

MANAGEMENT RESPONSE TO THE PROGRAM PERFORMANCE EVALUATION REPORT FOR LOAN 1743-MON: SECOND FINANCIAL SECTOR PROGRAM IN MONGOLIA

A. General Comments

1. We appreciate OED's Program Performance Evaluation Report (PPER) on the Second Financial Sector Program (the Program). We find it analytically sound and well-prepared. We agree with its overall satisfactory rating of the Second Financial Sector Program. We note that the findings of the PPER are useful and the issues and lessons identified in the PPER will provide a better approach in preparing similar programs in the future.

2. We note that ADB has supported the development of Mongolia's financial sector throughout the course of the country's transition to a market economy. As the PPER observes, the Second Financial Sector Program was a core part of the financial sector reform package that was put together in coordination with the Government, the World Bank, and International Monetary Fund (IMF). The Program formed one part of a consistent package of ADB's support, which has also included two other program loans, significant amounts of technical assistance, a technical assistance (TA) loan and two private sector operations.

3. Working in close coordination with other key development partners, notably the World Bank and the IMF, we have supported a process of institutional building, development of the legal framework, and sector privatization. Key outcomes of the Program are a fully-privatized commercial banking system capable of supporting the further development of Mongolia's private sector-led economy and an appropriate regulatory and supervisory framework.

B. Comments on Lessons Learned

4. The PPER has identified some key lessons which we agree should be fed into the design and implementation of ADB's future interventions in Mongolia's financial sector. We note that a number of lessons from the Program have been already incorporated into the design of later projects, including Loan 2218-MON (SF): Financial Regulation and Governance Program.

5. **Importance of Government Ownership.** We fully agree with the PPER observation that the Program's success was the result of continuous Government commitment to and ownership of financial sector reform. However, we do not believe that ADB overestimated the political will to reform. In fact, uninterrupted government support for market-oriented reform, despite frequent changes of government, has been a notable feature of Mongolia's transition.

6. **Government's Capacity.** We agree with the PPER observation that the lack of capacity often became a constraint on Government when it endeavored to move forward simultaneously on a wide range of reforms and the reform agenda should have been matched by capacity in the key government agencies, which even today needs further strengthening.

7. **Choice of Executing Agency.** The PPER's observations about the choice of executing agency are generally valid. However, we note that in the case of Mongolia in 1999, the Bank of Mongolia (BOM) was the only institution in the financial sector with any real capacity. Choosing the Mongolian Stock Exchange to implement the capital markets aspects of the Program, as recommended in the OED report, was not a viable option at that time.

C. Comments on Follow-Up Actions

8. We generally support the follow-up actions proposed by the PPER. However, we offer the following comments on the individual follow-up actions.

9. Follow-up Action (i). We fully support the suggested follow-up action. We note that the draft laws on trusts and investment funds are being redrafted by the Financial Regulatory Commission (FRC). Staff will dialogue with the FRC and the Government on the timetable for their planned adoption.

10. Follow-up Action (ii). We support the follow-up action. We note that TA 4910-MON: Strengthening the Pension Reform, approved in December 2006, is already assisting the Government in its review of pension legislation.

11. Follow-up Actions (iii) and (iv). We agree with the PPER's suggestions related to nonbank and capital markets. We note that these issues will be addressed in a proposed TA for Capital Market Development to be processed in 2008.

12. Follow-up Action (v). The marginal viability of some of the smaller banks due to intense competition for deposits has been an important policy issue in Mongolia. We note that the BOM and the Government encourage consolidation of the commercial banking sector through mergers and acquisitions rather than seeking to strengthen smaller banks through equity participation.

13. Follow-up Action (vi). We note that the suggestion would be applicable for the larger banks, subject to the review of the current legal framework.

14. Follow-up Action (vii). We agree with the importance to support innovations in financial products. However, we believe that given the current development stage of the financial market in Mongolia, ADB should continue to place emphasis on the development of the emerging primary mortgage market. Securitization of mortgages will develop as gaps in the legal framework are remedied and the primary market demonstrates financial performance.

15. Follow-up Action (viii). In general, Mongolian enterprises are often too small to receive direct support from ADB's private sector window. However, ADB will continue to support the corporate sector through our operations in the banking sector.

16. We will remain engaged with Mongolia's financial sector in a proactive manner. In addition to the ongoing TAs and loans supporting financial sector development, ADB stands ready to respond to the emerging needs of the country and will continue to support the reform and capacity building process through a combination of policy dialogue and advisory technical assistance.