ADB

Evaluation Study

Rapid Sector Assessment
October 2008

Financial Sector in Mongolia—Transition to a Market Economy Built on Successful Financial Reforms

Operations Evaluation Department

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 30 April 2008)

Currency Unit	–	togrog (MNT)
MNT1.00	=	$0.00858
$1.00	=	MNT1,165.5

ABBREVIATIONS

ADB	–	Asian Development Bank
BIS	–	Bank for International Settlements
BOM	–	Bank of Mongolia
BTC	–	Bankers Training Center
CAR	–	capital adequacy ratio
CB	–	central bank
CDS	–	central depository system
FIU	–	financial intelligence unit
FRC	–	Financial Regulatory Commission
FRGP	–	Financial Regulation and Governance Program
FSPL I	–	First Financial Sector Program Loan
FSPL II	–	Second Financial Sector Program Loan
FSRP	–	financial sector reform program
FX	–	foreign exchange
GDP	–	gross domestic product
HRD	–	human resource development
IAS	–	international accounting standards
IDA	–	International Development Association
IMF	–	International Monetary Fund
MIS	–	management information system
MSE	–	Mongolia Stock Exchange
NBFI	–	nonbank financial institution
NPL	–	nonperforming loan
SCC	–	savings and credit cooperative
SCHCD	–	Securities Clearing House and Central Depository
SME	–	small and medium-sized enterprise
SOE	–	state-owned enterprise
TA	–	technical assistance
TDB	–	Trade and Development Bank
USAID	–	United States Agency for International Development

NOTE

In this report, "$" refers to US dollars.

Keywords

adb, asian development bank, banking sector, capital market, development effectiveness, financial reform, financial sector, impact, mongolia, nonbank financial institutions, strategy, transition to a market economy

Director	:	R. Adhikari, Operations Evaluation Division 1 and Officer-in-Charge, Operations Evaluation Division 2, Operations Evaluation Department (OED)
Team Leader	:	C. Kim, Senior Evaluation Specialist, Operations Evaluation Division 2, OED
Team Members	:	J. Dimayuga, Evaluation Officer, Operations Evaluation Division 2, OED R. Perez, Senior Operations Evaluation Assistant, Operations Evaluation Division 2, OED

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In accordance with the guidelines formally adopted by the Operations Evaluation Department (OED) on avoiding conflict of interest in its independent evaluations, the Director General of OED did not review this report and delegated approval of this evaluation to the Director of Operations Evaluation Division 1. The fieldwork and preparation of this report were undertaken by C. Kim, mission leader. Sarath Thalakada (Financial Sector Specialist) was the international consultant and Baasanjav Tsolmon (Financial Analyst) was the local consultant. To the knowledge of the management of OED, the persons preparing, reviewing, or approving this report had no conflict of interest.

EXECUTIVE SUMMARY

Introduction

This sector assistance program evaluation report presents an independent evaluation of Asian Development Bank (ADB) assistance to the financial sector in Mongolia. The report identifies lessons from past ADB strategies and programs in the sector and is intended to provide inputs for preparation of the country assistance program evaluation of Mongolia and for formulation of the next country partnership strategy.

Country Context

Mongolia is a landlocked, low-middle income country with a population of about 2.6 million and a per capita gross domestic product (GDP) of about $1,490 in 2007. Its economy faced many challenges during the transformation, beginning in the early 1990s, from a centrally-planned to a market-oriented economy. With support from ADB, the Government of Mongolia (the Government) initiated many reforms in key areas that reduced inflation and improved growth. The Government was committed to increasing the pace of reforms by addressing the urgent economic problems facing the economy and providing a more sustainable basis for growth. It placed high priority on financial sector reform and restructuring of the banking system. The banking system is now capable of responding to market signals and helping in the efficient operation of a market-based economy. The private sector has benefited most from this transformation. The loans given by the banking system have been predominantly for private sector development, and these accounted for 97% of total loans outstanding over the 5-year period 2002–2006. Accordingly, the private sector's contribution to GDP increased from merely 3.3% of GDP in 1989 to 70.3% of GDP in 1999, reaching about 77.8% of GDP in 2006. This helped accelerate the process of overall economic growth in the country, with the GDP growth rate increasing from 3.2% in 1999 to 9.9% in 2007. Despite these, Mongolian domestic market is relatively small in size, i.e., $3.9 billion GDP at current prices in 2007. It borders with two large and fast-growing economies of the People's Republic of China and Russian Federation.

Government's Sector Strategies

In the 1990s the Government adopted a strategy that included macroeconomic stabilization to address immediate problems, sustainable economic growth, and implementation of reforms considered necessary for a successful transition to a market economy, as well as a central role for commercial banks. The main objective of the reform program was to promote establishment of a competitive, autonomous, market-based, and sound financial system that could regain public confidence and efficiently mobilize and allocate resources for economic growth. The financial sector reform program was therefore expected to: (i) strengthen financial intermediaries, (ii) strengthen the legal and regulatory framework for the financial sector, and (iii) establish a market-based financial intermediation process.

In 2000, the Government formulated a Medium-Term Strategy for Financial Sector Development (covering the period 2000–2005), based on lessons from efforts to reform the financial sector during the previous decade. It also addressed the liquidity and solvency problems faced by commercial banks as a result of the 1999 financial crisis, which was caused by a severe drop in the prices of major commodity exports.

In 2003, the Government prepared the National Action Plan for 2004–2008. That plan highlighted the importance of continued financial sector reforms to achieve a GDP growth rate of about 6% over the medium term. Accordingly, the plan set out to (i) consolidate financial sector stabilization, (ii) strengthen the stock exchange to mobilize savings for productive investments, and (iii) develop a broader range of financial services and instruments.

ADB Assistance

Over the last 16 years, ADB has given considerable assistance in support of the transformation of Mongolia's financial sector. The assistance comprised three program loans, two project loans, one technical assistance (TA) loan, 21 advisory TA grants, and three project preparatory TA grants. In addition, loan and equity investments were made in a commercial bank. The three program loans are the First and the Second Financial Sector Program Loans and the Financial Regulation and Governance Program.

ADB's strategy for Mongolia addressed three priority concerns: (i) creation of an environment conducive to a competitive, efficient market economy; (ii) development of the human resources and requisite skill base of the country; and (iii) establishment of adequate physical infrastructure needed for a market economy. The strategy recognized the important role of the financial sector in facilitating and supporting growth in other sectors of the economy.

During 1991–1999, ADB aimed to support reforms for extensive operational and financial restructuring of commercial banks. These reforms covered banking practices and skills, and the banking sector policy, legal, regulatory, and supervisory framework needed in order for the Mongolian banking sector to reach internationally acceptable financial and prudential norms.

During the following 5-year period (2000–2005), ADB aimed to support the Government's Medium Term Strategy for Financial Sector Development through (i) the ongoing bank restructuring and privatizing program, contributions to further strengthening of financial sector policies and procedures, and introduction of financial sector-based good governance; and (ii) diversification and deepening of the financial sector and financial services.

In line with the Government's action plan for 2004–2008 and ADB's country strategy and program for 2006–2008, ADB's financial sector strategy focused on further stabilization and strengthening of the banking sector, and took steps toward further diversification and deepening of the financial sector to promote private sector-led economic development, particularly in less-developed rural areas. The banking sector was to be further stabilized and strengthened through better governance practices and depositor protection, improved supervision of banks, and development of a more effective collateral framework. Steps were taken to consolidate the fragmented regulatory structure for nonbank financial institutions and strengthen their weak institutional capacity; fill gaps and anomalies in the legal framework; improve governance practices, disclosure, and investor confidence; harmonize tax impediments; and introduce an effective anti-money laundering regime. These issues are being addressed by ADB's Financial Regulation and Governance Program, approved in November 2005.

Rating of Overall Performance

Bottom-Up Evaluation. The overall rating of ADB's assistance performance in the financial sector was "successful." The banking subsector is performing well while the capital markets subsector is lagging behind. The financial sector assistance program for the evaluation period was considered "relevant", "effective", "efficient", and its sustainability "likely." The assessment covered three program loans, two project loans, one TA loan, four project preparatory TA projects, and 21 advisory TA projects. Two completed financial sector program loans have been rated "successful" although there were some inefficiencies with respect to the 2-year delay in the completion of the second program (including the unsuccessful privatization of the stock exchange) and the cancellation of the rural finance loan. The ongoing third program loan is being implemented satisfactorily. Of the 21 advisory TA projects, 18 have been completed with 14 rated "generally successful" and four rated "partly satisfactory." The other three advisory TA projects are ongoing and based on the outcomes achieved so far, they have been rated "successful."

Top-Down Evaluation. The overall positioning of the financial sector strategies for the evaluation period was assessed "satisfactory." ADB's strategies for the financial sector remained relevant and consistent with those of the Government throughout the strategy and program formulation, evaluation, and implementation stages. Likewise, ADB's overall performance in the sector was satisfactory. A considerable amount of effort and funds were spent in researching, analyzing, formulating, and prescribing policy reforms that were efficient and effective in facilitating the transformation process. However, ADB had some shortfalls in its engagement in the sector. While dealing with very complex financial sector programs, it lacked consistent, sufficient level of supervision to ensure their effective implementation. Either the provided staff deployment or the level delegation to the resident mission for the program implementation supervision and portfolio management remained weak and inconsistent. The program delivery in the capital markets subsector in particular has sometimes been sketchy and ineffective, leaving the key issues such as the privatization of the MSE and the expansion of the stock market operations still unresolved.

The overall rating, based on the bottom-up and top-down evaluation of ADB assistance in the financial sector, is "successful" with scope for improvement in ADB's future engagement in the sector.

Lessons Identified

The key lesson identified and worthy of replication in future ADB operations in similar situations was that the success of the financial sector strategies and programs was a result of (i) the continued Government commitment and ownership of the programs and the way the programs were formulated and implemented through a combined effort of the Government and the key donors, with ADB playing the lead role; and (ii) the emphasis placed on bank privatization, which allowed a more efficient and effective financial intermediation system to be put in place than would have been possible had they been restructured under the same government ownership.

Another key lesson identified was that ADB should not overestimate the capacity of the Government and the political will present to formulate and implement reforms and new laws, and/or amend existing ones. New reforms, laws and/or amendments to existing laws should have been better sequenced, phased, and presented in a more convincing manner through greater research, analysis, and consultation.

With regard to ADB's engagement in the sector, dealing effectively with complex financial sector program loans and ensuring effective sector involvement–particularly for those loans involving policy reforms, new laws and/or amendment of existing laws, and human resource and institutional development goals–requires enhanced supervision budgets and staff skills and incentives, so as to enable sustained program supervision on the part of ADB.

It is difficult to develop capital markets in small economies like Mongolia. The issue could be viewed from subregional economic cooperation perspective.

As in the case of the rural finance loan that was canceled during its implementation, ADB's project performance monitoring mechanisms should have been strengthened to watch for early warnings signaling that projects were running into difficulty, so that proactive steps could be taken to resolve impending problems before they actually occurred. Such actions would have prevented unwarranted and premature loan cancellation, and avoided the waste of considerable resources that were expended on loan processing by the Government and ADB.

Future Challenges, Opportunities, and Recommendations

Commercial Banking Sector. The commercial banking system faces many challenges, including (i) coping with a rather volatile economy based on a few commodity exports; (ii) a relatively large number of fully privatized banks; (iii) the marginal profitability of some of the smaller banks, because of intense competition for deposits intake and resulting reduced margins; (iv) rapid expansion of banking operations in terms of deposits and lending; (v) the need to keep nonperforming loans at a manageable level under expanding loan portfolios; and (vi) the need for enhancement of staff skills and capacity, at both the central bank and commercial bank levels, to meet the expanded operations. These challenges open some opportunities for ADB. In order to maintain the stability of the banking system, there will be a need to continue strengthening the regulatory, supervisory, governance, internal control, and accounting/auditing frameworks.

The smaller commercial banks operate on a marginal basis in terms of deposit and lending operations, internal controls, staff skills, and profitability. A challenge would be to keep them viable in the face of any volatility in the economy. In this context, ADB may consider equity and loan investments in some selected commercial banks, with the goal of strengthening their capital structures; widening the long-term resource base; strengthening their governance, internal control, and risk assessment in accordance with best international practice; and improving their overall viability.

Commercial banks are able to provide only short-term loans, which are more suitable for trading, microfinance, and consumer finance. As a result, small and medium-sized enterprises (SMEs) that require longer-term loans have limited access to bank finance at present. There is an opportunity to fill this gap by supplying appropriate funding for SME development, for both employment generation and poverty alleviation.

ADB's housing finance loan introduced primary mortgage finance into the country for the first time. The policies and procedures introduced are in use by commercial banks for the new mortgage finance product now being promoted. Based on the success of primary mortgage finance, the private commercial banks, supported by the Government, have established the Mongolia Mortgage Corporation to promote a secondary mortgage finance market, and are looking into prospects for securitization opportunities. This presents another challenge.

Nonbank Financial and Capital Market Sectors. The new umbrella supervisory authority (the Financial Regulatory Commission) tasked with supervision of both nonbank financial institutions and capital markets is faced with the challenge of filling the gaps in the legal framework and strengthening the regulatory, supervisory, governance, internal control, and accounting and auditing frameworks. It has a tremendous workload in this regard but is severely constrained in terms of resources. It is also faced with the challenge of increasing public confidence in the capital markets. The authority needs outside assistance from the Government and donors to achieve these objectives. This is another opportunity for ADB.

Based on the above analysis of the future challenges and opportunities in the financial sector, the following is a summary of recommendations for consideration in ADB's future operations.

Recommendation	Responsibility	Timing
A. Recommendations for the Commercial Banking Sector		
1. **Assist further banking sector reforms.** In order to maintain the stability of the banking system, there will be a need to continue strengthening the regulatory, supervisory, governance, internal control, and accounting/auditing frameworks. ADB may consider supporting further reforms in the banking sector using its suitable modalities to meet the challenges and opportunities the sector faces.	East Asia Department	The new Mongolia CPS to address this over 2009–2011.
2. **Consider equity and loan investments by private sector operations.** ADB needs to consider equity and loan investments in some selected banks to help strengthen their operational capacity and systems and induce best international practices. Another opportunity will likely emerge with the Government's present proposal to open the banking system to undertake nonbank and capital market activities (e.g., fund placement, initial public offerings, and underwriting). ADB may look into helping introduce these new products to the banking system.	Private Sector Operations Department, East Asia Department	As soon as possible. Also, the new Mongolia CPS to address this over the new Mongolia CPS to address this over 2009–2011.
3. **Examine the prospects for introducing longer-term deposit and loan instruments and products for SME promotion**. ADB may investigate the possibility of using commercial banks for channeling a credit line to meet the gap in the supply of rural finance in the country.	East Asia Department	The new Mongolia CPS to address this over 2009–2011.
4. **Support the rural finance.** ADB may investigate the possibility of using successful banks to channel a credit line to meet the country's rural finance supply gap.	East Asia Department	The new Mongolia CPS to address this.
5. **Support development of the housing finance market.** In consultation with other aid agencies involved in this area, ADB may examine the possibilities of providing assistance to the new secondary mortgage product through strengthening the legal and regulatory framework, and perhaps providing equity and loan support for the mortgage corporation.	Private Sector Operations Department, East Asia Department	The new Mongolia CPS to address this over 2009–2011.
B. Recommendations for the Nonbank and Capital Market Sectors		
6. **Support development of nonbank and capital market sectors.** ADB needs to examine suitable modalities to support policy reform and capacity enhancement in terms of human resource and institutional development, covering both the nonbank activities to be undertaken by commercial banks and the work that FRC needs to undertake for further development of the nonbank and capital market sectors.	East Asia Department	Examine it as soon as possible, so that the new Mongolia CPS can address this over 2009–2011.

Ramesh B. Adhikari
Director, Operations Evaluation Division 1
and Officer-in-Charge, OED 2
Operations Evaluation Department

I. INTRODUCTION

1. Over the 16 years between 1991 and 2007, the Asian Development Bank (ADB) has given considerable assistance in support of the transformation of Mongolia's financial sector. The assistance has taken the form of three program loans, two project loans, and one technical assistance (TA) loan, totaling $86.7 million; 21 advisory technical assistance (ADTA) grants for $9.3 million; and three project preparatory technical assistance (PPTA) grants for $1.8 million. In addition, loan and equity investments ($4.5 million and $1.6 million, respectively), under the Private Sector Operations Department, were made in the Trade and Development Bank (TDB) (Appendix 1). The three program loans are the First and Second Financial Sector Program Loan (FSPL I and II, respectively) and the Financial Regulation and Governance Program (FRGP).[1]

2. This report on an assessment of ADB's assistance to Mongolia's financial sector evaluates ADB's country strategy and program in the financial sector; its sector positioning; the quality of the programs, projects and TA projects in the sector; and their performance, including private sector participation in the financial sector and contribution to development results in general. The report identifies lessons from the past ADB strategies and programs in the sector and is intended to provide inputs for the preparation of the Country Assistance Program Evaluation of Mongolia and for the formulation of the next country partnership strategy.

3. The evaluation is based on the Operations Evaluation Mission's field study in Mongolia during 20 June–4 July 2007, Operations Evaluation Department (OED) evaluation studies,[2] and secondary data from Government of Mongolia (the Government) sources,[3] the International Monetary Fund (IMF) and World Bank resident missions in Mongolia, and ADB.[4] A participatory evaluation approach was adopted during the field study to judge the extent of ownership by borrower and beneficiaries of ADB's financial sector strategy and assistance. This was done through interviews based on a set of specially-designed questionnaires, the outcomes of which were discussed with the interviewees. A cross-section of beneficiaries involved in the formulation, processing, and implementation of ADB's assistance were contacted for this purpose, namely, senior officials of the Ministry of Finance, Bank of Mongolia (BOM), Financial Regulatory Commission (FRC), Chamber of Commerce, Bankers' Association of Mongolia, and the State Property Committee.

II. BACKGROUND AND SECTOR CONTEXT

4. **Background.** Mongolia is a landlocked, low-middle income country with a population of about 2.6 million and a per capita gross domestic product (GDP) of about $1,490 in 2007. Like some other centrally planned economies, Mongolia inherited a Soviet-style mono-banking

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[1] These are (i) *Financial Sector Program Loan* (FSPL I), for $35.0 million, approved by ADB on 19 December 1996; (ii) *Second Financial Sector Program Loan* (FSPL II), for $15.8 million, approved on 22 June 2000; and (iii) *Financial Regulation and Governance Program* (FRGP), for $10.0 million, approved on 15 June 2005.

[2] ADB. 2008. *Special Evaluation Study on ADB Assistance for Domestic Market Development*. Manila. ADB. 2007. *Program Performance Evaluation Report on Mongolia: Second Financial Sector Program*. Manila.

[3] Such as Bank of Mongolia *Annual Reports* and *Statistical Bulletins;* and the *Mongolia Stock Exchange Annual Report for 2006.*

[4] These include the following ADB documents: ADB. November 1996. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistant Grant to Mongolia for the Financial Sector Program*. Manila; ADB. June 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to Mongolia for the Second Financial Sector Program*. Manila; and ADB. November 2005. *Report and Recommendation of the President to the Board of Directors for Proposed Program Loan and Technical Assistance Grant for Financial Regulation and Governance Program*. Manila.

system in which all banking business was conducted by the State Bank of Mongolia. The mono-bank acted as cashier to the Government and allocated financial resources to industries according to government directions within the framework of a credit plan (the financial counterpart of the physical plan specifying output targets), and not on the basis of commercial considerations. The financial system was not designed to respond to administered price signals and interest rates. The monobanking system has been transformed into a two-tier system in 1991, with a central bank and a number of state-owned commercial banks, and then, into a fully-privatized current banking system by 2000, with 16 private commercial banks. The Mongolia Stock Exchange (MSE) was set up in February 1992 to help implement the Government's privatization program. MSE that has about 380 listed firms is running with still limited capacity. There are a few hundred nonbank financial institutions in place. The banking system is regulated by BOM, and the capital markets and nonbank sectors by FRC.

5. **Sector Context.** Mongolia's economy faced many challenges when transforming itself from a centrally-planned to a market-oriented economy. Beginning in 1991, the Government initiated various reforms in key areas, supported by ADB-financed TA projects (as described in Appendix 1); the high inflation and negative growth were arrested and began improving in 1994. The Government was committed to increasing the pace of reforms by addressing the urgent economic problems facing the economy and providing a more sustainable basis for growth. The Government's commitment to reform was demonstrated by various measures that included removal of the ban on the export of cashmere, raising power and heating tariffs, raising petroleum prices to market-related levels, and enacting two new banking laws. Further reforms were implemented that included restructuring of the civil service and reducing staff levels, accelerated privatization, and reform of the banking sector, which accounted for bulk of financial sector assets in Mongolia.

6. These issues were covered in a standby arrangement approved by IMF's Board in early 1997. The Government placed high priority on financial sector and enterprise reform and IMF made it clear that developing a sound plan for restructuring the banking system in conjunction with further enterprise reform was a precondition for concluding a standby arrangement. Also, the Government and IMF looked to ADB and the World Bank to provide further assistance in these areas. The recovery remained fragile, however, as developments in the banking sector threatened to disrupt the progress that had been made. To this end, the Government entered into negotiations with the IMF for a new 3-year arrangement under the Enhanced Structural Adjustment Facility in 1997. The Government was committed to implementing the program agreed with the IMF.

7. Under the financial sector reform process in 1990s, a basic institutional structure had been established, but major weaknesses remained in lending and accounting practices as well as in bank supervision and regulation. Significant gaps in legal and institutional structures emerged as the sector evolved. The need for greater training and skills development became clear. There was also a gap in the knowledge and skills base needed to understand the role that the commercial banks should play in a market-oriented economy, and to operate them successfully.

8. Further, the state-owned commercial banks that came into being with the break up of the mono-banking system inherited a large accumulation of nonperforming loans (NPL), particularly those given to state-owned enterprises (SOE). Consequently, many of these banks, particularly the larger ones, became illiquid and insolvent. As a result, eight of 20 banks were closed between June 1998 and December 1999, while some of the others were kept in operation through frequent injections of liquidity by the central bank (BOM) and recapitalization of capital

structures of five of the largest commercial banks in line with BOM's capital adequacy requirements. The Government also assumed responsibility for the directed and inherited loans. These adverse developments caused an erosion of public confidence in the banking system, which threatened to undo the progress achieved and cause a banking crisis. Many of these issues were addressed by FSPL I and the associated TA grants, approved in December 1996, which helped the Government introduce market-orientation and commercialization in the banking system. FSLP I aimed to help reform the legal, regulatory, and policy environment for the commercial banks and strengthen them by improving the commercial orientation, efficiency, and prudence of their operations. FSPL I complemented and reinforced the IMF's Enhanced Structural Adjustment Facility for 1997–2000. Under the IMF facility, the Government adopted a strong macroeconomic stabilization program based on tight fiscal and monetary policies to curb inflationary pressures and wide-ranging sector reforms to strengthen banking. ADB assistance in parallel focused on (i) bringing the legal and regulatory framework for the banks up to international standards, (ii) facilitating bank restructuring to strengthen viable banks and close insolvent banks, and (iii) reducing the Government's involvement in the banking system.

9. The reforms undertaken in 1990s had positive results. They helped develop an environment conducive to private sector-led development, supported by a relatively small and fragile financial system. The impact of these reforms led to an average annual GDP growth rate of 3.9% in 1995–1999. Inflation was reduced from over 50% in 1996 to less than 10% in 1998.

10. However, the difficult political environment in the late 1990s and the 1999 financial crisis that followed the Asian financial crisis adversely affected the banking system and the ongoing reform process. The commercial banks once again began to face severe liquidity and solvency problems, and they required recapitalization and strengthening of governance practices and internal controls. In addition, high intermediation costs and the limited reach of the financial system had to be addressed, while the nonbank and capital market sectors needed to be developed to diversify and deepen the financial sector and its services. The circumstances necessitated a second phase of the reform program, which was addressed by the FSPL II and associated TA, approved in June 2000.

11. To carry forward the first phase of financial sector reforms, the Government, with the assistance of the International Development Association (IDA), formulated a long-term vision and medium-term strategy for financial sector development.[5, 6] To implement this strategy, the Government asked IDA and ADB to support the second phase of financial sector reforms. In response IDA and ADB developed a comprehensive financial sector reform program covering the various subsectors of the financial sector, for potential parallel financing of the associated structural adjustment costs. As an umbrella program, the financial sector reform program was supported by (i) a financial sector adjustment credit of $32 million equivalent approved by IDA on 20 April 2000 and (ii) ADB's FSPL II of $15.8 million equivalent and its associated TA.

12. The reform program supported by FSPL II and the associated TA helped strengthen the banking system. As a result, the operations of the banking system improved, with (i) increasing deposits and loan portfolios (deposits and loans as a share of GDP increased from 14% and 8% in 1999 to 39% and 35% in 2004, respectively), (ii) a drop in the NPL ratio, and (iii) an overall improvement in the profitability of banks. Nevertheless, some weaknesses persisted. Although interest rates showed a downward trend, they nevertheless remained high. The deposit and

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[5] World Bank. 1999. *Mongolia Financial Sector Strategy.* Washington.
[6] The Financial Sector Adjustment Credit was ratified by Parliament on 18 May 2000.

lending rates of banks continued to be high, with rates in 2004 of about 14% for deposits and 25% for lending. The high interest spreads were symptomatic of high credit risk, high operating costs, strong demand for bank loans because of a lack of other funding sources, and limited competition among the banks.

13. The NPL ratio declined from a high of 54% in 1999 to a relatively high level (7%–11%) during 2000–2004.[7] This reflected the earlier poor performance of bank loans improved although there was room for strengthening the weak internal controls and risk assessment capacities and the collateral framework. Other areas that needed strengthening were governance and depositor protection.

14. To diversify and deepen the financial sector, the nonbank financial institutions (NBFI) and capital market subsectors that were lagging behind needed to be developed. Necessary actions at that time included bringing the fragmented regulatory and supervisory structure for the subsectors under one umbrella, strengthening institutional capacities, closing gaps and anomalies in the legal framework, reducing tax impediments, increasing investor confidence through better governance and disclosure, and introducing an effective anti-money-laundering mechanism.

15. A third phase of reforms were therefore needed to strengthen the above-mentioned weaknesses in the banking and nonbank sectors. The reforms proposed under ADB's third sector reform program (FRGP) and associated TA approved in November 2005 are addressing these issues.

III. GOVERNMENT'S FINANCIAL SECTOR STRATEGY

16. In the 1990s the Government adopted a strategy that included macroeconomic stabilization to address immediate problems, sustain economic growth, and implement reforms considered necessary for successful completion of the transition to a market economy, including the central role that commercial banks would play in it.

17. The Government's strategy was to vigorously pursue reform of the financial sector, in particular the commercial banking system. The main objective of the reform program was to promote establishment of a competitive, autonomous, market-based, and sound financial system that could regain public confidence and efficiently mobilize and allocate resources for economic growth. The objective was to be achieved through a financial sector reform program designed to: (i) strengthen financial intermediaries, (ii) strengthen the legal and regulatory framework for the sector, and (iii) establish a market-based financial intermediation process.

18. A major component of the reform program undertaken by the Government in 1990s was to support the establishment of a well-defined operating and regulatory frameworks for the banking sector based on internationally accepted norms. In this regard, the powers and responsibilities of BOM were enhanced in a range of activities including the supervision of commercial banks. BOM's powers were also enlarged to make commercial banks conform to (i) internationally accepted norms, as required by the Bank for International Settlements (BIS) with respect to capital adequacy and classification of loans; and (ii) internationally-accepted accounting practices, as required by the International Accounting Standards (IAS) with respect to making proper provisioning for bad loans, among other requirements. In September 1996, the

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[7] The NPL ration has further declined to a lower-than-average level of 3.2% in 2007.

Government enacted the Law on Central Banking to provide a legal basis for BOM to carry out these responsibilities and properly supervise and regulate commercial banks. The Government expected BOM to exercise these powers to establish greater discipline among commercial banks and restore public confidence in the banking system.

19. To address the substantial portfolio problems of banks during late 1990s, the Government reform program also addressed the need for improvement in the legal and institutional framework for defining property rights and facilitating debt recovery.

20. In order to establish market-based financial intermediation, the reform program included measures to eliminate government influence on credit decisions by divesting direct and indirect state shareholdings in banks and improving the autonomy of banks and increasing the accountability and responsibility of bank shareholders and managers. The reforms also sought to discontinue the practice of giving preferential interest rates for favored sectors, and to limit undue external influence on credit decisions by imposing limits on lending to shareholders. The Government recognized that reform of SOEs was critical to addressing the problems of the financial and banking sector and to sustain the economic recovery, maintain stability, and attract foreign direct investment into the country. Accordingly, with the support of the World Bank under its Banking and Enterprise Sector Adjustment Credit, the Government began to address enterprise reform, with emphasis on the six largest defaulters to the banking system.

21. Reforms were also initiated to diversify and increase the competitiveness of the financial sector. Steps were taken to establish a clear and well-defined regulatory structure for NBFIs that included financing and leasing companies and trust and investment companies.

22. An important component of the Government's reform program was strengthening of viable commercial banks through financial and operational restructuring. A major part of the Government's restructuring strategy was to remove the unrecoverable directed and inherited loans from the balance sheets of commercial banks, substituting these with interest-bearing Government securities. The 1997 budget provided adequate funds to finance the cost of banking sector restructuring. The Government also addressed the impacts to employees due to restructuring of banks and SOEs, through social security and poverty reduction programs assisted by bilateral and multilateral donors.

23. The reform program required all commercial banks to implement appropriate credit policies and procedures as well as management information systems (MIS), and supported the improvement of credit and risk management policies and systems. Training in these areas had been initiated with donor assistance. Commercial banks allocated resources for staff training and skills development.

24. The Government's reform program strategy described above was intended to establish Mongolia's banking system on a sound financial foundation and enable its operation according to internationally accepted standards, with respect to the regulatory framework and accounting practices. Once operating soundly, the banking system was expected to contribute to the protection of depositors' interests, and to increase confidence in the country's banking system. It was also expected to facilitate resource mobilization and increase the efficiency of resource allocation, thereby benefiting the population at large. In addition, the reform program was expected to facilitate access to credit by private entrepreneurs, which would impact positively on employment opportunities in the country's growing private sector. Through these developments, the reform program was also expected to have a positive impact on poverty reduction.

25. In 2000, the Government formulated a Medium-Term Strategy for Financial Sector Development (roughly covering the period 2000–2005), based on lessons from efforts to reform the financial sector during the previous decade. It also addressed the liquidity and solvency problems faced by commercial banks as a result of the 1999 financial crisis, which was caused by a severe drop in prices of the major commodity exports. The main thrust of that strategy was to continue the movement toward establishment of a market-based financial system. The restructuring of the commercial banks was to be pursued more vigorously to reduce the role of the government in allocating financial resources, through liquidation of non-viable banks, and privatization of the more viable banks.[8]

26. That strategy also incorporated a host of other reforms to strengthen the development of sustainable rural financial institutions, and further diversify and deepen the financial sector through promoting the nonbank and capital market subsectors. The reforms to strengthen the banking system included (i) improvements in corporate governance practices in banking institutions in accordance with international practice, as issued by the BIS; (ii) changes to the Civil Code to allow movable property to be offered as loan collateral; (iii) expansion of the types of immovable property that could be used as loan collateral; and (iv) changes that expedite procedures for and reduce costs associated with collateral registration, through improvements proposed to the Office for Immovable Property Registration. The strategy also included reforms to strengthen bank supervision and regulation through measures that established (i) minimum capital requirements, (ii) asset classification, (iii) an exit policy to facilitate the liquidation of troubled banks, and (iv) the foundation for developing a Government bonds market and an interbank market. The need for developing human resources and capacity enhancement was given high priority in that strategy.

27. The nonbank and capital market subsectors were to be promoted through the establishment of a single regulator and supervisor (FRC) to oversee both those subsectors. The FRC replaced the Mongolia Securities and Exchange Commission, and introduced prudential norms, minimum capital and licensing requirements for NBFIs. A strategy was adopted for promoting capital markets that included many reforms efforts. These sought to (i) strengthen the regulatory body; (ii) accelerate privatization of SOEs to increase the number of stocks listed on MSE; and (iii) introduce the Law on Trusts and Law on Investment Funds, as part of the effort to establish a legal framework for promotion of new investment instruments. The MSE was to be separated into two institutions: the MSE would oversee trading functions, while the Central Depository System handled clearing, settlement, and depository functions. Other steps were also to be taken to enhance public confidence in capital market operations.

28. In 2003, the Government finalized a national poverty reduction strategy in the form of the Economic Growth Support and Poverty Reduction Strategy, from which the Government prepared the National Action Plan for 2004–2008. That plan highlighted the importance of continued financial sector reforms in ensuring a GDP growth rate of about 6% over the medium term.[9] Accordingly, the plan set out to (i) consolidate financial sector stabilization, (ii) strengthen the stock exchange to mobilize savings for productive investments, and (iii) develop a broader range of financial services and instruments.

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[8] Two of the largest state-owned commercial banks (ITI Band and Reconstruction Bank) were liquidated in 2000. The largest state-owned bank (TDB) was also privatized in 2000. The two other large state-owned commercial banks (Agriculture Bank and Savings Bank) were restructured and subsequently privatized, with the former operating as Khan Bank, and the latter continuing to operate as Savings Bank.

[9] Government of Mongolia. 2004. *Action Plan of the Government of Mongolia for 2004–2008.* Ulaanbaatar.

IV. ADB STRATEGY AND OPERATIONS IN THE SECTOR

A. Country Operational Strategy

29. ADB's medium-term operational strategies for Mongolia since the mid-1990s aimed at facilitating the transition to a market-based economy, which required the emergence of a vigorous and competitive private sector that would encourage efficient allocation and utilization of resources, and provide the basis for sustained economic growth, generation of income and employment opportunities, and reduction of poverty. In that context, ADB's strategy addressed three priority concerns: (i) creating an environment that is conducive to a competitive, efficient market economy; (ii) developing the country's human resources and requisite skill base; and (iii) establishing adequate physical infrastructure needed for a market economy.

30. ADB's country assistance strategy recognized the important role of the financial sector in facilitating and supporting growth in other sectors of the economy. The Government had initiated policy measures and legislative steps to begin the establishment of a modern two-tier banking sector, but the financial sector required substantial additional reforms to service the needs of a market economy and facilitate the growth of the private sector. The strengthening of the banking sector was therefore an important component of that strategy.

31. Macroeconomic stability was considered essential to the strategy and to the development of the banking sector. The strategy recognized that TA aimed at improving skills and operational practices in commercial banks would be effective only if the regulatory framework had been put in place and the supervision capability of BOM had been strengthened. The strategy also recognized the importance of strengthening internationally acceptable accounting, auditing, and good governance standards and practices in commercial banks. Improved credit delivery to the industrial and agricultural sectors would be ensured with the establishment of an efficient commercial banking system within a well-supervised regulatory framework. The strategy also recognized the need to develop microfinance schemes to support the country's efforts to reduce poverty.

32. The country strategy and program (CSP) for 2006–2008[10] identified financial underdevelopment as a main constraint on private sector-led economic growth and poverty reduction. The banking sector had stabilized and strengthened since the crises of the 1990s, and the Government had started to build the basic foundation for the nonbank sector. However, the financial sector's role in promoting economic growth had been limited. The cost of borrowing was high and financial outreach limited. The lack of long-term funding sources limited productive investment. There were few savings instruments and insurance products. A sound financial system with improved efficiency and outreach was a key medium-term outcome envisioned.

B. Financial Sector Strategy

33. Mongolia's transition to a market economy had generally been successful, compared particularly with other countries that were also members of the Council for Mutual Economic Assistance. The Government, with support from ADB, IMF, and the World Bank, had undertaken a program of reforms aimed at macroeconomic stabilization and liberalization. As a result of these measures, the annual inflation rate had declined, and since 1994 the economy had been growing.

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[10] ADB. 2005. *Country Strategy and Program (2006–2008): Mongolia.* Manila.

34. Financial sector reforms would contribute to macroeconomic stability and were a crucial component of the ongoing structural adjustment in Mongolia. A well-developed and efficient financial sector performs the key economic functions of mobilizing and protecting savings and allocating resources to their most productive use. The Mongolian financial system was unable to perform those functions adequately. Commercial bank deposits in Mongolia remained relatively very low staying at around 25% of GDP. This very low deposit ratio revealed significant levels of financial disintermediation with the banking sector in Mongolia, providing limited support for development of the other sectors.

35. Given these circumstances, ADB's strategy for the financial sector during 1991–1999 aimed to support reforms for extensive operational and financial restructuring of commercial banks. These reforms covered banking practices and skills, and the policy, legal, regulatory, and supervisory framework governing the banking sector to allow the Mongolian banking sector to reach internationally acceptable financial and prudential norms. There was also a need for new institutions and policy instruments, as well as for new skills that would enable Mongolia to develop a commercially oriented, competitive, and efficient financial sector. The reforms were expected to take time and involved high learning and other costs. In December 1996, ADB approved the FSPL I and the associated TA components in support of implementing the reform program to deal with the continuing need to restructure and develop the banking sector.

36. Based on the success of the reforms carried out with ADB, IMF, and World Bank assistance, as detailed above, ADB's financial sector strategy for Mongolia during 2000–2005 aimed to support the Government's Medium-Term Strategy for Financial Sector Development on two distinct fronts. First, it sought to (i) provide continued support for the ongoing bank restructuring and privatization program, to consolidate and develop reputable (and model) financial institutions; (ii) contribute to further strengthening of financial sector policies and procedures; and (iii) introduce financial sector-based good governance practices, to bring about greater transparency and accountability at all levels of banking operations and strengthen market discipline. Second, it supported the diversification and deepening of the financial sector to facilitate further development of financial intermediation in the country, and to make available to the private entrepreneur and investor a choice of instruments, mechanisms and institutions to meet their demand for various financial services and thereby reduce the dependency and pressure on the banking system to provide those services.

37. Accordingly, ADB's financial sector strategy during this period supported the development of equity and debt markets, reformation of the pension scheme, as well as the development of financial leasing and insurance companies; extension of credit through development of onlending operations for small and medium-sized enterprises (SME), rural enterprises, households, microfinance, and housing; and improved efficiency and outreach of financial intermediation to support stable economic growth and poverty reduction. ADB approved FSPL II and the associated TA components in June 2000 in support of this ongoing reform program. Two loans, one for housing[11] and the other for rural finance,[12] were approved in October 2001 to facilitate diversification and deepening of the financial sector following FSPL II.

[11] ADB 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loan to Mongolia for the Housing Finance (Sector)* (Loan 1847, for $15 million, approved on 18 October 2001). Manila.
[12] ADB 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loan to Mongolia for the Rural Finance* (Loan 1848, for $8.69 million, approved on 25 October 2001). Manila.

38. In line with the Government's Action Plan for 2004–2008 and ADB's CSP for 2006–2008, ADB's strategy for the financial sector then focused on further stabilization and strengthening of the banking sector, and took steps to further diversify and deepen the financial sector in order to promote ongoing private sector-led economic development, particularly in the less-developed rural areas, and thereby contribute positively to poverty reduction. The banking sector was to be further stabilized and strengthened through better governance practices and depositor protection, improved BOM supervision of banks that were owned and/or had banking relationships with financial groups and conglomerates (commonly called consolidated supervision), and development of a more effective collateral framework. With regard to promotion of further diversification and deepening of the financial system, steps were taken to (i) consolidate the fragmented regulatory structure for NBFIs and strengthen their weak institutional capacity; (ii) fill gaps and anomalies in the legal framework; (iii) improve governance practices, disclosure, and investor confidence; (iv) harmonize tax impediments; and (v) introduce an effective anti-money laundering regime. These issues were being addressed under FRGP.

V. EVALUATION OF ASSISTANCE

A. Bottom-Up Evaluation of ADB Sector Assistance

1. Overview of the Sector Assistance

39. ADB's assistance to Mongolia's financial sector focused on two broad areas supported by three program loans for $60.0 million and two project loans for $23.7 million: (i) the establishment of a soundly operating, privately owned commercial banking system capable of responding efficiently and effectively to a market-based economy; and (ii) the establishment of nonbank financial institutions and capital markets subsectors that would help to expand, diversify, and deepen the financial sector to reduce pressure on the commercial banking sector, provide entrepreneurs and the general public with a choice of financial instruments to meet their demands, and generally help reduce high real interest rates.

40. As summarized in Table 1, ADB's sector assistance program encompassed programs, projects, and TA projects, and was implemented in three stages. The first stage focused on establishing a privately-owned commercial banking system that operated soundly and was capable of responding to a market-based economy. Assistance was given to facilitate transformation of the mono-banking system into a two-tier system through (i) bank restructuring, with a view to their ultimate liquidation and/or privatization; (ii) improvements in commercial banking skills and MIS, and (iii) improvements in BOM's bank regulation and supervision. This was accomplished through policy dialogue and the FSPL I, approved in 1996, supporting the reform programs.

41. The second stage of ADB assistance involved the establishment of nonbank and capital market sectors that would help to expand, diversify, and deepen the financial sector through assistance that aimed to (i) facilitate liquidation of the banks that appeared unviable; (ii) privatize those found viable; (iii) allow entry into the sectors of new (including foreign-owned) banks; (iv) continue improving commercial banking skills; (v) continue improving and strengthening BOM's bank regulation and supervision; and (vi) strengthen and/or introduce new nonbank and capital market institutions and products for expansion, diversification, and deepening of the financial sector. ADB continued its policy dialogue with the Government and approved the FSPL II in 2000 in support of the ongoing reform program. The Housing Finance Sector Loan and Rural Finance Loan were both approved in 2001 for these purposes.

42. In the third stage, ADB assistance aimed to (i) upgrade and consolidate the emerging private sector-owned commercial banking system with good governance practices and an improved collateral framework, to reduce both loan risks and transaction costs; (ii) consolidate the fragmented regulatory structure for nonbank and capital markets, and strengthen their weak institutional capacity; (iii) fill gaps and anomalies in the legal framework; (iv) strengthen the stock exchange to mobilize savings for productive investments and to increase investor confidence through better disclosure; (v) harmonize tax impediments; and (vi) introduce an effective anti-money laundering regime. ADB's FRGP aimed to address these issues.

43. The first two program loans (FSPL I and FSPL II) were completed and closed. The program performance audit report prepared for the first loan in October 2003 rated the program loan "successful" on an overall assessment basis (para. 66). The program performance evaluation report prepared on the second loan in December 2007 rated it "successful" on an overall assessment basis (para. 23). The FRGP is still active and is likely to be implemented satisfactorily. The Housing Finance Sector loan was implemented successfully and is to be closed shortly. The Rural Finance Loan was unsuccessful and canceled in August 2006 with only about $1 million utilized out of the loan of $8.7 million.

44. ADB also approved a TA loan for upgrading skills and systems of the commercial banks being restructured for $3.0 million approved in December 1996 (piggybacked to FSPL I). ADB also gave a loan and made an equity investment in April 2004 to facilitate the privatization of the TDB and another loan and equity investment for the Khan Bank, formally the Agriculture Bank, in 2007. TDB is now operating efficiently as a fully privately-owned commercial bank.

45. Table 1 below lists the types of TA projects and the periods in which they were approved by ADB. These comprised three PPTA projects and 21 ADTA projects. Three PPTA projects were approved during the period 2000–2004 for preparation of the rural finance and housing sector finance projects, both of which were approved by ADB in 2001, and the third financial sector program that led to the approval of FRGP in 2005. All resulted in well-formulated and successfully implemented projects, except for the Rural Finance Project. All three PPTA projects have now been closed.

46. Of the 21 ADTA projects, 15 were approved during 1991–1996, four during 2000–2004, and two during 2005–2007. Three of these TA projects were piggybacked to loans. The ADTA projects covered a wide range of activities such as commercial bank liquidation, restructuring and privatization; upgrading commercial banking skills and MIS; improving and strengthening BOM's regulatory and supervisory framework; introduction of prudential norms and accounting/auditing standards for BOM and commercial banks in accordance with international practice (BIS and IAS, respectively); developing the regulatory and supervisory framework for promotion of nonbank and capital market sectors; introducing new financial products into the market such as mortgage finance, insurance schemes, pension systems, trust and investment fund operations; and introduction of an anti-money laundering regime.

Table 1: Program Loans, Project Loans, TA Loan, and TA Grants

Item	1991–1999	2000–2004	2005–2007
Program Loans	• Loan1509-MON:Financial Sector Program (1996)	• Loan 1743-MON: Second Financial Sector Program (2000)	• Loan 2218-MON: Financial Regulation and Governance Program (2005)
Project Loans		• Loan 1847-MON:Housing Finance (2001) • Loan 1848-MON: Rural Finance (2001)	
TA Loan	• Loan 1510-MON: Upgrading Skills and Systems of Commercial Banks (1996)		
Project Preparatory TA		• TA 3397-MON: Rural Finance (2000) • TA 3406-MON: Housing Sector Finance (2000) • TA 4236-MON: Third Financial Sector Program (2003)	
Advisory TA	• TA 1536-MON: Adviser to Mongolia Stock Exchange (1991) • TA 1542-MON: Training for MSE (1991) • TA 1643-MON: Institutional Support for Mongol Bank (1992) • TA 1855-MON: Institutional Strengthening of Financial Sector (1993) • TA 2219-MON: Strengthening Commercial Banking Sector (1994) • TA 2353-MON: Strengthening of Financial Intermediaries (1995) • TA 2371-MON: Administrative Reform of Social Insurance (1995) • TA 2390-MON:Improving Accounting and Auditing System (1995) • TA 2543-MON: Development of Procedures for Reconstruction and Liquidation of Insolvent Banks (1996) • TA 2605-MON: Development of Bank Restructuring Strategies (1996) • TA 2697-MON: Implementation of Bank Restructuring Strategies (1996) • TA 2720-MON: Strengthening of Supervisory and Restructuring Capacity of the Bank of Mongolia (1996) • TA 2797-MON: Developing Regulatory Framework for Non-Bank Financial Institutions (1997) • TA 2964-MON: Improving Accounting and Auditing Systems (1997) • TA 3208-MON: Strengthen Restructuring of the Banking System (1999)	• TA 3459-MON: Strengthening Financial Sector Development (2000) • TA 3709-MON: Strengthening Policy for Social Security Reform (2001) • TA 3904-MON: Support Privatization in the Banking Sector (2002) • TA 4393-MON: Establishing an Effective Anti-Money Laundering Regime (2004)	• TA 4737-MON: Capacity Building for Financial Sector Reforms (2005) • TA 4910-MON: Strengthening the Pension System (2006)
Private Sector		Loan 7197-MON and Equity 2081-MON: Trade and Development Bank of Mongolia (2004)	Loan 7259-MON and Equity 2343-MON: Khan Bank (2007)

MON = Mongolia, TA = technical assistance.
Source: Operations Evaluation team.

47. The TA projects largely served the objectives of reform formulation and implementation, and capacity enhancement in terms of both human resources and institutional capacity in the financial sector. In particular, they assisted ADB to assess and analyze policy issues, and articulate policy dialogue during the formulation and implementation of the respective program and loan projects. They were also well coordinated and sequenced with the projects of other development partners to achieve maximum impact. Hence, on an overall basis, they contributed positively to the establishment of a fairly well regulated and supervised private and market-oriented banking system, and diversification and deepening of the financial sector to support private sector-led economic development in the country. The TA for establishment of an anti-money laundering regime was closed in 2007, successfully establishing the regime that is now in operation, while two ADTA projects are ongoing.

48. There were a few setbacks in regard to some of these TA projects. The TA loan for Upgrading Skills and Systems of Commercial Banks (1510-MON), where some portion of the TA was intended to set up MIS for commercial banks, could not be fully implemented owing to the wrong choice of the consulting firm for that purpose. The draft laws on trusts and investment funds prepared with TA for Strengthening Financial Sector Development (3459-MON) would have been more likely to have been approved by Parliament and Cabinet, respectively, had the TA consultants prepared notes to better brief politicians on the need for those two new laws (paras. 50 and 51). Finally, the consultant for TA for Strengthening the Pension System (4910-MON) recommended that the draft law on voluntary private pension plans prepared by the consultant be postponed for approval by Parliament as the current conditions in Mongolia were not adequate for establishment of such a scheme. This raises the question as to whether ADB's programming of that TA was premature, given the country's nascent stage of financial sector development, and the public's general lack of savings for making voluntary pension contributions.

49. **Factors Impeding Implementation.** Implementation of programs, projects and TA has generally been completed within the planned timeframes. In regard to the three program loans, FSPL I was completed successfully and within the planned completion date. FSPL II was also completed successfully but with a delay of about 2 years, due to delays in implementing policy actions relating to issues such as corporate governance, loan collateral, the interbank market, and strengthening of MSE operations. The implementation of FRGP is ongoing successfully, without major impediments to hinder implementation within the planned completion date. Of the two project loans, the housing finance sector loan has been completed successfully and within the planned completion date. The rural finance loan was canceled for reasons outlined earlier. The TA projects have also been completed successfully and within the planned completion dates, except in the three cases discussed above.

50. With regard to the Government's absorptive capacity, several matters should be highlighted. The laws on trusts and investment funds (prepared under TA 3459-MON, associated with FSPL II) have not been implemented. The TA consultants prepared both laws but the former was not approved by Parliament, while the Cabinet did not approve the latter, as the existing Company Law and Securities Market Law were seen to provide an adequate legal basis for their operations, with no separate laws needed for those purposes. FRC was revising the new laws for Parliament's approval. The privatization of MSE remains outstanding due to differences regarding the privatization method. The issue will be resolved shortly and presented to the Cabinet for approval before end 2007. The Rural Finance Loan (1848-MON) for $8.7 million, approved in October 2001, was canceled after utilizing only about $1.0 million due to (i) competition from the privatized banking system, which spread into rural areas with rural finance

products; and (ii) the failure of many of the savings and credit cooperatives (SCC) that were to serve as vehicles for dispensing the loan in rural areas.

51. It now appears that ADB's suggestion to privatize the MSE was premature, and should have been made after MSE was operating viably, when the prospects for privatization and the price received by the Government would have improved. The other failures could also be attributed in part to ADB. If the TA consultants that prepared the laws on trusts and investment funds had also prepared convincing briefing notes for the politicians that outlined the inadequacy of existing and need for new laws, the situation would have had a better chance of being understood and the laws approved by Parliament and Cabinet, respectively. ADB is partially to blame for the rural finance loan failure. Instead of canceling such a large proportion of the loan in 2006 because of the demise of many SCCs, the unused loan proceeds could have been re-channeled through the private banks that had branches in the rural areas (Khan Bank, for example) and microfinance institutions that were operating in those areas (such as Xac Bank), as they had by that time become successful and viable private banks. The lack of rural finance is considered a major impediment to further economic growth and poverty alleviation.

52. In all three cases the adverse impacts could have been avoided, had ADB been proactive in watching for early warning signals, and taken appropriate actions without waiting for events to unfold. While it promptly undertook the design and formulation of the sector programs to meet the urgent demand, its performance during implementation and resources allocated often were inadequate to handle the complexity of the reform programs involving multiple subsectors with different development stages.

2. Rating of Assistance Performance (Bottom-up)

53. The performance ratings of the three program loans, two project loans, one equity and loan investment in TDB, one TA Loan, 21 ADTA projects, and three PPTA projects are given in Appendix 2. Two program loans (FSPL I and FSPL II) have been completed, implemented satisfactorily, and have been rated "successful." The third program loan (FRGP) is ongoing and being implemented satisfactorily. Based on the outcomes achieved so far, it has been rated "likely to be successful." Two project loans (housing finance and equity and loan investments in TDB) have been completed, implemented satisfactorily, and rated "successful." The third project loan (rural finance) was canceled for reasons stated above and rated "unsuccessful." The TA loan for upgrading skills and systems of commercial banks has been completed and rated "partly successful."

54. Of the 21 ADTA projects, 18 have been completed, with 14 rated "generally successful" and four rated "partly successful." The other three ADTA projects are ongoing; based on the outcomes achieved so far, they have been rated "generally successful." The three PPTA projects have been completed, with two (housing finance and third financial sector program [FRGP]) rated "generally successful"; the third (rural finance) was rated "unsuccessful", as its outcome (a loan for rural finance) was canceled by ADB during implementation for reasons stated earlier.

55. The overall rating of ADB's assistance performance[13] in the financial sector was "successful." The ADB financial sector strategy and program on average was considered

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[13] The performance ratings were prepared following ADB. 2006. *Guidelines for the Preparation of Country Assistance Program Evaluation Reports.* Manila.

"relevant", "effective", and "efficient", and its sustainability "likely." The assessment covered three program loans, two project loans, one TA loan, three project preparatory TA projects, and 21 ADTA projects. The ongoing projects were evaluated based on quality-at-entry obtained from project documents and available project administration data. The assessment of the ongoing program loan (FRGP) and the three ongoing ADTA projects should be considered as tentative. A summary of the evaluation is presented in Table 2.

Table 2: Performance Rating of ADB Assistance in the Financial Sector

Relevance	Effectiveness	Efficiency	Sustainability	Impact	Overall Rating
2	4	2	4	4	16
Relevant	Effective	Efficient	Likely	Substantial	Successful

Source: Operations Evaluation team.

56. **Relevance.** ADB's strategies and programs for assisting Mongolia's financial sector were assessed "relevant." They were in accordance with those of the Government and ADB's sector strategies. They were also coordinated well with those of the donor partners (e.g., IMF, IDA/World Bank, United States Agency for International Development), with ADB playing the lead role. They evolved over an approximately 15-year period, responding positively to changes in circumstances, some of which were violent. Nevertheless, they remained focused and encompassed a balanced approach to assisting the development of the three constituent subsectors of the financial sector—the banking, nonbank, and capital market subsectors. However, as pointed out above its assistance to the capital market appeared premature, in particular its attempt to restructure and privatize the MSE, considering the country's potential for domestic capital market development at that time. Nonetheless, ADB assistance in establishing the umbrella regulatory authority (i.e. FRC) that has sole responsibility for consolidated regulating and supervising the entire nonbank and capital market sectors is regarded relevant.

57. **Effectiveness.** The strategy and program for development of the financial sector was assessed "effective." This result is supported by the program performance audit report FSPL I, program performance evaluation report on FSPL II, TA completion reports, and OED's TA performance evaluation reports done on six of the 18 completed ADTA projects. The Government and ADB were of the view that an efficiently functioning financial sector was the key to achieving a market-based economy for promoting rapid economic development, with the private sector as the engine of growth. That outcome was achieved successfully, in that the country now has a small but vibrant and efficient fully private sector-owned banking system (see Appendix 3 for banking sector developments); and nascent nonbank and capital market subsectors with prospects for future growth (see Appendix 4 for nonbank sector developments and Appendix 5 for capital market sector developments). They have, in turn, contributed positively to private sector development and overall economic development in the country (Appendix 6). The capital markets development effort made by ADB under the financial sector reform programs was less effective in privatizing the MSE and selling shares of SOEs through it. ADB assistance in creating functioning securities legislation and supervision structure was not effective at the completion of the TA. Despite the Cabinet passing a resolution in 2004 calling for privatization, MSE has not been privatized until now. FSPL II targets related to selling shares in SOEs through MSE were only partly met. However, the measures requiring changes in exchange rules and minimum capitalization levels for brokers were met.

58. The Government's intention to develop an efficiently functioning financial sector for promoting rapid economic development with the private sector as the engine of growth, largely

based on ADB assistance, was largely achieved. The country now has a vibrant and efficient, fully private banking system and nascent nonbank and capital market subsectors with prospects for growth. The banking system is now entirely privatized. The 16 banks in operation perform autonomously and efficiently with satisfactory growth in deposits and loans, returns on assets and equity, and easing nonperforming loan ratios.[14] Strong deposit and loan growth reflects improving public and investor confidence in the banking system. Real interest rates continue to be high but show a downward trend and should decline further with greater competition among banks and further diversification and deepening of the financial sector. The financial market has, in turn, contributed to private sector development and overall economic development. Bank loans have been predominantly for private sector development, which accounted for an average of 97% of total bank loans outstanding over 2002–2006. The private sector's contribution to GDP increased from only 3.3% in 1989 to 70.3% in 1999 and to 77.8% in 2006.

59. ADB support for capacity building covered a wide range of activities, such as commercial bank liquidation, restructuring, and privatization; upgrading commercial banking skills and management information systems; improving and strengthening the regulatory and supervisory framework of the BOM; introducing prudential norms and accounting and auditing standards to BOM and commercial banks in accordance with international practices (e.g., BIS and IAS); developing the regulatory and supervisory framework for promoting the nonbank and capital market sectors; introducing new financial products into the market such as mortgage finance[15], insurance schemes, pension systems, and trust and investment fund operations; and introducing an effective anti-money laundering regime. All of the advisory assistance served the objectives of reform formulation and implementation, as well as capacity development. Advisory assistance served to inform ADB-led policy dialogue and was well coordinated and sequenced with the support provided by other development partners. Overall, ADB advisory assistance contributed to establishing a fairly well regulated and supervised private and market-oriented banking system. BOM has become an independent and effective regulator of the banking sector. Under this strengthened regulatory and supervisory umbrella, the 16 privately owned commercial banks enjoy greater public confidence in their operations, operate autonomously under good governance codes, are competitive and profitable, and provide generally efficient banking services to the general public.

60. **Efficiency.** ADB's strategy and program was assessed "efficient." The program loans, project loans, and the TA projects were completed reasonably within the completion dates as forecast at the time of their respective appraisals. The efficiency could be judged by the present performance of the banking system. The banking system has now been entirely privatized. The 16 banks now in operation are performing autonomously and efficiently with satisfactory growth rates in deposits and loans,[16] returns on assets[17] and on equity,[18] and decreasing NPL ratios.[19] These data show they are providing efficient services to the public, while deposit and loan growth rates reflect increasing public and investor confidence in the banking system. Real

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[14] Deposits as a percentage of GDP rose from 17.6% in 2002 to 46.2% in 2007. Return on assets fell from a high of 4.3% in 2002 to 2.2% in 2005 but rebounded to 2.5% in 2007. Return on equity of 20.8% in 2002 fell to 12.1% in 2005 but rebounded to 20.8% in 2007. Similarly, loans outstanding as a percentage of GDP increased from 18.7% in 2002 to 46.8% in 2007. Nonperforming loans rose from 5.1% of the outstanding portfolio in 2002 to 6.4% in 2004, but eased to 3.2% in 2007.

[15] Of the total bank loan balance, the mortgage finance loan took 7.8% as of end of the second quarter of 2008.

[16] Deposits as a percentage of GDP increased from 17.6% in 2002 to 31.4% in 2006. Similarly, loans outstanding as a percentage of GDP increased from 18.7% in 2002 to 38.6% in 2006.

[17] Return on assets decreased from a high of 4.3% in 2002 to 2.2% in 2005 but increased to 2.7% in 2006.

[18] Return on equity of 20.8% in 2002 decreased to 12.1% in 2005 but increased to 14.3% in 2006.

[19] NPLs increased from 5.1% of the outstanding portfolio in 2002 to 6.4% in 2004, but decreased to 3.2% in 2007.

interest rates continue to be high but are showing a downward trend, and should decline further with greater competition among the banks and further diversification and deepening of the financial sector, supported by the expanding nonbank and capital market sectors. There were some inefficiencies with respect to the 2-year delay in the completion of FSPL II (including unsuccessful privatization of the MSE), cancellation of the rural finance loan, and the three TA projects whose outcomes were ineffective. However, on an overall basis, the program loans could be said to have been "efficient."

61. **Sustainability.** Overall, the sustainability of the outcomes of ADB's sector assistance is considered "likely." The reforms supported by ADB's program loans have helped BOM establish a sound regulatory, supervisory, and accounting/auditing framework for the banking system. It is being enforced effectively and the banking system is functioning well. The FRC that was recently set up is developing legal, regulatory, supervisory, and accounting/auditing frameworks for the nonbank and capital market sectors; work is progressing satisfactorily with substantial achievements expected by 2008. FRC has begun to supervise and control operations of NBFIs. The minimum capital requirement has been increased (to MNT200 million to enlarge the fund base for operations and reduce the impact of risk assets on the viability of NBFIs). The main challenges presently facing FRC are continued upgrading of regulations to meet international standards and enhance its capacity to provide strengthened supervision to the nonbank and capital market sectors. FRC, BOM, and the Ministry of Finance are actively cooperating in dealing with reform measures and the Ministry of Finance formed a new unit to focus on financial sector policy and capital market development. The authorities are aware of the fragility of the three subsectors and are taking steps to address this issue through further strengthening and enforcement of the regulatory frameworks, good governance practices, internal controls, and measures to increase investor confidence in the nonbank and capital market sectors. The smaller banks and insurance companies are particularly susceptible to adverse economic developments. The sustainability of ADB's capital development efforts will rest on the results expected to be achieved under the FRGP with regard to creating an adequate legal and institutional framework for capital market development and addressing supply problems.

62. **Impact.** The contribution of ADB's assistance for development of Mongolia's financial sector over the last 15 years is "substantial." This rating is based on a four-category scale of high, substantial, modest, and negligible. ADB's assistance helped Mongolia transform its mono-banking system to a two-tier system that is now privately owned and efficiently providing the banking services demanded by the general public and investors. It is now capable of responding to market signals and helping in the efficient operation of a market-based economy. The private sector has benefited most from this transformation. The loans given by the banking system have been predominantly for private sector development, averaging about 97% of total loans outstanding over 2002–2006. Accordingly, the private sector's contribution to GDP increased from only 3.3% of GDP in 1989 to 70.3% of GDP in 1999, and about 77.8% of GDP in 2006. The private sector's significant contribution to GDP also helped to accelerate the process of overall economic growth in the country.[20] GDP growth rate increased from 3.2% in 1999 to 9.9% in 2007.

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[20] Exports increased from $454.2 million in 1999 to $1,545.2 million in 2006; the current account balance turned a surplus of $63.4 million in 2004, increasing to $306.3 million in 2006; total foreign reserves increased from $155.9 million in 1999 (representing 14.3 weeks of imports) to $718 million in 2006 (representing 25.2 weeks of imports); inflation dropped from a high of 11% in 2004 to 6.0% in 2006; unemployment remained at a reasonable level of around 3.5%; and the exchange rate has remained steady around 1,200 MNT per US dollar.

63. The impact of ADB's capital market assistance remained relatively low. Nonetheless, capital market activity steadily increases, as the financial market broadens and alternative forms of investment finance and term savings instruments are adopted. Some 380 companies are listed on the MSE, slightly down from a high of 420 companies earlier in the decade, as efforts are made to improve the quality of the listed firms. Mining and telecommunication firms tend to dominate the market, which continues to trade but a few days per month. In 1998, about a third of the companies listed on the exchange (i.e. 129 firms) were government-owned, and today less than a tenth (32 firms) are publicly-owned. The value of the market capitalization has steadily increased over the past decade, rising from MNT51 billion (about $47 million) in 2002 to a high of MNT890 billion (about $761 million) in July 2008. Higher equity results from a combination of blue-chip firms entering the market (i.e., mobile telecommunication companies) and price appreciation. While high rates of interest on bank deposits discouraged investor interest in the debentures market, there continues to be growing investor interest in equities as the economy advances.

B. Top-Down Evaluation

64. **Positioning.** The IMF in early 1990s laid the foundation for macroeconomic stabilization, sustained economic growth, and for reforms necessary for successful completion of the transition to a market economy through its standby and enhanced structural adjustment facility arrangements. Thereafter, ADB took the lead role in developing Mongolia's financial sector (comprising the banking, nonbank, and capital market subsectors). ADB's role was in terms of continuing dialogue on policy and institutional reforms through three program loans, a number of ADTA grants to prepare the groundwork for bank restructuring, strengthening, and privatization, and by way of two project loans for diversifying and deepening of the financial sector through introducing new loan products for housing and rural finance. The World Bank, on the other hand, focused on reforming the SOEs, with emphasis on the six largest defaulters to the banking sector under its Banking and Enterprise Sector Adjustment Credit. In 2000, ADB was joined by the IDA/World Bank in developing the financial sector reform program that covered the various subsectors of the financial sector for parallel financing of the associated costs of structural adjustment.

65. Over the years, ADB had developed a comparative advantage in assisting the development of financial sectors, other than the development capital markets in several cases, having been engaged in similar financial sector developmental roles in other countries in the Asia-Pacific region. That institutional comparative advantage positioned ADB to effectively contribute to Mongolia's efforts to develop a financial sector–particularly the banking subsector–in line with that needed by a market-based economy. Mongolia now has a banking system that is soundly established, fast growing, vibrant, and fully privately-owned, and nonbank subsectors that lag behind the banking system but show good prospects for success in the future. This fact is a testimony to the effectiveness of ADB's long-term involvement in the sector strategy support over the last 16 years. Furthermore, ADB's program lending modality and related business processes that were applied to the three sequenced financial sector programs helped the Government to achieve many of the sector goals based on dynamic and comprehensive sector reforms.

66. There are two additional reasons underlying the effectiveness of ADB's support: (i) the Government's continuing commitment to aggressive formulation and implementation of policy and institutional reforms, often in the face of painful adjustment costs (liquidation of banks with resultant unemployment, loss of deposits by depositors following liquidation of some banks, and high interest rates); and (ii) the complementary and mutually supportive roles played by other development partners, mainly the IMF and the IDA/World Bank, which helped ADB make a

meaningful contribution. Taking all these positive factors into account, the overall positioning of the financial sector strategies for the evaluation period has been assessed “satisfactory.” This rating has been based on a four-category scale of highly satisfactory, satisfactory, partly satisfactory, or unsatisfactory. A summary evaluation of the positioning of ADB’s consecutive strategies is presented in Table 3 and detailed in Appendix 7 of this report.

Table 3: Rating of the Positioning of ADB Sector Strategies

	Criteria for Positioning						
Sector Strategy	**Sufficient Basis for the Strategy**	**Government’s Absorptive Capacity and Ownership**	**ADB’s Comparative Advantage and Partnership with Other DPs**	**Focus/ Selectivity and Synergies**	**Long-Term Continuity**	**Constraints/ Risks and Adjustment/ Monitoring Mechanisms to Achieve Targets**	**Weighted Average of All Criteria**
1991–1996	3 (HS)	3 (HS)	3 (HS)	3 (HS)	2 (S)	2 (S)	2.7
1997–2000	2 (HS)	2 (S)	3 (HS)	2 (S)	2 (S)	2 (S)	2.2
2001–2006	3 (HS)	2 (S)	2 (HS)	2 (S)	2 (S)	2 (S)	2.2
Overall							**2.4 (S)**

ADB = Asian Development Bank, DP = development partner, HS = highly satisfactory, S = satisfactory, PS = partly satisfactory; and US = unsatisfactory. The ratings were prepared following the *Guidelines for the Preparation of Country Assistance Program Evaluation Reports.*
Source: Operations Evaluation team.

67. ADB’s strategies for the financial sector remained “relevant” and consistent with those of the Government throughout the strategy and program formulation, evaluation, and implementation stages. There were many challenges and setbacks on the way, such as the Asian and Russian financial crises during the latter part of the 1990s, but the Government remained fully committed to and took full ownership of the strategies during the period. These positive aspects allowed ADB’s financial sector strategies to be implemented satisfactorily and reasonably within the estimated timeframes. They proved effective in yielding the expected benefits of transforming the mono-banking system into banking and nonbank systems (except for MSE) that are private sector-owned, function fairly well, are capable of responding to a market-based economy, and can facilitate private sector-led development in the country.

68. The positioning of the sector assistance program was assessed “satisfactory” on an overall basis. The assessment was based on a four-category scale of highly satisfactory, satisfactory, partly satisfactory, or unsatisfactory (Table 4). ADB’s sector assistance program was relevant and responsive during all stages of the project cycle and during this evaluation period. It remained consistent with the Government and ADB’s strategies for development of the financial sector and development objectives. It was also well coordinated and mutually supportive of the strategies of the IMF, IDA/World Bank, and other development partners. In terms of positioning over the last 15 years, ADB’s sector assistance has strengthened and improved the privately-owned commercial banking system, and broadened its scope to develop in parallel the nonbank and capital market subsectors, although the progress was slow in these subsectors. ADB’s comparative advantage in financial sector development work, covering both policy dialogue and support for phased sector reforms, except the lagging capital markets subsector, has proved useful in programming sector assistance for high impact and benefits.

Table 4: Evaluation Rating of the Positioning of Sector Assistance Programs

	Criteria for Positioning						
Sector Program	**Sufficient Basis for the Program**	**Government's Absorptive Capacity and Ownership**	**ADB's Comparative Advantage and Partnership with Other DPs**	**Focus/ Selectivity and Synergies**	**Long-Term Continuity**	**Constraints/ Risks and Adjustment/ Monitoring Mechanisms to Achieve Targets**	**Weighted Average of All Criteria**
1991–1996	3 (HS)	2 (S)	3 (HS)	3 (HS)	2 (S)	2 (S)	2.5
1997–2000	2 (HS)	2 (S)	3 (HS)	2 (S)	2 (S)	2 (S)	2.2
2001–2007	3 (HS)	2 (S)	2 (S)	2 (S)	2 (S)	2 (S)	2.2
Overall							**2.3 (S)**

ADB = Asian Development Bank, DP = development partner, HS = highly satisfactory, S = satisfactory, PS = partly satisfactory; and US = unsatisfactory. The ratings were prepared following the *Guidelines for the Preparation of Country Assistance Program Evaluation Reports.*
Source: Operations Evaluation team.

69. **Contribution to Development Results.** ADB's financial sector program contribution to the achievement of development results at a national level is rated "substantial." There were positive synergies arisen from ADB support in the financial sector to other sectors through the drastically improved financial intermediation. These include financial sector's contribution to the private sector in general (para. 58) and the agriculture and agribusiness, small and medium enterprises, trading, housing, construction, and mineral sectors specifically. These, in turn, have contributed to the higher level economic growth, poverty reduction and improvement of overall livelihood, regional cooperation, and the private sector development.

C. Assessment of ADB Performance

70. ADB's performance in the sector was "satisfactory." A considerable amount of effort and funds were spent in researching, analyzing, formulating, and prescribing policy reforms that were efficient and effective in facilitating the transformation process. That was done through TA. During the 15–year period of ADB's involvement, the policy reforms and human resource and institutional development work continued to be focused in financial sector development, with sufficient flexibility to respond to challenges posed by the changing political and economic environments (as occurred in the late 1990s). ADB also adopted a balanced approach to sector development. Initially, the focus was on the transformation of the mono-banking system into a two-tier system. Once that was achieved, ADB continued to expand and strengthen the banking system, but at the same time widened the focus to include development of the nonbank and capital market sectors, and diversification and deepening of the financial sector. That approach was intended to make available alternative mechanisms and institutions for depositors and borrowers that would make the financial sector more competitive and efficient.

71. However, ADB had some shortfalls in its engagement in the sector. While dealing with very complex financial sector programs, it lacked consistent, sufficient level of supervision to ensure their effective implementation. Either the provided staff deployment or the level delegation to the resident mission for the program implementation supervision and portfolio management remained weak and inconsistent. The program delivery in the capital markets subsector in particular has sometimes been rather sketchy and ineffective, leaving the key issues such as the privatization of the MSE and the expansion of the stock market operations still unresolved.

72. The failure of the canceled rural finance loan, only a small portion of which was utilized, can be attributed to a faulty project design by ADB. Too much emphasis was laid on the SCCs system for dispensing loan proceeds, although alternative credit vehicles could have been considered (e.g., the banking system and nongovernment organizations). In addition, changes could have been implemented even after ADB found the SCCs system to be incapable of dispensing the credit as originally conceived, by dispensing the credit through the banking system, instead of canceling the major portion of the loan (about $7.69 million or 90%). That action denied access to credit by the rural sector at a time when there was a large unfulfilled gap in the supply of rural credit.

D. Overall Evaluation

73. The overall rating based on the bottom-up and top-down assessments of ADB assistance in the financial sector is “successful” with scope for improvement in ADB’s future engagement in the sector.

VI. LESSONS IDENTIFIED

74. Several lessons are evident from ADB’s sector strategies and program designs and the way ADB supervised their implementation. The key lesson identified and worthy of replication in future ADB operations in similar situations is that the success of the strategies and programs was attributed to (i) the Government’s continued commitment and ownership of the programs and the way the programs were formulated and implemented through a combined effort of the Government and the key donors, with ADB playing the lead role; and (ii) the emphasis placed on privatization of the banks, rather than restructuring them under the same government ownership, which allowed a more efficient and effective financial intermediation system to be put in place.

75. Another key lesson identified was that ADB should not overestimate the capacity of the Government or the political will present to formulate and implement reforms and new laws and/or amend existing ones. Many other sectors were also undergoing reforms (e.g., health and education), and institutions such as the Parliament, the Cabinet and the Ministry of Justice were consequently overburdened with reform-related requests. Under the circumstances, the chances of new reforms and laws and/or amendments to existing laws being considered and approved by the respective authorities would have improved had they been better sequenced and phased, and presented more convincingly following additional research and analysis.

76. With regard to ADB’s engagement in the sector, dealing with complex financial sector program loans—particularly those involving policy reforms, new laws and/or amendment of existing laws, and human resource and institutional development goals—requires consistent, long-term program supervision to ensure effective implementation. Such programs should be provided with enhanced supervision budgets and staff incentives, and staffed by individuals with the skills required to enable them to undertake the needed supervision. Also, difficulties in developing capital markets (i.e., stock and bond markets) in a small economy with a small number of inexperienced formal sector players should have been carefully estimated and judged in developing policy reform steps for the subsector. The program condition to privatize the MSE by June 2003 turned out to be premature considering the much underdeveloped stock market and the overall capacity deficiencies in the government-owned institution.

77. As in the case of the rural finance loan that was canceled during implementation, ADB’s project performance monitoring mechanisms should have been strengthened to watch for early

warning signals of projects that were running into difficulties, so that proactive steps could be taken to resolve impending problems before they actually occurred. Such actions would have prevented unwarranted and premature loan cancellation and avoided the waste of the considerable government and ADB resources expended on program/project processing.

VII. FUTURE CHALLENGES, OPPORTUNITIES, AND RECOMMENDATIONS

A. Commercial Banking Sector

78. The commercial banking system faces many challenges, including (i) coping with a rather volatile economy based on a few commodity exports; (ii) the relatively large number of fully privatized banks; (iii) the marginal profitability of some of the smaller banks because of intense competition for deposits intake and resulting reduced margins; (iv) rapid expansion of banking operations, in terms of deposits and lending; (v) the need to keep NPLs at a manageable level under expanding loan portfolios; (vi) the need for upgrading of staff skills and capacity enhancement at both the central bank and commercial bank levels to meet the expanded operations; (vii) the reduced emphasis being placed by private banks on promotion of SMEs and rural development through appropriate lending instruments and mechanisms; (viii) the need to further reduce high real interest rates; and (ix) the need to become conversant with the increasing sophistication (in terms of business practices) of a market-oriented economy, such as the growing number of large business groups/families with varied interests in banking, insurance, manufacturing, and other commercial activities.

79. BOM is aware of these challenges, constantly reviewing developments, and taking steps to deal with them through appropriate action. It has faced similar or more difficult situations before, in the late 1990s; by learning from these experiences, BOM appears confident that it can adequately meet these new challenges as well. The banking sector still dominates the financial sector, controlling over 90% of its total assets.

80. These challenges open some opportunities for ADB as well. In order to maintain the stability of the banking system, there is a need for continued strengthening of the regulatory, supervisory, governance, internal control, and accounting/auditing frameworks. ADB can be open to assisting further reform processes using suitable assistance modalities to meet these new challenges and opportunities.

81. The smaller commercial banks (about five in number) operate on a marginal basis in terms of deposit and lending operations, internal controls, staff skills, and profitability. They will face challenges to remain viable in the face of any volatility in the economy, and there is opportunity for their further strengthening in the above areas. In this context, ADB may consider equity and loan investments in some selected banks to strengthen their capital structures; widen the long-term resource base; strengthen their governance, internal control, and risk assessment in accordance with best international practice; and improve their overall viability. Another opportunity will likely emerge with the Government's present proposal to open the banking system to undertake nonbank and capital market activities (e.g., fund placement, initial public offerings, and underwriting). ADB may look into helping introduce these new products to the banking system.

82. Because of the present short-term nature of deposits raised by commercial banks, they are able to provide only short-term loans that are more suitable for trading, microfinance, and consumer finance. Given the circumstances, SMEs that require longer-term loans (say, up to 5 years) have limited access to bank finance at present. There is an opportunity to fill this gap in

the supply of appropriate funding for SME development for employment generation and poverty alleviation. It is recommended that ADB examine the prospects for introducing longer-term deposit and loan instruments and products for SME promotion. The rural finance sector continues to be poorly serviced, because commercial banks find business opportunities in the urban centers easier to access and more profitable. Three commercial banks[21] are operating successfully and profitably by providing mainly micro and rural finance. ADB may investigate the possibility of using these three banks to channel a credit line to meet the country's rural finance supply gap.

83. ADB's housing finance loan introduced primary mortgage finance into the country for the first time, and the policies and procedures it introduced are now being used by commercial banks for the new mortgage finance product they are now promoting. Based on the success of primary mortgage finance, private commercial banks, with the support of the Government, have established the Mongolia Mortgage Corporation to promote a secondary mortgage finance market, and are looking into prospects for securitization opportunities. This is another challenge and drawing the attention of several aid agencies. In close consultation with them, ADB may also examine the possibilities of providing assistance for development of this new secondary mortgage product by way of strengthening the legal and regulatory framework, and perhaps providing equity and loan support for the mortgage corporation for further promotion of housing development and the attended benefits that would accrue for the economy in terms of new business opportunities and employment generation.

B. Nonbank and Capital Market Sectors

84. The FRC was set up in early 2006 as the umbrella authority to supervise both nonbank (nonbank financial institutions, securities companies, insurance companies, and SCCs) and capital market sectors, including the MSE and the Securities Clearing House and Central Depository. It is faced with the challenge of filling the gaps in the legal framework and strengthening the regulatory, supervisory, governance, internal control, and accounting and auditing frameworks. It has a tremendous workload in this regard but is severely constrained in terms of resources (physical infrastructure, organization and management, staff and knowledge capacity, and capital and operational budgets) (Appendixes 4 and 5).

85. It is also faced with the challenge of increasing public confidence in the capital markets and helping guide future growth, including: (i) the need for listed companies to prepare their financial statements accurately and on time, with full accountability and transparency, and to publish all company information that needs to be in the public domain on a timely basis; (ii) training of local audit companies to audit their financial statements accurately, on a timely basis, and in accordance with the responsibilities as laid down in the IAS; (iii) preventing insider trading and off-exchange trading, which despite significant reductions due to the specialized operations of MSE and Securities Clearing House and Central Depository (SCHCD), nevertheless require close vigilance by FRC to ensure they do not recur; (iv) educating the general public and market players on their respective rights and responsibilities and the importance of self-regulation for mutual benefit; and (v) the need to introduce quickly the laws for promotion of trust and investment fund operations as required by ADB. The FRC, MSE, and SCHCD are aware of these challenges and are taking steps to meet them adequately.

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[21] These are Xac Bank, Khan Bank, and Mongol Post Bank.

86. The FRC requires external assistance from the Government and donors to achieve these objectives, providing an opportunity for ADB. ADB may look into suitable modalities for assisting the Government's capital market development initiatives to support policy reform and capacity enhancement of the authority, covering both the nonbank activities to be undertaken by commercial banks and the work that FRC needs to undertake for further development of the nonbank and capital market sectors, as outlined above.

Recommendation	Responsibility	Timing
A. Recommendations for the Commercial Banking Sector		
1. **Assist further banking sector reforms.** In order to maintain the stability of the banking system, there will be a need to continue strengthening the regulatory, supervisory, governance, internal control, and accounting/auditing frameworks. ADB may consider supporting further reforms in the banking sector using its suitable modalities to meet the challenges and opportunities the sector faces.	East Asia Department	The new Mongolia CPS to address this over 2009–2011.
2. **Consider equity and loan investments by private sector operations.** ADB needs to consider equity and loan investments in some selected banks to help strengthen their operational capacity and systems and induce best international practices. Another opportunity will likely emerge with the Government's present proposal to open the banking system to undertake nonbank and capital market activities (e.g., fund placement, initial public offerings, and underwriting). ADB may look into helping introduce these new products to the banking system.	Private Sector Operations Department, East Asia Department	As soon as possible. Also, the new Mongolia CPS to address this over 2009–2011.
3. **Examine the prospects for introducing longer-term deposit and loan instruments and products for SME promotion**. ADB can investigate the possibility of using commercial banks for channeling a credit line to meet the gap in the supply of rural finance in the country.	East Asia Department	The new Mongolia CPS to address this over 2009–2011.
4. **Support the rural finance.** ADB investigate the possibility of using successful banks to channel a credit line to meet the country's rural finance supply gap.	East Asia Department	The new Mongolia CPS to address this.
5. **Support development of the housing finance market.** In consultation with other aid agencies, ADB needs to examine the possibilities of providing assistance to the new secondary mortgage product through strengthening the legal and regulatory framework, and perhaps providing equity and loan support for the mortgage corporation.	Private Sector Operations Department, East Asia Department	The new Mongolia CPS to address this over 2009–2011.
B. Recommendations for the Nonbank and Capital Market Sectors		
6. **Support development of nonbank and capital market sectors.** ADB may examine suitable modalities to support policy reform and capacity enhancement in terms of human resource and institutional development, covering both the nonbank activities to be undertaken by commercial banks and the work that FRC needs to undertake for further development of the nonbank and capital market sectors.	East Asia Department	Examine it as soon as possible, so that. the new Mongolia CPS can address this over 2009–2011.

ASIAN DEVELOPMENT BANK LOANS AND TECHNICAL ASSISTANCE FOR MONGOLIA (1991–2007)

Table A1.1: Loan Projects

Project Reference Number/Title		Amount $ million	Approved	Current Status	PCR/ Rating	PPER/ Rating
1509	Financial Sector Program Loan	35.0	19 Dec 1996	Closed	NR	S
1510	Upgrading Skills and Systems of Commercial Banks (TA Loan)	3.0	19 Dec 1996	Closed	PS	
1743	Second Financial Sector Reform	15.0	22 Jun 2000	Closed	S	S
1847	Housing Finance (Sector)	15.0	18 Oct 2001	Closed		
1848	Rural Finance	8.7	25 Oct 2001	Active		
2218	Financial Regulation and Governance Program	10.0	15 Jun 2005	Active		
	Total	**86.7**				

NR = No Rating, PCR = project completion report, PPER = project performance evaluation report, PS = Partially Successful, S = Successful. TA= technical assistance.

Source: Asian Development Bank.

Table A1.2: Advisory Technical Assistance

TA Reference Number/Title		Amount ($'000)	Date Approved	Current Status	TCR/ Rating	TPER/ Rating
1536	Adviser to Mongolian Stock Exchange	100.0	17 Jul 1991	Closed		
1542	Training for the Mongolian Stock Exchange	95.0	24 Jul 1991	Closed		
1643	Institutional Support to the Mongol Bank	100.0	02 Jan 1992	Closed		GS
1855	Institutional Strengthening of the Financial Sector	595.0	17 Mar 1993	Closed	PS	PS
2219	Strengthening of the Commercial Banking System	600.0	05 Dec 1994	Closed	GS	
2353	Strengthening of Financial Intermediaries	600.0	30 Jun 1995	Closed	GS	GS
2371	Administrative Reform of Social Insurance	900.0	28 Jul 1995	Closed	GS	
2390	Improving Accounting and Auditing System	600.0	05 Sep 1995	Closed	GS	
2543	Development of Procedures for the Reconstruction and Liquidation of Insolvent Banks	100.0	19 Mar 1996	Closed		GS
2605	Development of Bank Restructuring Strategies	100.0	09 Jul 1996	Closed		GS
2697	Implementation of Bank Restructuring Strategies	100.0	03 Dec 1996	Closed		PS
2720	Strengthening of Supervisory and Restructuring Capacity of the Bank of Mongolia	1,000.0	19 Dec 1996	Closed	GS	
2797	Development of a Regulatory Framework for Nonbank Financial Institutions	100.0	20 May 1997	Closed		
2964	Improving Accounting and Auditing Systems	688.0	23 Dec 1997	Closed	GS	

TA Reference Number/Title		Amount ($'000)	Date Approved	Current Status	TCR/ Rating	TPER/ Rating
3208	Strengthening Restructuring of the Banking System	220.0	17 Jun 1999	Closed	GS	
3459	Strengthening Financial Sector Development	600.0	22 Jun 2000	Closed	PS	
3709	Strengthening Policy for Social Security Reform	600.0	28 Aug 2001	Closed	PS	
3904	TA to Support Privatization in the Banking Sector	150.0	23 Aug 2002	Closed		
4393	Establishing an Effective Anti-Money Laundering Regime	500.0	17 Sep 2004	Active		
4737	Capacity Building for Financial Sector Reforms	900.0	15 Dec 2005	Active		
4910	Strengthening the Pension System	650.0	20 Dec 2006	Active		
	Total	**9,298.0**				

GS = Generally Successful, PS = Partially Successful, TA = technical assistance, TCR = technical assistance completion report, TPER = technical assistance performance evaluation report.
Source: Asian Development Bank.

Table A1.3: Project Preparatory Technical Assistance

TA Reference Number/Title		Amount ($'000)	Date Approved	Current Status	TCR/ Rating	TPER/ Rating
3397	Rural Finance	700.0	02 Feb 2000	Closed		
3406	Housing Sector Finance	600.0	02 Mar 2000	Closed		
4236	Third Financial Sector Program	500.0	03 Dec 2003	Closed		
	Total	**1,800.0**				

TA = technical assistance, TCR = technical assistance completion report, TPER = technical assistance performance evaluation report.
Source: Asian Development Bank.

PERFORMANCE RATING OF ADB PROGRAMS, PROJECTS, AND TECHNICAL ASSISTANCE PROJECTS IN THE FINANCIAL SECTOR

Table A2.1: Performance Rating of Programs and Projects

Program/Project	Relevance	Effectiveness	Efficiency	Sustainability	Impact	Overall Rating	Overall Rating
A. Program Loans							
1. FSPL I (completed)	2	4	2	4	4	16	Successful
2. FSPL II (completed)	2	4	2	4	4	16	Successful
3. FRGP[a] (ongoing)	3	4	2	4	4	17	Successful
B. TA Loans							
4. Upgrading Skills and Systems of Commercial Banks	2	3	2	3	3	13	Partly Successful
C. Project Loans							
5. Housing Finance (completed)	3	4	2	4	6	19	Successful
6. Rural Finance (canceled)	2	0	0	0	0	2	Unsuccessful
7. Loan and Equity Investment in TDB (completed)	3	4	2	4	4	17	Successful

FRGP = Financial Regulation and Governance Program, FSPL = Financial Sector Program Loan, TA = technical assistance, TDB = Trade and Development Bank.

Notes:

1. Relevance: highly relevant (3 points), relevant (2 points), partly relevant (1 point), and irrelevant (0 point).
2. Effectiveness: highly effective (6 points), effective (4 points), less effective (2 points), and ineffective (0 point).
3. Efficiency: highly efficient (3 points), efficient (2 points), less efficient (1 point), and inefficient (0 point).
4. Sustainability: most likely (6 points), likely (4 points), less likely (2 points), and unlikely (0 point).
5. Impact: high (6 points), substantial (4 points), modest (2 points), and negligible (0 point).
6. Overall rating: highly successful (20 points and above), successful (16–19 points), partly successful (11–15 points), and unsuccessful (10 points or less).

Source: Operations Evaluation Mission.

Table A2.2: Performance Rating of Advisory Technical Assistance Projects

TA Reference Number	Title	Amount ($'000)	Date Approved	Current Status	TCR/ Rating	TPER/ Rating	SAPE Rating
1536	Adviser to Mongolian Stock Exchange	100.0	17 Jul 1991	Closed			GS
1542	Training for the Mongolian Stock Exchange	95.0	24 Jul 1991	Closed			GS
1643	Institutional Support to the Mongol Bank	100.0	02 Jan 1992	Closed		GS	GS
1855	Institutional Strengthening of the Financial Sector	595.0	17 Mar 1993	Closed	PS	PS	PS
2219	Strengthening of the Commercial Banking System	600.0	05 Dec 1994	Closed	GS		GS
2353	Strengthening of Financial Intermediaries	600.0	30 Jun 1995	Closed	GS	GS	GS
2371	Administrative Reform of Social Insurance	900.0	28 Jul 1995	Closed	GS		GS
2390	Improving Accounting and Auditing System	600.0	05 Sep 1995	Closed	GS		GS

TA Reference Number/Title		Amount ($'000)	Date Approved	Current Status	TCR/ Rating	TPER/ Rating	SAPE Rating
2543	Development of Procedures for the Reconstruction and Liquidation of Insolvent Banks	100.0	19 Mar 1996	Closed		GS	GS
2605	Development of Bank Restructuring Strategies	100.0	09 Jul 1996	Closed		GS	GS
2697	Implementation of Bank Restructuring Strategies	100.0	03 Dec 1996	Closed		PS	GS
2720	Strengthening of Supervisory and Restructuring Capacity of the Bank of Mongolia	1,000.0	19 Dec 1996	Closed	GS		GS
2797	Development of a Regulatory Framework for Nonbank Financial Institutions	100.0	20 May 1997	Closed			PS
2964	Improving Accounting and Auditing Systems	688.0	23 Dec 1997	Closed	GS		GS
3208	Strengthening Restructuring of the Banking System	220.0	17 Jun 1999	Closed	GS		GS
3459	Strengthening Financial Sector Development	600.0	22 Jun 2000	Closed	PS		PS
3709	Strengthening Policy for Social Security Reform	600.0	28 Aug 2001	Closed	PS		PS
3904	TA to Support Privatization in the Banking Sector	150.0	23 Aug 2002	Closed			GS
4393	Establishing an Effective Anti-Money Laundering Regime	500.0	17 Sep 2004	Active			GS
4737	Capacity Building for Financial Sector Reforms	900.0	15 Dec 2005	Active			GS
4910	Strengthening the Pension System	650.0	20 Dec 2006	Active			PS
	Total	**9,298.0**					

TA = technical assistance, TCR = technical assistance completion report, TPER = technical assistance performance evaluation report, GS = Generally Successful, PS = Partially Successful.
Source: Asian Development Bank.

Table A2.3: Performance Rating of Project Preparatory Technical Assistance Projects

TA Reference Number/Title		Amount ($'000)	Date Approved	Current Status	TCR/ Rating	TPER/ Rating	SAPE Rating
3397	Rural Finance	700.0	02 Feb 2000	Closed			US
3406	Housing Sector Finance	600.0	02 Mar 2000	Closed			GS
4236	Third Financial Sector Program	500.0	03 Dec 2003	Closed			GS
	Total	**1,800.0**					

GS = Generally Successful, SAPE = Sector Assistance Program Evaluation, TA = technical assistance, TCR = technical assistance completion report, TPER = technical assistance performance evaluation report, US = Unsuccessful.
Source: Asian Development Bank.

BANKING SECTOR DEVELOPMENTS

A. Overview

1. The Bank of Mongolia (BOM, the central bank) has now become an independent and effective regulator of the banking sector. Under this strengthened regulatory and supervisory umbrella, the commercial banks are now enjoying greater public confidence in their operations, enabling them to play a positive role in deposit mobilization and efficient allocation of resources for their most productive use. The 16 commercial banks presently operating in the country are now fully privately-owned, operate autonomously under good governance codes, are competitive and profitable, and are providing efficient banking services to the general public. The resultant improved financial intermediation system has helped accelerate the process of economic development.

Table A3.1: List of Banks in Operation
(as of July 2007)

No.	Name	Foreign Investment	Management	Area	Number of Branches
	Large Banks (Assets over MNT100 billion)				
1	Golomt Bank			Urban	42
2	Trade and Development Bank	Yes	Foreign	Urban	20
3	Khan Bank	Yes	Foreign	Rural	440
4	Anod Bank			Urban	21
	Medium Banks (Assets over MNT30–100 billion)				
5	Mongol Post Bank			Rural	227
6	Chinggis Khan Bank	Yes	Foreign	Urban	2
7	Savings Bank	Yes	Foreign	Urban	43
8	Zoos Bank	Yes		Urban	32
9	Kapitron Bank			Urban	16
10	Xac Bank	Yes	Foreign	Rural	39
11	Ulaanbaatar Bank			Urban	9
	Small (Assets below MNT30 billion)				
12	Capital Bank	Yes		Urban	27
13	National Investment Bank	Yes		Urban	1
14	Credit Bank	Yes		Urban	7
15	Transport Bank	Yes	Foreign	Urban	3
16	Erel Bank			Urban	5
	Total				**934**

Note: Classification of banks as large, medium, and small is informal, and for analytical purposes only.
Source: Bank of Mongolia.

2. The Central Bank Law and the Banking Law clearly define the role of the central bank in regulating, supervising, and controlling commercial banking activities. Since 2006, in order to further strengthen BOM's governance structure, two non-executive directors have been appointed to its Board of Directors. The basic framework to carry out those responsibilities is firmly laid down, meeting international standards, and at present appears to be enforced effectively.

3. However, the central bank faces many challenges, including (i) coping with a rather volatile economy based on a few commodity exports; (ii) the relatively large number of fully privatized banks; (iii) the marginal profitability of some of the smaller banks, resulting from

intense competition for deposits and resulting in reduced margins; (iv) rapidly expanding banking operations, in terms of deposits and lending; (v) the need to keep nonperforming loans at a manageable level under expanding loan portfolios; (vi) the need to upgrade staff skills and capacity enhancement at both the central bank and commercial bank levels, so as to meet the needs of expanded operations; (vii) the reduced emphasis given by private banks to promotion of small and medium-sized enterprises and rural development through appropriate lending instruments and mechanisms; (viii) providing assistance to further reduce real interest rates; and (ix) dealing with increasingly sophisticated business practices present in a market-oriented economy, such as the growing number large business groups/families with varied interests (e.g., in banking, insurance, manufacturing, and other commercial activities). BOM is aware of these challenges, and is constantly reviewing developments and taking steps to address them through appropriate actions. It faced similar or more difficult situations previously (in the late 1990s), has learned from those experiences, and appears confident in its ability to adequately address these new challenges. The banking sector dominates the financial sector, controlling over 90% of its total assets.

4. Draft legislation is expected to be considered by Parliament before end-2007 that would amend the central banking and banking laws and enable commercial banks to engage in nonbanking activities such as underwriting and private fund placement, for which there appears to be a growing demand. This would (i) provide commercial banks with wider opportunities to invest their excess liquidity in different instruments and diversify their portfolios, (ii) help reduce interest rates through the use of competitive instruments, and (iii) generally contribute to greater diversification of the country's financial system. This would also expand the scope of BOM's activities to include examining, supervising, controlling, and reporting accurately on these nonbanking activities on a consolidated supervision basis in conjunction with the Financial Regulatory Commission (FRC). BOM's capacity would need to be enhanced in terms of organization, management, staff, policies, and procedures to cope with this additional challenge.

5. There have been other positive developments that would bring greater stability to the banking and financial sectors. In 1997, a credit information bureau was established within BOM. It helps to reduce potential bad debts as well as loan transactions costs of commercial banks by making available credit histories and credit performance information on prospective borrowers for credit and risk analysis**.** An anti-money laundering law, prepared with the assistance of Asian Development Bank (ADB) technical assistance (TA), was passed by Parliament in July 2006; a financial intelligence unit (FIU) was established within BOM, in accordance with international standards, and began operations in November 2006. Its role is to manage potential risks to the banking sector arising from suspicious cash and other bank transactions. The Government is also preparing a proposal for approval before end-2007 to establish a deposit insurance scheme to protect (particularly small) depositors, increase public confidence in the banking system and further facilitate deposit mobilization. The most recent development has been the establishment of a Financial Stability Board comprising three high level members—the minister of finance, governor of BOM and chairman of the FRC—with the objective of adopting a macro risk-management approach to joint forecasting of financial sector developments and assessment of likely risks, enabling recommendations to the appropriate authorities regarding coordinated actions to manage sector-wide risks more proactively and effectively. It will periodically publish financial stability reviews. These institutions/mechanisms are discussed in detail below. They should help the financial sector cope with likely adverse impacts arising from excessive competition in the banking sector, a slowdown in economic growth, and/or external shocks.

6. **Prudential Regulations*.*** The Basle II Accord requires about 25 regulations to be introduced and implemented by central banks. BOM has implemented 23 of these, while one

pertaining to overseas branch operations is considered inapplicable, as no Mongolian banks currently have any overseas branch operations. The remaining regulation relating to supervision of consolidated accounts of group businesses is being partially complied with. Amendments to the central banking and banking laws referred to earlier would provide for supervision of these consolidated accounts, and provide for a safety net to protect BOM's bank supervisors against possible litigation by commercial banks in the course of performing their bank supervision duties.[1] The banks are also subject to legal lending limits (e.g., single and group borrower limits).

7. **Accounting and Auditing Standards.** International accounting standards have been introduced. These are being implemented in a transparent manner with respect to the preparation of their accounts and audit statements by the large and some of the medium-sized commercial banks, and to a lesser extent by the smaller banks. The noteworthy features are: a more differentiated approach towards credit risk assessment for calculation of minimum capital requirements; stronger supervision of the adequacy of credit risk management processes and policies of commercial banks; additional bank information disclosure requirements that will enhance market transparency and market discipline; adequate loan provisioning against stringent rules for bad loan assessments and classification; and the calculation of the capital adequacy ratio (CAR) based on the risk-weighted assets formula. The CAR measures the ability of banks to cover credit and foreign exchange (FX) losses. Based on this formula, BOM insists on a minimum CAR of 10% for banks as against the minimum Basle II requirement of 8%. BOM requires three banks to meet a CAR of 12% in view of their higher loan asset risks. If the CAR falls below 10%, BOM recommends measures to improve the quality of assets and/or increase capital. The CARs of some banks are above the specified minimum limits. The risk-weighted CAR of all banks declined from 18.5% in March 2006 to 16.5% in March 2007, despite an increase in minimum capital required to MNT8 billion (about $7 million) in April 2006.[2] That decline occurred due to rapid credit growth outpacing the growth in capital. Nevertheless, the relatively high CARs, well above the minimum set by BOM, reflect the sound capital structures of the banks on an overall basis at present. However, the CAR levels of the smaller banks would need to be monitored carefully to maintain their viability in the face of intense competition and possible volatility in the economy. BOM considers the penalties for infringement too low and amendments to the central banking and banking laws are being prepared to increase them.

8. **Bank Supervision.** The basic framework for bank supervision, which should help BOM examine banks and enforce regulations more effectively, is now in place. Article 31 of the Banking Law specifies the actions that could be taken (such as revoking licenses and termination of the services of the chief executive officer) against commercial banks that violate the prudential regulations, accounting and auditing standards, legal lending limits and other applicable rules and regulations. BOM conducts onsite full examinations of all the 16 banks every year based on the "CAMELS" principles[3] and their adherence to prudential regulations and international accounting standards, as outlined above. These examinations are performed independently of the internal and external audits of the banks. Offsite examinations are done on the basis of the quarterly, 6-monthly and annual accounts submitted to BOM by the banks. Also, more sophisticated examination methods are now being adopted, in which attempts are made to

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[1] The present Banking Law states that there cannot be any litigation during the course of their work. The proposed amendments seek to strengthen that provision.

[2] The minimum capital requirement has been increased three times from MNT0.5 billion to MNT1.0 billion, then to MNT4.0 billion, and finally to MNT8.0 billion (about $7 million) in April 2006.

[3] Based on the CAMELS principles, banks are examined and audited on the basis of capital, assets, management, earnings, liquidity and sensitivity to market risks.

forecast the future financial and operational positions of the banks based on market sensitivity. Procedures are being developed to conduct consolidated supervision of varied business interests of banks and their owners. Two violations of the regulations have come to light recently.[4] Although they did not adversely affect public confidence in the banking system, they nevertheless revealed that BOM's supervision capability continues to have deficiencies, and would need to be considerably improved to prevent similar future occurrences.

9. **Ownership of Commercial Banks.** The Government has divested itself of all commercial banks, and the present 16 banks are now fully owned by the private sector. Only three are survivors of the previous two-tier regime, but these are now fully privatized, while the remaining 13 banks are new. Two are fully-owned by foreign investors, while another five have various proportions of foreign investment. Four of the 16 banks are informally categorized as large in size, seven as medium, and five as small. Mongolia has liberal rules allowing foreign banks to operate in the country, but none have shown interest to date. Foreign direct investment in the banking sector has increased slightly (from 2.3% of gross domestic product [GDP] in 2002 to 3.3% in 2006) but remains a very small proportion of the total foreign direct investment in the country (geological prospecting and exploration [53%] and trading and catering [28%] were the two main recipients of foreign direct investment in 2006).

10. **Autonomy of Commercial Banks.** The banks are now fully autonomous, with no government involvement in their policy-making, management and operations. The "directed" credit and interest rate fixing regimes no longer exist. The shareholders now appoint their respective boards of directors and they in turn appoint their key management personnel. Six of the banks have foreign management.

11. **Governance of Commercial Banks.** All the banks practice good governance principles. BOM adopted the corporate governance regulation in 2006, with full enforcement starting in 2007; the law clearly delineates the various codes of corporate governance that boards of directors, senior management, and internal and external auditors need to observe. All commercial banks have internal auditors and audit committees that report directly to their respective boards of directors. Independent external auditors audit the annual accounts of all commercial banks, based on international accounting standards. Well-known and internationally reputed auditing firms audit the large and medium-sized banks, while the accounts of small banks are audited by local audit firms. Based on BOM requirements, all the banks now publish summaries of their financial statements and adherence to prudential ratios and legal lending limits on a quarterly basis in the country's major newspapers. These actions demonstrate the transparency of their financial positions and operations, and have also served to enhance the confidence of the general public and international business community in Mongolia's banking system. The four small banks appear to lag behind the others in terms of good governance practices. BOM is aware of their shortcomings in this regard and is taking steps to address the issue. All the banks are also registered as companies under the National Registration Office that

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[4] One violation relates to the misappropriation of cash at the Savings Bank, amounting to about $12 million in respect of an inter-branch/interbank transaction that was discovered by BOM during an onsite visit. It is understood that the new private owners of that bank have placed responsibility for meeting that loss with the Government, as the privatization agreements assigned responsibility for covering any liabilities prior to privatization to the Government. BOM has since improved its software for online checking of interbank settlements/balances within a few days of the transactions. The case is said to be now under investigation by the police department. The other violation relates to an alleged scam relating to a letter of credit opened by a local bank for import of about $70 million in goods. No details are available at present.

requires them to observe the various rules and regulations as prescribed by the Company Law of 1999.

12. **Deposits and Loan Growth.** Deposits with banks have been growing significantly, reflecting increasing public confidence in the banking system. This growing trend is due to the expanding economy, increased foreign worker remittances and foreign direct investment inflows. Time and term deposits have been increasing by about 30%–40% per annum since 2002. Deposits as a percentage of GDP increased from 17.6% in 2002 to 31.4% in 2006. The increasing deposits have enabled the banks to expand their lending considerably, mainly to the private sector, recording an annual credit growth of over 50% during 2002–2005. The other factors that led to the sharp credit expansion are the robust economic growth and competition among the banks. Bank loans to the public sector (mainly utilities) have been negligible, averaging about 2.7% of the total loans outstanding over the 5-year period 2002–2006; this signifies a complete shift[5] from the lending structure under the previous system, in which bank loans to the public sector predominated. Similarly, loans outstanding as a percentage of GDP increased from 18.7% in 2002 to 38.6% in 2006.

13. **Loan Portfolio Diversification.** The loan portfolios of the 16 commercial banks are fairly well diversified. In 2006, the industrial sector/processing took up the largest portion (34%), followed by trade (27%), agriculture (11%), construction (11%), mining (3%), transportation (1%) and others (13%). Thus, a downturn in any particular sector would not adversely affect the viability of the banking sector as a whole. However, in 2006, most loans were short-term (57%), followed by medium-term (38%) and long-term (over 5 years; 5%) loans. This heavy bias towards short-term lending results from the short-term nature of the deposit structure. There appears to be an urgent need to develop more long-term deposit and lending instruments, particularly to promote development of more small- and medium-sized enterprises for employment generation and poverty reduction. Also, with only three banks servicing the rural areas, including one specializing in rural credit, there appears to be a need to spread banking into rural areas to provide competition and to improve their services in the rural areas.

14. Another characteristic of the loan portfolio is the fairly large content of FX-denominated loans. The FX-denominated loan portfolio as a percentage of the total portfolio increased from 37.6% in 2002 to 43% in 2006. The borrower and the banks are exposed to a FX risk in the event of a depreciation of the togrog. To guard against this risk, the FX risk is carefully assessed by banks and covered either through FX inflows, FX deposits of the borrower, or through higher interest rates.

15. **Interest Rates on Deposits and Loans and Interest Spread.** Interest rates for both deposits and loans are now fully liberalized with the banks being free to charge interest on a risk-reward basis. Market interest rates are showing a declining trend with the increasing competition and gradual decrease in the inflation rate, with lending rates dropping faster than those on deposits. The lending rates have dropped from 26.6% in 2002 to 20% in 2006,[6] while

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[5] BOM regulations allow banks a net-open position not to exceed 15% of capital for one currency and 40% for all currencies. If the total FX exposure is measured in terms of the value at risk (VAR) method then, the VAR cannot exceed 10% of capital. Only one bank calculates this risk on that basis and using a management information system model. Other banks calculate the net-open position on the basis of total FX liabilities-total FX assets.

[6] The lending interest rate is the arithmetic average of the weighted averages of domestic currency loans and FX loans.

deposit rates have dropped from about 14% in 2002 to 13.5% in 2006.[7] The interest spread has also dropped from 15.4% in 2002 to 8.9% in 2006, but nevertheless remains attractive.[8] The interest rates are positive in real terms, with inflation currently running around 6% at the end of 2006. Similarly, the weighted average interest rates on central bank (CB) -bills increased from 9.9% in 2002 to 15.75% in 2004, decreased to 4.75% in 2005, and then increased again to 6.42% in 2006. These high spreads may not be sustainable in the medium to long term, and a further drop could be expected with the rapid sophistication and expansion of the financial markets.

16. **Competition, Efficiency, and Viability.** Private enterprise has led to intense competition among banks for both deposits and loans, with the public benefiting from greater efficiency in meeting their demand for various banking services. The banks have developed some niche markets and specializations to cope with this competitive environment. Of the 16 banks, three specialize in rural areas, two in microfinance, and the balance in general banking activities. They have also increased their branch network from 682 in 2004 to 832 in 2006 to spread their outreach systems and develop business in rural areas.[9] The four large banks handle most of the corporate accounts, with total market share of about 40% for loans and about 72% for deposits, while the remaining 12 banks focus on consumer and retail banking services, controlling 60% for loans and about 28% for deposits. The attractive average spread of about 11.6% during the 5-year period 2002–2006 has enabled banks to be very profitable, with a return on equity of 20.8% in 2002; this decreased to 12.1% in 2005, and then increased again to 14.3% in 2006. Similarly, the return on assets decreased from a high of 4.3% in 2002 to 2.2% in 2005, and then increased to 2.7% in 2006. These returns are much higher than those achieved in some industrialized countries.[10] The smaller banks are less profitable, with return on assets of around 1.0% to 1.5% as a result of having to pay higher deposit rates to attract deposits. These returns are on an after-tax basis. The banks are subject to an effective tax rate of about 20%.[11] The profitability of banks would have been even higher if not for the BOM reserve requirement of 5% on all deposits (reduced from 14% in March, 2007), on which no interest is received. These high returns may not be sustainable in the medium to long term, and some decreases can be expected. The banks have set up specialized departments and/or divisions for risk-management (e.g., credit risk, FX risk) and for asset-liability management, in order to reduce risks and maintain high profitability levels.

17. **Status of Nonperforming Loans.** The aggregate nonperforming loans (NPLs) increased from MNT11.7 billion to MNT60.0 billion over 2002–2006. The ratio of NPLs to total loans outstanding increased from 5.1% in 2002 to 6.4% in 2004, and decreased to 4.9% in 2006. These ratios indicate that NPLs are at a manageable level. The larger banks show a

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[7] The deposit interest rate is the arithmetic average of the arithmetic averages of domestic currency deposits and FX deposits. The weighted averages on deposits cannot be calculated as yet due to the preponderance of deposits at different interest rates in the 16 different banks. BOM will calculate them in the near future with improvement in their management information system (MIS).

[8] The interest spread has been calculated as follows: interest income on loans/total loans x 100 – interest expenses on deposits/total deposits x 100.

[9] The 832 branches and other units at the end of 2006 comprised 118 branches, 662 payment and settlement centers, 31 cash offices, one money-changing unit, two representative units, and 18 others (advisory and other units all belonging to the Khan Bank).

[10] According to the International Monetary Fund's twice-yearly publication "Global Financial Stability Report", the returns on assets in 2006 were: Korea (1.3%), United States (1.4%), Czech Republic (1.4%), Hong Kong (1.7%), and Australia (1.8% in 2005).

[11] The present income tax rate on profits is 10% for the first MNT100 million of taxable income, and 25% on the excess of taxable income over MNT100 million. Interest income on government bonds is not taxable.

better NPL ratio, raising concerns about the continued viability of the smaller banks in the event of an economic slowdown and/or unexpected external shocks. The banks appear to be aware of this concern and are taking steps to meet the challenge, through strategic planning, strengthening of policies and procedures to meet international standards, product and customer diversification, development of niche markets, selective marketing, efficiency improvements in the provision of their services, and skills upgrading and capacity enhancement (paras. 20–21). The ratio of public sector NPLs to total loans outstanding was negligible, averaging about 0.3% during 2002–2006.

18. **Debt Recovery Process.** The debt-recovery process needs to be further expedited and the associated costs reduced. This would reduce loan transaction costs, enhance the efficiency of banking services, and further strengthen the financial intermediation process. A new law on immovable property that is in Parliament for approval before end-2007 would allow for non-judicial foreclosure of collateral, and allow banks to go directly to the Marshall's office to seize immovable property for auction without going through a lengthy court process, during which time the loan does not accrue interest. There is also a need to have a registration process for movable property (as exists for immovable property), and a means of registering property and liens more rapidly. At present, there is only one property registration office for immovable property. Regionalization of property registration in and outside Ulaanbaatar, with appropriate electronic communication and access, would accelerate the property registration and searching process. Two other new laws are also being processed with support from the United States agency for International Development, one to provide for asset-backed security, and the other for mortgage bonds. The ongoing staff training programs in credit and risk management, proper appraisal of property values, and legal documentation should reduce the need for litigation.

19. **Management information Systems.** The banks continue to install and improve their MIS, first introduced under ADB TA. Improvements are now being financed by banks from their own profits. Considerable information is produced on a regular basis on loans, deposits, cash balances, income, expenses and NPLs, assisting management to take effective decisions on various business matters. Branch offices are being continuously linked with head office operations. Staff members are being trained to cope with the expanding use of MIS, but systems in the smaller banks appear to need further strengthening, particularly to improve their internal controls.

20. **Banking Skills Upgrading.** Banks are placing a high priority on skills upgrading for (i) capacity enhancement, (ii) to cope with competition and any slowdown in economic expansion, and (iii) to increase efficiency in service provision. Staff training that supplements the training provided by the Bankers Training Center (BTC) (para. 21) is being done using four methods: (i) on-the-job training, (ii) classroom-type training on a structured basis, (iii) training provided by BTC, and (iv) the use of foreign training on an ad hoc basis, particularly by the larger banks. Staff training presently focuses on customer relations, MIS, credit and other forms of risk-management and asset-liability management. The banks that have foreign management appear to have an advantage in skills upgrading, particularly in the more sophisticated and modern methods of banking. Also, the smaller banks seem to recruit staff trained by the larger banks to quickly upgrade their skill base, particularly in the relatively weaker areas of risk management in a competitive environment, corporate governance practices, and introducing greater transparency in the preparation of their accounting statements.

21. ***Bankers Training Center.*** First established within BOM in 1993, BTC became dormant and was re-established in 1999 with ADB TA for furniture, equipment, MIS and training of trainers and bank staff. It is performing a useful purpose by training Mongolian bank staff and

thereby positively contributing to the stability of the banking system through improvement in the quality and efficiency of banking services in the country. Well-structured programs and training required on a case-by-case basis cover a wide range of subjects: basic entry-level training for new staff, training of loan officers on risk and asset-liability management, human resource development, and MIS. The yearly training program is designed in conjunction with the commercial banks and regularly updated based on market requirements. A BTC trainer and BTC-trained trainers from commercial banks and BOM conduct the training. Currently, the German Agency for Technical Cooperation (GTZ), with support from BOM and local trainers, has taken the lead role in training of trainers from commercial banks and commercial bank staff over a 4-year program (2005–2008). Training packages have been prepared for training of commercial bankers in three stages (basic, medium and advanced). Of the estimated 6800 staff presently in the banking industry, about 3,000 have been trained thus far (at the rate of about 1500 per year), and the balance of 3,800 are to be trained over the next 2.5 years, ending in 2010. Plans are also underway to train trainers and prepare training modules to provide training in (i) mortgage financing based on the experience of the ADB Housing Finance Loan, (ii) property valuation, (iii) securitization, and (iv) in the macroeconomic environment.

22. **Credit Information Bureau.** BOM established the bureau in 1997 to provide credit status information on prospective bank borrowers. The banks are using this facility, which is helping them reduce (i) exposure to potential bad debts, (i) loan transactions costs, and (iii) the need for recourse to the judicial system for recovery of bad debts. Its operations are being upgraded with the support of the World Bank. In addition, the Mongolia Bankers Association is working with the International and Finance Corporation, United States Agency for International Development, and the German Agency for Technical Cooperation (GTZ) to form another credit information bureau to further strengthen credit information operations in terms of expanding the information database, and the speed and efficiency of information dissemination. It is questionable whether there is room for two credit information bureaus to operate in the country's small financial system. A compromise may be to privatize the existing credit information bureau within BOM, and subsequently upgrade its operations through private management.

23. **The Financial Intelligence Unit and Anti-Money Laundering Law**, prepared with the assistance of ADB TA, was passed by Parliament in July 2006. It created FIU within BOM that meets international standards, and which began operations in November 2006. Its role is to manage potential risks to the banking sector arising from suspicious cash and other bank transactions. The FIU performs only investigative functions, dependently of BOM. The banks are required to report directly to FIU all cash transactions exceeding MNT24 million (about $18,000), and other transactions that appear suspicious; these are then investigated independently by FIU, which makes suggestions as to how these should be dealt with. Some suspicious cases are already being followed up by FIU, but it needs to strengthen its operations in terms of staff strength (it has only two staff at present), training, and coordination of its activities with those of the banks, BOM and the FRC. An independent, regionally based Asian and Pacific group of anti-money laundering institutions evaluates its operations on a mutual basis. The last evaluation was done in December 2006 and its results are awaited.

24. **Housing Finance.** ADB's Housing Finance Loan successfully introduced a housing finance instrument and vehicle for the primary market. Since then, most of the 16 commercial banks have started providing mortgage financing. The policies, procedures, legal documentation, and housing finance mechanism developed under the loan are now being used by the commercial banks to promote their mortgage financing facility. This has resulted in a construction industry boom; the demand for housing units far exceeds supply at present, due to current economic development and employment. It is yet to be determined whether the HFC will

be treated as a banking or nonbanking institution for regulation, supervision and control purposes. The progress of the construction industry boom will need to be watched closely by authorities to ensure a slowdown in the industry does not adversely affect the banking industry.

25. **Mongolia Mortgage Corporation.** Following the success of the housing finance loan scheme, the Government first established the Housing Finance Corporation in September 2006 with support provided by the United States Agency for International Development (USAID). It changed its name to Mongolia Mortgage Corporation in October 2006. The Mongolia Mortgage Corporation is a limited liability private sector company, jointly owned by a group of 10 banks (about 90% of the capital) and BOM (about 10% of the capital). It is the country's first secondary market company to develop affordable housing finance based on best international practice. Mongolia Mortgage Corporation's present paid up capital of MNT11 million will soon be raised to MNT 2.2 billion. It is now preparing the first securitization of a package of mortgages with the support of the International Finance Corporation (IFC), Kreditanstalt für Wiederaufbau (KfW), and USAID. As mentioned earlier, a Mortgage Law and a Mortgaged-Backed Securities Law are being prepared to support the proposed securitization program. The Mongolia Mortgage Corporation is currently collaborating with the Government on resolving the legal, regulatory and institutional issues necessary to promote development of the primary and secondary mortgage markets, and to standardize underwriting policies and documentation for issuance of loans on the primary mortgage market. Its present staff of three persons would need to be increased to meet its proposed activities.

26. **Financial Stability Board.** The most recent development has been the establishment of a Financial Stability Board by the three primary financial sector development authorities (Ministry of Finance, BOM, and FRC) with participation by three high-level members (the minister of finance, governor of BOM, and chairman of the FRC). They signed a memorandum of understanding in May 2007 with the objective of adopting a joint approach to macro risk management by (i) forecasting developments in the financial sector, (ii) assessing likely risks, and (iii) recommending coordinated action to the appropriate authorities to manage sector-wide risks in a more proactive and effective manner. The board meets jointly for this purpose as well as to prepare a quarterly financial stability review; it is supported by various specialized working groups (e.g., on research) and a small staff. These developments should help the financial sector weather adverse impacts arising from an economic slowdown and/or external shocks, and generally assist in stabilizing financial sector operations.

27. **Deposit Insurance Scheme.** The Government has also decided to establish a deposit insurance scheme to safeguard deposits, particularly those of small depositors, so as to encourage deposit mobilization and maintain the stability of the banking system. Legislation for this purpose is now being prepared for presentation to Parliament for consideration before end 2007.

28. **Interbank Market.** In line with ADB's recommendations, steps have been taken to develop the interbank market. BOM's liquidity support to the commercial banks has been largely halted, to encourage banks to manage liquidity among them. A number of liquidity support schemes have been abolished: (i) resource deficiency loans provided to commercial banks by BOM to support special economic activities, (ii) settlement clearing loans to meet banks' short-term liquidity needs associated with payments clearing, (iii) general liquidity support on a case-by-case basis, and (iv) the refinance facility. BOM has also eliminated credit ceilings on lending by banks to nonbanks. The only two remaining support schemes are an overnight facility (charging a very high interest rate as a penalty to encourage banks to first approach other banks for overnight liquidity, rather than BOM), and the repo facility.

29. In tandem, the auctioning of CB-bills has now been made the main policy instrument for monetary management and for development of the money market. Based on assessments of the excess liquidity in the market, every Tuesday, BOM announces the volume, maturity and maximum interest rates on CB-bills to be auctioned the next day. Banks have responded positively to this facility and it has proven a successful and effective monetary policy instrument. The volume of CB-bills auctioned has increased, but rather erratically, from MNT61,000 million in 2002 to MNT125,700 million in 2005 (due to excess liquidity in the market), and then dropping to MNT70,800 million in 2006. The weighted average CB-bill rate increased from 9.9% in 2002 to 15.75% in 2004, dropped to 4.75% in 2005, and increased again to 6.42% in 2006, due to excess liquidity in the market (from December 2004 onwards, data are shown at market price).

30. The operations of the interbank market remain small compared to those of the overall banking sector, mainly because of the market's excess liquidity. However, the framework for satisfactorily operating an interbank market in the country is now in place. Interbank operations totaled MNT74.9 billion as of 31 December 2005, but decreased to MNT58.2 billion as of 31 December 2006. The decrease was due to the reduced excess liquidity in the market in 2006.

31. The efficiency of interbank operations is considered to be improving, although there are still few products transacted among the banks. Investment products include interbank deposits, interbank loans, BOM CB-bills, repos on BOM CB-bills (7 and 91 days), and the recently introduced overnight product. BOM will soon change their bill products to have three maturity dates (7, 84, and 364 days), and revise the auction process to further develop the interbank market.

32. BOM has recently decided to change its strategy for monetary management, focusing on inflation rather than the money supply as it did previously. The target inflation rate for each year will be announced in advance, with the Government taking steps to achieve that target through appropriate monetary instruments action.

33. **Present Status of Financial Intermediation.** The expansion and improvement in the efficiency of providing banking services have contributed to an improvement in the overall financial intermediation process in the country. The ratio of loans to GDP increased from 18.7% in 2002 to 38.6% in 2006; the ratio of deposits to GDP increased from 17.6% in 2002 to 31.4% in 2006; and total bank assets increased from 40.1% of GDP in 2002 to 68.4% in 2006. The details of these indicators are given in Table A3.2. There is some evidence of excess liquidity in the banking system that banks consider prudent to keep to meet any unforeseen volatile developments in the market. This is also cyclical in nature, with loan demand increasing in the summer (second and third quarters of the year) and decreasing in the winter (fourth and first quarters of the year).

Table A3.2: Financial Intermediation (in %)

Year	2002	2003	2004	2005	2006[a]
M2/GDP	37.9	47.5	43.5	45.2	48.4
Loans/GDP	18.7	29.9	31.2	34.1	38.6
Deposits/GDP	17.6	24.6	26.6	27.5	31.4
Total bank assets/GDP	40.1	60.6	59.5	60.4	68.4
Total bank loans (billion MNT)	231.4	442.1	606.8	859.9	1,223.3
Total loan growth (%)	71.3	91.1	37.3	41.7	42.3
Total NPL (billion MNT)	11.7	21.1	39.1	49.5	60.0
NPL/Total Loans (%)	5.1	4.8	6.4	5.8	4.9
Banks' lending-weighted average interest rates	26.6	25.6	24.0	21.6	20.0
Banks' interest rates on deposits (non-weighted)[b]	14.0	14.0	13.2	12.6	13.5
Central Bank-bills weighted average rate	9.9	11.5	15.8	4.8	6.4

M2 = broad money, GDP = gross domestic product, MNT = Mongolian togrog, NPL = nonperforming loan.

[a] Preliminary data.

[b] The weighted average interest rate on deposits is not available from the Bank of Mongolia's Statistical Bulletin.

Source: Bank of Mongolia, National Statistics Office.

NONBANK FINANCIAL INSTITUTIONS SECTOR DEVELOPMENTS

A. Overview

1. Much as it has done in for development of the banking sector, the Government has vigorously pursued a reform program to establish the framework for sound operation of the nonbank and capital market sectors, so as to diversify and deepen the financial sector. The Asian Development Bank (ADB) has supported this reform program through continuous policy dialogue and program, project and technical assistance (TA). The reform program has been implemented satisfactorily, and Mongolia now has a legal, regulatory, and accounting/auditing standards framework that largely meets international standards, promotes the development of the nonbank and capital market sectors, and facilitates the country's further economic growth. At the same time, much remains to be done to effectively enforce this framework. The progress made in the implementation of the nonbank and capital markets reform program is outlined below.

B. Financial Regulatory Commission

2. The main outcome of the reform program has been establishment of the Financial Regulatory Commission (FRC) by the Law on FRC Legal Position passed by Parliament in November 2005. ADB supported the establishment of the FRC. Under that law, it has sole responsibility for adopting a consolidated approach to regulation and supervision of the entire nonbank and capital market sectors, comprising four subsectors: nonbank financial institutions (NBFI); savings and credit cooperatives (SCC); securities companies; insurance companies; and the operations of the capital markets sector, comprising the Mongolia Stock Exchange (MSE) and the Securities Clearing House and Central Depository (SCHCD). Previously, the legal, regulatory, supervisory, and control framework was fragmented between various government agencies (e.g., the Bank of Mongolia [BOM], Ministry of Finance and tax authority). That led to deficiencies in supervision and control, and failures of some NBFIs such as SCCs, which adversely affected public confidence in the entire financial system. FRC's main objectives are: policy formulation for financial regulation; regulation and supervision of nonbank and capital markets; licensing of providers of financial services; improving accountability and transparency of nonbank and capital markets; and ensuring sustainability of financial institutions and services.

3. In line with these objectives, during its short lifespan the FRC has introduced a large proportion of the legal, regulatory, and accounting standards needed to ensure the activities of the NBFI and capital markets sectors can be adequately supervised and controlled, according to international standards. These are being enforced as effectively as the FRC's present capacity allows, through more strict licensing requirements. Steps are being taken to fill the remaining gaps in the regulatory framework. This foundation should facilitate the expansion of the NBFI and capital markets sectors, help diversify and deepen the financial system, and contribute to acceleration of economic growth in the country.

4. The FRC faces five challenges in carrying out its responsibilities: the need to (i) strengthen its capacity in terms of (a) capital and operational budgets, (b) physical infrastructure, (c) organization, (d) management, (e) staff, (f) MIS, and (g) policies and procedures to effectively regulate, supervise, and control this large and expanding NBFI and capital markets sectors; (ii) introduce the laws required for (a) promotion of trust operations and investment funds, (b) improvement of corporate governance codes, and (c) establishment of the balance of regulations required, for example, for more effective regulation of the insurance companies and SCCs; (iii) undertake staff training and MIS development for market players (e.g., brokers, dealers, insurance agents, managers and administrators of SCCs, loan and trust

officers of NBFIs, and staff of MSE and SCHCD) to allow them to perform their respective roles more efficiently and effectively; (iv) promote the further development of the NBFI and capital markets sectors through awareness and knowledge dissemination programs to attract participants into these markets, as they reduce their present sole dependence on the banking system for financial services; and (v) educate the public in stock market activities and increase the liquidity of the stock market by playing a proactive role in enticing some of the larger and well performing commercial banks and companies engaged in manufacturing, mining, construction and tourism to list some portion of their shares in the MSE. FRC is taking some steps in this regard but they should be expedited.

5. The most recent development in the NBFI and capital markets sectors is a government proposal to amend the central banking and commercial banking laws to allow commercial banks to engage in nonbank financial services. This is being done with the intention of using the banking system's present unutilized liquidity for investment purposes. The FRC would need to further strengthen its capacity to meet this additional challenge of expanded operations in the NBFI and capital market sectors. The supervision and control of these activities would need to be done on a consolidated, joint basis to ensure the continued stability of both the banking and nonbanking sectors.

6. **Reorganization of the FRC.** A proposal has been approved by the FRC Board to reorganize the FRC in order to carry out the development of the NBFI and capital markets sectors in a more focused manner. FRC would have four specialized departments to oversee (i) the securities industry and capital market development, (ii) NBFIs, (iii) SCCs, and (iv) insurance companies. There would also be separate departments for legal, accounting and accounting standards and administration, and international relations. This model is based on the international standard model for nonbank regulation, supervision and control.

7. As of 1 June 2007, the nonbank and capital markets sectors consisted of 300 institutions made up of 141 NBFIs,[1] 118 licensed and active SCCs, 27 securities companies, 14 insurance companies, as well as the MSE and SCHCD. The NBFI and capital markets sectors are in an incipient stage of development and therefore quite small at present, representing less than 10% of the total assets of the financial sector. The present status of each of the four subsectors of the NBFI sector as well as the capital markets sector (i.e., operations of the MSE and SCHCD) is detailed below.

C. Nonbank Sector Developments

1. Nonbank Financial Institutions Subsector

8. The legal environment for NBFI operations was established through the Law on Nonbank Financial Activities, passed by Parliament in December 2002. BOM previously regulated and supervised the NBFIs, and introduced regulations with respect to the minimum capital requirement, asset classification, liquidity, foreign exchange exposure, the need for accounting/auditing to meet international accounting standards, and provisioning. These regulations continue to be relevant and are being used. New regulations have recently been completed to strengthen the existing regulations; they address licensing of NBFIs to conduct

[1] NBFIs are engaged in the following activities: lending, factoring, leasing, issuance of guarantees and payment instruments, electronic payments and remittances, foreign exchange services, trust services, investment of short-term financial instruments, and advisory services. Deposit taking is not allowed, however.

NBFI activities, prudential ratios for NBFIs, NBFI accounting, and offsite supervision of NBFIs. FRC will establish a working group shortly to amend the Law on NBFI activities to allow NBFIs to undertake financial leasing operations. As required, the NBFIs also publish their audited statements in the major newspapers of the country. There is increasing foreign investment in the NBFI sector.

9. There are also special regulations for trust operations which the Association of NBFIs considers essential for prudential regulation. A working group has been established to examine the draft Law on Trusts prepared with ADB TA (TA 3459-MON), but not passed by Parliament in November 2003. Another working group is planned to look into the draft Investment Fund Law prepared with the same TA and not passed by the Cabinet of Ministers. According to the FRC, the current Securities Market Law provides adequately for investment funds. A regulation for investment fund operations is also in place. Nevertheless, the FRC plans to begin drafting a Law on Investment Funds during 2007. FRC has not received any applications for licenses to establish investment funds to date, probably due to the lack of opportunities for investment of funds, given the lack of development of the capital market. Investment funds should be promoted, as they could be good sources of long-term (especially foreign) funds, for financing relatively larger projects that cannot be handled by the local commercial banks at present.

10. The FRC has begun to supervise and control operations of the NBFIs, which is considered one of the more stable subsectors of the nonbank sector. The minimum capital requirement has been increased to MNT200 million to enlarge the fund base for operations and reduce the impact of risk assets on the viability of the NBFIs. The main challenges presently facing the FRC are continued upgrading of regulations to meet international standards and enhance its capacity to provide strengthened supervision. FRC has taken steps to strengthen NBFI operations by: conducting training for NBFIs on the legal environment, good governance practices, MIS, prudential regulations and accounting; undertaking awareness and information dissemination programs on activities of NBFIs, and rights of NBFI clients; and promoting the microfinance sector by collaborating with the microfinance development fund and the "Sustainable Livelihood" project being implemented by the Government and the International Development Association.

11. At present, there are 141 NBFIs in operation; their total assets have increased from MNT12,459 million in 2002 to MNT69,262 million in 2006, an annual growth rate of just over 50%. In 2006 total assets were about 2.2% of gross domestic product (GDP), slightly larger than the insurance sector (0.7% of GDP), but much smaller than the banking sector (68.4% of GDP in 2006). Their main activity (70% to 80% of the total business) is giving short-term loans to small businesses, which have a maturity of up to 2 years maturity, are secured by movable and immovable property, and have interest rates of about 2.5%–3.5% per month. Other activities of NBFIs are money changing, funds remittance, debit card operations, and trust operations. Their funding is based on their own capital contributions, and deposits are not accepted. The large margins are required due to the high-risk nature of the loans and the high loan transaction costs. Interest rates have fallen from about 4.5% per month about 4 years ago. About 20 NBFIs specialize in serving rural areas, 10 are located in Ulaanbaatar and have branches in rural areas, and the balance of 111 operate only in Ulaanbaatar. There is one large NBFI; about 50 are very active, while the other about 90 are not. All are profitable, and none are expected to fail, as most operate as subsidiaries of large companies and have individual customer bases. The nonperforming loan ratio is around 5% of the total outstanding loan portfolio, and is considered manageable because of targeted marketing, close relationships with borrowers, and careful project/borrower analysis and supervision.

12. The Association of NBFIs, in collaboration with the microfinancing committee of the Chamber of Commerce, provides staff training. The topics presently covered are: MIS, credit and FX risk management, the legal environment, and new products. The training expenses are borne by the Association. The training supplements are provided by the FRC.

2. Savings and Credit Cooperatives Subsector

13. There are now 118 licensed SCCs in operation. A new law to govern their operation is in an advanced stage of preparation for consideration and approval of Parliament before end 2007. It will cover issues related to membership, share capital, loan operations, and obligations with respect to taking and repaying deposits from members and non-members.

14. Loopholes in the previous SCC Law will be covered adequately in the new law. Those loopholes led to irregularities in the cooperatives system and caused the demise of many SCCs, with depositors losing considerable amounts of money (amounting to about MNT66 billion); combined with loans in arrear to SCCs (about MNT13 billion), the total loss is estimated at about MNT79 billion. These losses adversely affected the SCC sector in particular and the financial sector in general. The loopholes in the previous SCC law included a weak legal foundation which was poorly implemented; lack of public unawareness of financial and legal aspects and principles of the cooperatives system; weak internal controls; and inadequate training, guidelines and general information on the operations of the cooperatives system (such as the responsibilities of the management of the SCCs, depositors and loan borrowers).

15. Having learned from this major setback, the SCC system is being revamped and revitalized by laying down a stronger foundation. The new law would delineate the FRC as the sole authority to regulate, supervise, and control the SCC system, and has been submitted for approval by Parliament before end-2007. FRC has also introduced four regulations on licensing, SCC operations, accounting (a United Nations Development Programme and Ministry of Finance joint project), and onsite examinations of SCCs. Another four regulations are to be introduced by the FRC before end-2007 pertaining to: performance evaluation of SCCs, strengthening accounting and auditing procedures of SCCs, strengthening operations of SCCs, and establishing a special credit information bureau for NBFIs. The legal, regulatory, and accounting/auditing framework has been prepared with the assistance of the Canada Cooperative Association and the Canada International Development Agency. The loopholes in the earlier law and regulations have now been covered adequately. Within this framework, the Union of SCCs was established in December 2006 for the present 118 members. A code of conduct for the union is now under preparation.

16. Previously, there were 947 registered cooperatives. License applications were made by 349 under the new stricter licensing regulations, and the FRC has given licenses to only 118 of these applicants, taking into consideration their history, performance, management, capital structure, and documentation. The stricter requirements will ensure the cooperative system operates with greater integrity, efficiency, and effectiveness.

17. FRC will need to enhance its capability to effectively supervise and control the activities of the SCCs. Apparently, not all 118 SCCs are complying with the new accounting/auditing framework, and this issue needs to be resolved as soon as possible. The FRC also needs to upgrade its capacity to properly examine SCC audits and take appropriate action. As with the other nonbank subsectors, the FRC is planning to provide training to SCC administrators, members and auditors on their respective rights and obligations, backed up by awareness and information dissemination programs.

18. A new law is being prepared by the Ministry of Justice to compensate up to 50% of the lost deposits (about MNT33 billion). The total loss amounts to 79 billion MNT (MNT66 billion in deposits, with MNT13 billion in loans outstanding to SCCs), and any outstanding loans recovered from the borrowers would be used to repay the Government to reduce this commitment. Those who defrauded the cooperatives by way of mismanagement, resulting in the loss of deposits and loans, are now under police investigation, with about MNT44 billion of assets seized. The Operations Evaluation Mission expressed its concern to the BOM regarding the precedent this would create in terms of enticing banks to pursue indiscriminate deposit mobilization, as was done by these failed SCCs, and the harmful effect that it would have on the financial sector. This now appears to be a more political matter, which is being addressed by Parliament. The Operations Evaluation Mission was informed that the new law would cease to exist once the particular SCC deposit loss has been adequately resolved.

3. Securities Companies Subsector

19. There are 27 securities companies now in operation, and the legal framework to govern their operations is in place. Three laws—the Securities Law, Company Law, and the Civil Code—govern the securities companies. Prudential regulations are also in place, as laid down by the FRC, MSE, and the SCHCD. The accounting procedures are those specified by FRC and the Company Law. The laws, regulations, and accounting procedures are in accordance with international standards. Rules for licensing and onsite examination are also in place and being enforced. The FRC is now in the process of preparing prudential regulations that will be in place before end 2007, while re-licensing of insurance companies is proceeding satisfactorily.

20. The activities of securities companies include brokerage, dealing in stocks and bonds, funds placement, underwriting, initial public offerings, and bond issues on behalf of customers. The characteristics of the 27 securities companies are as follows: (i) all 27 are limited liability companies but only one (the largest) is listed on the MSE; (ii) 25 are brokers and dealers, one specializes in underwriting, and the other deals with both activities (broker/dealer and underwriting); (iii) 10 are of reasonable size and the other 17 employ approximately two operators (a manager and broker/dealer); (iv) two are said to be profitable while the balance of 25 are either marginally profitable or loss-making; (v) of a total 380,000 accounts, the largest company controls about 50,000 accounts, while the balance is controlled by the other 26 companies; and (vi) the largest company accounts for about 65% of the MSE transactions while the other 26 account for the remaining 35%.

21. Other features of the market are: (i) the market has been liberalized and opened to foreign investment; (ii) brokerage fees appear to be somewhat high (about 2% to 5% of the cost of transactions, which is used in part to pay the fees of FRC, MSE, and SCHCD, but those fees are negotiable); (iii) the companies are subject to the normal corporate income tax;[2] (iv) a capital gains tax of 10% is payable on stock transactions (the MSE has submitted a proposal to the FRC to have the capital gains tax abolished); (v) no minimum amount is required to open an account, but SCHCD charges an account opening fee of $5 per account; (vi) of the 387 listed companies, only about 30 companies are said to have tradable stock, which accounts for about 80% of total market capitalization; (vii) the stocks being traded in the market are mainly from tourism, construction, and mining companies; (viii) off-exchange trading has been stopped while insider-trading has been reduced considerably with the establishment and operation of the

[2] The income tax rate on profits is 15% for the first MNT100 million of taxable income, and 30% on the excess of taxable income over MNT100 million. Interest income on government bonds is not taxable.

FRC, MSE, and SCHCD; (ix) minimum capital requirements for brokers are: MNT50 million for broker/dealers and MNT200 million for underwriters; and (x) branch operations are very limited owing to lack of interest in stock market operations and investor capital in the rural areas.

22. There are three main concerns regarding stock market operations: the need (i) to enhance the capacity of the FRC to enforce the regulatory and accounting/auditing standards framework effectively; (ii) to increase investor confidence in the stock market; and (iii) to increase liquidity in the market, so as to increase stock transactions and make the industry more profitable. The FRC has begun to take steps to address all these concerns. The regulations and rules are being enforced more effectively to minimize violations and off-exchange trading, and the reduction in violations has led to positive developments. The FRC also now requires securities companies and listed companies to prepare transparent accounting and audited statements on a timely basis, which should enhance public confidence in stock market operations. Training programs are being planned for brokers and dealers to improve the quality of their services. Similarly, training programs supported by awareness and information dissemination campaigns in newspapers and electronic media are being planned for investors regarding the rights of shareholders and advantages of investment in stock market operations.

23. In order to increase market's liquidity, the FRC needs to launch a more proactive promotional campaign to get some large and successful companies, including the successful commercial banks and insurance companies, to list some portion of their shares on the MSE. Action should also be taken to promote foreign investment in the market, particularly as the togrog is currently appreciating in value. Given the limited business opportunities and lack of liquidity in the market, some consolidation between the securities companies is likely to take place through mergers, bankruptcies, and voluntary business closures. The FRC should be aware of this concern and be prepared to take appropriate action to ensure that any such bankruptcies and/or business closures would not adversely affect the securities industry as a whole.

4. Insurance Subsector Developments

24. There are 14 private insurance companies now in operation. The insurance industry is governed by two laws: The Law on Insurance and the Law on Insurance Professional Participants, both passed by Parliament in April 2004. They were prepared with the support of ADB TA and comply with the standards and principles set by the International Association for Insurance Supervisory Agencies, which lays down the legal basis for regulation and operation of "general" insurance companies consistent with international standards. At present, there are three main concerns with respect to the insurance sector: (i) the absence of the required regulatory and accounting/auditing standards framework for proper regulation, supervision, and control of the insurance industry in accordance with the two aforementioned laws; (ii) the inadequacy of FRC's capacity in terms of funds, organization and staff for effective enforcement of the regulatory and accounting/auditing standards framework; and (iii) the present unprofitable state of the industry, and in particular of the nine relatively small companies, whose failure might adversely affect public confidence in the insurance industry.

25. About 21 regulations are required under the Law on Insurance, but only about 10 are in place at present; the balance will be completed before end-2007. Another eight regulations are required under the Law on Insurance Professional Participants, but none of these are in place. The FRC will complete these in 2008. Also, the FRC has drafted the required accounting/auditing standards in accordance with international standards for insurance companies and these are in the process of being approved by the other relevant government

authorities. These outstanding matters need to be urgently addressed by the FRC to lay down a sound foundation to facilitate the supervision and control of the companies now in operation, as well as to facilitate the overall growth of the industry.

26. Another new law on compulsory liability insurance for automobile drivers is now being drafted by FRC for approval of Parliament before end-2007. The need to introduce life insurance and other forms of compulsory insurance schemes is also being examined.

27. The insurance industry is relatively very small at present. Its total assets accounted for only about 0.7% of GDP in 2006; this compares with insurance industries in more developed countries, where assets are some 10–12% of GDP, and the Mongolian banking sector, which had assets amounting to 68% of GDP in 2006. Because of its present small size, the insurance industry as a whole does not appear to be viable, but an improving trend could be seen beginning in 2006. The insurance system recorded a profit of MNT82.3 billion in 2004, but has become unprofitable since then, with losses of about MNT789 billion in 2005. Losses decreased to MNT129 billion in 2006. The largest insurance company is foreign-owned, and is believed to be the most profitable (primarily because of its Mongol Airlines account); another 4 are marginally profitable, and the balance of 9 are barely profitable or loss-making. The total assets of the industry increased from MNT15.1 billion to MNT22.1 billion in 2006, for an average annual rate of about 22%. The reserve fund stood at MNT12.1 billion in 2006, with a net addition (income less claims) of MNT2.41 billion in that year.

28. The other characteristics of the present insurance industry are as follows: (i) each of the 14 companies in operation is in general insurance, and all are registered as private limited liability companies, but none are listed on the MSE; (ii) the main line of business is fire and/or property insurance (68%), fiduciary insurance (23%), and other liability insurance (9%); (iii) one large company controls about 41% of the insurance business, four others about another 39%, and nine relatively very small companies accounting for the balance (20%); (iv) the large company referred to earlier is fully foreign-owned, while the other 13 companies are fully locally-owned; (v) 22 companies operated in 2005 but, this dropped to 14 companies in 2006, largely because of FRC's increase of the minimum capital requirement to MNT500 million (about $400,000) in 2006; (vi) the 14 companies presently have about 520 staff and about 1,500 insurance representatives; (vii) the total insurance premium income increased from MNT6,318 billion in 2003 to MNT11,824 billion in 2006, at an annual average rate of about 23%, and total claims increased from MNT1,236 billion in 2003 to MNT2,776 billion in 2006, at an annual average of about 33.2%; (viii) eight companies transferred MNT2.8 billion for re-insurance in 2006, up 39.5% from 2005; and (ix) the loss rate in 2006 was 23.4%, a decrease of 1.5% compared to 2005.

29. Considerable awareness-raising would need to be undertaken to promote an "insurance culture" in Mongolia, in order to widen and deepen the insurance industry and to enhance its viability. This strategy would need to be supported by training of staff and field agents, and development of MIS to increase the efficiency of services being provided to the public, particularly for timely settlement of claims. Also, annual accounts would need to be prepared on a timely basis and audited properly to ensure transparency. The FRC is planning to provide support to the industry in all these areas. As required by the FRC, the insurance companies now publish their quarterly accounts in the major newspapers of the country to increase public confidence in the insurance industry. This is an encouraging development. The FRC needs to do more, however, by quickly implementing the complete regulatory and accounting/auditing framework that is needed, and increasing its own capacity to effectively enforce that framework.

CAPITAL MARKET SECTOR DEVELOPMENTS

A. Overview

1. The Financial Regulatory Commission (FRC) is playing a significant role in facilitating development of capital markets in Mongolia. It has been supported by the Asian Development Bank (ADB) through continuous policy dialogue and through reforms initiated under ADB projects, programs and technical assistance. Other donors such as the World Bank and United States Agency for International Development have also given assistance. Its achievements within its short lifespan are noteworthy, especially the legal, regulatory, and accounting/auditing frameworks that have been introduced, and which now provide a sound foundation for capital market growth. A nascent but growing securities market is now in place, as shown below, but more needs to be done to ensure its stable and sustainable development.

2. The achievements to date and the gaps that remain to be filled were discussed in detail under each of the four key market players—nonbank financial institutions (NBFIs), securities companies, savings and credit cooperative, and insurance companies (Appendix 4, paras. 8–29). In order to avoid repetition, only the issues directly relevant to capital market development and not referred to in that section will be discussed here.

3. The most significant development with respect to the capital markets has been the separation of the trading function (handled by the Mongolia Stock Exchange [MSE]) from that of clearing, settlement, and depository functions (now the responsibility of the Securities Clearing House and Central Depository (SCHCD) System, as recommended by ADB. Their separation into specialized and focused institutions has contributed positively to both their respective development and development of the capital markets in general. The Government's state-owned enterprise (SOE) privatization program, which was also supported by ADB, has progressed satisfactorily with the more viable SOEs (including the key securities markets players such as the NBFIs, securities companies, and insurance companies) already privatized; most are now listed on the MSE. The latest development features of the MSE and SCHCD as well as of the privatization program are narrated below. ADB's recommendation that the MSE should be privatized, however, remains outstanding. The Government has accepted the recommendation and hopefully it will be acted upon during 2008. Privatization of SCHCD will need to be addressed after its operations are more viable.

4. FRC presently faces several challenges relating to increasing public confidence in the capital markets and guiding their future growth: (i) the need for listed companies to prepare their financial statements accurately and on time with full accountability and transparency, and to publish on a timely basis all company information that needs to be in the public domain; (ii) training local audit companies to audit their financial statements accurately, on a timely basis, and in accordance with their responsibilities, as laid down in the International Accounting Standards; (iii) preventing insider trading and off-exchange trading, which have reduced significantly following the specialized operations of the MSE and SCHCD, but nevertheless require close vigilance by FRC to prevent their recurrence; (iv) educating the general public and market players on their respective rights and responsibilities and the mutual benefits stemming from self-regulation; and (v) the need to introduce quickly the laws for promotion of trust and investment fund operations as required by ADB. The FRC, MSE, and SCHCD are aware of these challenges and are taking steps to meet them, as shown below.

5. The FRC declared 2007 as the "Year of Capital Market Development" (i) to create enthusiasm; (ii) attract the attention of government, pubic, legal entities, and securities market

intermediaries towards the emphasis now being placed on capital market development; and (iii) publicize capital market investment possibilities for the benefit of all participants.

6. FRC's work program has the following objectives, based on past experience and the need to fill existing gaps: (i) assess the current status of the market, prepare a development strategy for the future, and improve the legal environment; (ii) develop a capital market infrastructure, introduce new financial instruments, and increase the number of capital market products and services; (iii) develop management information systems, software solutions, and staff training programs to improve the efficiency of the FRC and market players; (iv) disseminate information to FRC, market players, and the public to increase their knowledge of the capital market; and (v) introduce international standards for corporate governance to protect investor rights. The details of these objectives are given in Appendix 8. The objectives have been included in FRC's work program; most of the work has already been started, and the FRC expects to complete it by end 2007. An assessment of the current status of the capital markets and development of a strategy for its future development is underway, with the ultimate objective of persuading the Government to issue a well defined and coordinated policy for capital markets development.

7. In order to carry out its work program, the FRC was reorganized in July 2007 to give more focused attention to the development of the capital markets through creation of four specialized departments, focusing on (i) capital markets and securities, including securities companies; (ii) NBFIs; (iii) savings and credit cooperatives; and (iv) insurance companies. It is, however, doubtful whether the FRC would be able to complete its workload by 2007, or even 2008. It faces severe capacity constraints in terms of physical infrastructure, capital and operational budgets, organization, staff and other needed resources. Under the circumstances, FRC requires the continuing support of the Government and donor community to enable it to successfully implement its work program, and thus facilitate development of a more robust and vibrant capital market. Once such a market is in place, both entrepreneurs and investor would have a choice of instruments that (i) meet their respective demands, (ii) reduce the present total dependency on the banking system for the services they need, and (iii) contribute to diversification and deepening the country's financial sector.

B. Performance of the Mongolia Stock Exchange

8. The FRC monitors the public dissemination of information by securities issuers, securities owners, and professional institutions, as required under its legal acts and regulations. Listed companies have deadlines for submission of complete, audited annual and half-yearly financial reports to FRC and MSE, and are required to submit information on securities transactions in a format provided by the FRC. Listed companies are subject to the normal corporate tax, while tax is not payable by individuals on share dividends and interest on bonds.

9. MSE continues to supervise and inspect the financial and operational performance of listed companies. Companies applying for listing on the MSE need to meet the criteria stated in the Securities Law. Listed companies are required to pay fees, which enable the MSE to operate.[1] MSE is in the process of amending the Listing Regulation to facilitate foreign investment. At present, MSE's main challenge is to ensure listed companies make accurate and timely disclosure

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[1] Fees payable are (i) on stocks (a) initial and additional listing fee (subject to the par value of shares) of MNT50,000 up to MNT10 million, 0.5% for MNT10 million to MNT100 million, and MNT500,000 for over MNT100 million, and (b) an annual listing fee (subject to the par value of shares) of MNT40,000 up to MNT10 million, 0.4% for MNT10 million to MNT100 million, and MNT400,000 for over MNT100 million; and (ii) on bonds, a listing fee of 0.1% of the total trading value.

of company information that needs to be in the public domain, that they prepare their accounts with full accountability and transparency, and that they are properly audited by competent audit firms. The FRC plays the lead role in this regard, but the MSE has supplemented FRC's efforts by setting up information and training centers to educate the public on stock market operations and their rights as shareholders. Awareness programs and advisory services are released regularly through print and electronic media for this purpose. This training is also being provided to listed and unlisted companies. Marketing is undertaken to attract the more successful companies to list their shares on the MSE, but the response has not been very positive.

10. Both stocks and bonds (government and corporate) are traded on the MSE. Its operations are relatively small compared to world standards, but are increasing. Over the last 5 years (2002–2006), the MSE has expanded its activities and improved its viability, reflecting the growing public confidence in its operations. After making losses in 2004 and 2005, it recorded a small profit of MNT2.7 million in 2006. Its net worth of MNT1.858 billion in 2006 was represented by Government's equity of MNT1.792 billion, reserves of MNT56 million, and other assets of MNT10 million. The number of listed companies decreased from 403 in 2002 to 387 in 2006 (new listings less de-listings, for a net de-listing of 16 companies), mainly as a result of stricter listing requirements now being applied by the FRC and MSE. The trading volume increased by about a factor of nine, from MNT1,373 million in 2002 to MNT12,604 million in 2006; market capitalization increased 3.7 times during the same period. The stock market index with respect to the 20 best performers increased from 934 in 2002 to 2,031 in 2006. The increased share market activity is a result of the privatizing effect (see below for details) and issue of initial public offerings. These rapid increases have continued in the first half of 2007. The operational performance indicators during 2002–2006 are given below.

Table A5: Data on Stock-Market Operations (2002–2006)

Year	2002	2003	2004	2005	2006
1. Listed companies	403	402	395	392	387
2. Market capitalization:					
- in MNT million	35,848	49,513	29,832	55,701	131,179
- in $ million	31.9	42.4	24.7	45.6	112.6
3. Trading value:					
- in MNT million	1,373	896	654	2,547	12,604
- in $ million	1.2	0.8	0.5	2.1	10.8
4. Trading volume:					
- in $ million	9.8	8.1	9.1	25.9	74.5
5. Bond trading					
in MNT million					
- Government	41,691	21,723	12,464	6,768	4,462
- Corporate	2,958	2,988	2,777	2,664	961
6. Index (top 20)-close	934	896	586	1,019	2,031

MNT = Mongolian togrog.
Source: Mongolia Stock Exchange Fact Book 2006.

11. **Privatization of the MSE.** The ADB requirement that the MSE should be privatized continues to be an outstanding issue. The Operations Evaluation Mission informed the State Property Committee and the MSE that MSE's privatization should be included in the

Government's privatization program for 2008, to be prepared in December 2007. Apparently, the delay is due to differences in the mechanisms to be used for its privatization. The mission suggested that it could be done in two stages: initial privatization of MSE's management to improve its viability, followed by privatization of the institution on a joint venture basis to bring the latest technology in stock exchange operations into the country. Whatever privatization method is adopted, the mission requested that privatization be expedited.

12. **Mongolian Securities Clearing House and Central Depository Co. Ltd.** The SCHCD operated as a separate department of the MSE for about 16 years. In October 2006, it legally separated from the MSE, with the establishment of SCHCD as a separate state-owned limited liability company. The separation was supported by ADB. The MSE is now responsible for the trading function, while the securities clearing, settlement and depository functions are performed by the SCHCD, which received a license from the FRC in October 2006 to conduct those functions. There are no plans at the moment for its privatization.

13. It is financially profitable and operating efficiently with profitability increasing from MNT3.6 million in 2003 to MNT20.2 million in 2006 at an average annual rate of about 150%. It has about 300,000 customers, and transactions consist of about 70% stocks and 30% government and corporate bonds. Foreigners are allowed to open accounts without any restrictions. The market value of transactions conducted increased from MNT1.8 billion in 2003 to MNT2.9 billion in 2006 at an average annual rate of about 17.5%. The share transactions are in respect of about 387 listed companies. In 2006, SCHCD distributed dividends worth $70,000 from 16 listed companies. The required regulations and accounting/auditing standards are in place. Its operations are supervised and controlled by the FRC. The two main challenges are staff training and development of the management information system so it meets the latest technology and international standards in settlement, clearing, payments, and depository services.

14. **Status of the Privatization Program.** The Government has carried out the privatization program effectively with considerable ADB support through policy dialogue and technical assistance. It appears to have slowed down recently, however. At the start of the privatization program in the early 1990s, there were about 5,000 SOEs, including many small shops, and about 70–80 manufacturing, construction, mining, and utility entities. Most of the shops and some enterprises have now been privatized. About 60 SOEs remain to be privatized, consisting of small- and medium-sized enterprises, power, construction, and mining enterprises. Some of these are expected to be included in the 2008 privatization program. The slowdown appears to reflect a lack of commitment by the present government to proceed with privatization at the earlier pace.

15. About 400 privatizations were achieved through conversion to public limited liability companies, followed by public listing through the MSE. Approximately 200 were converted into limited liability companies but have not yet been listed, reflecting the potential for further public listings and opportunities for increasing market liquidity.

16. **Capital Gains Tax.** The capital gains tax has already been reduced from 15% to 10% in early 2007. A draft amendment to the tax law to abolish the capital gains tax of 10% altogether, as proposed by the FRC and MSE, has been submitted to Parliament and has the support of the Ministry of Finance and the tax authority. It is expected to be approved by Parliament before end-2007. The tax on interest income at the present rate of 10% will remain. Thus, there would be a tax advantage-driven incentive to develop the capital markets sector.

PRIVATE SECTOR AND OVERALL ECONOMIC DEVELOPMENT IN THE COUNTRY

1. The implementation of reforms in the banking, nonbank, and capital market sectors have contributed significantly to private sector development as well as to overall economic development in the country.

2. All 16 commercial banks in operation in the country are privately-owned and managed without any government involvement in "directed" credit or in the determination of deposit and lending interest rates. Similarly, all the players in the nonbank financial institution (NBFI) sector are also privately-owned. These are 114 NBFIs, 118 savings and credit cooperative, 27 securities companies, and 14 insurance companies. While the Mongolia Stock Exchange may be privatized in 2008 or so, the Securities Clearing House and Central Depository would remain under state ownership for a few more years until its viability and attractiveness for privatization increase.

3. Commercial banks hold over 90% of the total assets of the financial sector. The loans they have given have been predominantly for private sector development, averaging about 97% of their total loans outstanding over 2002–2006. The financing provided by the NBFIs has also been mainly for private sector development, except in the case of some insurance companies that also extended to state-owned enterprises such as Mongol Airlines. Backed by the increasing financing to the private sector from the banks and NBFIs, which is supplemented by owners' equity, the privatization program, and foreign direct investment, the private sector's contribution to gross domestic product (GDP) rapidly increased from only 3.3% of GDP in 1989 to 70.3% in 1999, and then to about 77.8% in 2006. This helped increase GDP growth in the country from 3.2% in 1999 to 8.4% in 2006. Exports increased from $454.2 million in 1999 to $1,545.2 million in 2006; the current account balance turned to a surplus of $63.4 million in 2004, increasing to $306.3 million in 2006; total foreign reserves increased from $155.9 million in 1999 (representing 14.3 weeks of imports) to $718 million in 2006 (representing 25.2 weeks of imports); inflation dropped from a high of 11% in 2004 to 6.0% in 2006; unemployment remained at a reasonable level of around 3.5%; and the exchange rate has remained steady around MNT1,200 per US dollar. The economic data issued by the Bank of Mongolia that reflect these improvements are detailed in Table A6, below.

Table A6: Main Economic Indicators (1999–2007)

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP real growth %	3.2	1.1	1.0	3.8	6.1	10.6	7.3	8.6	9.9
Inflation %	10.0	8.1	7.9	0.3	5.1	8.3	12.7	5.1	9.0
Unemployment %	4.7	4.6	4.6	3.4	3.5	3.6	3.3	3.2	2.8
Loan/GDP %	8.4	6.6	12.1	18.7	29.9	31.2	34.1	38.6	NA
Deposit/GDP %	11.4	9.1	12.1	17.6	24.6	26.6	27.5	31.4	NA
Exports - $ million	454.2	535.8	523.2	523.9	627.3	872.1	1,068.6	1,545.2	1,952.0
Imports - $ million	567.1	676.0	693.1	752.8	826.9	1,021.0	1,224.0	1,516.0	2,170.0
Current account balance - $million	(60.0)	(54.0)	(77.0)	(108.0)	(99.0)	27.0	29.0	222.0	101.0
Total foreign reserves–in $ million	157.0	190.9	206.7	268.2	204.0	207.8	333.2	718.0	1,001.0
By import weeks	14.3	14.7	15.5	18.5	12.8	12.0	16.3	25.2	NA
$ exchange rate in MNT	1,021.0	1,077.2	1,098.4	1,110.0	1,147.0	1,187.0	1,205.0	1,177.0	1,170.0

GDP = gross domestic product, MNT = Mongolian togrog, NA = not available.
Source: Bank of Mongolia Annual Report 2006. International Monetary Fund Staff Report, July 2008. IMF. Key Indicators of Developing Asian and Pacific Countries, 2008. ADB.

POSITIONING OF THE ASIAN DEVELOPMENT BANK'S FINANCIAL SECTOR STRATEGIES IN MONGOLIA

Positioning Criteria	1991–1996 Country Strategy	1997–2000 Country Strategy	2001–2006 Country Strategy
• Basis for sector strategy	• Based on ADB experience in similar transitional economies. • ADB's ADTA outcomes and policy dialogue. • Government's strategy. • Coordination with ESAF/IMF and World Bank strategies supported by ADB/FSPL I and piggybacked TA.	• Based on ADB experience in similar transitional economies. • ADB's ADTA and PPTA outcomes and policy dialogue. • Government's strategy. • ADB-IDA/World Bank's FSRP and supported by FSAC of IDA and ADB's FSPL II and piggybacked TA.	• Based on ADB experience in similar transitional economies. • ADB/ADTA and PPTA outcomes and policy dialogue. • Government's MTS for Financial Sector Development (2000–2005). • Continuation of ADB-IDA/World Bank's FSRP and supported by FSAC and ADB's FRGP.
• Government absorptive capacity and ownership	• Coordination with Government and other donor partners' strategies and policy dialogue ensured ownership. • ESAF/IMF, ADB's FSPL I, and Government budget support available for financial sector and SOE structural adjustments. • HRD and institutional constraints acknowledged and overcome with ADB's ADTA support.	• Coordination with Government, FSRP, and other donor partners' strategies and policy dialogue ensured ownership. • Government budget, FSAC, and ADB's FSPL II support available for financial sector and SOE structural adjustments. • HRD and institutional constraints acknowledged and overcome with ADB's ADTA support.	• Coordination with Government's MTS, FSRP, and other donor partners' strategies and policy dialogue ensured ownership. • Government budget, FSAC, and ADB's FRGP support available for financial sector and SOE structural adjustments. • HRD and institutional constraints acknowledged and overcome with ADB's TA support.
• ADB's comparative advantage in the sector and harmonization of sector strategies with other development partners	• ADB recognized as playing lead role in financial sector development. • ADB major donor for financial sector development with FSPL I and piggybacked TA, PPTA, and ADTA. • ADB's strength in policy dialogue recognized based on experience and outcomes of TA, PPTA, and ADTA. • Coordination with ESAF/IMF and World Bank strategies at macro and sector, project, and TA levels.	• Based on ADB experience in similar transitional economies. • ADB's strength in policy dialogue based on experience and outcomes of TA, ADTA, and PPTA. • Continued harmonization with IMF and IDA/World Bank FSRP and supported by FSAC of IDA and ADB's FSPL II and piggybacked TA.	• Based on ADB experience in similar transitional economies. • ADB's strength in policy dialogue based on experience and outcomes of TA, ADTA, and PPTA. • Continued harmonization with IMF and IDA/World Bank's FSRP.

Positioning Criteria	**1991–1996 Country Strategy**	**1997–2000 Country Strategy**	**2001–2006 Country Strategy**
Focus/Selectivity and synergies:			
• Issues and challenges addressed	• The overall strategy highlighted the problems of creating a financial sector that could respond adequately to market signals and help develop an efficiently operating market-based economy. • The two-tier banking system created by transforming the mono-banking system was not operating efficiently to serve private sector needs.	• While continuing to restructure and strengthen the two-tier banking system, the strategy during this period also addressed the challenge of diversifying and deepening the financial structure to provide competition to the banking system and to give the depositor and borrower a wider choice of instruments and mechanisms.	• Having successfully established a two-tier privately-owned banking system that was now operating efficiently, the strategy focused on continued strengthening of the banking system while giving equal focus to expanding and strengthening the growing nonbank and capital market sectors.
Focus/Selectivity and synergies:			
• Sector focus	• Restructuring banks created under the two-tier system with a view to privatization. • Strengthening legal, regulatory, supervisory, and accounting/auditing standards at BOM. • Strengthening HRD and institutional capacities at the BOM and commercial banks.	• Active privatization of the restructured banks. • Continued strengthening of legal, regulatory, supervisory, and accounting/auditing framework of BOM. • Continued strengthening of HRD and institutional capacities at the BOM and commercial banks. • Establishment of legal, regulatory, supervisory, and accounting/auditing frameworks for nonbank and capital market sectors.	• Improve and strengthen the private banks with governance and internal controls that meet international standards. • Continued strengthening of legal, regulatory, supervisory, and accounting/auditing framework of BOM. • Continued strengthening of HRD and institutional capacities at BOM and commercial banks. • Assist in strengthening and expansion of the nonbank and capital market sectors through legal and regulatory improvements, introduction of new financial products and steps to increase investor confidence.
• Focus/Selectivity and synergies	• ADTA for formulating reform agenda for policy dialogue, bank restructuring, and HRD and institutional strengthening in BOM and banks. • Program loan (FSPL I) to support policy reform implementation for restructuring banks and for	• PPTA for formulating housing and rural finance loans. • ADTA for HRD and institutional strengthening of housing and rural finance sectors. • ADTA for formulating policy reform agenda for policy dialogue for bank	• PPTA for formulating FRGP. • FRGP for supporting policy reform agenda for strengthening privatized banks, BOM, and nonbank and capital market sectors. • ADTA for HRD and institutional

Positioning Criteria	1991–1996 Country Strategy	1997–2000 Country Strategy	2001–2006 Country Strategy
	HRD and institutional strengthening in BOM and banks. • TA piggybacked to FSPL I for HRD and institutional strengthening in BOM and banks.	restructuring, and HRD and institutional strengthening in BOM and banks. • Program loan (FSPL II) to support policy reform implementation for restructuring and privatization of banks, establishment of foundation for nonbank and capital market sectors, and HRD and institutional strengthening in BOM, banks, and nonbank and capital market sectors. • FSPL II/TA piggybacked for HRD and institutional strengthening in BOM, banks, nonbank and capital market sectors.	strengthening of housing finance and rural finance sectors.
Focus/Selectivity and synergies:			
• Coherence of issues, focus, and instruments	• Strategy was coherent, focused, and well positioned for financial sector development to be in line with the demands of a market-based economy. • Accordingly, supported bank restructuring with a view to privatization to facilitate transformation of mono-banking system to a workable two-tier system. • Also, supported HRD and institutional strengthening of BOM and banks.	• Strategy continued to be coherent, focused, and well-positioned for further financial sector development to be in line with the demands of a market-based economy. • Accordingly, supported next stage of bank restructuring and privatization to further facilitate transformation of the mono-banking system to a workable two-tier system. • Continued to support HRD and institutional strengthening of BOM and banks. • Continued to focus on financial sector development, diversification and deepening through development of nonbank and capital market sectors.	• Strategy continued to be coherent, focused, and well-positioned for further financial sector development, in line with the demands of a market-based economy. • Supported strengthening of privatized banks to allow their efficient operation in a market-based economy. • Supported legal and regulatory improvements for better functioning of the nonbank and capital market sectors. • Introduced new products and measures for increasing investor confidence in those two sectors to facilitate further diversification and deepening of the financial sector.
Focus/Selectivity and synergies:			
• Long-term continuity of the	• It was considered that a market-based economy	• Involvement in transforming the banking system	• Involvement in the financial sector

Positioning Criteria	**1991–1996 Country Strategy**	**1997–2000 Country Strategy**	**2001–2006 Country Strategy**
sector strategy	was the most efficient system for promotion of private sector development to facilitate rapid economic development for employment creation and poverty reduction. The key to achieving that was a transformed and privatized banking system that was capable of efficiently responding to signals generated by a market-based economy.	continued with restructuring and privatization of the banks. • With this transformation proceeding on course, emphasis was now given to diversification and deepening of the financial sector with the promotion of the nonbank and capital market sectors.	continued to consolidate, strengthen and ensure stability of the privatized banking system. At the same time, steps were taken for further strengthening of the diversified and deepened financial sector that was now emerging, through further promotion of the nonbank and capital market sectors.
• Risk assessments and monitoring mechanisms to achieve the sector strategy's envisaged results	• Risks were properly assessed in terms of runs on banks due to their liquidity and solvency problems, the ability of BOM and commercial banks to implement restructuring plans, and adverse consequences for employment as a result of bank closures. These risks were mitigated by assistance through TA, and ADB funding of costs associated with bank restructuring. • Monitoring mechanism set up through a Steering Committee of BOM, MOF, and MOJ, loan tranching conditions, and ADB regular supervision.	• Risks identified in terms of the new Parliament taking time for approving FSPL II, Government's inability to implement reform measures owing to pressure from vested interests, weak capacity, and lack of coordination among involved agencies. These risks mitigated by the nature of reform measures of FSPL II and considerable TA support. • The same monitoring mechanism, loan tranching conditions, and ADB regular supervision continued.	• Risks identified as poor management in transition from BOM to FRC of regulatory powers over nonbank and capital market sectors, possible delays in introduction of needed new legislation and legal amendments, and resistance from vested interests for reform measures. These risks mitigated by BOM cooperation, TA support, stakeholder consultations, and coordination with donor agencies. • The same monitoring mechanism, loan tranching conditions, and ADB regular supervision continued.

ADB = Asian Development Bank, ADTA = advisory technical assistance, BOM = Bank of Mongolia, ESAF = Enhanced Structural Adjustment Facility, FRC = Financial Regulatory Commission, FRGP = Financial Regulation and Governance Program, FSAC = Financial Sector Adjustment Credit, FSPL = Financial Sector Program Loan, FSRP = Financial Sector Reform Program, HRD = human resource development, IDA = International Development Association, IMF = International Monetary Fund, MOF = Ministry of Finance, MOJ = Ministry of Justice, MTS = Medium-Term Strategy, PPTA = project preparatory technical assistance, SOE = state-owned enterprise, TA = technical assistance.
Source: Operations Evaluation team.

FINANCIAL REGULATORY COMMISSION'S WORK PROGRAM (2007–2008)

A. Objectives of Financial Regulatory Commission's Work Program (2007–2008)

1. Assess status of capital markets and prepare development strategy:

1.1 Draft mid-term strategy program "Government policy to develop capital market" in collaboration with related bodies, submit draft for approval, and begin implementation
1.2 Collaborate with respective organizations to combine the privatization policy and capital market development issues
1.3 Related laws and rules implementation
1.4 Draft following legislation to improve the sector's legal environment:

(i) Amendment to securities market law
(ii) Renew existing rules and regulations for securities market
(iii) Renew law on securities trading (for stock market operations)
(iv) Amendment to company law
(v) New laws on trusts and investment funds (the laws prepared under Asian Development Bank technical assistance [TA] were rejected by the previous Parliament/Cabinet, which the Financial Regulatory Commission is confident would be approved by the new government in power with the support given by the Ministry of Finance)
(vi) New law on assets valuation
(vii) Amendments to income tax laws and to Government and municipal property law. Most of these will be completed by year-end 2007 or early 2008.

2. Develop capital market infrastructure, introduce new financial instruments, and increase number of capital market products and services:

2.1 Strengthen the Securities Clearing House and Central Depository (SCHCD) to reduce risks associated with clearing, settlement and depository transactions
2.2 Assess broker and dealer companies for further strengthening of their operations
2.3 Initiate cooperation with international institutions to establish information and training centers for capacity building and human resource development for the International Finance Corporation and securities market intermediaries
2.4 Initiate collaborations with academics and universities to expand capital market research activities
2.5 Renovate the hardware and software of the capital market intermediaries in order to build a unified data base covering all correlated parameters of the sector, as well as strengthen the accounting, auditing and reporting systems
2.6 Encourage the introduction of new products and services
2.7 Apply for connection with capital market networks of other countries
2.8 Provide security for networks and software.

3. **Develop management information system and software solutions:**

3.1 Develop an information technology network to connect all domestic market participants
3.2 Apply for connections to capital markets networks of other countries
3.3 Build database for exchange of data and other information through networks
3.4 Provide security to networks and software

4. **Improve financial knowledge of organizations and individuals, set up financial market-related information dissemination system for the public:**

4.1 Organize closer supervision of joint-stock companies, renew their rating systems, and strengthen listing requirements of the Mongolia Stock Exchange
4.2 Preparation, in collaboration with the European Bank for Reconstruction and Development, a corporate governance code in compliance with international standards, and develop procedures for their enforcement
4.3 Promote government agencies, municipal authorities, and companies to issue securities
4.4 Install systems to check account balances of stockholders kept with SCHCD
4.5 Take steps to protect the rights of small shareholders
4.6 Prescribe special requirements for auditors allowed to audit financial statements of joint-stock companies
4.7 Undertake enforcement action on joint-stock companies that violate securities laws and rules

5. **Introduce international standard corporate governance to protect investor rights:**

5.1 Organize information and advertising programs to educate the general public on capital markets, investment, and financial management
5.2 Conduct training for securities market intermediaries and securities issuers in collaboration with professionals and professional institutions
5.3 Cooperate with mass media organizations to give publicity to capital market developments
5.4 Translate into the Mongolian language standards such as the securities market principles of the International Organization for Securities Companies, and the principles of corporate governance of the Organization for Economic Cooperation and Development, and have them published
5.5 Restructure and reorganize the Mongolia Stock Exchange and SCHCD in accordance with world standards