to strengthen the banking prudential regulation. Compared with other transition economies in the region (e.g. Vietnam), Mongolia has moved closer toward full compliance with the Basel Core Principles for effective banking supervision. The monthly and quarterly data on the banking sector released by BOM are generally compatible with the recommendations of IMF's General Data Dissemination System in terms of coverage, periodicity and timeliness. An IMF staff assessment on the compliance with the Basel Core Principles in late 2002 concluded that "**the overall standard of banking supervision was reasonable.**"[14] This regulatory framework has the following main features:[15]

- A risk-weighted capital adequacy ratio (10%) higher than the BCP minimum requirement
- A time-based loan classification system that allows downward classification based on qualitative assessment

[14] See Annex 2c for Fund staff's Summary Assessment of Compliance with BCPs.
[15] See Annex 2a & 2b for more details on BOM prudential norms.

- Adequate general and loss provisioning requirements
- Specific limits on single borrower exposure and insider/connected party lending
- Specific limits on foreign currency exposures
- A Prompt Corrective Actions (PCA) regime with triggers based on CAR levels
- Adequate power and authority of BOM for distressed bank resolution

45. However, major **loopholes still exist in the banking regulatory regime**. The existing framework for prompt corrective actions (PCA) is based on the minimum capital adequacy ratio (CAR). The CAR is a backward-looking indicator and relying on this indicator alone is not adequate to trigger early interventions. In fact, a number of enforcement measures other than PCAs are available to BOM (e.g. penalties, MOUs), but they are not mandatory by law and are carried out on a discretionary basis, leading to inconsistencies between banks. Another major loophole is related to consolidated supervision. Several banks either own insurance companies, or have insurance firm as a sister company within the holding group. There are also cases of cross-ownership between banks. BOM is preparing regulations on consolidated supervision, and has a training program on the subject supported by the Bank's Second Private Sector Development Credit Project.

46. BOM has a kind of CAMELS rating system, but does not use it as a central tool for scheduling on-site examination or taking corrective actions.[16] The timing and frequency of on-site examination dose not appear to take into consideration the specific risk profiles, the type of activity and the relevant importance of individual banks. **Examiners are more used to verifying calculations and checking compliance, than to adequately assessing risk**. On a few occasions, BOM supervisors were able to identify the problems, and took some prompt corrective actions. MOUs were used to restrict loan growth of the banks, and one weak bank was put under the BOM controller for a while.

47. Regulatory reports by banks are due at the BOM on a monthly basis, which provide quantitative information for BOM's quarterly CAEL rating of banks.[17] The off-site surveillance division does not consider qualitative factors for CAEL assessment, while those factors are included in the CAMELS rating by the on-site examination division. The lack of communication and coordination between the two supervision divisions might lead to different interpretations of the same situation. The off-site staff rely on the less frequent on-site examinations to confirm the quality of regulatory reports, and there are no adequate verification procedures. **Late, persistently inaccurate or misleading regulatory reports might be accepted without any punitive measures**. The multi-dollar Letter of Credit (L/C) case involving three Mongolian banks revealed that banks could provide persistently inaccurate or misleading supervision returns without being detected or punished by BOM. The frequency and coverage of off-site staff's communication with banks appear to be less than desired, limiting the utility of the CAEL assessment.

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[16] The initial "S" in the term CAMELS stands for **S**ensitivity Analysis.
[17] CAEL stands for **C**apitalization, **A**ssets quality, **E**arnings and **L**iquidity.

48. BOM's supervisors have received much more training abroad, compared not only to staff of Mongolia's banking system and the government, but to their peers in the Chinese or Vietnamese central banks. However, **BOM's ability to enforce prudential regulations is affected by the relative inexperience of its young staff, limited expertise, and legacies of a compliance-checking culture**.

49. **These weaknesses in the regulatory framework and practices, which are aggravated by the under-developed market infrastructure (e.g. credit information and assets valuation) and the lack of political will, had a direct impact on the central bank's ability to maintain financial sector stability**. For example, among the largest five banks, one bank was known to the market and the supervisors for its poor assets quality and reckless activities (such as offering deposit rates higher than lending rates) for most of 2002 - 2005. The bank's assets registered an average annual growth of over 100 percent in 2000–2004. A comparison of this bank and its peer group and the system average showed the bank's level of non-current loans was alarmingly higher, and its ROA and ROE significantly lower.[18] However, the bank was allowed to pursue its aggressive strategy for a long while. When the central bank finally decided to act, it elected a less severe action (sent in a controller), and the justification by the supervisors was that this bank's CAR level did not require more severe PCA.

50. *NBFI sector*. Until January 2006, NBFIs (excluding the SCCs) were licensed, regulated and supervised by BOM in accordance with the 2003 Law on Non-Bank Financial Activities. Following the adoption of the law, BOM issued regulations on licensing, prudential norms, and onsite and offsite supervision procedures. The prudential regulations of NBFIs require these institutions to maintain a RWCAR of 40 percent, but allow them to extend loans to a single borrower at 25 percent of capital and to connected parties at 10 percent of capital. In 2003, BOM withdrew the business license of five NBFIs following its onsite examination of these institutions. In general, the licensing and supervision of NBFIs are more lax compared to those for commercial banks, as demonstrated in the following table:

Table 5: Frequency of NBFI supervision

	Mandatory Capital for Entry (MNT)	Frequency of Onsite Examination	Frequency of Supervision Returns
Commercial banks	8 billion	Once a year	Monthly
NBFIs, UB-based	100 million	Once every two years	Quarterly
NBFIs, Other large city-based	30 million	Unknown	Unknown
NBFIs, rural-based	1 million	Unknown	Unknown

Source: BOM

51. In October 2005, BOM raised the minimum capital requirements of NBFIs to MNT200 million, MNT100 million and MNT10 million, respectively. Given the large capital flows in the country as a result of the recent economic boom and from overseas investors and migrant workers, the new capital requirements might not be adequate for sector consolidation purposes.

[18] See Appendixes Table 7 a-b for details.

52. It is not clear whether BOM collected financial and operational data of NBFIs that were as detailed as those collected from commercial banks. Detailed financial and operational data are important for better sector assessment and improved regulation. Although they are prohibited from taking deposits from households and businesses**,** a number of NBFIs have funded their operations by documenting deposits mobilized from the general public as a trust instrument. **The lack of a law on trust has created this regulatory arbitrage opportunity. The lack of commercial means to fund their operations also forces NBFIs to take the arbitrage opportunity**. In many countries, NBFIs are permitted to use money market instruments (MMIs), such as jumbo certificates of deposit and money market deposit accounts, to fund operations. It is much easier for banking regulators to monitor and regulate these money market instruments, as part of the NBFI supervision. The government should consider revising the relevant laws and regulations to allow Mongolian NBFIs to issue MMIs.

53. *SCC industry*. SCCs have helped to broaden citizens' access to finance, but the exponential increase in the number of SCCs could be attributed to a lax market entry policy and the absence of an effective oversight framework and capacity. Member-owned financial institutions, or credit cooperatives, should be "not-for-profit" organizations, operating in a closed market, i.e., among their members. These mutual-assistance organizations should not be allowed to provide financial intermediation in the broader market. On the contrary**, many SCCs in Mongolia act like for-profit commercial banks or NBFIs, but have not been subjected to the same magnitude of prudential regulation and supervision**.

54. A number of laws, such as the Civil Code, the Law on Cooperatives and those on banking, deposits, loans and financial transactions govern the establishment and operation of SCCs. In November 2003, BOM issued the guidelines on SCC prudential regulation. The guidelines provide norms on (i) capital adequacy; (ii) sufficiency and availability of reserves for loan losses; (iii) optimal financial structure; (iv) earnings quality; and (v) liquidity, which are generally consistent with the PEARLS ratios developed by the World Council of Credit Unions.[19] However, **there are no specific supervision policies and procedures, as well as qualified staff, to enforce the laws and regulations regarding the SCC industry**.

55. In many countries, credit cooperatives are monitored by self-disciplinary industry bodies, such as a supervisory unit at the national association. Some countries appoint a specialized agency responsible for SCC supervision and oversight. In Mongolia, until January 2006, the tax authorities provided some oversight over SCCs, assisted by three seconded staff from the BOM in collecting and evaluating SCCs' quarterly reports. However, the tax agencies did not have the authority to enforce the relevant laws and regulations. Neither did they have the capacity to do so. There are two national organizations of SCCs in Mongolia: Mongolian National Federation of Savings and Credit Cooperatives and National Confederation of Credit Unions of Mongolia, but

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[19] PEARLS stand for **P**rotection, **E**ffective Financial Structure, **A**sset Quality, **R**ates of Return, **L**iquidity, and **S**igns of Growth. It is a system of 39 financial ratios which the World Council of Credit Unions (WOCCU) uses worldwide to monitor the performance of credit unions.

neither is considered by BOM and donors as capable of monitoring and ensuring SCC compliance with the existing laws and regulations.

56. One important government initiative for strengthening the regulatory framework of the non-bank financial institutions was the establishment of a sector-wide new regulatory authority for all Mongolian financial institutions, except for the commercial banks. In November 2005, Parliament passed a law to establish the Financial Regulatory Commission (FRC), which was subsequently formed in January 2006. The new agency is entrusted to regulate and supervise over 20 insurance companies, 25 brokerage-dealer houses, close to 150 NBFIs and 845 (40-50% inactive) registered SCCs. Meanwhile, it is the regulator of the securities market, which had over 370 listed companies (about 100 companies stocks are dormant) and more than 200,000 unregistered individual shareholders. As of March 2006, the new agency only had three full-time senior management members (including the Chairman), and about 20 staff transferred from BOM and other government units. It had yet to receive the budget allocation, and was struggling with limited office space, a poor IT system and a meager budget it inherited from the Securities Regulatory Commission. There is an urgent need to help the FRC become fully operational as soon as possible.

57. *Challenges and Recommendations*. There has been impressive progress in strengthening banking regulation and supervision standards, but **the momentum for continuous strengthening should be maintained,** in order to meet the challenges of the expanding financial markets and diversifying financial products and services. The Bank team recommends that BOM consider:

(i) Expanding the PCA triggers to include the composite or critical component rating of CAMELS, to allow remedial actions at an early stage.
(ii) Establishing a "Ladder of Enforcement" which should include the expanded PCA system, and a range of formal and informal enforcement actions.
(iii) Including collection and analysis of qualitative information such as internal and external audit reports and minutes of board meetings in off-site surveillance of banks.
(iv) Consolidating and modernizing its data management system to establish a centralized database with verification procedures to facilitate the monitoring and analysis of the banking sector.
(v) Orienting bank examinations toward forward-looking risk assessment.

58. **The biggest challenge, however, is strengthening of enforcement**. Although the banking regulatory framework is only half-way toward full compliance with the Basil Core Principles, strengthened enforcement would significantly improve BOM's supervision effectiveness. The key is the political will to act promptly and adequately when a situation requires BOM to do so. This requires an appropriate governance structure to ensure BOM's independence, autonomy and accountability. In the case of bank failure, Parliament should immediately launch a public inquiry to review and evaluate the timeliness and adequacy of BOM's corrective actions, and the cost of the

bank failure. Those found responsible for major omissions or collusions should be held accountable. Improvement of supervision practices appeared to have been overlooked in BOM's agenda for strengthening the institutional capacity for supervision. High priority should be given to the development of a set of comprehensive operational policies and procedures for supervision and supervision planning (both onsite and offsite) in accordance with international practice.

59. The regulatory gap related to NBFIs' trust activities should be removed. A trust in the form of a trust certificate or a trust fund is an amount of capital which a person (the trustor) places in the custody of a trustee such as a NBFI or a commercial bank for clearly stated purposes. The latter, as the trustee/executer/administrator of the trust, then makes investments in accordance with the trust contract terms. The general public in Mongolia may not be able to distinguish a trust fund certificate from a regular checking account book, and the trust activities seem to be out of BOM's jurisdiction. A well-prepared trust law shall govern the rights and obligations of the parties to a trust. **The government should give priority to a trust law in its legislative work program, in order to create a favorable legal environment for sustainable development of non-bank financial institutions**.

61. **There are strong rationales for establishing an appropriate regulatory framework for savings and credit cooperatives**. Although they are "not-for-profit" organization, SCCs conduct businesses with their members through commercial banks (e.g. payment services and jumbo deposits). A wide-spread liquidity problem of SCCs can trigger systemic losses, as demonstrated by the savings and loans crisis in the United States in the 1980s. This framework is particularly needed in Mongolia, since SCCs take advantage of the regulatory gaps to engage in commercial banking activities, and are able to mobilize funding from the general public. However, regulation and supervision of SCCs are often complicated by the organizational and operational characters of these institutions, the regulator capacity limits, and the trade-off between prudential regulation and its cost to the economy.

62. The government prepared a draft Law on Savings and Credit Unions in 2004 - 2005. The draft law is a good effort to incorporate international practices for SCC regulation and supervision. However, it still allows SCCs to accept "non-member" deposits, although with a limit. **The new SCC legal and regulatory framework should be guided by the following principles**:

(i) SCCs are mutual-assistance and not-for-profit financial institutions formulated on a voluntary basis.
(ii) As such, SCCs should only operate among their members.
(iii) The business lines of SCCs should be limited to the basic financial products and services, such as loans, deposits and payment services, at least at the current developmental phase of Mongolia's financial markets.

63. It is also not clear whether the government will subject all SCCs to prudential regulation, and if any alternatives have been considered. The draft SCC law requires

SCCs to manage risks at a level similar to the prudential requirements for commercial banks, despite the fact that many SCCs, especially those in rural areas and under-served/unserved communities, do not have the technical staff and information systems to comply with this provision. **The government should consider adopting a different approach toward regulation of SCCs**: ensuring by law that they operate as true, not-for-profit and mutually-beneficial organizations; and then designing an appropriate oversight regime, taking into consideration the tradeoff between over-regulation and regulatory effectiveness. Given the regulatory capacity limits and the impact on the government's budget, it will be too costly to put all SCCs in Mongolia under prudential regulation and supervision. The Bank team recommends that the government consider subjecting the largest SCCs (e.g., the largest 14 SCCs with the average assets of over MNT 500 million) to prudential regulation. The remaining SCCs, especially those with an asset size of below MNT100 million may be subjected to regulatory oversight by a special unit of the new Financial Regulatory Commission or by a single national association, after the existing national organizations are consolidated.

64. There are clear cost-benefit tradeoffs between establishing a new agency and enhancing the existing one, and it will take time for the new agency to become operational. **There is an urgent need to make the FRC fully operational**. The government should factor in FRC's operational funding needs in its annual budget and medium-term fiscal framework, so that the new agency could develop a core team of qualified staff and invest in basic office IT. More importantly, the FRC will need to develop a set of basic operational policies and procedures and a practical work program with sequencing of tasks. In the medium term, the FRC should adopt a clear mission statement, and develop and implement an institutional capacity-building strategy. A transitional institutional arrangement between the FRC and BOM may be needed to make sure there will be no regulatory void, especially for large NBFIs and SCCs.

Section IV – BOM Governance

65. The central bank is a crucial public institution of the market economy. It is entrusted by the general public to maintain price stability, and in many countries (e.g., Mongolia), financial sector stability as well. Because of the critical role a central bank plays in an economy, it is very important that the institution enjoys adequate autonomy and is accountable for its actions to prevent abuses of power and misuse of the public's monies. This requires an appropriate governance structure for a central bank that clearly defines the objective, authority, autonomy and accountability of the bank, and has a system of governing bodies for checks and balances.

66. *Legal provisions*. **The Mongolian government generally accepts the principles for central bank autonomy and accountability** in the 1991 Law on Central Bank and the following amendments in 1996 and 2003. The central bank law provides adequate authority to BOM in formulating and executing monetary and exchange rate policies. The law defines the objectives of BOM as maintaining currency stability and supporting economic growth through price and financial sector stability. In practice Parliament and

BOM treated price stability as the central bank's primary objective, which is in conformity with international experience.[20] The central bank law also entrusts BOM with authority over foreign reserve management and banking regulation and supervision. The central bank law requires BOM to report directly to Parliament, and strictly limit lending to fiscal authorities, thus separating the central bank from the administrative arm of the government. However, the law fails to establish a proper structure for central bank governance. The law is also vague on the central bank's off-balance-sheet obligations, which is a loophole for quasi-fiscal activities.

67. *Governance structure*. **The organizational structure of BOM does not have an effective "balances and checks" system with separate governing and management bodies**. By law BOM governor enjoys extensive discretionary power over monetary and exchange rate policy, foreign reserves investments and banking supervision enforcement. Following the adoption of a new public sector finance law, the 2003 amendment to the central bank law further delegates the power of a "General Manager" for central bank financial management and personnel policies to the BOM governor. There is a "Board of the Bank of Mongolia," but this is an executive committee which acts as the assistant and advisor to the governor in accordance with the central bank law. The composition and business procedures of this board are left to the discretion of the governor.

68. As a result of the 2003 amendment to the central bank law, a Supervisory Board was established for BOM. This board is responsible for overseeing the management performance in achieving central bank objective(s) and maintaining the bank's sound financial conditions. The Supervisory Board is also entrusted with overseeing BOM's internal controls. The supervisory board is required to have seven independent members. As of 2005, the board was composed of two former BOM governors, three university professors (one of them was the Chairman), and the chairman of the Chamber of Commerce. The independence of the Supervisory Board was tempered, as its expenses, including staff salaries, board members' remunerations and operating costs were determined by the BOM governor in consultation with the Supervisory Board and the Parliament's Economic Standing Committee. It is quite unusual for a business representative sitting on the central bank's supervisory board, as there is clearly a potential conflict of interest.

69. *Quasi-fiscal and investment activities*. In 2003 - 2005, a number of anomalies in BOM operations was revealed by the central bank's external auditors and the IMF, such as:

- Lending to/providing guarantee for private commercial entities.
- Transferring profits to the state's budget before allocating at least 40 percent of them to BOM's general reserve fund.
- Extending credit to the government in excess of the legal limit.

[20] Maintaining currency stability in nominal terms has proved to be difficult and complicated for a central bank in a small, open economy highly vulnerable to exogenous factors. The Law on Central Bank needs to be amended to better define the primary objective of BOM as price stability.

- Providing letters of credit in large amounts far exceeding BOM capital for the benefit of the Ministry of Finance and other government agencies.
- Putting part of Mongolia's foreign reserves with foreign commercial banks at below AA credit ratings.
- Aggressively participating in financial derivatives markets without prudent policies and procedures for foreign reserve management.

70. **Both international experience and Mongolia's own banking history show that the central bank's engagement in quasi-fiscal activities is an important cause of inflation**. The Law on Central Bank has specific provisions prohibiting BOM from over-lending to the government, but the provisions were sometimes ignored by the legislative body which adopted the law. The aggressive financing activities seemed to have originated from BOM's desire for profit making, or loss stopping. On the contrary, BOM suffered heavy losses in 2004 and in the first half of 2005. It was assumed that these anomalies were responsible for a 50 percent shrinking of BOM's capital.[21]

71. *Transparency*. Transparency is a fundamental building block of a sound governance structure for a central bank. Central banks should communicate according to a pre-announced schedule to the public their objectives for policy, the policy decisions, and the supporting data and rationale. The terms and accountability of a central bank and its finances should also be disclosed. Compared with its peers in some central banks of the region (e.g. that of Vietnam and Laos), BOM did much better in disclosing monetary and banking information. For monetary policy purposes, the central bank publicized an annual policy statement, which was followed by a periodic summary of implementation assessment. The central bank's external website provided annual financial statements audited by independent, external auditors of international reputation, as well as a monthly monetary survey and other statistical bulletins. While BOM sometimes missed the pre-announced schedule for the publication of its audited annual financial statements, it did publish the audit reports with qualified opinions or comments on the breach of central bank law. [22]

72. However, there was no clear indication that the central bank took timely actions to address the problems identified by the auditors. Ernst & Young issued a qualified opinion on BOM's 2003 financial statements because of the anomalies in the central bank's operations, but when KPMG audited BOM's 2004 financial statements, the problems were still there. **It is not clear whether the Supervisory Board and Parliament, which is entrusted by Mongolia's Constitution to provide oversight of the central bank, have ever reviewed the audit reports and required BOM to take remedial actions**. It appears that the general public and their representatives in Parliament have yet to familiarize themselves with the guiding principles and legal

[21] The two peak periods of losses occurred in April to August 2004 and the first half of 2005. In January–June 2005, the current losses were US$8.7 million, accounted for over 30% of BOM's equity at the end of 2004.
[22] Before 2005, Ernst & Young was BOM's auditor. In 2005, BOM replaced E&Y with KPMG, which issued an unqualified opinion of the central bank's 2004 financial statements only in late June2005, and revealed the anomalies in the notes to the financial statements.

provisions of central bank functions and operations, and the implications for their livelihood and the economy if the principles are not complied with.

73. *Challenges and recommendations*. **The existing BOM organizational structure centralizes power of governing, policy formation and implementation, financial control and personnel decision all at the position of the governor**. This is a highly risky and fragile structure. Too much stake hangs on one person's integrity, talent, expertise and vigilance. Even if a central banker possesses all these qualities, he/she may not be able to always remain sharp and focused, with so much power and responsibility vested in a single person.

74. A central bank's profits, or the seigniorage, come from its role as the issuer of the country's currency and the mandatory keeper of required reserves from commercial banks. **Central banks should not seek to maximize profits, or allow financial considerations to override policy considerations,** because there is a clear conflict of interest with their mandate. Furthermore, central banks usually do not have to maintain an adequate capital base vis-a-vis their assets, because it is not supposed to be exposed to large commercial risks. When a central bank is exposed to these risks, it does not have a buffer (i.e. an adequate capital base) for risk mitigation.

75. **The capital depletion of BOM will, if not done so already, severely weaken its capability to carry out its responsibilities mandated by law**. If the central bank tries to "recapitalize" through seigniorage, the market may discount the central bank's commitment to price stability, and inflationary expectations will rise. If BOM's capital continues to deplete, it will have a difficult task to convince commercial banks to maintain an adequate capital base. In either case, the central bank may lose its credibility, which is the main fear of central bankers all over the world.

76. BOM management expressed its willingness to address the problem, and reversed/rescinded a few commercial transactions. More needs to be done. A sound and effective governance structure is a more lasting and stronger safeguard against the recurrence of anomalies than changes that focus on individual executives. **Parliament should give top priority to amending the Law on Central Bank to provide a legislative basis for a sound BOM governance structure**.

77. More specifically, **Parliament should consider revising the Law on Central Bank** to:

(i) Separate the governing function from the management function of BOM.
(ii) Enhance the power, responsibility and obligation of the Supervisory Board, and spell out the minimum qualifications of its members, so that it can act as a governing body of BOM.
(iii) Establish a monetary policy committee under the Supervisory Board, which should be responsible for formulating policy, and have at least two qualified monetary economists as the non-executive members,

provided that these members do not have a conflict of interest for sitting on the policy board.

(iv) Establish broad modalities of accountability for the conduct of monetary and exchange rate policy and for banking regulation and supervision.

(v) Strengthen the internal audit and control function under the Supervisory Board.

(vi) Set up a remunerations committee directly under the Supervisory Board, which should be responsible for reviewing and determining remunerations of BOM staff at and above the department director level.

(vii) Lay out the procedures for appointment, terms of office, and any general criteria for removal of, the members of BOM's governing body and the governor.

(viii) Adopt a "two-step" system for nominating and confirming the central bank governor and members of the governing and policy boards under which these officials are nominated and confirmed/appointed by separate authorities.

(ix) Prepare and adopt formal rules and procedures for the official meetings of the governing, policy and management boards.

(x) Prepare and adopt a code of conduct, laying out the framework for standard of professional and ethical conduct, including those related to personal financial affairs and conflict of interest, to which all BOM staff and board members are required to adhere.

(xi) Establish a Work Ethics Unit within BOM which reports directly to the Supervisory Board on matters related to the code of conduct.

(xii) Enhance legal protections for BOM staff in carrying out their official duties.

78. In order to strengthen transparency of BOM operations in accordance with IMF's Code of Good Practices regarding central bank transparency,[23] **Parliament should review and take the following actions on a semi-annual basis**:

(i) Conditions for BOM credit, advances or overdrafts to the government

(ii) Amounts and terms of credits, advances, or overdrafts by BOM to the government, and those of the government deposits at BOM

(iii) Information about the assets, liabilities and commitments of Mongolia's foreign exchange reserves

(iv) Summary BOM balance sheets and income statements

(v) BOM actions to address issues identified by its external auditor

[23] Interim Committee of IMF: Code of Good Practices on Transparency in Monetary and financial Policies: Declaration of Principles, September 26, 1999.

Section V – Micro and Rural Finance

79. **The general legal/regulatory/policy environment in Mongolia encourages formal and informal financial institutions to provide services to different strata of the economy**: individuals, households and businesses in both urban and rural areas. The microfinance (including and rural finance) movement in Mongolia was initiated by the international and bilateral donors in the mid-1990s. At the early stage of the movement, the project-led approach, coupled with poor financial disciplines, resulted in disappointing outcomes. After 1998, the microfinance industry underwent dramatic changes, and achieved significant level of outreach to targeted clienteles and self-sustainability. Unlike in many other countries, many of Mongolia's commercial banks provide micro-lending products.[24] Other institutions active in the microfinance industry include NBFIs; SCCs; pawnshops; Non-Governmental Organizations (NGOs) and donor-sponsored credit programs. By 2004, **Commercial banks accounted for over 83 percent of the formal microfinance market** (including the SME segment), followed by NGOs and donor programs (9.4%). Despite their large numbers, NBFIs shared only 2.7 percent and SCCs 4.4 percent of the formal market.

80. **Main borrowers of micro-loans come from the urban areas, and a large portion of them are traders**. Salary and pension loans are very popular. Even in the rural areas, consumer loans and salary/pension loans account for an important share of banks' portfolios. Some studies estimated that micro-loans as well as SME loans extended in the two largest cities (Ulaanbaatar and Darkhan) accounted for at least 80 percent of the total micro/SME loans outstanding.[25] The main source of employment in Mongolia is the services sector, followed by agriculture and industry. The services sector absorbs 75 percent of the workforce in urban areas, but only 5 percent in rural areas. This could partly explain the predominance of urban traders among micro-borrowers.

81. Another characteristic of Mongolia's microfinance industry which differs from a typical global case is that **a large portion of micro borrowers are the poor and vulnerable non-poor**. Poverty remains a major problem in Mongolia, especially in the rural areas. According to the available survey data, about one third of the population lived in the capital area, but there was still 43 percent of the population classified as rural residents. Thirty-six percent of the population, or over 860,000 people, made a living on less than one US dollar a day. Eighty-five percent of Mongolia's herders had a flock of less than 200 animals and 63 percent of less than 100 animals. The conventional wisdom is that a herder will need a flock of 200 to 300 animals to stay above the poverty line. Herders have little opportunity to diversify their income sources, and their annual income can fluctuate dramatically, as the herds are highly susceptible to natural disasters.

[24] For the purpose of this paper, a micro-loan has a value of equal to or less than US$4,000, which is about 4 times of Mongolia's GDP per capita.

[25] "Sub-sector Review of Microfinance in Mongolia (2004)," UNDP & Ministry of Social Welfare and Labor, April 2005

82. *Commercial banks role*. **The prominent role of the commercial banks in Mongolia's SME- and micro-finance is determined by the characteristics of the economy**. According to studies of the Ministry of Trade and Industry (MTI), only 4 percent of the business establishments in Mongolia employed more than 50 workers. Throughout the transition period, growth through merger and acquisition is rare. Households, individuals and small family businesses are the majority of financial sector borrowers. Because commercial banks play a significant role in Mongolia's microfinance market, the poor and the vulnerable have also benefited from savings products, funds transfer, and payment and remittances services.

83. KHAN Bank (AgBank) inherited the former mono-banking system's rural branches, and was privatized once in the early 1990s. The bank soon went insolvent and continued to suffer losses throughout the rest of the 1990s. In 2001–2003, the government successfully carried out a restructuring and privatization of this bank under the FSAC program. By 2002-2003, KHAN Bank achieved self-sustainability; and in 2004–2005 its outreach was remarkably improved. The bank's rural branch network covers all the *aimegs*, many of which were not served by any bank for a long while. The bank also established an online core banking system linking its rural branches with the head office in Ulaanbaatar through satellite connections. KHAN Bank was the first among Mongolia financial institutions to offer deposit- and pension-backed loans, herder loans, and piloted a non-cash based payment instrument (salary cards).

84. XacBank's predecessor was a number of donor-sponsored microfinance NGOs. After its incorporation in 2001, the bank experienced fast but steady growth. In addition to achieving self-sustainability, XacBank is known for its innovation. In order to reach to potential borrowers in remote areas at a manageable cost and risk, XacBank extended wholesale loans to selected SCCs and NGOs through franchise arrangements, and employed a mobile branch approach to collect deposits and service loans. The bank piloted a financial leasing product to extend the loan maturity to 12 months. The microfinance rating agency Planet Rating assigned a global rating of A- to XacBank in June 2004. Among the six Planet Rating indicators, XacBank scored "A" for Governance and Decision-making, Activities (products and services), and Financing and Liquidity.

Table 6: Leading rural and micro finance banks

	KHAN Bank	**XacBank**
Total assets (MNT millions)	205,300.00	59,252.97
NPLs as a percentage of total assets	2.89%	0.62%
Average loan size (MNT)	2,000,000	760,023
Average value of loan per officer	239,444	217,587
Return on Assets	2.64%	3.22%
Return on Equity	36.58%	23.40%

Source: Mongolian Banking Association, 2006, XacBank, and staff calculations.

85. **The success of the two leading microfinance banks can be attributed to their application of the following key principles of microfinance**:

- Charge adequate lending rate to cover relatively high transaction cost associated with micro-lending,
- Maintain high loan recovery rate, and
- Provide innovative products aimed at outreaching the under-serviced and un-serviced segments of the economy.

The two banks also implemented an outreach strategy by:

- Targeting a viable underserved market;
- Conducting market research before entering the market;
- Establishing a well-known brand and improving the bank's public image;
- Paying attention to product design;
- Making efforts to understand costs; and
- Managing change.

86. A number of banks tried to copy KHAN Bank's success. They also offered salary/pension loans and opened new branches at *aimeg* and/or lower administrative levels. It remains to be seen whether this was an appropriate business strategy, because more branches do not necessarily lead to better outreach, but will certainly add pressure to the profit margin of the banks, especially in scarcely populated rural Mongolia. As competition in the micro/SME markets intensifies and the interest margin on micro-loans narrows down, not all these expansions are sustainable. **Mongolian banks will need to develop market segmentation strategies based on solid market research and a good understanding of their own niche**.

87. *NBFIs role*. **Most of Mongolia's NBFIs (106 out of 110) are licensed with lending as the core activity**. They are also concentrated in the Ulaanbaatar area. Over sixty NBFIs target borrowers in the micro/SME segments. Many NBFIs provide consumer loans to individuals and households to help meet the rising consumption demand. Other licensed activities of NBFIs include factoring, leasing and trust, but these markets are at best embryonic in Mongolia. There are six joint-venture NBFIs with capital investment from EU, China, Japan and UK. In addition, three NBFIs are 100 percent owned by Belgian, Chinese and Russian investors. In 2004, these NBFIs had a total equity capital of MNT3.5 billion, which accounted for about 20 percent of that of the NBFI industry (MNT17.8 billion).

88. *SCCs role*. The other main non-commercial bank player in SME- and micro-finance is the SCCs. In 2002 - 2005, **SCCs mushroomed to 870, but only half of them were active.** Of the functioning SCCs in 2004, only 14 had total assets over MNT500 million. The largest SCCs also had the least number of members. Their assets per member were nine times those of the small SCCs. Most of the SCCs are located in Ulaanbaatar.

Table 7: Savings and Credit Cooperatives industry:

Asset Size (in MNT million)	**Number of SCCs**	**Total Assets (MNT '000)**	**Assets per SCC**	**Number of Members**	**Assets per Member**

			(MNT 000)		(MNT '000)
Over 500 million	14	35,900,000	2,564,285	7,500	4,787
100 – 500 million	24	5,200,000	216,667	3,000	1,733
Below 100 million	250	6,000,000	24,000	11,700	513
Totals	288	47,100,000	163,541	22,200	2,122

Source: UNDP, BOM.

89. *Informal micro-lenders*. Among the semi-formal and informal micro-lenders, the role of Non-Governmental Organizations (NGOs) in improving access to finance is worth mentioning. It was estimated that 35 NGOs including donor funded programs and project units, engaged in micro-lending and accounted for 9.5 percent of Mongolia's microfinance market (2004). Because of the commercialization of microfinance programs in Mongolia after 1998, NGOs' share of the microfinance market is on the decline. However, **NGOs in microfinance may continue to play a key role in improving access to finance for the poor and the unserved** that commercial banks are not be able to reach for good reasons. In addition, pawn shops extend small loans against tangible assets and personal properties. No data is available on the size and operations of pawn shops. Other informal micro-loan providers include individuals, traders, shop-keepers and input suppliers, operating mostly in the low-income market segment as a source of simple loan products and pawn-type services.

90. *Micro-financing products*. **The predominant micro-financing products are short-term loans** backed by personal properties (usually family apartment) or salary/pension payments. In recent years some financial institutions (e.g. XacBank and a few finance companies) introduced leasing-like credit facilities for equipment rentals. These facilities are similar to secured loans, but have a longer maturity of 12 months. In more developed economies, financial leasing is usually an instrument of multiple-year financing: it is relatively safer to provide longer-term funding through leasing; as the ownership and title to the underlying asset are clearly vested with the lessor (the lender) until the lessee makes the final payment under the contract. In addition, financial leasing is treated differently than direct purchasing in tax and accounting laws and regulations in those countries. Mongolian financial institutions could not benefit from financial leasing due to the defects in the existing laws and regulations on taxation and accounting.

91. *Challenges and recommendations*. The main microfinance institutions in Mongolia have adopted the international practices. However, pressure is mounting to force the financial institutions to price lending products below the market. Sometimes, donor sponsored microfinance programs were used to bring down the lending rate, as the cost of funding of these programs was much lower than that of the commercial banks' regular sources. On the other hand, loan portfolio quality, risk management and corporate governance – all important and pertinent issues for Mongolia's microfinance institutions, have received much less attention. As stated in Section II, Mongolia's financial institutions, especially the commercial banks, need an adequate profit margin to manage credit risk and build up a strong capital base. **A number of structural weaknesses have contributed to the high interest environment**, such as: (a) high credit

risk in a small, open economy vulnerable to external shocks, (b) a common practice of high leverage by firms, (c) a weak culture for honoring debt and penalizing those who default, (d) high explicit/implicit NPL level, (e) high funding cost for financial institutions due to over-banking and the banks' need to maintain a liquidity (cash and cash equivalent) level of around 40 percent to cope with unforeseen events. In a liberalized environment like Mongolia, financial institutions' lending rate is composed of the cost of funding (direct and indirect) and a risk premium. Exerting political pressure on BOM and the financial institutions to lower lending rate regardless of the risk would distort the market and hurt the institutions' ability to enhance their capital base.

92. If there is a strong justification for subsidies out of social concerns, **the subsidies should be time-limited and rule-bound**. The "smart subsidies" should aim at assisting the borrowers to gain economic self-sufficiency, as providing funding for survival is a social welfare function. It will be unrealistic to expect the formal financial sector to serve all the poor people, including the poorest. **For the poorest segment, NGOs funded by donors could be more cost-effective lenders and smart subsidy distributors**.

93. It should be noted that a large portion of micro-loans extended in Mongolia appear to be used for school tuition, medicine and hospital expenses, food and drink, and household appliances. This could partly explain the popularity of salary and pension-based loans. While this type of micro-loan helps people satisfy their basic consumption needs and better manage cash flows, **more attention should be given to the role of microfinance for income-generating and productive activities**. New savings products should be introduced to encourage people to save more for their business' longer-term growth and for the accumulation of personal wealth.

94. The overwhelming short maturity of loan products has been reported as a major impediment to access to finance. Given the limited capacity of Mongolian financial institutions in maturity transformation, and the reluctance of the public to leave their limited savings to banks for long-term safekeeping, the lack of longer-term funding may not be significantly alleviated in the medium term. Meanwhile, **application of the proven commercial financing products should help extend micro-loans' maturity curve**. Laws should be adopted or revised to facilitate the use of these products, such as disaster insurance products for herders, factoring and discounting of accounts receivables, warehouse receipts financing, leasing, and other forms of transaction-based lending.[26]

95. **The government should revise the draft Law on Financial Leasing in accordance with international practices**. The specific maturity to economic/physical life ratio (75%) in the 2004 draft is contradictory to the provision for secondary equipment leasing. The minimum price to cost ratio (90%) would require the lessee (the borrower) to provide at least 10 percent up-front down payment for security, while a regular lease contract should be able to address the security concern. As in a number of legislative cases, specific considerations of a business nature, such as the two ratios in the draft Financial Leasing Law, should have been left to the parties to negotiate and agree to

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[26] The government was cooperating with the World Bank on the development of an index-based insurance product for herders under the MN-Index-Based Livestock Insurance Project.

in the form of a commercial contract, rather than being engraved in a law. **The authorities should also consider further revisions of tax laws and accounting rules** to address the applicability of VAT, depreciation method and income tax deductibles with regard to financial leasing contracts. Without these parallel changes, financial leasing can not be successful in Mongolia.

96. Community-based NGOs can bring micro-loan products and help formal financial institutions selling savings products to the poor and the vulnerable. They may also play a major role in the government and donors outreach to the poorest population. **In order to create a favorable environment for NGOs in microfinance, the following changes would need to be made**:

(i) Amend the Law on NGOs to allow NGOs to use grants and accumulated surpluses to provide microfinance services on a not-for-profit basis.
(ii) Clarify the tax laws and regulations to allow NGOs to maintain surpluses generated from operations as loan capital and reserves and prohibit distribution of surpluses to sponsors and donors.
(iii) Distinguish NGOs engaged in micro-lending from those NGOs which provide technical and administrative assistance to micro and small enterprises, and register them in separate categories.
(iv) Assign a central agency to collect periodical reports on NGOs' operations and financials in order to facilitate the monitoring and analysis of NGOs role in improving access to finance.

Annex 1: Government's Long-Term Vision (March 2000)

Key Lessons Learned from Past Efforts to Reform the Financial Sector

The following lessons from the experience of the last 10 years of financial sector restructuring were taken into consideration in determining the long-term vision and medium term strategy for financial sector development:

(a) It is necessary to build the infrastructure aimed at supporting a market-based financial system, with strong financial discipline and prudential controls.
(b) Investor confidence is crucially dependent on the existence of sound corporate governance systems and practices in the financial sector.
(c) The financial sector will not develop without a state that supports contract enforcement, protection and securitization of private property.
(d) Financial sector restructuring will not be successful unless the sequence of reforms is determined correctly and a stable political environment exists.
(e) State intervention in allocation of financial resources hinders development of a market-based financial sector.
(f) The fact that the state recapitalizes insolvent banks and takes their risks increases potential losses in the future.
(g) The role of the government in the ownership of financial institutions impairs their rapid growth as viable entities.
(h) Lax entry requirements result in an excessive number of weak, poorly managed banks.
(i) A sound financial sector cannot be created without an appropriate legal framework and operational structures aimed at strengthening the repayment culture.
(j) Capital markets and NBFIs should be developed to complement the banking sector and foster a balanced financial structure.

Long-Term Vision for Financial Sector Development

Based on the above lessons and exchange of views with key stakeholders, the long-term vision for the financial sector in Mongolia for the next 10 years is envisaged as follows:

- The role of the state will be directed to ensuring macroeconomic and financial sector stability, and the state will intervene only in circumstances where market forces patently fail to work.
- There is an effective, autonomous central bank and a legal framework which requires good prudential regulation, corporate governance, and supervision and prompt corrective actions.
- A relatively few number of sound and efficient domestic and foreign banks would emerge and would be capable of providing efficient banking services in a competitive environment.

- Ownership of all commercial banks will have been transferred to the private sector.
- Basic payment and banking services are available to meet demand outside Ulaanbaatar through a variety of channels.
- The financial sector will have a cadre of banking and related personnel trained in best international practices.
- The legal environment for conducting financial activities as well as accounting standards will be rigorously enforced, with the aim of strengthening public confidence in the financial institutions.
- There is a growing number of NBFIs (e.g. finance and leasing companies, contractual savings institutions, cooperatives, and microfinance companies) to help meet the demand for savings and investment.
- A healthy and well-governed capital market will be developed to complement the banking sector.

Source: Government of Mongolia's Letter of Development Policy dated March 29, 2000

Annex 2: Prudential Regulation and BCP Assessment

A. BOM Prudential Norms, 2005

Prudential Norms	Benchmarks
Capital/Risk-weighted assets (Tier 1)	Equal to/Greater than 10%
Aggregate open position of foreign exchanges/Capital	Between +/- 40%
Single borrower exposure/Capital	Equal to/Less than 20%
Single connected party exposure/Capital	Equal to/Less than 5%
Aggregated connected party exposure/Capital	Equal to Less than 20%
Liquidity assets/Liabilities*	Equal to/Greater than 18%
Minimum reserves/Liabilities	Equal to/Greater than 14%

Note: The liquidity ratio was removed and the minimum reserve ratio raised at the end of 2004.

Source: BOM

B. Required Loan Provisioning Level, 2005

	Current	Passdue	Sub-standard	Doubtful	Loss
Required provisioning level as % of general and classified loans	1	5	40	75	100

Source: BOM

C. BCP Compliance Assessment, 2002

Core Principles	Complied	Largely Complied	Marginally Not Complied	Not Complied	Not Applicable
1. Objectives, Autonomy, Powers, and Resources			X		
1.1 Objectives			X		
1.2 Independence			X		
1.3 Legal framework		X			
1.4 Enforcement powers	X				
1.5 Legal protection			X		
1.6 Information sharing		X			
2. Permissible Activities			X		
3. Licensing Criteria		X			
4. Ownership	X				
5. Investment Criteria	X				
6. Capital Adequacy		X			
7. Credit Policies			X		
8. Loan Evaluation and Loan-Loss Provisioning			X		
9. Large Exposure Limits	X				
10. Connected Lending		X			
11. Country Risk			X		
12. Market Risks		X			
13. Other Risks			X		
14. Internal control and Audit			X		
15. Money Laundering				X	
16. On-Site and Off-Site Supervision		X			
17. Bank Management Contact		X			
18. Off-site Supervision		X			
19. Validation of Supervisory Information	X				
20. Consolidated Supervision				X	
21. Accounting standards			X		
22. Remedial Measures		X			
23. Globally consolidated Supervision					X
24. Host Country Supervision					X
25. Supervision Over Foreign Banks' Establishments		X			

Source: IMF: Mongolia, Improving Banking supervision and Accounting Standards, March 2003

Annex 3: List of Bank task team and Background Reports

Xiaofeng Hua (TTL)	Planning, organizing and monitoring the reviews, and drafting the report
Bold Magvan (Consultant, team member)	Collecting, processing and analyzing data from BOM and the public sources, and drafting the backgrounder on the status and issues of financial sector in 2000 – 2004, (Background paper dated September 2005)
Gyeongsoo Bae and Robert Liu (OPD, team members)	Reviewing BOM banking supervision practices (Back to Office Report dated July 2005)
Jacob Yaron & Nergui Sandajav (Consultants):	Report on Mongolia's Microfinance Industry, August 2005)
Josellito Galardo (Consultant):	Key Issues in Broadening and Deepening Access to Financial Services, June 2005
Lars-Ake Larsson (Consultant):	Report on Participating Bank Eligibility Review under PSDC II dated June 2005
Paul Vonckx (Consultant, team member):	Carrying out a banking sector financial diagnostic and functional review (Report on banking sector financials dated May 2004)

APPENDICES

Table 1: Mongolia, Selected Macro-Sector Indicators

(In billions of togrogs)	1999	2000	2001	2002	2003	2004
Broad Money (M2)	220.4	258.8	331.4	470.1	703.6	847.0
Currency	87.3	100.9	109.2	120.8	131.5	143.5
Deposits	133.1	157.9	222.2	349.3	572.1	703.5
Claims on non-banks	82.8	68.8	138.6	236.1	424.5	617.3
Performing loans	40.7	52.9	127.7	219.5	387.8	556.3
Loans to public sector	8.6	6.3	10.4	12.2	16.2	12.6
Loans to private sector	31.4	45.5	114.8	203.7	365.0	533.0
Accrued interest receivables	0.7	1.1	2.5	3.6	6.6	10.7
NPL	42.1	15.9	10.9	16.6	36.7	61.0
(In percent)						
M2 to GDP	23.8	25.4	29.7	38.2	51.4	55.5
Currency to GDP	9.4	9.9	9.8	9.8	9.6	9.4
Deposits to GDP	14.4	15.5	19.9	28.4	41.8	46.1
Claims on non-banks to GDP	8.9	6.8	12.4	19.2	31.0	40.5
Performing loans to GDP	4.4	5.2	11.4	17.8	28.3	36.5
Loans to public sector to GDP	0.9	0.6	0.9	1.0	1.2	0.8
Loans to private sector to GDP	3.4	4.5	10.3	16.5	26.7	34.9
NPL to GDP	4.5	1.6	1.0	1.3	2.7	4.0
Currency to M2	39.6	39.0	32.9	25.7	18.7	16.3
Deposits to M2	60.4	61.0	67.0	74.3	81.3	83.1
Claims on non-banks to M2	37.6	26.6	41.8	50.2	60.3	72.9
Performing loans to M2	18.5	20.4	38.5	46.7	55.1	65.7
Loans to public sector to M2	3.9	2.4	3.1	2.6	2.3	1.5
Loans to private sector to M2	14.2	17.6	34.6	43.3	51.9	62.9
NPL to M2	19.1	6.1	3.3	3.5	5.2	7.2
Memorandum items:						
Nominal GDP (In billions of togrogs) /1	925.3	1018.9	1115.6	1231.3	1368.8	1525.4
Nominal GDP (In millions of US dollars)	905.5	946.3	1016.4	1109.0	1193.4	1290.4
Nominal exchange rate: MNT/US$ (period average)	1021.8	1076.4	1097.7	1110.3	1146.5	1182.1

Source: BOM and Bank staff calculation

Table 2, Banking System Growth

	2000	2001	2002	2003	2004	06/30/05
Growth of Assets	12.7	47.4	48.2	67.6	34.2	16.0
Growth of Loans	-14.7	102.3	71.4	80.3	45.3	18.6
of which						
Foreign currency loans	-9.8	82.6	74.1	90.2	57.6	25.4
Domestic currency loans	-16.5	116.1	69.7	74.4	37.2	13.5
Growth of Deposits	18.8	40.5	57.4	63.7	22.0	18.1
of which						
Foreign currency deposits	14.6	26.4	54.8	85.1	28.5	11.5
Domestic currency deposits	22.4	51.5	59.1	50.2	17.0	23.7
Memorandum items:						
Loans (% of assets)	29.6	40.6	46.9	50.5	54.7	55.9
FC loans (% of total loans)	41.0	37.0	37.6	39.7	43.0	45.5
DC loans (% of total loans)	59.0	63.0	62.4	60.3	57.0	54.5
Deposits (% of liabilities)	80.7	77.7	80.9	79.9	74.1	74.5
FC deposits (% of total deposits)	43.7	39.3	38.7	43.8	46.1	43.5
DC deposits (% of total deposits)	56.3	60.7	61.3	56.2	53.9	56.5

Source: BOM report, 2005 and Bank staff calculations.

Table 3A: Banking System Balance Sheet Structure – Assets

(MNT millions)

	1999	2000	2001	2002	2003	2004
Total assets [1]	180,651	225,728	332,732	418,600	898,598	1,071,792
First five banks, subtotal	161,172	196,470	263,167	329,232	556,719	722,080
Second tier Mongolian banks, subtotal	19,479	29,258	69,564	80,769	269,377	262,318
Two Russian banks, subtotal	n/a	n/a	n/a	8,600	72,503	87,396
Shares in %						
First five banks	89	87	79	79	62	67
Second tier Mongolian banks	11	13	21	19	30	24
Two Russian banks	n/a	n/a	n/a	2	8	8
Memorandum items						
NFBIs assets (MNT millions)[2]	n/a	3,000	23,400	12,500	18,900	28,700
NFBIs assets (as % of banking sector assets)[2]	n/a	1.3%	7.0%	3.0%	2.1%	2.7%
SCC assets (MNT millions)[3]	400	n/a	n/a	n/a	n/a	47,100
SCC assets (as % of banking sector assets)	0.2%	n/a	n/a	n/a	n/a	4.4%

Source: [1] Monthly Bulletin of December 2005, from Mongol bank
[2] Mongolbank Annual Report, 2004
[3] Mongolian Tax Authorities

Table 3B: Banking System Balance Sheet Structure - Loans by Sector

	1999	2000	2001	2002	2003	2004
Total loans (MNT millions)	44,131.1	59,684.5	135,065.9	231,449.8	441,949.5	606,178.1
(As % of total loans)						
Industrial sector	**50.7**	**55.3**	**57.0**	**51.5**	**43.7**	**43.0**
Agriculture	1.9	3.0	5.6	4.1	5.7	4.7
Electricity, steam and water supply	-	-	3.0	1.5	1.9	2.5
Construction	3.2	5.0	5.5	6.2	7.5	8.6
Mining and quarrying	22.1	21.1	14.8	15.4	8.4	8.6
Manufacturing	23.6	26.2	28.1	24.2	20.1	18.7
Trade and service sector	**49.3**	**44.7**	**43.0**	**48.5**	**56.3**	**57.0**
Public and private service	46.7	35.7	-	-	-	-
Wholesale and retail trade	-	-	28.7	30.8	34.0	34.6
Traveling and hotels, restaurants	-	-	2.9	1.7	1.8	2.0
Transport, storage and communication	0.9	6.9	2.1	2.9	3.0	2.8
Real estate lease	1.1	1.0	0.8	1.1	2.2	2.6
Health and education	0.3	0.3	0.9	0.6	0.5	1.0
Financial intermediaries	0.4	2.3	0.4	0.5	1.0	0.9
Others	-	-	7.2	11.0	13.8	13.1

Source: BOM, Loan report and Staff calculations.

Table 3C: Banking System Balance Sheet Structure - Performing Loans

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Performing loans (MNT million)	46,548	33,973	40,274	28,170	41,544	124,198	214,862	409,935	547,726
(As % of total performing loans)									
Up to 1 year	86.8	88.7	92.1	94.4	93.5	91.4	91.0	76.2	78.5
from 1 to 5 years	12.5	11.2	7.9	5.6	5.7	5.1	5.8	20.9	16.8
5 and above years	0.7	0.0	0.0	0.0	0.8	3.5	3.2	2.9	4.7

Source: BOM, Loan report and Staff calculations.

Table 3D: Banking System Balance Sheet Structure - Deposits by Maturity

	Total Deposits (Tg mln)	Demand deposits	> 30 days	1-3 month	3-6 month	6-12 month	1-2 years	2-5 years	5 < years
Total		21.4	9.9	23.4	21.1	20.6	2.4	0.3	0.9
TDB		40.2	6.9	20.3	14.9	17.6	0.0	0.0	0.0
Golomt		31.2	15.2	31.8	7.4	13.1	0.1	0.0	1.1
Anod		18.1	15.9	24.0	24.2	8.8	9.0	0.0	0.0
AgBank		15.8	3.0	17.7	25.7	37.8	0.0	0.0	0.0
Savings		25.7	2.6	33.7	26.6	7.1	0.3	1.3	2.7
Post		8.2	9.2	15.0	33.7	33.8	0.1	0.0	0.0
Zoos		9.2	14.5	21.3	31.9	17.3	5.2	0.1	0.5
XAC		23.7	6.1	16.5	11.3	19.9	1.0	6.3	15.3
UB City		17.2	0.5	10.6	26.8	36.9	8.1	0.0	0.0
Capitron		18.5	11.3	20.8	21.8	27.7	0.0	0.0	0.0
Credit		21.6	4.6	28.0	38.5	7.3	0.0	0.0	0.0
Transport		8.7	0.0	13.9	14.9	62.5	0.0	0.0	0.0
Inter		37.0	17.3	11.7	13.8	20.2	0.0	0.0	0.0
Capital		8.0	5.8	32.8	25.7	19.0	8.4	0.2	0.0
Erel		4.9	16.0	34.7	28.2	16.2	0.0	0.0	0.0

Source: BoM and Bank staff estimates based on 2004 data.

Table 4A: Loan Growth by Assets Classification

	2000	2001	2002	2003	2004
Performing loans	43.6	144.2	73.0	79.2	41.7
NPL (incl. Past due)	-62.2	-31.6	52.4	95.5	88.1
Past due	-56.2	40.3	168.0	133.0	92.5
NPL (exlc. Past due)	-62.7	-38.0	29.5	80.1	85.0
Substandard	-26.2	-42.3	57.4	167.7	114.9
Doubtful	-87.0	17.1	66.9	74.5	258.9
Loss	-62.8	-39.8	21.0	60.2	48.4

Table 4B: Loan categories by quality

	1999[1]	2000	2001	2002	2003	2004
(%)						
Performing loans/Total loans	45.3	76.2	92.0	92.8	92.2	90.0
Performing loans - private/Total loans	40.1	68.1	84.9	88.0	88.5	87.9
NPL (including past dues)/Total loans	53.8	23.8	8.0	7.2	7.8	10.0
NPL (excluding past dues)/ Total loans	50.1	21.9	6.7	5.1	5.1	6.5
Loan Loss Reserves/Total loans	-47.0	-20.1	-6.9	-5.3	-5.1	-6.3
Accrued interest/ Total loans	0.9	1.7	1.8	1.6	1.6	1.8

[1] Data for 1999 is including the seven liquidated banks.

Source: BOM and Bank staff calculations.

Table 5A: Interest Rates of Mongolian Banks

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
(%)														
Time Deposit Rate - MNT	8.0	44.2	131.6	101.5	59.5	50.7	38.0	27.5	23.4	16.8	13.9	14.5	14.4	13.8
Total Deposit Rate - MNT	2.4	17.9	56.7	57.6	36.9	25.9	22.0	17.0	14.3	11.1	9.1	10.0	10.7	10.5
Time Deposit Rate - US$	10.0	50.0	72.0	72.0	42.6	43.0	42.8	12.6	7.4	6.5	6.3	6.1	6.5	6.2
Total Deposit Rate - US$	8.0	41.1	20.4	6.0	16.5	20.1	14.9	4.6	3.8	3.8	3.8	3.4	3.6	3.7
Ex ante lending rate - MNT	27.5	109.0	185.9	113.4	97.8	93.3	79.0	45.8	38.8	34.7	41.4	33.4	31.5	30.0
Ex post lending rate - MNT									7.0	13.2	13.2	14.9	13.9	15.1
Spread - MNT	25.1	91.1	129.2	55.8	60.9	67.4	57.0	28.8	24.5	23.6	32.3	23.4	20.8	19.5
Net Interest Margin - MNT									4.5	8.3	8.2	8.7	7.0	7.7

Table 5B: Interest Rates in Selected Foreign Countries

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Ex ante lending rate - FSU average	n/a	30.5	93.5	108.3	115.8	57.8	38.0	37.7	33.2	30.0	23.9	19.4	16.5	
Ex ante lending rate - Eastern Europe	240.7	250.4	208.7	45.1	29.3	32.7	24.4	21.7	17.0	16.6	12.3	12.0	10.3	
Ex ante lending rate - Low-income courtiers	18.0	19.6	31.4	39.9	38.1	37.5	27.8	25.7	28.7	30.0	28.5	24.8	24.6	
Ex ante lending rate - Lower-middle-income countries	45.3	26.1	29.4	36.2	39.0	30.6	24.4	24.6	21.8	20.0	17.8	17.2	16.7	
NIM - Former Soviet Union							11.8	6.1	17.8	15.3	12.5	9.7	8.8	6.9
NIM - Russia							11.8	6.1	17.8	15.3	12.5	9.7	8.8	6.9
NIM - East Europe							10.1	17.9	10.1	9.2	10.5	9.0	8.3	6.3
NIM - Far East and Central Asia							4.8	-3.2	1.6	5.1	5.9	7.3	7.9	7.5
NIM - ASEAN							4.7	-6.3	-2.1	4.0	5.4	7.1	8.1	9.0
NIM - OECD							8.6	10.7	14.7	10.2	11.0	8.6	7.7	8.0
NIM - USA							9.4	10.3	10.1	9.9	10.3	10.5	9.1	10.2

Source: US Federal Reserve, http://www.federalreserve.gov/releases/h15/data.htm, BOM and Bank staff calculations.

Table 6: Dollarization of Mongolia's Economy

	1999	2000	2001	2002	2003	2004
ASSETS						
Total assets (MNT billion)						
Assets in FC/Total assets	37	39	33	36	43	44
Liquid assets in FC/Total assets	22	27	18	18	23	20
Liquid assets in FC/Total liquid assets	48	55	41	45	57	59
Loans in FC/Claims on non-banks-net	39	41	37	38	40	43
Loans in FC/Total assets	15	12	15	18	20	24
LIABILITIES						
Total liabilities (MNT billion)						
Deposits in FC/Total Deposits	45	44	39	39	44	46
FX denominated liabilities/Total liabilities	38	41	35	36	43	42
Assets in FC/Liabilities in FC		110	111	109	114	113
Loans in FC/Liabilities in FC		35	34	50	56	53
Loans in FC/Household Deposits in FC		81	57	74	77	94

Source: BOM, Bank staff calculations

Table 7A: Compliance with BOM Prudential Norms

	Prudential Requirement	2000	2001	2002	2003	2004
Minimum Reserve Ratio	(14 % of liabilities)	16	12	13	10	9
Minimum Reserve Ratio - MNT	(14 % of MNT liabilities)	22	16	14	12	10
Minimum Reserve Ratio - FC	(14 % of FC liabilities)	8	4	10	7	9
Liquidity Ratio	(18 % of liabilities)	55.4	48.4	48.8	41.0	29.2
FX Exposure	(+/- 40 of capital)	29	20	36	37	33.6
Single borrower exposure	(=/< 20% of capital)					
Single connected party exposure	(=/< 5% of capital)					
Aggregated connected party exposure	(=/< 20% of capital)					
Capital Adequacy	(10 % of risk-weighed assets)	27.0	24.6	20.0	20.4	20.0
Tier I to Capital Ratio	(5% of risk-weighed assets)	7	10	9	10	17.1
Memorandum items:						
Liquid Assets to Total Assets Ratio		49	43	41	40	34
Capital Adequacy (non-risk weighted)		13	14	12	13	15
Tier I Capital Adequacy (non-risk weighted)		7	10	9	10	10
Leverage ratio		7.5	7.1	8.0	9.0	8.1
Return on Assets		4.2	5.9	4.3	3.1	1.6
Return on Equity		20.6	23.2	20.8	14.7	14.5

Note: Liquidity requirement was removed at the end of 2004.

Table 7B: Weak Bank as Compared to Peers

	Weak Bank	Bank 1	Bank 2	Bank 3	Bank 4	System Average
Household deposit as % to total deposit	95.7	35.1	80.4	91.1	76.3	75.1
Loan to deposit ratio	95.2	74.5	67.8	70.7	82.3	81.1
Non-current loans as % to total loans	20.3	12.9	10.1	4.4	8.2	10.4
Net NCL to capital ratio	2.4	0.7	1.2	0.5	1.0	0.77
Net NCL to capital ratio	1.5	0.6	1.1	0.4	0.8	0.61
Provisions to capital ratio	64.1	30.2	54.8	21.6	41.5	28.9
ROA	0.4	2.6	0.9	2.1	1.2	1.4
ROE	5.7	14.4	17.4	48.6	22.2	17.8

Source: BOM, Bank staff calculations

Table 8A: Loan to 20 Largest Borrowers (% of total loans)

	Apr-05	Ranking by Loan Concentration	Ranking by Assets
Inter	98.6	1	12
UB City	88.5	2	10
Credit	71.7	3	15
Erel	69.3	4	17
Chinggis	68.0	5	6
Capitron	45.1	6	9
Transport	44.1	7	16
Saving	41.7	8	7
Capital	38.4	9	14
TDB	37.9	10	1
Zoos	29.3	11	8
Post	28.3	12	5
Golomt	28.0	13	2
Anod	25.1	14	4
XAC	7.2	15	11
AgBank	6.4	16	3
Menatep	n/a		
Sector average	36.2		

Table 8B: Loan to 50 Largest Borrowers (% of total loans)

	Apr-05	Ranking by Loan Concentration	Ranking by Assets
Inter	100.0	1	12
Chinggis	97.4	2	6
UB City	96.5	3	10
Erel	86.8	4	17
Credit	84.2	5	15
Capitron	65.8	6	9
Transport	62.0	7	16
TDB	59.8	8	1
Saving	56.3	9	7
Capital	52.9	10	14
Golomt	49.5	11	2
Post	49.0	12	5
Anod	47.7	13	4
Zoos	45.6	14	8
AgBank	9.6	15	3
XAC	7.4	16	11
Menatep	n/a		
Sector average	54.8		

Source: BOM and Bank staff calculations.

Table 9A: Cross-Country Comparison – Domestic Credit to Private Sector

	1995	1996	1997	1998	1999	2000	2001	2002	2003
(As % of GDP)									
Mongolia*	8.4	8.9	7.1	9.9	8.0	6.1	11.5	18.0	29.6
Former Soviet Union	7.6	6.7	7.6	10.5	10.6	11.2	12.8	15.1	18.4
Eastern Europe	28.8	29.6	31.9	30.7	30.2	29.6	27.2	28.6	31.1
Low-income countries	14.4	13.0	13.4	13.8	14.1	14.0	13.0	13.9	14.5
Lower-middle-income countries	31.3	32.0	33.7	34.6	33.6	33.3	32.6	34.1	34.3

Source: GDF&WDI, BOM and Bank staff calculations

Table 9B: Cross-Country Comparison – Operating Efficiency

%, 2000-2003 average	OC/TA	NIM	ROAA	ROAE
Mongolia	4.0	6.1	2.7	30.6
Former Soviet Union	7.2	4.2	2.4	12.9
East Europe	3.6	3.5	0.5	5.8
Low-income countries	2.8	4.1	1.1	19.3
Lower-middle-income countries	2.3	3.4	0.5	8.4
OECD	2.2	2.0	0.7	11.9
World-average	2.1	1.9	0.6	10.7

OC: Operating cost; TA: Total assets; NIM: Net interest margin; ROAA: Return on average assets; ROAE: Retrun on average equity

Source: Bankscope, BOM and Bank staff calculations

Table 9C: Cross-Country Comparison – Real Interest Rates

	1995	1996	1997	1998	1999	2000	2001	2002	2003
(%)									
Mongolia*	41.0	46.4	42.4	36.4	31.2	23.1	35.1	32.5	26.5
Former Soviet Union	-39.7	27.4	24.7	30.5	11.7	16.9	16.4	15.4	9.1
Eastern Europe	11.0	10.4	5.1	6.5	11.7	9.1	8.8	8.6	7.9
Low-income countries	5.5	11.8	19.2	9.7	9.1	14.0	14.4	9.3	11.6
Lower-middle-income countries	1.5	0.3	-0.3	-0.3	0.2	3.0	0.4	0.7	1.1

Source: GDF&WDI, BOM and Bank staff calculations.

Table 9D: Cross-Country Comparison – Interest spread

Country/Group	1995	1996	1997	1998	1999	2000	2001	2002	2003
Mongolia*	60.9	67.4	57.0	28.8	24.5	23.6	32.3	23.4	20.8
Former Soviet Union	61.5	29.9	20.0	21.1	17.0	17.1	12.9	10.6	9.1
Eastern Europe	11.2	12.7	6.5	5.6	7.9	7.9	6.0	6.2	5.1
Low-income countries	19.8	18.6	12.7	13.6	13.6	14.7	14.3	13.7	15.2
Lower-middle-income countries	18.8	14.2	11.5	10.7	10.8	10.6	9.3	9.3	9.5

Source: GDF&WDI, BOM and Bank staff calculation

Table 9E: Cross-Country Comparison – Number of Banks

	Number of banks per 100,000 people
Mongolia	0.69
Low income	0.13
Lower middle income	0.49
Upper middle income	1.92
High income	1.72
Philippines	0.05
Turkey	0.07
Korea	0.04
Malaysia	0.10

Source: GDF&WDI, WB Bank Regulation and Supervision Database, and Bank staff calculations.