ASIAN DEVELOPMENT BANK

RRP: MON 30101

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

June 2000

CURRENCY EQUIVALENTS
(as of 30 May 2000)

Currency Unit	–	Tugrug
Tug1.00	=	$0.000985
$1.00	=	Tug1,015.0

ABBREVIATIONS

AB	–	Agricultural Bank
ADB	–	Asian Development Bank
ASDP	–	Agricultural Sector Development Program
BIS	–	Bank for International Settlements
BITI	–	Bank of Investment and Technological Innovation
BOM	–	Bank of Mongolia
CDS	–	Central Depository System
DPL	–	development policy letter
ESAF	–	enhanced structural adjustment facility
FSAC	–	Financial Sector Adjustment Credit
FSP	–	Financial Sector Program
FSP II	–	Second Financial Sector Program
FSRP	–	Financial Sector Reform Program
GDP	–	gross domestic product
IDA	–	International Development Association
IMF	–	International Monetary Fund
ISU	–	Insurance Supervision Unit
MIS	–	management information system
MOF	–	Ministry of Finance
MSE	–	Mongolian Stock Exchange
MSEC	–	Mongolian Securities and Exchange Commission
NBF	–	nonbank financial
NBFI	–	nonbank financial institutions
NPL	–	nonperforming loans
PRGF	–	poverty reduction growth facility
RB	–	Reconstruction Bank
SB	–	Savings Bank
SCC	–	savings and credit cooperatives
SCS	–	Securities Clearing System
SDR	–	special drawing rights
SOEs	–	state-owned enterprise
SSIGO	–	State Social Insurance General Office
SSNDP	–	Social Safety Net Development Program
TA	–	technical assistance
TDB	–	Trade and Development Bank
USAID	–	United States Agency for International Development

NOTES

(i) The fiscal year of the Government and its agencies ends on 31 December.
(ii) In this report, "$" refers to US dollars.

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LOAN AND PROGRAM SUMMARY

Borrower Mongolia

The Proposal The Asian Development Bank's (ADB) support for the Government's Second Financial Sector Program (FSP II) will comprise a program loan of $15 million equivalent; and a technical assistance (TA) grant for Strengthening Financial Sector Development. FSP II and the International Development Association's (IDA) Financial Sector Adjustment Credit (FSAC) jointly support the Government's Financial Sector Reform Program (FSRP), the umbrella program.

The Program

Rationale Mongolia's impaired financial system is potentially the most significant constraint to achieving stable economic growth and the Government's socioeconomic development objectives, including poverty reduction. In view of the vulnerabilities of the economy to supply-side shocks as experienced in 1994, 1996, and 1998, and the concomitant effects on the banking system, the development of a sound, stable, and resilient financial system is imperative to avoid disruptions from protracted banking crises and improve financial intermediation. These disruptions have led to decreasing confidence in the banking system, as banks became insolvent and domestic savings were wiped out. Increases in intermediation spreads and higher bank restructuring costs have added to fiscal pressures and eroded macroeconomic stabilization.

Since 1996, the Government has accelerated financial sector reforms under ADB's Financial Sector Program loan (FSP), which was satisfactorily implemented by June 1999. Notably, from mid-1998 the pace of banking reforms accelerated, and bold measures were introduced. Commercial banks' prudential regulations were strengthened, eight insolvent banks were closed, bank licensing requirements were made more stringent, bank exit policies were tightened, and loan recovery became a priority. Subsequently, the Government adopted a comprehensive financial sector strategy that provides a long-term vision and medium-term strategy for the development of the sector. This strategy was unanimously supported at a financial sector coordination of external financers meeting in Ulaanbaataar in February 2000.

The FSRP will build on these reforms to improve banking governance with the objective of strengthening financial intermediation. The FSRP also aims to achieve a more balanced financial structure by developing nonbank financial intermediaries, capital markets, and contractual savings institutions. The FSP II supports these reforms. In addition, the

FSP II will address legal and regulatory deficiencies in the nonbank financial sector and capital markets, including the pension and insurance systems. These reforms are expected to promote the medium-term goal of enhancing domestic resource mobilization, including long-term sources of investment funds to complement the lending channels intermediated through the banking system and improve efficiency in resource allocation.

The FSP II will support the Government's efforts to develop a balanced, competitive, and market-based financial system according to its long-term vision for financial sector development and its medium-term strategy to achieve this vision. The FSP II is classified as pro-poor growth, as without these reforms domestic resource mobilization and thus investment will be constrained, resulting in lower employment and income. It will focus on improving financial sector governance and contribute to reducing poverty.

Objective and Scope

The objective of the FSP II is to promote the development of a competitive, stable, and broad-based financial system in order to strengthen financial intermediation, enhance domestic and external resource mobilization, and support sustainable economic growth.

The FSP II will focus on (i) fostering improved governance and operations in the banking system, (ii) developing marketable loan collateral, (iii) promoting the development of the interbank market, (iv) enhancing the regulatory and supervisory framework for nonbank financial institutions, (v) strengthening the operational and regulatory capacity of the Mongolian Securities Exchange Commission (MSEC), (vi) developing legal infrastructure to create a conducive environment for the securities markets, (vii) supporting the transformation from an unfunded to a partially funded pension system, (viii) building the capacity of Social Security Insurance General Office (SSIGO), and (ix) strengthening the legal and regulatory framework for insurance sector development.

Classification

Economic growth

Environmental Assessment

Category C. Environmental implications were reviewed, and no significant adverse environmental impacts were identified.

The ADB Loan

Loan Amount and Terms

A policy loan of SDR11,448,000 ($15 million equivalent) is proposed from ADB's Special Funds resources. The loan will have a maturity of 24 years including a grace period of 8 years. The loan will carry an annual interest charge of 1 percent during the grace period and 1.5 percent during the amortization period.

Program Period and Tranching The loan is expected to be used over 36 months commencing from the date of loan effectiveness. The loan proceeds may be used to finance the cost of eligible imports incurred within 180 days prior to the date of effectiveness. The loan will be released in two tranches. The first tranche will be $5 million equivalent, and the second tranche $10 million equivalent. The first tranche will be released upon effectiveness of the Loan Agreement. The second tranche is expected to be released by December 2001, subject to the fulfillment of all conditions for release of the second tranche set forth in the policy matrix. The FSP II also contains a set of conditions that must be fulfilled for its successful completion.

Executing Agency The Bank of Mongolia (BOM) will be the Executing Agency for the FSP II. It will have overall responsibility for implementation, including the administration and disbursement of the loan proceeds, maintenance of accounts, and preparation of quarterly progress reports on FSP II implementation. A steering committee has been established to oversee the FSP II implementation. The committee will be chaired by the deputy governor of BOM, and will include high-level representatives from the Ministry of Finance (MOF), MSEC, Mongolian Stock Exchange (MSE), SSIGO, Ministry of Justice, and State Property Committee. The steering committee will meet at least once every three months to ensure that the proposed reforms are undertaken in accordance with the agreed timetable. An adequately staffed program implementing unit has been established within BOM.

Procurement The loan proceeds will be utilized to finance the full foreign exchange costs (excluding local duties and taxes) of imports procured in and from ADB member countries, other than those specified in a list of ineligible items and those items financed by other multilateral and bilateral official sources. All procurement under the loan will be undertaken through normal commercial practices for the private sector or the Government's prescribed procurement procedures acceptable to ADB, with due consideration to economy and efficiency. The Borrower will certify that the volume of eligible imports exceeds the amount of the projected disbursements under the ADB loan in a given period. ADB will have the right to audit the use of loan proceeds and to verify the accuracy of the Borrower's certification.

Counterpart Funds The counterpart funds to be generated from the loan proceeds will be used to finance the structural adjustment costs for reforms to be initiated and implemented under the FSP II.

Technical Assistance

To help the Government implement the FSP II, ADB will provide TA for $600,000 equivalent to strengthen financial sector development. The TA will support (i) strengthening of the banking supervision system and development of loan collateral; (ii) capital market reforms through legal and regulatory strengthening of the equity markets; and (iii) strengthening of the legal, regulatory, and institutional framework for developing contractual savings institutions. The TA will be financed by ADB on a grant basis from the ADB-funded TA program. It is estimated that about 18 person-months of international consulting services and 10 person-months of domestic consulting services will be required. All consultants will be engaged in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for the recruitment of domestic consultants.

Risks and Safeguards

The principal risk lies in the timing of the proposed FSP II. The FSP II loan will be presented for Board consideration just prior to a Parliamentary election. It is expected that the FSP II will be ratified by the current Parliament (within July). However, if this Parliament does not ratify the FSP II, then the new Parliament may need additional lead time before final ratification. This concern is considered manageable in view of the nature of the policy actions proposed under FSP II, which have support from the various political groups.

A second risk is that, because of resistance or lack of cooperation by vested interests, the Government may be unable to implement the policy measures required to strengthen legal provisions and privatization of the MSE. In addition, there may be risks associated with weak capacity at the agency level to successfully implement the reforms, as well as risks stemming from weak coordination between institutions. To address these downside risks from weak capacity, TA will be provided to key agencies—BOM, MOF, MSEC, SSIGO—for institutional upgrading. Policy coordination will be supported by the high-level steering committee and program implementation unit.

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on a proposed loan to Mongolia for the Second Financial Sector Program (FSP II). The report also describes proposed technical assistance (TA) for Strengthening Financial Sector Development, and if the proposed loan is approved by the Board, I, acting under the authority delegated to me by the Board, shall approve the TA.

II. INTRODUCTION

2. In 1991, Mongolia began a comprehensive reform process. The goal was to transform the economy from a centrally planned to a market-based system. The Government's reform program, backed by firm external assistance, sought to achieve a systemic transformation to a market economy, accelerate economic growth, and reduce poverty. The economic transformation has been marked by the removal of price controls, privatization of state-owned enterprises (SOEs), and development of a conducive environment for private sector-led development supported by a relatively small and fragile financial system. The impact of these reforms led to an average annual gross domestic product (GDP) growth rate of 3.6 percent over the last five years. Inflation has been brought down from over 50 percent in 1996 to single digit in 1998 (although it increased to 10 percent in 1999). However, in several areas economic progress has been frequently interrupted by protracted political uncertainties and terms of trade shocks due to volatile commodity export prices because of the vulnerabilities of the small, narrow-based, open economy. These developments have often strained the fiscal and external accounts.

3. The economic and political vulnerabilities have complicated the process of financial sector development in Mongolia. To lay the foundation for a sound and market-oriented financial sector, the Government launched the first phase of its financial sector reforms from 1996 to 1999. This was supported by the Asian Development Bank's (ADB) Financial Sector Program (FSP) loan[1], for SDR24.201 million ($35 million equivalent) and two TAs.[2] The FSP focused on (i) establishing a legal and regulatory framework for the financial sector consistent with international standards; (ii) restructuring the banking system to strengthen viable banks and close insolvent banks; (iii) reducing the Government's involvement, while encouraging market orientation and commercializing the banking system; and (iv) developing capacities to improve bank credit and risk management, portfolio and asset-liability management systems, and supervision systems.

4. Implementation of the FSP,[3] though somewhat slower than expected, helped introduce market orientation and commercialization in the banking system. Key reforms included liberalizing banking policies, strengthening regulations, and restoring health of the viable banks, while closing insolvent banks. Currently with the exception of the Agricultural Bank (AB) under receivership, and Savings Bank (SB) with lending restrictions and pending restructuring, all banks meet capital adequacy requirements. Furthermore, comparing prudential regulations in the banking system as a whole between December 1997 and December 1999 reveals that capital adequacy, liquidity, foreign exchange exposure, and loan loss provisioning requirements

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1 Loan 1509-MON: *Financial Sector Program*, for $35 million, approved on 19 December 1996.

2 TA 2720-MON: *Strengthening the Supervisory and Restructuring Capacity of Bank of Mongolia*, for $1 million, approved on 19 December 1996; and TA Loan 1510-MON: *Upgrading Skills and Systems of Commercial Banks*, for $3 million, approved on 19 December 1996 to support loan implementation.

3 R107-99: Loan 1509-MON: *Financial Sector Program* Loan, Progress Report: Release of Second Tranche, 15 July 1999.

have all improved. However, the financial sector remains weak, lacks diversification, and plays a limited role in the economy. Financial intermediation in Mongolia would benefit from stronger and better managed banks, together with the development of nonbank financial institutions (NBFIs). The structure of the financial sector is unbalanced, the stock market is small and illiquid, and market-based insurance and leasing businesses are just beginning to emerge.

5. The FSP complemented and reinforced the enhanced structural adjustment facility (ESAF), for 1997-2000, approved by the International Monetary Fund (IMF). Although the first annual arrangement eventually lapsed on 30 July 1998 due to a sharp deterioration in the fiscal accounts, in July 1999 the Government negotiated a second annual arrangement of SDR14.8 million for 1999-2000. Under the ESAF, the Government adopted a strong macroeconomic stabilization program based on (i) tight fiscal and monetary policies to curb inflationary pressures and (ii) wide-ranging sector reforms to strengthen banking.

6. 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.[4] These were discussed at an external assistance coordination meeting in Ulaanbaatar in February 2000. To implement this strategy, the Government asked ADB and IDA to support the second phase of financial sector reforms. In response, ADB and IDA have developed a comprehensive Financial Sector Reform Program (FSRP) covering the various subsectors of the financial sector for potential parallel financing of the associated costs of structural adjustments. This umbrella program, the FSRP, will be supported by (i) a financial sector adjustment credit (FSAC) of $32 million equivalent approved by IDA on 20 April 2000[5] and (ii) the proposed FSP II.

7. The broad objectives and scope of the FSP II were discussed with the Government during the Reconnaissance Mission fielded in January 2000. Following this, ADB participated in the external assistance coordination meeting in February to finalize the pace and sequence of overall financial sector reforms over the medium term. An ADB mission subsequently visited Washington in March 2000 to discuss the FSRP with the Government, and develop coordination and parallel financing arrangements. Subsequently, a joint ADB-IDA mission[6] visited Ulaanbaatar in late March 2000 and reached agreements on a common development policy letter and policy matrix (Appendix 1) which form the basis for the FSRP. At IDA's request, an ADB representative attended the World Bank Board presentation of the FSAC.

8. The implementation of this common policy framework will be jointly supervised by ADB and IDA. Under the agreed arrangements, the FSAC will focus on banking reforms, while the FSP II will focus on reforms of financial governance, nonbank financial (NBF) intermediaries (including capital market development), and contractual savings. See policy matrix for FSP II in Appendix 2. The FSP II program framework is presented in Appendix 3.

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4 World Bank. 1999. *Mongolia Financial Sector Strategy*. Washington.

5 FSAC was ratified by Parliament on 18 May 2000.

6 The Mission comprised B. Carrasco, Mission Leader; K. Moinuddin, Principal Adviser; and V. You, Counsel. The Mission was also assisted in the field by B. Hitchcock, Sr. Programs Officer. R. Lynn Ground, Co-Task Manager; H. Hahm, Sr. Financial Economist; and C. Escudero, Sr. Counsel of IDA participated in the Mission.

III. THE MACROECONOMIC CONTEXT

A. Development Objectives, Strategy, and Plans

9. The Government's medium-term economic adjustment and reform strategy aims to stabilize the economy and maintain social protection programs within a prudent medium-term expenditure framework. The reform strategy also seeks to accelerate enabling structural reforms that facilitate private sector-led development as well as public sector restructuring. This stabilization and adjustment program is complemented by investments in social and economic infrastructure that aim to reduce poverty and strengthen Mongolia's competitiveness. The key components of the strategy include (i) macroeconomic stabilization, (ii) financial sector development, (iii) private sector development, (iv) new approaches to infrastructure development, (v) promotion of foreign direct investment, (vi) promotion of export-oriented industries, and (vii) human and social sector development.

10. The Government's medium-term development strategy emphasizes sustained economic growth and development of a strong financial sector. The strategy highlights the importance of developing a healthy financial system to improve macroeconomic stability, mobilize savings, and restore credit to cash-strapped sectors of the economy. For a more detailed presentation of the Government's long-term vision and medium-term strategy for financial sector development see paras. 52-53.

B. Recent Macroeconomic Performance and Prospects

1. Macroeconomic Performance

11. Mongolia began the transition to a market-based economy in 1991. Following three years of adjustment characterized by negative growth, the economy grew at an average annual rate of 3.6 percent during 1994-1999. The source of growth is traced primarily to private sector-led agriculture sector development, following the privatization of livestock herding and manufacturing, and expansion of service. Mongolia's economic performance is heavily dependent on the production and export of primary commodities including cashmere, copper, and gold. These three commodities are, however prone to volatile price fluctuations in world markets, which have exposed Mongolia to significant terms of trade shocks in 1994, 1996, and again in 1998 that have adversely affected macroeconomic stability.[7] The severe winter of 1999-2000 resulting in a serious depletion of Mongolia's livestock have far-reaching implications for poverty reduction in the coming years.

12. Notwithstanding terms of trade reversals, the macroeconomic framework has gradually, albeit modestly, improved. Tight monetary policy pursued during 1997-1999 has resulted in the inflation rate dropping from 53 percent in 1996 to 6 percent in 1998, even though it rose to 10 percent in 1999. While tugrug depreciation was moderate in early 1998, the Bank of Mongolia (BOM) devalued the currency by 16 percent in mid-1998 to accommodate the sudden fall in copper prices. Monetary policy will continue to aim at containing inflation at a single-digit rate and facilitate exchange rate management in order to build up international reserves.

13. For the past five years, the budget deficit averaged 10 percent of GDP (excluding privatization proceeds). Despite a 3 percent increase in the value-added tax (from 10 to 13 percent in 1998), the introduction of a $7 per ton excise tax on petroleum, and the reinstatement

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[7] Since late 1997 average export prices of copper fell by 23 percent, cashmere 21 percent; and gold 5 percent resulting in a fall of export earnings of 23 percent in 1998.

of a 5 percent import tax in 1999, difficulties in mobilizing tax revenue continue. Tax revenues, which represent 18 percent of GDP, could be improved. As a result of weak revenue collection, fiscal adjustments have been mostly accommodated by reductions of capital expenditures. This has dampened long-term economic growth prospects. The severe terms of trade shock and the spillovers of the Asian and Russian crises have also had a significant impact on the budget deficit,[8] which rose to 11.3 percent in 1998. The Government's move to defer its pension liabilities and social transfers has affected vulnerable segments of the population. In addition, delays in interest payments on bank restructuring bonds have negatively affected the financial position of the banks. Prudent fiscal management will be critical to achieving and sustaining macroeconomic stability.

14. Mongolia's balance of payment position has been tenuous. In 1998, the external current account deficit deteriorated and rose to 11.4 percent of GDP. The weakness of the external account stems from the country's narrow export base, which is heavily dependent on primary commodities that are subject to higher price volatility. Foreign direct investment inflows continue to be moderate; annual inflows rose to $2.9 million in 1999 from $2.6 million in 1997. International reserves rose to $100 million in 1999 (11.6 weeks of import coverage), up from $75 million (7.1 weeks of import coverage) in 1998 reflecting the tugrug depreciation in 1998 and the effects on net exports (largely due to a decrease in imports). The domestic and external resource gaps have been met by external borrowing. By the end of 1999, the external debt grew to an estimated 78 percent of GDP (up from 53 percent in 1995). However, most of this debt has been contracted on a long-term, concessional basis. The Government continues to limit foreign borrowing to concessional lending. Despite moderate improvements to macroeconomic management, Mongolia remains a relatively poor country with income per capita estimated at $430 with official development assistance contributing up to 30 percent of the consolidated budget. This makes Mongolia one of the biggest recipients of multilateral aid in per capita terms. A recent sovereign risk rating by an international credit rating agency classified the country as B minus. Trends in key macroeconomic indicators for 1994-1999 are presented in Supplementary Appendix A.

2. Macroeconomic Prospects

15. The Government with IMF support has embarked on a strong adjustment program to maintain inflation below 10 percent, promote sustained annual output growth of about 4 percent, and strengthen Mongolia's external position. Central to the achievement of these objectives is the implementation of a fiscal policy package designed to reduce the overall Government deficit to 6.5 percent of GDP by 2001, from 11.3 percent in 1998. This fiscal policy package, presented to Parliament in April 1999, includes measures to increase Government revenue by 2 percent of GDP and reduce its spending by about 1 percent of GDP on an annual basis. The goal is to eliminate net bank credit to the Government by 2000, thereby averting a resurgence of inflationary pressures and freeing-up additional resources for private sector development. Successful implementation of the public sector reform program and acceleration of the privatization of the most valuable SOEs are critical for fiscal consolidation. At the same time, the adoption of a flexible exchange rate policy will facilitate smooth adjustment to changes in the terms of trade.

16. Mongolia's medium-term economic outlook is predicated on the Government's success in adhering to fiscal and monetary programs in support of strengthening macroeconomic fundamentals. In particular, the fiscal position needs to be strengthened by improving tax

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8 Losses in unrealized budget revenues in 1998 were approximately Tug20 billion reflecting decreased income tax and dividend payments from Erdenet Mining Corporation.

revenue collection. The effects of the Zud—the severe winter condition that killed 2 million head of livestock out of a total stock of 32 million—will put pressure on the fiscal and monetary programs. Preliminary estimates put the livestock losses at up to $30 million. The Government expenditures will likely rise in response to the emergency, thus fueling inflationary expectations. Efforts to contain public spending in the run-up to the parliamentary elections scheduled for July 2000 are also being closely monitored. The continued maintenance of a prudent monetary policy will help contain inflationary pressures emanating from external shocks and domestic relative price adjustments. In the longer term, sustained improvements in Mongolia's welfare will also crucially hinge on how efficiently it diversifies its economy and reduces dependence on the exploitation of primary commodities, such as copper, for income and employment generation. To reduce the destabilizing effects of the significant price volatility of key commodities, the FSAC will seek to introduce measures to mitigate risks and improve macroeconomic management.

17. In addition to these macroeconomic policy measures, the Government recognizes that its strategy for private sector-led growth must also be built on the foundation of a solvent and efficient financial system. Moderate fiscal deficits coupled with single-digit inflation over the medium term should lead to a lowering of the central bank's bill rate (short-term monetary policy instrument). Combined with ongoing bank restructuring and loan recovery efforts to be supported under the FSRP, the lowered central bank bill rate is expected to result in lower interest spreads and improve financial intermediation. This is likely to improve access to credit in the economy. The enhanced banking regulatory framework will improve asset quality in the banking system. These measures combined with the continuation of official loan disbursements and improvements in foreign direct investment inflows are expected to help improve economic growth prospects in the medium term.

IV. THE SECTOR

A. Background, Constraints, and Issues

1. Banking System

a. Background

18. Mongolia currently has 12 licensed commercial banks, with a network of over 500 branches, subbranches, and cash counters, while foreign (minority) participation is limited to one bank. The banks have about 500,000 customers and employ approximately 2,000 people. As of December 1999, the three largest banks in terms of assets—Trade and Development Bank (TDB), SB, and Golomt Bank—held some 80 percent of all bank assets. In terms of deposit liabilities (time and demand deposits), SB alone had about 46 percent of total deposits. Net lending in the banking system is Tug53.6 billion backed by total assets of Tug182 billion. Capital adequacy in the banking system is 20 percent. As of December 1999, the three problem banks—AB, Bank of Investment and Technological Innovation (BITI), and Reconstruction Bank (RB)—accounted for about 10 percent of total assets and 56 percent (BITI and RB account for 50 percent) of nonperforming loans in the banking system. Eight banks are fully or partially owned by the Government. Fully private commercial banks account for about 10 percent of all assets. Financial intermediation through the banking system is limited. There is a narrow range of financial instruments (domestic and foreign currency deposits, and treasury and central bank bills), with only one bank offering a checking account facility.

19. Financial sector reforms in Mongolia were initiated in 1991. To replace the monobanking system, the Government established a two-tier banking system and entrusted Bank of Mongolia

(BOM) with responsibility for maintaining monetary stability and supervising the operations of commercial banks. During 1991-1995, measures were taken to phase out directed lending, improve banking regulations, and encourage commercial banks to adopt better credit management. However, the banking system remained fragile. Commercial banks had loan-to-deposit ratios of more than 80 percent, were unable to maintain sufficient liquidity to service the needs of their clients, and violated reserve requirements and liquidity norms stipulated by BOM. Four of the five large commercial banks and three of the smaller, privately owned, banks were technically insolvent. In part, the weaknesses of the banking system reflected (i) carryover costs associated with inherited and directed loans, (ii) poor management, (iii) a weak regulatory and supervisory framework, and (iv) a limited skills base.

20. In July 1996, the incoming Government announced a plan to promote the establishment of a sound market-based financial system. Salient features of this plan, supported by ADB, IMF, and World Bank, include (i) closure of two large insolvent banks: Ardyn Bank and Insurance Bank; (ii) the creation of the Mongolian Asset Restructuring Agency to purchase nonperforming assets of banks in exchange for Government bonds; (iii) establishment of two new banks, RB and SB, with the former inheriting the performing loans and commercial deposits, and the latter taking over the household deposits of the two closed banks; and (iv) restructuring of AB and BITI. These reforms restored some confidence in the banks in 1997. This led to a rise in deposits, bank profitability, and their capital adequacy (to 12.5 percent, exceeding the 10 percent prescribed minimum), as well as to some improvement in asset quality and banking system liquidity. However, progress in banking system reforms was overshadowed in early 1998 by the failed merger of RB and Golomt Bank. This diverted resources needed for financial sector reforms and delayed the progress of financial sector restructuring. Imprudent lending, and poor management and internal controls generated heavy losses for RB.

21. From July 1998 and throughout the six-month hiatus under a caretaker government, reforms slowed. In December 1998, the Parliament appointed the current Government. In February 1999, a bank restructuring action plan, was agreed to by the Government, ADB, IMF, and the United States Agency for International Development (USAID). Under this plan, the management of three insolvent banks, AB, BITI, and RB, were removed and replaced by conservators in February-May 1999. Reorganization plans were approved and implemented, leading to operational and financial restructuring. Shareholders in AB and BITI were asked to increase the capital (RB is state-owned), and following the negative response, shareholders' capital was written down to cover the losses. In October 1999, BOM placed BITI and RB under receivership, revoked their licenses, and proceeded with an orderly liquidation of the two banks. In the case of AB, a receiver was appointed in October, and a restructuring plan was approved to rehabilitate the bank.

22. Despite a difficult political environment and the severe external supply shocks induced by the combined effects of the Asian and Russian Crises in 1997 and 1998, by December 1999, the Government had satisfactorily complied with the reform program under the FSP (footnote 1).[9] Notable achievements under the FSP include the adoption and enforcement of improved prudential regulations and supervision, and steps to facilitate debt recovery and eliminate bank insolvency. The FSP also supported strengthening market discipline by reducing state involvement in the management of banks[10] and tightening enforcement of banking laws to address the pervasive default culture. This was also intended to improve the debt recovery problems largely responsible for the large share of nonperforming loans and weak asset quality

9 The Progress Report (footnote 3) provides a detailed assessment of financial sector reforms implemented under the FSP.

10 State involvement in the banking system was exercised directly through state ownership of banks and indirectly by influencing lending policies through directed credit programs.

in the banking system. Bank restructuring activities were a central focus of the FSP and after a slow start, 8 (of 20) banks were closed from June 1998 to December 1999. In addition, and to prevent the entry of weak banks, licensing requirements were strengthened and minimum bank paid-in capital was increased (para. 27). Supplementary Appendix B presents data on banking system indicators.

b. Constraints and Issues

23. Notwithstanding these improvements, the banking system remains fragile. The second phase of banking reform is now directed at addressing structural problems with the objective of strengthening financial intermediation in the economy. A healthy banking system will support efficient intermediation and improve growth prospects of the economy. To lay firm foundations for the development of a sound and stable financial system, the following systemic weaknesses need to be addressed.

i. High Intermediation Cost

24. The fundamental issue to be addressed by the FSRP is to lay the groundwork for the reduction of the high intermediation spreads in the banking system. The spreads are symptomatic of general distress in the banks reflecting the increased risks of default, high operating costs, and large stock of nonperforming assets in the banks' portfolios. Short-term, domestic currency loans are being contracted at annual (nominal) average interest rates ranging from 24 to 47 percent, and banks pay annual (nominal) average deposit rates on domestic currency time deposits of about 10 to 30 percent. Despite a significant reduction in inflation over the past two years, only recently has there been a fall in the central bank bills rate (benchmark monetary policy instrument) which is now at 11 percent compared with 20 percent in April 1999. In addition, limited availability of marketable collateral has constrained lending activities throughout the banking system. Improving asset quality in the system and ensuring timely access to secured collateral will be key to relaxing credit constraints, reducing interest spreads, and improving financial intermediation.

ii. Regulatory Forbearance

25. Faced with what was an undercapitalized banking system, the central bank has focused on restoring the health of problem banks by facilitating their recapitalization through profit retention and/or debt write-offs. However, political pressures together with continued lax lending, limited supervision capabilities, and weak legal enforcement for debt recovery have aggravated the problem of nonperforming loans. Ad hoc liquidity support to insolvent banks under lender of last resort arrangements, reinforced by the absence of explicit safety nets in the banking system, has led to direct Government involvement through bailouts. This has resulted in a large fiscal restructuring cost of approximately 5 percent of GDP over the past four years.

iii. Weak Governance and Internal Controls in the Banking System

26. Banks are poorly managed and have limited commercial orientation. State-owned banks are operated by managers who were trained under the old system based on directed lending that was subject to political interference. Newly privatized banks are owned by individuals who view ownership primarily as a means to finance their business activities over any other priority. In addition to insider lending, lending to related parties continues and is often supported by less stringent credit evaluation, or other privileges at times exceeding the regulatory limit. In other instances, loans have continued to flow to companies despite debt-servicing problems. In the absence of qualified bank

managers, internal oversight is weak with lack of understanding of rules of responsibility and weak enforcement of checks and balances. The limited disclosure and reporting requirements together with the absence of effective accountability perpetuates bad management.

iv. Limited Incentives Framework to Support the Development of Strong Banks

27. The development of a core, sound banking system is constrained by lax bank entry conditions, weak regulatory oversight, and the absence of a clear bank exit strategy. In September 1999, the minimum bank paid-in capital was raised to Tug1 billion from Tug400 million (and is to be raised to Tug2 billion for all banks under the FSAC effective June 2001). Bank licensing is not subject to standard testing based on "fit and proper"[11] conditions; this erodes the development of sound banks with strong management. Despite attempts to use the power of the law to deal with negligence and malfeasance on the part of bank owners which caused bankruptcy, the weak legal and regulatory framework and the attendant moral hazard problem continue to present major hurdles to developing a healthy banking system. On the regulatory side, there is limited scope to take advance and effective prior action in the case of early warnings of bank distress. There is no bank insolvency law in place (although a draft law has been prepared under an ADB TA) nor any prompt corrective action program linking remedial trigger actions to specific capital targets. To strengthen the banking system, it is critical that the Government adopt a bank exit strategy that is incentive compatible, places ultimate responsibility for bank failure on the owners, and stresses prompt action to resolve failed banks.

v. Limited Reach of Financial Services

28. The banking system provides a narrow range of financial instruments usually limited to demand, savings, and time deposits on the liabilities side. Government bonds and treasury and central bank bills dominate assets. In the absence of a functioning interbank market, financial market are generally not liquid. Loans are concentrated in few enterprises and often confined to better-known firms. Difficulties in registering and accessing even the limited types of property as loan collateral due to institutional and legal constraints further undermines lending activities. Term finance is unavailable; the usual practice to overcome this problem is to continue rolling over short-term loans. This generates maturity mismatch and increases overall risk in the banking system. In the rural areas, formal lending is even more constrained than in the urban areas. Prior to 1999, the rural areas were serviced by AB, and will be partly serviced by the Mongol Post Bank (BOM has issued lending licenses to Mongol Post Bank in five aimags [provinces]) and AB (upon successful restructuring and recapitalization). The newly formed savings and credit cooperatives (SCCs) and finance companies offer a new channel for increasing the provision of financial services in the rural areas. The pawnshops provide the bulk of informal lending. Secondary markets in existing assets are thin, and raising equity through the stock market is not yet a viable option for the corporate sector.

2. Nonbank Financial Sector

29. Mongolia's NBF sector, at a nascent stage of development, comprises SCCs, finance companies, and leasing companies. SCCs were reintroduced in Mongolia in 1997 following what was an extended use of credit cooperatives prior to 1991. In three years, 32 SCCs were licensed. SCCs are registered and affiliated to two competing and separate associations, or federations of SCCs. These include the National Confederation of Savings and Credit Cooperatives with 21

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11 "Fit and proper" conditions require the regulator to ensure that bank management has the necessary knowledge, background, and experience to operate a bank.

members and the Association of Savings and Credit Cooperative with 11 members. In addition, all SCCs are registered with the tax office.

30. SCCs provide loans ranging between $500 and $3,000 according to the needs of their members. Loans tend to be used for trade finance and seed capital for business start-ups. Lending rates generally reflect cost of capital; however they are lower than rates charged by pawnshops. The SCCs, like all forms of cooperatives, are basically operating as self-regulatory organizations as allowed for under the Cooperatives Act, and are governed by their members according to the rule: one member, one vote.

31. The number of SCCs has been rapidly increasing; in 1999 21 new licenses were issued. This expansion largely reflects the difficulties small firms and households face, in gaining access to credit from banking institutions. Given Mongolia's small capital base and small and widely dispersed population, SCCs are well suited to lend especially in rural areas where maintaining an extensive branch banking network may not be a viable option. Most SCCs have been established in urban centers, and it is expected that these will soon expand into rural areas.

32. Although SCCs by virtue of their small size are not a potential source of systemic risk, there is practically no regulatory oversight other than informal means of enforcing discipline through peer (member) pressure. Some SCCs have already failed, and if this subsector is to expand, confidence must be built by bringing them under systematic supervision and regulation. To avoid any ensuing regulatory fragmentation and coordination failures, and the cost implications of starting up a new institution, BOM should provide regulatory oversight of SCCs.

33. In 1999, following BOM's approval of basic regulations on finance companies (non-deposit-taking institutions), BOM licensed operations of two finance companies. Licenses were issued to (i) a former bank, Bayanbogd Bank, that was unable to meet the minimum paid-in capital requirement (Tug1 billion) and (ii) a former cooperative, Golden Fund, which was supported by Micro Start, a program of the United Nations Development Programme. Golden Fund has grown quite rapidly over the past six months successfully expanding operations. Golden Fund intends to develop as a microlending institution. Several nongovernment organizations have been supporting Golden Fund, including the National Association of Mongolia Agricultural Cooperatives, LEOS (a women's organization), Mongolia Women's Federation, rotary clubs (Ulaanbaatar), Open Society (Soros), and Local Development Fund. Golden Fund has lending operations in Ulaanbaatar, Khentii, and Dornogobi aimags, and provides loans of up to $300 at interest rates of 5-7 percent monthly, with 1-10 months tenure through five branches. As of December 1999, Golden Fund had a loan portfolio of Tug1 billion covering some 5,000 loans. Its loan portfolio consists of trading loans (70 percent), small-scale manufacturing loans (20 percent), and loans in the services sector (10 percent). The lending operations to date have registered a repayment rate of 98 percent. The challenge facing Golden Fund is how to expand activities and remain commercially viable as it faces nonconcessional sources of financing and will have to operate under market conditions. Two new finance companies were licensed in 2000, namely Gobi Initiative (supported by USAID) and Mongol Credit (supported by TACIS).

34. Finance companies are expected to focus on small lending activities, primarily business loans in urban areas. BOM regulations prohibit finance companies from deposit taking. This is expected to limit their ability to leverage funds and inhibit their intermediation functions. Finance companies are not expected to compete with banks for the same clientele, but instead, are expected to develop small lending niche markets. Nevertheless, they need to operate within a sound prudential regulatory framework including capital adequacy, liquidity requirements, and other standard prudential requirements. There are two financial leasing companies, Boddi Leasing Company and Orchid Leasing Company. Until recently, the supervision of financial leasing

companies was subject to uncertainty due to the debate between BOM and the Ministry of Finance (MOF) about which institution should be vested with this responsibility. Although BOM has now been vested with this responsibility, there has been little progress over the past two years in introducing minimum prudential standards and improved reporting requirements. The Supervision Department of BOM needs to be strengthened; otherwise enforcement capabilities will be severely tested.

35. Finally, various leasing companies have been operating for the past few years. These companies are mostly dealing with leasing of durable goods, plant, and equipment, and are not subject to any systematic oversight by a designated regulatory agency. Supplementary Appendix C presents some key data on nonbank financial companies.

3. Capital Markets

a. Background

36. Relatively smaller than the banking system, capital market activity started in 1991 with the establishment of the Government-owned Mongolian Stock Exchange (MSE). A major impetus to the stock market was provided by the privatization of SOEs during 1991-1994: SOE investment coupons were allocated to more than 2 million citizens for the purpose of trading on the MSE. About 1.2 million citizens became shareholders of 470 companies. In September 1994, the Securities Law of Mongolia was enacted, followed by the establishment of the Mongolian Securities and Exchange Commission (MSEC). The Partnership and Company Law was enacted in May 1995, and amended in August 1999 as the Company Law.

37. MSEC was established by the Government in 1995 to regulate and monitor securities market trading. It has a Board of five commissioners – the chairperson is nominated by the Prime Minister; one member is nominated by the minister of finance, another by the governor of BOM; and two are nominated by the Parliament. All commissioners serve for a 5-year term. MSEC is also responsible for implementing the Securities Law and other legislative acts and procedures, protecting investor interests, enforcing disclosure requirements, and carrying out educational and public awareness programs.

38. The MSE operates as a nonprofit (i.e., profits revert to the national budget) and self-regulatory organization. It has six departments and employs over 60 staff. The Trading and Information Department is responsible for organizing the trading and dissemination of market information to investors. The Listing and Supervision Department receives applications from companies to be listed on the MSE, oversees disclosure of financial and material information; and implements supervision of trading, clearing, and settlement transactions. The Clearing, Settlement and Depository Department is set up to provide a book-entry clearing system. Under this system, shares deposited by securities companies and other participants are held in the central depository. Clients in turn must have only one account in the central depository, and must use member securities companies as intermediaries. All stock trading at the MSE is settled the business day following the day of the transaction (T+1).

39. Active secondary trading on the MSE started in August 1995. At present, there are 418 companies listed, of which 324 are privatized enterprises. The market capitalization, as of February 2000, was $37 million, close to 4 percent of GDP, down from $53 million in early 1998. Trading activity has declined sharply over the last year, as evidenced by the drop in average daily trading from $25,000 in September 1998 to about $13,000 in January 2000. Listed companies are classified according to one of three categories, A, B, or C, based upon standard indicators of asset quality such as price/earnings ratios, and liquidity of the shares. Currently

the majority of the listed companies are classified in C (or lowest) category. These companies are supported by 41 securities brokerage companies, a central depository agency and a clearing agency. No foreign companies are listed on the MSE, although the conditions and requirements for foreign companies are the same as for domestic companies.

40. To promote foreign investment, no tax is imposed on the dividend and profit gained from stock trading (however, a new law that will tax dividends and profit from securities trading will become effective January 2001). In addition, repatriation of profits and dividends, as well as proceeds from the sale of assets and securities is permitted.

b. Constraints and Issues

41. While steps have been taken to develop the securities industry, the capital market is still at a nascent stage of development. Major supply-side issues include a small corporate sector and slow progress in privatizing the remaining 95 SOEs, the largest of which are likely to be sold to strategic investors outside of the MSE.[12] So far there have been no initial public offerings. On the demand side, limited capacity of MSEC to serve as an effective policymaker and regulator has dampened investor confidence, and indicates the need for considerable institutional strengthening. Of late, there have been cases of collusion among brokers and dealers to influence price movements on the MSE, further undermining investor confidence.

42. Securities companies are generally weak. Minimum authorized capital of a securities company according to the Company Law is Tug1 million for a limited liability company and Tug10 million for a joint stock company. Admission fee into the MSE is Tug5 million (paid once) and the annual membership fee Tug1 million. More recently and following the economic downturn, there have been calls to lower the annual membership fee, although administration of the MSE has not yet conceded to these demands.

43. Following the fall in market capitalization and because of the difficulty to maintain profitability, surviving securities companies have reacted to the market downturn by following a growth strategy based on charging large trading commissions. These are currently set at 5 percent of the share price on any buy or sell order. A “round trip” leading to a buy and eventual sell will imply an investor’s reservation value on expected gains of at least 10 percent. These high transactions costs, which are tantamount to a tax on securities trading, represent a serious impediment to fostering a vibrant securities market. The new regulations should clearly focus on the larger interests of the securities industry as a whole and not protect the interests of a particular group. In addition, securities companies which are financially weak need to strengthen their balance sheets in parallel with the strengthening of their commercial orientation in order to develop into professional client-based premier service providers.

44. On the supply side, over the short- to medium-term, the development of capital markets is closely linked to the success of the Government’s privatization program. Following a lull in the 1994-1996 privatization program, in 1997 the Government launched a second phase of the privatization program after passage of the new Privatization Law. The implementation of the 1997-2000 privatization program has led to the privatization of some 900 SOEs raising total privatization proceeds of Tug41 billion. A new privatization program is expected to be approved following the formation of the new Government. Currently, many of the strategic SOEs are on a negative list established by Parliament, thus preventing the Government from privatizing them.

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[12] Seventeen large, most-valuable SOEs are on a separate list, that will be approved by Parliament on a case-by-case basis. These include TDB, Neft Petroleum Import Concern, Gobi Company, Erdenet Mining Corporation, Mongol Daatgal Insurance Company, Mongolian Stock Exchange, and MIAT Mongolian Airlines, (para. 44).

Under the arrangement, any proposal to privatize the companies on the negative list will have to be presented to Parliament on a case by case basis. The measure reflects Parliament's insistence on having a role in the divestment of SOEs in strategic sectors, given the sensitive nature of some of the most valuable companies rather than opposition to privatization. The 2000-2003 privatization program is likely to be as strong as the 1997-2000 program. It is expected that the sale of a part of these stocks through the MSE will strengthen investor interest in the stock exchange.

45. While the legal framework for establishing companies is in place, many enterprises have recently been changing their legal status from joint-stock companies to limited liability companies, without changes to their shareholding structure. Such practices reduce transparency and act against good corporate governance; in particular, they result in further neglect of the small shareholder's interests. The protection of investors' interests is critical to fostering increased demand for tradable stocks. While the draft Securities Law does include actions to support protection of small investors' interests, implementation will take time. The draft law also gives greater power to MSEC to strengthen monitoring and enforce regulations. However, the institutional capacity at MSEC is weak. Unless there is a commitment from the Government to provide additional resources and improve supervisory and regulatory skills at MSEC, enforcement will be compromised. Public awareness of the benefits and risks of the equities and debt markets together with efforts to restructure and improve MSEC, including improved accounting standards and timely flow of information, will also need to be strengthened to inspire greater investor confidence.

46. In addition, there is currently no legal basis for the development of institutional investors. Legislation, regulations, and guidelines for their operations including investment funds and trusts will have to be developed. The establishment of the legal infrastructure to support institutional investors will lead to the eventual integration of contractual savings institutions in capital market development through pension and insurance funds, and enhance the prospects of longer-term sources of finance. Finally, Mongolia is unique in terms of its Government-owned stock exchange; the question of whether capital markets can be made more vibrant by privatizating the MSE must be examined. Supplementary Appendix D presents statistics on capital market indicators.

4. Pension System

a. Background

47. The development of the capital market will benefit from reform of the pension system to ensure its social and fiscal sustainability. Mongolia's pension system is modeled on a pay-as-you-go system under which current generations contribute to meeting the pension obligations of retired workers. The Pension Fund, which is one of five social security funds, operates on a 19.0 percent contribution from the wages of employed workers and 9.5 percent contribution of self-employed earnings.[13] For the nongovernment sectors, employers contribute 13.5 percent of their wages, and employees 5.5 percent; whereas government employees contribute 1.1 percent of their wages with government contributing 17.9 percent. Coverage is mandatory, with the exception of the self-employed and herders. Significant transfers from the Government budget supplement these pension contributions, which are not accumulated or invested, in order

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[13] The other components of social insurance, with the respective employer-employee contributions from the wages, include social benefits insurance (1.0 percent each), work injury insurance (1.0-3.0 percent contributed by the employer), unemployment insurance (0.5 percent each) and health insurance (3.0 percent each). The self-employed contributions to these schemes are 1.0 percent, no unemployment contributions, and a fixed sum of Tug800 for health coverage.

to meet the current pension obligations. The collection of contributions and payment of benefits are administered by the State Social Insurance General Office (SSIGO). Like other transition economies, the pension system has been affected by the (i) growing number of unfunded liabilities; (ii) contribution arrears, particularly from state-owned bodies; and (iii) narrow base of pension contributions relative to recipients (low replacement rate). Supplementary Appendix E presents data on pension funds.

b. Constraints and Issues

48. To address these issues, the Government pension plan aims to introduce notionally defined individual pension accounts. The Law on Individual Pension Accounts, adopted by Parliament on 11 June 1999, provides that workers born after 1 January 1960 will be given individual pension accounts indicating their past pension contributions with effect from 1 January 2000.[14] One of the critical elements in the Government's decision to introduce partial funding was the need to ensure a proper balance between the long-run fiscal sustainability of the pension system vis-à-vis intergenerational equity. While the new law will result in changes to the benefit structure for many groups in the population, depending on years of service and the current privileges they enjoy, the truncation is based on sound actuarial analysis to weigh the net cash-flow generation under various reform options. The cost of the program of individual accounts under the chosen truncation date is likely to grow more slowly over time relative to GDP than alternate reform options, although the projections are subject to the assumptions being realized. USAID has provided TA support to help develop administrative systems to introduce notional individual accounts. The annual returns to the individual contributions will be determined by SSIGO. While the new system will enable pension payments to be closely linked to contributions, the pension fund will be unfunded for the foreseeable future. The Government plans to invest a part of the contributions of the younger workers in the domestic capital markets. The Government also plans to introduce nonstate voluntary pensions to supplement the current first pillar pension provisions.

49. While a credible reform plan has been formulated by the Government with USAID TA support, several critical issues need to be resolved. If the reform program is to be effective, the creation of individual accounts has to be followed by the introduction of partial funding. In this regard, the actual process and timing of the transition to partial funding and the associated costs need to be carefully worked out. The investment potential in domestic capital markets is not yet clear, and needs to be examined. The Government’s recent announcement to increase pensions to equalize the benefits between the pre- and post-1995 retirees has introduced some complexities in the process of benefit calculations. At present there is no law governing supplementary nonstate pensions; the passage of such law is crucial in light of plans being formulated by the NBFIs to offer voluntary retirement savings products.[15]

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14 The individual contributions will be determined by the individual’s length of service in the work force, his/her monthly average wage calculated over the best five years’ of earnings during a consecutive 10-year period prior to the establishment of the individual account on 1 January 2000, and an average index of the national average wage in the last five years.

15 The experience of the Republic of Kazakhstan (Loan 1589-KAZ: *Pension Reform Program*, for $100 million, approved on 15 December 1997) demonstrates the need to strengthen the legal and regulatory framework as well as implement broad-ranging capital market reforms prior to embarking on pension reforms. In this regard, and particularly given the nascent state of capital markets in Mongolia, it is critical to ensure that the gradual conversion of the individual accounts from notional to real is undertaken with due care to the investment options.

5. Insurance Industry

a. Background

50. The insurance sector is at a nascent stage of development. The state insurance company, Mongol Daatgal, was established in 1934, and has been wielding significant monopoly power in the industry. The law governing insurance activities was enacted only in 1997. At present, there are 11 insurance companies, including Mongol Daatgal, of which 9 are private. The Insurance Supervision Unit (ISU) of MOF is responsible for all policy, legal, and regulatory activities governing the insurance industry. ISU has a staff of three officers at present, although there are provisions under the law for the establishment of aimag-level insurance supervision offices. ISU's operational and regulatory capacities need to be significantly strengthened to help develop contractual savings institutions in Mongolia.

b. Constraints and Issues

51. Mongolia has an underdeveloped insurance sector. While there has been long history with insurance products, the growth of industry is affected by low level of incomes, lack of awareness of public to the significance and benefits of insurance sector, and lack of operational and regulatory capacity in the industry. Besides considerable regulatory support, policy and operational assistance is needed. There are no prudential requirements governing solvency in the industry at present, barring minimum capital requirements of Tug100 million ($95,000). Investment guidelines for insurance companies need to be strengthened as capital markets gradually develop in the country.

B. Government Objectives and Strategy

52. As the lead coordinator of the financial sector thematic group, IDA has supported BOM to develop the Government's long-term vision and a medium-term strategy for the financial sector. The objective of the Government's long-term vision is to double the size of the sector (assets as a percentage of GDP) in 10 years by ensuring the following:

(i) The role of the state will be directed to ensuring macroeconomic and financial sector stability; the state will intervene only in circumstances when market forces patently fail to work.

(ii) There is an effective, autonomous central bank and a legal framework that requires good prudential regulation, corporate governance, and supervision and prompt corrective action (i.e., the closure of banks when the capital adequacy ratio declines below a certain minimum level).

(iii) A relatively small number of sound and efficient domestic and foreign banks will emerge and will be capable of providing efficient banking services in a competitive environment.

(iv) Ownership of all commercial banks will be transferred to the private sector.

(v) Basic payment and banking services are available to meet demand outside of Ulaanbaatar through a variety of channels (e.g., microfinance institutions, regional cooperatives, private banks).

(vi) The financial sector will have a cadre of banking and related personnel trained in international best practices.

(vii) The legal environment for conducting financial activities and accounting standards will be rigorously enforced, with the aim of strengthening public confidence in financial institutions.

(viii) There is a growing number of NBFIs (e.g., finance and leasing companies, contractual savings institutions, cooperatives, and microfinance companies) to help meet the demand for savings and investment.

(ix) A healthy and well-governed capital market will be developed to complement banking.

53. To implement this long-term vision effectively, the Government has adopted a medium-term strategy for the financial sector to

(i) establish the foundations of a market-based financial system, including the development of modern banking skills, enhancement of auditing and accounting standards, enforcement of financial contracts, and establishment of an exit policy for troubled banks;

(ii) signal the Government’s commitment to uphold rights and obligations under financial contracts, beginning with the timely servicing of interest payments on Government bonds held by banks;

(iii) reduce the pervasive role of the state in allocating financial resources—until the revocation of the licenses in December 1999 of the deeply insolvent BITI and RB, Government-controlled banks accounted for about 90 percent of the assets in the banking system;

(iv) facilitate the development of sustainable rural financial institutions to provide payment systems and banking services appropriate to conditions existing in the sparsely populated country;

(v) prompt the consolidation of the banking system by doubling the minimum capital requirement of banks to Tug2 billion (about $1.9 million);

(vi) strengthen the legal framework for effective supervision and regulation by the central bank, including the requirement for prompt corrective action;

(vii) develop a resolution and liquidation framework for failed banks;

(viii) provide the foundations for the development of a market for Government bonds and an interbank market;

(ix) strengthen corporate governance in the financial sector by encouraging banks to follow international standards, such as the guidelines on corporate governance in banking institutions issued by the Bank for International Settlements (BIS);

(x) foster a healthy capital market by carrying out reforms in the MSE and MSEC to enhance investor confidence; and

(xi) institute a regulatory mechanism to guide the development of the NBF sector.

54. ADB's FSP II and IDA's FSAC are critical components to support the Government's FSRP, and help implement the Medium-Term Financial Sector Development Strategy.

C. External Assistance to the Sector

55. Mongolia has received significant support from external financiers to develop its financial sector. In the past, ADB has played a lead role in the financial sector. It has provided total assistance of $35 million for the FSP; nine TA grants for banking for $3.7 million; a TA loan of $3 million for upgrading banking skills, which is still ongoing; and three TAs for capital markets for $300,000.

56. IMF has in place a three-year arrangement under the poverty reduction growth facility (PRGF) formerly ESAF for SDR33.4 million. The second annual arrangement under the PRGF for SDR14.8 million was approved in June 1999. The first review under the second arrangement was completed by the Board in January 2000, and performance was rated satisfactory. First quarter 2000, macroeconomic data suggest that macroeconomic performance is good, however, the impact of the Zud will place added pressure on the macroeconomic program for the remainder of the year and the Government may need to take corrective actions to meet the financing requirements resulting from the Zud. At the time of printing the review of the second arrangement of PRGF is under way. The second annual component of the PRGF included financial sector reforms focusing in particular on bank restructuring activities that built upon the work undertaken by the FSP. Under the program of reforms, two banks have been closed and are under liquidation, and a third is under receivership and being restructured for the purpose of privatization. The IMF program has also supported continued fiscal consolidation and strengthening of tax administration, budget control, and management.

57. IDA is supporting the development of Mongolia's private enterprise and financial sectors under a private sector development credit ($12 million) approved in May 1999. This credit line is channeled through TDB and Golomt Bank. Through the FSAC, IDA is sharing the financing of the FSRP with ADB (para. 6).

58. The TA program of USAID has provided bank restructuring experts for AB, BITI, and RB, supported the financial audits of these banks, and helped with the technical work for privatizing TDB. USAID has also funded a TA project for pension reforms to strengthen the institutional and legal building blocks to develop the pension system in Mongolia; it is to be completed in 2000. Assistance has also been provided to support the development of a microcredit institution. Finally, Gesellschaft für Technische Zusammenarbeit has supported the strengthening of AB, and Japan Bank for International Cooperation has provided a number of advisers to support strengthening of rural credit, payment systems, and commercial banking. Details on external assistance for the financial sector is provided in Supplementary Appendix F.

59. ADB envisages involvement in three sector lending operations that support the financial sector. These include the proposed (i) Agriculture Sector Development Program (2000), (ii) Rural Finance Project (2001),[16] and (iii) Housing Sector Finance Project (2001). During the processing of the FSP II, activities have been coordinated and efforts made to reinforce possible policy actions to complement these projects. Another ADB project, the Social Safety Net Development Program

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16 An improved supervisory and regulatory framework for SCCs supported by the FSP II will promote an enabling environment for the development of SCCs expanding the outreach of financial services throughout the country, and which is expected to set the groundwork for the Rural Finance Project.

(SSNDP) (2000), will address social concerns by supporting the development of a social safety net, through unemployment insurance and disability protection. Pension systems will not be included under the SSNDP. ADB has been in policy discussions with SSIGO and USAID for some time on strengthening financial management of the pension system and improving financial sustainability of the pension scheme. In view of the increasing unfunded liabilities in the pension system, these aspects will take priority over extending additional benefits under the system for the present. Accordingly, and in view of ADB's increasing focus on building-in social concerns in pension operations, this division of responsibilities between the SSNDP and the FSP II (i.e., pension system reforms will be addressed under the FSP II) is considered justified and effective. Coordination of activities between these two projects will continue in the future.

60. In 1999, to ensure effective donor coordination in the financial sector, the Government invited funding bodies to form a thematic group and prepare the financial sector strategy with support of the World Bank. The financial sector strategy lays down the long-term vision and medium-term strategy for financial sector development. Drawing from this, the Government has worked closely with ADB and IDA to develop the FSRP (para. 6). ADB and IDA will launch joint periodic monitoring of the FSRP, and the two institutions will closely consult with each other on the performance of their respective FSP II and FSAC programs prior to tranche releases to achieve common evaluation of overall FSRP implementation. This will be reflected in the memorandum of understanding to be entered into by both institutions.

D. ADB's Operations and Strategy in the Sector

1. Country Operational Strategy

61. The main objective of the country operational strategy is to foster economic growth and reduce poverty by (i) focusing on income and employment generation through private sector development, and (ii) promoting good governance as an overarching economywide objective for the strategy. The strategy identifies five core sectors including the financial sector, for ADB support. The strengthening of financial sector would help (i) remove the fragility of the banking system to facilitate growth of private sector investment and savings, and (ii) develop microfinance schemes. Special emphasis will be on governance reforms within the sector to introduce greater transparency and accountability at all levels of financial institutions and operations. The financial sector strategy will support poverty reduction primarily by developing microfinance services and promoting private sector-led economic growth.

2. ADB's Program Lending Performance

62. Since Mongolia joined ADB in 1991, ADB has provided support for most sectors of the economy. Despite economic uncertainty, fiscal constraints, and institutional weaknesses in all sectors, ADB's portfolio in Mongolia is, in general, performing satisfactorily and implementation is proceeding on schedule. A high proportion of ADB lending has been through program loans (28.6 percent by number and 32 percent by amount) in view of the need to support structural adjustment. Release of the second tranches of program loans in the finance, industry, agriculture, and education sectors has been generally on track which demonstrates the Government's commitment and capacity to implement complex policy and sector reforms in a difficult domestic and international environment.

3. ADB's Financial Sector Strategy

63. ADB has been supporting financial sector reforms in Mongolia since 1991. The emphasis of ADB's sector strategy has been to help Mongolia move from a monobanking

system characteristic of centrally planned economies to a modern two-tier banking system. The technical support provided has helped establish a conducive legal and regulatory environment to facilitate the development of a market-based and commercially oriented banking system. This has involved strengthening the Banking Law, developing the framework for banking supervision and prudential regulations, and providing institutional development for BOM and selected commercial banks through training and skills development. Although, the supporting financial infrastructure is evolving, the banking system is under severe stress. External factors, such as (i) political instability and related difficulties in ensuring consensus on the implementation of difficult policy decisions, such as bank closures; and (ii) recurrent supply-side shocks (i.e., the Asian and Russian crises) that have induced losses in the corporate sector have added pressure on the fragile banking system. Internal problems, including (i) weak governance of the financial sector; (ii) lack of experienced and well-trained staff to manage banks effectively, from senior management to credit officers; and (iii) limited enforcement capacity at BOM and its inability to the arrest the loan default culture[17] have led until recently to increasing nonperforming loans and a decline in performance of banks. These factors have adversely affected asset quality and contributed to erosion of confidence in the banking system.

64. Keeping these issues in view, ADB's financial sector strategy in Mongolia aims to develop a balanced, competitive, viable, and stable financial system by broadening and deepening financial reforms to improve efficiency in the intermediation process. ADB's operational strategy allows for broad-ranging support for the financial sector by

(i) strengthening financial sector policies and regulations;
(ii) improving financial sector governance by introducing greater transparency and accountability at all levels of operations, including appropriate checks and balances to effectively prevent abuses by shareholders and directors, and strengthening market discipline;
(iii) restructuring and privatizing banks to consolidate and develop reputable and role model financial institutions;
(iv) developing equity and debt markets, reforming the pension system, and supporting the development of finance, financial leasing, and insurance companies;
(v) extending credit by developing onlending operations for small and medium-sized enterprises, rural enterprises, households, microfinance, and housing purposes; and
(vi) strengthening the efficiency and the outreach of financial intermediation to support stable economic growth and poverty reduction.

V. THE PROGRAM

A. Rationale

65. The deficiencies of the financial system have potentially affected Mongolia's growth and macroeconomic prospects. The banking crises have raised the cost of financial intermediation, wiped out public savings, and imposed a heavy burden on the budget and the economy because of the significant financial costs to restructure commercial banks. The development of a sound, efficient, and well-regulated financial system that is market based is fundamental to (i) achieve higher and sustainable growth and help meet the country's social and economic development objectives, particularly reduction of poverty, as well as (ii) develop a robust

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[17] The default culture reflects the prevailing incentives system that, given weak prudential regulations and enforcement capabilities and lack of market discipline, perpetuates moral hazard.

financial sector with institutions that can withstand the challenges of exogenous shocks to which Mongolia is vulnerable. A consolidated, resilient, and commercially viable banking system is crucial to inducing efficiency in financial intermediation. During the first phase of financial sector reforms (1997 to 1999), the Government adopted bold policy measures to address banking problems. These included (i) strengthening the prudential regulations, including raising the capital adequacy of banks; (ii) developing the legal framework to allow for bank bankruptcies, i.e., conservatorship and receivership of banks; (iii) closing eight insolvent banks; and (iv) enhancing the drive for loan recovery.

66. Despite these measures, the banking system is small and weak[18] with 12 licensed banks accounting for about $180 million of aggregate assets. The banks' distress[19] has posed problems of financial intermediation with supply of credit[20] falling below requirements. Banks have been primarily lending short-term at relatively large interest spreads,[21] and have rolled over these loans that has resulted in maturity mismatch in the system. Past practices of directed lending, reinforced by a pervasive loan default culture, have resulted in accumulation of nonperforming assets (equivalent to 37 percent of the loan portfolio). Delays in Government interest payments on bank restructuring bonds to banks have, in turn, aggravated cash-flow problems and placed further stress on bank balance sheets and solvency. Furthermore, the banking system has had to absorb the adverse supply-side shocks due to loan defaults that resulted from a significant fall in commodity prices and exports, thus worsening asset quality in the banking system.

67. While strengthening banking as the primary institution for deposit and lending activities is a priority for the Government's financial sector development strategy, sole dependence on it resulted in stress and overextension of banks. The stock market is small and illiquid, and the pension and insurance systems have played a limited role in terms of developing alternative sources of funds to finance economic growth. The Government has given priority to the development of the capital market and contractual savings institutions for diversifying the financial sector.

68. The equity markets remain at an early stage of development, and have received little external assistance since ADB first supported the creation of the MSE in 1991. Strengthening the equities market will enhance domestic resource mobilization and complement the banking system in developing long-term sources of funding for investment projects. Broadening and deepening the MSE and improving its regulation would generate greater confidence in the market and facilitate the supply of tradable securities primarily through the privatization of SOEs. This, in turn, would stimulate greater demand from investors seeking better quality stocks.

69. While the contractual savings reform measures that were initiated in 1995 have improved the financial health of the system to some extent, several of problems still exist, as in many of the other transition economies. These include (i) large deficits and long-run funding

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18 The ratio of bank assets to GDP has been falling over the past three years and stands at approximately 20 percent.

19 The three problem banks, namely AB, BITI and RB accounted for 56 percent of nonperforming loans in the banking system by late 1999. With ADB support, the three banks were placed under receivership in late 1999 and BOM has commenced liquidation procedures at BITI and RB, a significant step in restructuring the banking system.

20 M2 to GDP, an indicator of credit in the economy stands at 19 percent in 1999 down from 24 percent in 1995. During this period, currency to M2 (or the inverse of the money multiplier) has increased from 24 percent to 30 percent. Ninety-five percent of total loans have maturities of less than one year.

21 Interest spreads on local currency lending deposit range on average between 20 and 25 percent annually.

difficulties as a result of the generous benefit structure; (ii) contribution arrears, particularly from SOEs, due partly to enforcement problems and partly to poor SOE financial health; (iii) inadequate coverage, given the difficulties of collecting pension contributions from informal sector workers and herders; (iv) significant underreporting of income for pension contributions and the absence of a link between pension contributions and receipts as benefits are based on the last five years' of earnings; and (v) the narrow and declining base of pension contributors relative to recipients.

70. The development of the capital markets and contractual savings are important to enhance domestic resource mobilization, increase the supply of long-term sources of financing, and deepen financial markets. In recent years, the number of credit cooperatives and new finance companies has increased. To lay the foundation for development of the NBF sector, the Government plans to develop a proper legal and regulatory environment and supervision framework for stable growth of the equity markets, and pension and insurance systems. These reforms will complement banking reforms with the objective of supporting balanced financial sector development as set forth in the Government's medium-term financial sector development strategy. The Government has developed the FSRP, which consists of the FSAC and the FSP II to support the implementation of the strategy.

B. Objectives and Scope

71. The primary goal of the FSP II is to promote the development of a competitive, stable, and broad-based financial system to support enhanced resource mobilization and sustainable economic growth. The FSP II will focus on the following activities:

(i) Improve financial intermediation processes by

- (a) strengthening corporate governance of the banks in line with international best practices;
- (b) improving the loan collateral system by allowing for different types of property over which a security interest can be created, and improving procedures to allow for proper and easy registration and valuation of the property;
- (c) implementing a management information system (MIS) for the banks; and
- (d) developing interbank markets.

(ii) Strengthen prudential regulations and supervisory framework for the NBF subsector by

- (a) requiring finance companies to comply with risk-based prudential regulations;
- (b) issuing accounting standards for NBFIs;
- (c) restructuring the Supervision Department of BOM to improve monitoring and enforcement of regulation of NBFIs; and
- (d) enacting amendments to the Law on Cooperatives and any other required legislation to vest BOM with oversight responsibility over savings and credit cooperatives through second- and higher-tier credit associations.

(iii) Develop capital market infrastructure by

- (a) separating and privatizing the MSE, Central Depository System (CDS), and Securities Clearing System (SCS);

(b) strengthening operational and regulatory capacity at MSE;
(c) strengthening the Securities Law; and
(d) preparing a law on trusts and a law on investment funds.

(iv) Develop the pension system by

(a) transforming the current system to a partially funded system;
(b) improving the administrative processes in SSIGO, including developing its capabilities for pension payment collection, and strengthening financial management of the pension system; and
(c) introducing legislation to allow for the nonstate voluntary pension system.

(v) Strengthen the legal and regulatory reforms of the insurance system by

(a) increasing minimum capital requirements for the insurance industry;
(b) promoting liberal investment guidelines; and
(c) increasing premium incomes.

C. Policy Framework and Actions

72. The policy matrix for the FSRP (Appendix 1) provides for actions envisaged under the FSAC and FSP II. In the case of the FSP II, the policy framework (Appendix 2) includes 4 prior actions, 13 conditions tied to the release of second tranche, and 21 other policy actions to be completed over a three-year period.

1. Reform the Banking System

73. The FSAC will focus on bank restructuring measures at AB and SB, as well as measures to (i) strengthen the bank regulatory framework including asset classification, bank licensing requirements, bank exit strategy, and bank privatization (with a possible equity stake by ADB's private sector group); (ii) strengthen banking institutions, namely the Mongolian Asset Restructuring Agency and the Credit Information Bureau; and (iii) support capacity building and skills upgrading through a TA credit. The banking reforms under the FSP II will complement banking reforms under the FSAC. These combined policy actions are expected to develop a broad framework for the creation of a stable and competitive banking system. This is an important focus and agenda of the FSAC and builds on the progress made under past ADB operations.[22] To facilitate coordination, ADB and IDA will jointly monitor implementation progress within FSRP (para. 57). The salient features of the FSRP and the synopsis of banking system reform measures envisaged under the FSRP banking-focused actions are presented in Supplementary Appendixes G and H.

74. To support sustainability of the bank restructuring program, the FSP II aims to support development of (i) sound governance policies and structure, (ii) the regulatory framework for loan collateral, (iii) MIS for the banks, and (iv) interbank markets. These policy measures reinforce the FSAC policy framework.

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[22] The development of the financial sector in Mongolia as identified in the Government's long-term vision and medium-term strategy, while not focusing on the sequential aspects of reforms, recognizes the importance of developing a core banking system as a first priority to be complemented and succeeded by reforms focusing on the development of (i) the NBF sector including capital markets and NBFIs; and (ii) contractual savings institutions.

a. Strengthen Corporate Governance in Banking Institutions

75. Traditionally, state-owned banks operating under the old monobanking system focused on providing directed lending mandated by the planning authority. Management of banks had to be subservient to political goals, as decisions were subject to political interference. Private sector investments in banks will only be forthcoming if banks are generally viable entities and are able to generate returns on equity. The governance structure in private banks is critical to ensure that these banks do not serve the personal ends of their owners (i.e., financing owners' business activities). The limited liability nature of banking institutions together with the absence of effective accountability and internal controls means there is a high risk that bad management practices will be perpetuated to the detriment of the development of sound and efficient private banks. Unless sound corporate governance is in place, banking supervision cannot function effectively.

76. The FSP II will support the preparation of guidelines on best practices on corporate governance of commercial banks. The FSP II involves strengthening the commercial banks supervisory boards and internal control mechanisms in line with the report of Basle Committee on Banking Supervision on Enhancing Corporate Governance for Banking Organizations. Transparency of banking system reporting mechanisms will be improved based on the IMF Code of Good Practices on Transparency in Monetary and Financial Policies. The associated TA will help develop a model charter for banks, and guidelines to encourage banks to prepare or amend their charters based on this model. Adoption of these policy measures by commercial banks will help strengthen internal controls, and establish appropriate levels of accountability to foster checks and balances.

b. Improve Loan Collateral

77. The lack of collateral and uncertainty concerning the registered value of the collateral, and the ability to recover the loan by enforcing the security have posed serious problems for financial intermediation and added to the cost of borrowing. The expected approval later this year of amendments in the Civil Code to allow for movable property to be offered as loan collateral will ease the constraints facing borrowers and the banks. However, the types of property over which a security interest can be created must be further expanded, and procedures for registering property improved to allow for proper and easier registration and valuation of the property. The FSP II will support the preparation of a plan acceptable to ADB identifying the types of property that can be used as collateral.

c. Implement an MIS in Banks

78. The existing MIS of the commercial banks is rudimentary and provides limited scope for proper treasury management, foreign exchange operations, and other activities. The current chart of accounts for banks separates loans and deposits by a combination of counterpart obligations (state, private, etc.), currency, and classification (past due, substandard, doubtful, and loss) categories. This reflects the limitations of a manual statistical system. An automated system would limit segregation at the general ledger level to the generic nature of the transaction with all counterpart and condition segmentation done at the loan subsystem level and with reporting on the portfolio coming from the subsystem, not the general ledger level.

79. Six pilot banks have reached an agreement with BOM to develop and implement a MIS software for these banks on a cost-sharing basis. The adoption of this software is expected to be fully functional at TDB by the end of 2000, and will be installed in the remaining pilot banks in 2001. The MIS software is expected to strengthen the bank's commercial orientation by

improving banking operations, as well as strengthening reporting requirements to enhance banking supervision by BOM.

d. Develop an Interbank Market

80. There is no functioning interbank market in Mongolia. As financial markets develop, they gain breadth, as a wider range of instruments is available, and depth as the market volume increases, thereby increasing liquidity of the markets. The development of the interbank market is a necessary step in the evolution of a well-balanced financial sector. The monetary authorities have a role in promoting interbank market. An interbank market would provide banks with opportunities to invest funds, improve asset liability management, and reduce costs of funding thereby improving the profitability of banks.

81. The development of a more fluid interbank market, including the formation of a variable interbank rate, would provide a market signal on premiums associated with high risks. This would serve to enhance market discipline in the banking system. Under the FSP II, BOM in association with MOF will prepare a plan focusing on the prerequisites for developing an interbank market. The plan will include the formulation of a legal, regulatory, and institutional framework to develop an interbank market.

2. Strengthen Prudential Regulations and Supervision of NBFIs

82. In view of the limited outreach of the banking system, finance companies are expected to assume a greater role in financial intermediation in Mongolia (para. 28). Over the past years, BOM has licensed four non-deposit-taking finance companies and 21 credit cooperatives. Appropriate mechanisms need to be introduced, including regulations on licensing requirements, risk-based prudential standards, minimum paid-in capital to ensure a healthy nonbank financial system, and accounting standards for the NBFIs. The Supervision Department of BOM must also be properly organized to ensure effective supervision of NBFIs. Under the FSP II, BOM will (i) strengthen NBFI regulations requiring finance companies to comply with risk-based prudential regulations; (ii) issue accounting standards for NBFIs; (iii) restructure the Supervision Department of BOM to monitor and enforce NBFIs regulations; and (iv) enact amendments to the Law on Cooperatives and any other legislation to vest BOM with oversight responsibility over savings and credit cooperatives through second- and higher-tier credit associations.

3. Develop Capital Market Infrastructure

a. Separate and Privatize the MSE, CDS, and SCS

83. The MSE is state-owned and operates as a self-regulatory organization under the general oversight of MSEC. In addition, the CDS and SCS are part of the MSE with common staff. This affects the governance structure of securities markets, results in diffuse lines of responsibility, and limits the possibility of checks and balances within the system. In addition, it can result in a potential conflict of interest of senior staff and management. To address these concerns, the FSP II will focus on assessing the feasibility and preparing a plan, acceptable to ADB, to separate the MSE as a legal entity, and the CDS and SCS as one or two separate legal entities, with the objective of facilitating their eventual privatization. Privatization of the MSE, CDS, and SCS is a condition for program completion.

b. Strengthen Operational and Regulatory Capacity at MSEC

84. MSEC needs a major overhaul, and more and technically stronger staff if it is to effectively carry out its supervisory and regulatory functions. The failing confidence in the equity markets partly reflects the institutional and resource constraints at MSEC. The FSP II will support the strengthening of MSEC through the TA (paras. 110-113) to develop operational, management, administrative, and other relevant institutional strengthening measures.

85. Similarly, the FSP II will foster improved governance in the equity markets. This will primarily involve improving regulations to ensure that all trades are undertaken at MSE through accredited traders and as such reduce the scope for illicit trading. In addition, under FSP II and to strengthen the association of brokers, dealers, and subbrokers, minimum capital requirements of security firms will be doubled from Tug10 to Tug20 million. This will be complemented by measures to strengthen accountability and transparency through regulations on insider trading and development of a code of ethics and guidelines for MSEC and MSE employees.

c. Strengthen the Securities Law

86. For the securities market to function effectively and to complement the eventual privatization of the MSE, the Securities Law must be strengthened. FSP II will support efforts to strengthen: (i) MSEC's capacity as the regulatory body in charge of the securities markets; (ii) transparency of securities trading and disclosure requirements, and enforcement provisions; and (iii) improvement of corporate governance, in particular strengthening minority shareholders' rights, and having stricter auditing requirements for companies to be listed and broader representation among MSEC members. To improve confidence in the MSE, enforcement of listing requirements will be strengthened and greater penalties will be applied for breach of rules.

d. Prepare Law on Trusts and a Law on Investment Funds

87. The legal framework for the development of the securities market needs strengthening. To create a proper environment for the development of the securities market and thereby enhance domestic resource mobilization including through the participation of institutional investors, the FSP II will support the preparation of a law on trusts and a law on investment funds. The preparation and subsequent approval of these two important laws are expected to strengthen demand in the equity markets and improve domestic, and in the longer run, external resource mobilization as mutual funds and other investment funds develop.

4. Strengthen the Pension System

a. Develop a Partially Funded System

88. While the new system will enable pension payments to be closely linked to contributions, the pension fund will be unfunded for the near future. The Government intends to introduce partial funding gradually from 2005. However, this is not mandated in the law and no sound actuarial analysis has been undertaken to make an informed decision about the timing. Further, there is no legal and regulatory framework to govern the introduction of partial funding or on investments of the accumulated pensions in securities. There are concerns that the introduction of partial funding may be delayed or may not be successful unless the Government's efforts are supported in the legal and regulatory areas. The FSP II aims to support the Government's efforts in formulating an appropriate legal and regulatory framework for partial funding. TA

support (paras. 110-113) will also be provided to undertake new actuarial projections to guide the timing of phasing-in of the partial funding.

b. Improve the Administrative Processes in SSIGO

89. To facilitate the introduction of partial funding of the pension system, the administrative capacity of SSIGO needs considerable strengthening. In particular, SSIGO must develop a plan specifying the administrative and regulatory aspects involved in managing a partially funded system. Ad hoc changes to pensions, in the absence of an indexation mechanism, such as the recent Government announcement to increase pensions in order to equalize the benefits between the pre- and post-1995 retirees, result in administrative complexities in the process of benefit calculations. Under the FSP II, the Government will undertake several measures to strengthen its administrative capacity and processes to facilitate the change to a notional defined contributory system, and to improve pension collections. As part of the FSP II, TA support will also be provided for the introduction of pension indexation.

90. SSIGO has thus far only been a collection agency, without any role in long-term financial management or investments. As the Government moves toward partial funding, proper investment guidelines and regulations need to be drafted. As part of the legal and regulatory framework supported under the FSP II, the financial management and investment capacity in the pension system will be enhanced.

c. Develop Non-State Voluntary Pensions

91. To minimize the burden on the pay-as-you-go system, as well as to provide for supplementary budgets to the elderly, the Government plans to introduce non-state voluntary pensions to supplement the current “first pillar” pension provisions. There is currently no legal and regulatory framework governing supplementary non-state pensions. Such a law is critical to support the eventual development of voluntary retirement savings options. Under the FSP II, the Government will prepare draft legislation to facilitate the development of a voluntary private pension system.

5. Strengthen the Insurance System

92. While Mongolia has a long history with insurance products, there is a lack of operational and regulatory capacity in the industry. Besides considerable regulatory support, policy and operational assistance is needed to strengthen the system. There are no prudential requirements governing solvency in the industry at present, barring minimum capital requirements of Tug100 million ($95,000). Under the FSP II, the Government will submit draft amendments to the Law on Insurance to Parliament for approval. The amendments will (i) introduce risk-based solvency requirements in the industry, (ii) strengthen the minimum capital requirements, and (iii) increase the percentage of premium incomes that can be invested by the insurance companies. Support will also be provided to the ISU to develop and adopt a sound regulatory framework with adequate guidelines and standards, reporting and disclosure requirements, accounting, auditing and prudential norms, investment guidelines, and other conditions in accordance with international best practices.

D. Social and Environmental Issues

93. The FSP II is expected to have an impact on facilitating resource mobilization through the private banking system, capital markets, and the public finance sector. It will increase the efficiency of resource allocation, thereby increasing economic activity and benefiting all

elements of society including the poor and near poor. Appendix 4 presents the Poverty Impact Assessment for the FSP II. Through the banking system and capital markets, the FSP II is also expected to have a beneficial effect on growth and employment by reducing intermediation costs, and in time, reducing the cost of capital for businesses. It will also encourage direct private participation in economic activity.

94. The development of an interbank market will facilitate the use of monetary instruments and improve liquidity management of banks. The capital markets component of the FSP II will strengthen the operations of the stock exchange, improve investor confidence, and promote market trading. In addition, through legal reform, the FSP II will facilitate development of an investor base, which currently is nonexistent. Under the FSP II, development of the contractual savings institutions will foster mechanisms to ensure a timely transition to a partially funded system, reducing unfunded liabilities and fiscal pressures in the medium term. The improved performance of the pension and insurance system will enhance savings and the availability of productive resources to enhance investments.

95. The FSP II is classified as category C under ADB's environmental classification system. Its environmental impact is expected to be minimal.

VI. THE PROPOSED LOAN

A. Amount of Loan and Source of Funds

96. It is proposed that the ADB provide a loan of SDR11,448,000 ($15 million equivalent) from its Special Fund resources for the FSP II. The loan amount for the FSP II was determined on the basis of the strategic significance of the financial sector and the costs of structural reforms under the FSRP. The latter are estimated at $100 million equivalent,[23] and will consist of the following components:

(i) bank restructuring, including liquidation, restructuring, recapitalization, and settlement of severance payments ($51 million equivalent);
(ii) transition to a partially funded pension system ($28 million equivalent);
(iii) institutional strengthening of BOM, Mongolian Asset Restructuring Agency, MSEC, SSIGO, and ISU ($13 million equivalent); and
(iv) others including privatization of MSE, MIS development, and liberalizing guidelines for pension and insurance funds ($8 million equivalent).

B. Interest, Maturity, and Utilization Period

97. The Borrower will be Mongolia, and the loan will have a 24-year maturity, including an 8-year grace period. The loan will carry an annual interest charge of 1 percent during the grace period and 1.5 percent during the amortization period.

98. The loan will be utilized within 36 months commencing from the date of loan effectiveness. The loan proceeds may be used to finance eligible imports incurred within 180 days prior to the date of effectiveness.

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23 ADB's $15 million loan will cover the costs of adjustment under the FSRP, which is estimated at $100 million. The IDA loan is $32 million equivalent (for three years) to support a balance of payments financing gap of $30 million over the next two years. The financing gap for the third year could be an additional $15 million (these figures do not reflect the increase in the financing requirements resulting from the Zud).

C. Implementation Arrangements

1. Executing Agency

99. BOM will be the Executing Agency for the FSP II, and will have overall responsibility for the program implementation, including the administration and disbursement of the loan proceeds, maintenance of accounts, and preparation of quarterly progress reports on program implementation. These reports will include, progress made, problems encountered, remedial actions taken during the previous quarter, and proposed program activities and expected progress during the next quarter.

2. Steering Committee

100. A steering committee has been established to oversee implementation of the FSP II. The committee will be chaired by the deputy governor of BOM and will include senior representatives from MOF, MSEC, MSE, SSIGO, Ministry of Justice, and State Property Committee. The steering committee will meet at least once every three months to ensure that the proposed reforms are undertaken in accordance with the agreed timetable, all as set forth in the list of actions to be taken during the FSP II. An adequately staffed program implementing unit has also been established within BOM to oversee day-to-day program implementation.

D. Procurement

101. In accordance with the simplified disbursement procedures and related requirements for program loans,[24] procurement of goods and services produced in and originating in ADB member countries will be made with due consideration to economy and efficiency in accordance with standard public sector procedures in Mongolia and normal private sector commercial practices acceptable to ADB. In the case of goods commonly traded on the international commodity markets, procurement will be undertaken in accordance with procedures appropriate to the trade and acceptable to ADB.

E. Disbursement

102. The proceeds of the FSP II loan will be disbursed for a broad range of imports, subject to a negative list of ineligible items (Appendix 5). Disbursement of loan proceeds will be permitted on the basis of a certification provided by the Borrower confirming that in each year in which proceeds of the FSP II are expected to be disbursed, the value of total imports minus (i) imports from nonmember countries, (ii) ineligible imports, and (iii) imports financed under other official development assistance, is equal to or greater than the amount expected to be disbursed during the year.

F. Counterpart Funds

103. The policy framework for the FSP II includes specific components that bear distinct costs of structural adjustments. The counterpart funds to be generated from the loan proceeds will be used to finance the structural adjustment costs under the FSP II. Any counterpart funds not required will be used first to finance the local currency costs of other projects financed by ADB, and second for general development purposes.

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24 R50-98: *Simplification of Disbursement Procedures and Related Requirements for Program Loans,* 16 April 1998.

G. Monitoring and Tranching

104. The loan will be released in two tranches. The first tranche will be $5 million equivalent, and the second tranche will be $10 million equivalent. The Government has complied with a number of up-front policy actions and the first tranche can be released as soon as the Loan Agreement becomes effective. These actions include (i) understandings on the financial sector strategy; (ii) issuance of risk-based prudential regulations to govern licensing of finance companies, and guidelines for the calculation of capital adequacy and liquidity ratios and foreign exchange exposure for finance companies; (iii) restructuring and strengthening the Supervision Department of BOM to monitor and enforce prudential regulations for banks, finance companies, and financial leasing companies; and (iv) submission, to Parliament for approval, draft amendments to the Securities Law to enhance transparency for all trades in the securities market. ADB has been heavily involved in the policy dialogue supporting these actions. Since FSP II is a part of the FSRP, the timely meeting of ADB's up-front policy actions and IDA's first tranche release conditions is a strong signal of the Government's commitment to carry forward the reform program of FSP II. The second tranche is expected to be released by December 2001, but this will be dependent upon satisfactory implementation of the FSP II, in particular, the fulfillment of all conditions for release of the second tranche set forth in the policy matrix. The release of the second tranche has been synchronized with the release of the second tranche of FSAC, which is also a two-tranched loan.

105. For release of the second tranche, the following 13 actions will have to be satisfied:

(i) BOM will prepare and issue guidelines on best practices in corporate governance in banking institutions, including measures to strengthen internal control mechanisms, based on international practices such as the guidelines issued by BIS.

(ii) MOF and BOM will prepare a plan acceptable to ADB for development of an interbank market, including establishment of the legal, regulatory, and institutional framework.

(iii) The Government will prepare a plan acceptable to ADB on the expansion of types of property that can be used as loan collateral.

(iv) Progress acceptable to ADB will be achieved in implementing the program to introduce and operationalize integrated banking MIS software in the Mongolian banks participating in such program.

(v) Amendments to the Law on Cooperatives and any other necessary legislation will be enacted to provide for the regulation of second- and higher-tier credit associations by BOM.

(vi) MSE and MSEC will increase the minimum capital requirements for securities brokers and dealers to at least Tug20 million.

(vii) The Government will submit a draft law on trusts acceptable to ADB to Parliament for approval.

(viii) The Government will submit a draft law on investment funds acceptable to ADB to Parliament for approval.

(ix) The Government will prepare a plan acceptable to ADB to establish the MSE as a separate legal entity, and the CDS and SCS as a separate legal entity or entities with each entity having separate financial and accounting records and no MSE officials on its staff, for their eventual privatization.

(x) MSEC in collaboration with the MSE will develop a marketing and public awareness campaign to increase public knowledge of equity markets.

(xi) The Government will submit to Parliament, for approval, a draft amended and restated Securities Law acceptable to ADB, with provisions to improve financial governance (including protection of minority shareholder rights, increased penalties for Securities Law violations, stricter auditing requirements for companies to be listed, and broader representation of MSEC members) in line with international best practices.

(xii) SSIGO will prepare a plan, acceptable to ADB, for introducing partial funding of the pension system.

(xiii) MOF will draft and submit to Parliament, for approval, draft amendments to the Law on Insurance to (i) introduce risk-based solvency requirements in the industry, (ii) strengthen the minimum capital requirements, and (iii) increase the percentage of premium incomes that can be invested by the insurance companies in the securities market.

106. The Government must comply with an additional 21 monitorable actions during the FSP II period. Government assurances have been sought in the Loan Agreement for fulfillment of these policy actions. (A list of these monitorable actions are presented in Appendix 2).

107. ADB will, in cooperation with BOM, carry out semiannual reviews of progress in program implementation, and will assess its impact on the financial and other sectors of the economy. The Government will keep ADB informed of outcomes of the policy discussions with the World Bank Group and other multilateral and bilateral funding agencies that have implications for program implementation, and will provide ADB with an opportunity to comment on any resulting policy proposals.

108. In addition to the semiannual progress reports, BOM will submit a program completion report to ADB within three months of the end of the program period. This report will evaluate the implementation of the policy reform measures under the FSP II, their impact on the economy and the financial sector, lessons learned during the program period, and further reforms and assistance needed for the sector development.

H. Coordination with IDA

109. Because the FSP II and IDA's FSAC support components under the Government's overall FSRP, coordination between ADB and IDA in implementing the FSP II and FSAC will be critical to the success of the FSRP. In this regard, ADB and IDA are finalizing a memorandum of understanding, that details the coordination arrangements between the two institutions. Among other things, ADB and IDA will be required to promptly inform the other of any event that may interfere with, or hinder or impair the implementation of the FSRP, or that may interfere with Mongolia's performance of its obligations under its loan agreement with ADB or IDA. Joint supervision missions will be undertaken, in particular, prior to release of the FSP II and FSAC second tranches. While release of the second tranches of the FSP II and FSAC have been

synchronized to take place in December 2001, there are no common conditions between ADB and IDA for release of the first or second tranches of the FSP II and FSAC; tranche release will be at the sole discretion of the relevant lender under its respective loan agreement. There is no cross-default provision in the ADB or IDA loan agreement.

VII. THE TECHNICAL ASSISTANCE

110. The proposed TA, Strengthening Financial Sector Development, is an integral part of the FSP II as it will assist the Government in developing a more competitive, stable, and broad-based financial system by increasing the efficiency of financial intermediation and supporting the development of financial infrastructure. The TA will strengthen (i) the supervisory framework for NBFIs (2 person-months); (ii) the framework for secured collateral (2 person-month); (iii) legal, regulatory, and institutional framework for developing the capital markets (8 person-months); and (iv) the legal, regulatory, and institutional framework for developing contractual savings institutions (6 person-months). Appendix 6 presents the detailed terms of reference.

111. An international consulting firm with relevant experience in banking and capital market development in association with domestic consultants will be engaged to provide the services required. The TA will involve 18 person-months of international consulting and 10 person-months of domestic consulting. The consultants will be recruited by ADB using the simplified technical proposal format in accordance with ADB's *Guidelines on the Use of Consultants*, and other arrangements satisfactory to ADB for the engagement of domestic consultants.

112. The TA is estimated to cost $730,000 equivalent, including the foreign exchange cost of $580,000 and local currency cost of $150,000 equivalent. The Government has asked ADB to finance $600,000 equivalent to cover the entire foreign exchange cost and $20,000 equivalent of the local currency cost. The TA will be financed by ADB on a grant basis from the ADB-funded TA Program. The Government will provide $130,000 equivalent through in kind contributions of counterpart staff, office facilities, and logistical support. Appendix 7 presents the cost estimates and financing plan for the TA.

113. The TA will be executed by BOM. BOM will form a coordinating committee, which will have representatives from MOF, MSEC, MSE, and SSIGO. The TA is expected to start in September 2000 and be completed by March 2001.

VIII. PROGRAM BENEFITS AND RISKS

A. Benefits

114. Mongolia's impaired financial system is potentially the most significant constraint to stable economic growth and achieving the Government's socioeconomic development objectives, particularly, poverty reduction. The beneficial impacts on poverty associated with the FSP II can be summarized as follows:

(i) Strengthening the prudential and supervisory framework for SCCs and finance companies is expected to strengthen the development of sound and viable SCCs and improve access to credit by the more vulnerable and poorer segments of the population.

(ii) Strengthening the banking system will render banks more resilient and will avoid disruptions to the banking system from external shocks, which undermine growth prospects, wipe out savings, and lead to significant fiscal restructuring costs.

(iii) A consolidated, restructured, and well-regulated banking system will (a) on the expenditure side, free-up public sector resources to invest in productive activities such as infrastructure or social sectors (i.e., health and education), which may otherwise have been reallocated to bank restructuring or recapitalization; and (b) on the revenue side, relax credit constraints and strengthen credit to the private sector, expanding GDP growth and with it, the taxable revenue base to meet social safety net and other social expenditure needs to minimize vulnerability of the poor segment of the population.

115. The financial sector reforms under the FSP II are necessary to ensure a stable, viable, and competitive financial system based on improved asset quality in the banking system, and a more efficient banking intermediation process—all key elements in restoring credit in the domestic economy. Development of the capital markets and long-term contractual savings institutions will entail the creation of an enabling environment necessary to ensure domestic resource mobilization including long-term sources of investment funds to complement the lending channels intermediated through the banking system. The reforms subscribed under FSP II are expected to have a positive impact on savings and investment in the economy.

116. The adjustment costs resulting from the liquidation of BITI and RB, as well as the downsizing of AB, will have some short- to medium-term adverse effects reflecting loss of employment (initially estimated at 1,000 staff). However, on the one hand, as employees in the banking system are younger and generally better trained, they are more flexible and better suited to find new employment opportunities. On the other hand, the Program is expected to lead to the growth of the NBF sector and newly established finance companies and other NBFIs which will likely absorb retrenched staff from closed down banks. Accordingly, the net impact on poverty is likely to be small.

B. Risks and Safeguards

117. The principal risk lies in the timing of the proposed FSP II. The FSP II loan will be presented for Board consideration just prior to a Parliamentary election. It is expected that the FSP II will be ratified by the current Parliament (within July). However, if this Parliament does not ratify the FSP II, then the new Parliament may need additional lead time before final ratification. This concern is considered manageable in view of the nature of the policy actions proposed under the FSP II, which have support from the various political groups.

118. A second risk is that, typical of policy reform programs, the Government may be unable to implement the required policy measures because of resistance or lack of cooperation by involved parties such as the Parliament with respect to legal amendments, privatization of MSE and other policy actions. In addition, there may be risks associated with weak capacity at the agency level, the ability to recruit and retain qualified cadres especially at MSEC, and poor coordination between financial sector institutions.

119. To the extent that most of the reform measures are standard actions needed to foster an enabling environment for financial sector development, there should be limited risks of unsatisfactory compliance with the policy actions. To reduce the downside risks from weak capacity, TA is being provided to key agencies—BOM, MOF, MSEC, SSIGO—for institutional upgrading. Policy coordination will be assisted by the formation of a high-level steering committee and a program implementation unit.

IX. ASSURANCES

120. In addition to the standard assurances, the second tranche conditions set forth in the policy matrix, and the other actions under the FSP II, the Government has assured ADB that (i) the policies adopted and actions taken prior to the date of the Loan Agreement, as described in the development policy letter, will continue in effect for the duration of the FSP II period; and (ii) the Government will adopt the other policies and take the other actions included in the FSP II as specified in the development policy letter and/or the Loan Agreement, and ensure that such policies and actions continue in effect for the duration of the program period.

X. RECOMMENDATION

121. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve the loan in various currencies equivalent to Special Drawing Rights 11,448,000 to Mongolia for the Second Financial Sector Program, with a term of 24 years, including a grace period of 8 years, and with an interest charge at the rate of 1 percent per annum during the grace period and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board.

TADAO CHINO
President

1 June 2000

Ulaanbatar, May 10, 2000
MONGOLIA

Letter of Development Policy
Long-Term Vision, Medium-Term Strategy and Policies for the Financial Sector Reform Program

Mr. Tadao Chino
President
Asian Development Bank
6 ADB Avenue, Mandaluyong City
0401 Metro Manila
Philippines

Dear Mr. Chino:

Subject: Proposed the Financial Sector Reform Program

1. The Government is pleased to request the Asian Development Bank (ADB) and the International Development Association (IDA) to jointly finance the financial sector reform program for Mongolia. We are happy that both institutions are coordinating their efforts to support the program. This is an excellent example of donor coordination and partnership. The comprehensive approach to developing the financial sector that encompasses both banks and non-bank financial intermediaries, involving other donors such as USAID, JICA, GTZ, is an extremely positive development for Mongolia. The fact that we are writing a joint letter attached with a joint policy matrix to the presidents of the two international financial institutions bears testimony that we welcome close donor coordination in the financial sector. We have sent the same letter to President Wolfensohn of the IDA.

Background

2. A decade ago this past December 10, 1999, Mongolia embarked on a radical and comprehensive reform path—indeed, the path we choose entailed nothing less than abrupt systemic change encompassing all spheres of the nation's political, economic and social life. If one compares our situation today with that at the end of 1989, one finds that while Mongolia still faces many daunting challenges, we have made great strides in reshaping our lives and our destiny for the better.

3. Today, all citizens of Mongolia have the right and the opportunity to set their own goals, and to choose freely how best to accomplish these goals. Freedom of choice is perhaps the most priceless achievement of this remarkable decade in Mongolian history.

4. In 1990, Mongolia held its first free elections. These were an embodiment of the notion of pluralism and resulted in the formation of a new Cabinet from three different political parties, through which the basis for the ensuing comprehensive reforms of Mongolian society was established. Subsequently, under the 1992 Constitution, Mongolia has held two free and democratic parliamentary elections, as well as two presidential elections. New political parties have emerged, and the oldest one has evolved into a new democratic force.

5. The transformation of the economy has been equally dramatic. The reforms launched by the first democratic government in 1990-1992, including price liberalization, establishment of a new banking and financial system, and privatization, laid the foundation for the development of a private, market economy in Mongolia. The sweeping transformation of the economy which has taken place in this decade was a direct outcome of those first reforms.

6. The majority of the Mongolian people have come to comprehend in a relatively short period of time the necessity of relying on their own visions, abilities and drive to meet the challenges of the new era. At the same time, this decade has seen the emergence of new social problems such as unemployment and poverty. These were the inevitable result of the withdrawal of the large external subsidies which had previously financed the operations of the entire Mongolian economy and social services to the tune of more than 30% of our GDP, and of the collapse of COMECON trading block. No country could endure or has endured such a dramatic shock without experiencing a period of hardship. It is precisely for this reason that Mongolia has embarked on a path of drastic institutional and structural reforms in all spheres of the economy, and intends to continue on this path in

the future. Our national program of institutional, structural and policy reform is aimed at reducing the hardships of the transitional period, overcoming this period in the shortest time possible, and creating a solid foundation for the future development of an efficient economy and the progressive advancement of our society.

7. Substantial progress already has been achieved on the economic front. Mongolia has had five consecutive years of economic growth, and the economy expanded again, by 3.3%, in 1999 despite a further pronounced deterioration in our terms of trade. Inflation has been brought down to single digits. The livestock sector, the backbone of the Mongolian economy, has been privatized, and dynamic private companies also are operating in many other key sectors of the economy. A thriving small business sector is generating jobs and incomes for large numbers of our people. The November 1999 employment report shows that open unemployment has dropped below 6% of the labor force. This is suggestive of the underlying dynamism of our economy—an economy whose structure is on the way to being rebuilt, in the course of a decade.

8. At the same time, many serious challenges remain to be overcome. The external environment has turned extremely unfavorable, leading to excessive trade and budget imbalances and a sharp deterioration in the banking system which must and are being addressed through painful adjustment measures. The need for policies which will achieve more rapid economic growth and improvement in the living standards of the Mongolian people in the face of such a difficult environment is urgent, and that is we why have acted to take the measures needed to both minimize the costs of our adjustment to the huge external shock, and to lay the foundation for more rapid economic growth in the future. And we have done this despite an unfortunate cycle of political turmoil during 1998 and 1999. The banking sector is still very weak and unable to play its proper role in promoting economic growth. Some important sectors of the economy are still predominantly state-owned, and others, although privatized, are still not competitive and generating growth. The Government itself, which must lead the national process of transition to a more productive and efficient society and economy, has undergone relatively less structural change. Mongolia has barely begun to address the question of how to deliver necessary social services to its population without the large external subsidies which had previously financed them.

9. We are very fortunate in that we have many generous and reliable development partners, and as discussed at the Seventh Mongolia Assistance chaired by the World Bank in June 1999, Mongolia needs a transitory increase in donor aid to enable us to carry out the needed measures to adjust to the huge external shock—a shock totaling an estimated 17% of GDP during 1998-99—in a phased manner so as to avoid undue welfare losses. To this end, and to support a series of reforms aimed at creating a sound and efficient financial system needed for faster economic growth, we are requesting a Financial Sector Adjustment Credit from the IDA (the Association), in the amount of US$32 million equivalent, and a Financial Sector Reform Program Loan from the ADB in the amount of US$15 million equivalent to support the projected 2000 to mid-2003 balance of payments financing gap.

Macroeconomic Framework

10. **Terms of Trade Shocks.** The sharp falls in 1998-99 in world prices for copper, gold and cashmere, Mongolia's leading exports, have caused great harm to the Mongolian economy. In 1998, export earnings plunged US$150 million (or by amount equal to about 15% of GDP), due entirely to these price declines. This led to a cumulative depreciation of the exchange rate of 35%, and to a drop in official reserves. The sharp contraction in the value of exports due to the fall in commodity prices reduced Government revenues by almost 4% of GDP in both 1998 and 1999, relative to the level of 1997. Corporate taxes from the copper sector declined from 3% of GDP to nil in 1998, and in 1999.

11. Due to the steep decline in world prices for copper, the Erdenet Copper Concern also has been unable to settle its bills with the Energy Authority, the Oil Importing Company, and electric power stations, making it difficult for the latter to pay money owed to the coal mining companies and to the railways. All of these firms have in turn been unable to pay their expected taxes and dividends to the state budget. This created a cascading of arrears in the economy, causing slowdowns in the activities of these major producers, and a large increase in the Government's budget deficit—from 8.6 to 11.7% of GDP from 1997 to 1998, and in the creation of domestic credit to finance the deficit (to 3% of GDP in 1998). As a result, in 1998, the Government fell into arrears on payments of salaries and pensions. This external shock also contributed to a marked deterioration in financial sector performance, with non-performing loans rising to about 41% of total commercial bank loans.

12. The Government has acted with determination to address the imbalances caused by the terms of trade shock. The Value Added Tax Law was adopted and became effective on July 1, 1998. In September 1998, the VAT was raised from 10 to 13%, a 10% tax of the export of gold was adopted, and the excise tax of imported

petroleum and petroleum products was raised by US$7 a ton. In addition, the 1999 budget froze wages and salaries, and reduced outlays on goods and services.

13. **Government's Fiscal Program.** In May 1999, Government adopted a comprehensive, medium-term program to adjust to the impact of the terms of trade shock, including a package of measures to augment fiscal revenue by a further 2% of GDP annually and reduce capital spending and net lending by about 1% of GDP, with the support of the second year of the PRGF Arrangement, approved in June 1999, whose first review we successfully completed in January 2000. These fiscal measures, coupled with the 1998 tax increases, cut the overall deficit of the general Government to 9.9% of GDP in 1999, from 11.7% in 1998. This adjustment, together with higher net external financing with the support of the PRGF, reduced the Government's use of net banking system credit in 1999 to less than 1% of GDP, compared to 3% of GDP in 1998. The full-year effects of these tax measures, together with public administration reform and further privatization, are projected to narrow the General Government's overall deficit to 7.3% of GDP in 2000, and to 5.3% by 2002, with zero net domestic credit to Government beginning in 2000. Inflation, which was brought down to 6% in 1998 (from 21% in 1997 and 45% in 1996), rose to 10% by the end of 1999 due to the impact of lagged relative price adjustments to the external shock and excessive credit extended to the Government in 1998. It is projected to decelerate to 7% in 2000. At the end of 1999, the total General Government debt reached an estimated 78% of GDP, with external debt amounting to 71% of GDP. External debt service amounted to less than 6% of exports of goods and nonfactor services in 1999, due to the concessional nature of that debt and the high degree of openness of the economy. During 2000-02, the Government's total debt to GDP ratio is projected to increase to 79%, and its external debt, to 73% of GDP. At the same time, economic growth is projected to accelerate to 4-5%.

14. **The Budget for 2000.** The Government budget for 2000 seeks to consolidate fiscal sustainability and free-up resources for the private sector. As mentioned above, the overall deficit is projected to decline to 7.3% in 2000, and net domestic financing, to zero. The 2000 budget is geared to reversing the recent decline Government revenues relative to GDP, while reducing Government spending as a percentage of GDP and improving the prioritization of public spending. Total revenue is slated to rise to 28.4% of GDP, reflecting a slight increase in income taxes and dividends from the copper sector, and the full-year effects of the revenue measures introduced in 1999. Total spending is targeted to fall to 35.7% of GDP, compared to 36.3% in 1999 (and 39% in 1998). The budget makes provisions for the full servicing of public debt, including Government bonds. Outlays on goods and services will be tightly controlled and domestically-financed capital expenditures on lower priority projects will be reduced. The Government also will be undertaking a public expenditure review, with the support of IDA, during 2000. During 2000, the proposed Financial Sector Adjustment Credit would assist to achieve the above macroeconomic targets.

15. **Reducing the Size of the State.** Steps will also be taken to focus Government on core functions, outsourcing other activities, and to increase its efficiency, in the context of the Asian Development Bank (ADB) supported Governance Reform Program. Government also is taking action to improve the governance of state enterprises and curtail their involvement in activities that could be more efficiently carried out by the private sector. To improve pricing decisions, and allow state enterprises to operate on a commercial basis, these enterprises will be granted greater managerial autonomy. Regular financial audits of state enterprises will be instituted. State enterprises will continue to face hard budget constraints (zero net domestic bank credit), and will not receive Government transfers. In addition, the Government has expanded its privatization program, which yielded revenues of about 1.7% of GDP in 1998, to the largest state enterprises. The National Oil Import Concern and the Gobi Cashmere Company are to be privatized, as is the Trade and Development Bank (see also paragraph 38 below).

16. **Exchange Rate and Monetary Policy.** The Bank of Mongolia has continued to pursue the flexible exchange rate policy adopted in 1993 and effectively implemented in the last quarter of 1998 to facilitate the adjustment to the external shock, and will continue to do so in the future. At the end of 1999 the exchange rate was about 25% higher than at the end of the third quarter of 1998, leading to a depreciation of the Togrog of about 4% in real effective terms. International reserves also have substantially recovered from their 1998 decline, and official holdings of external assets reached US$151, or the equivalent of about 14 weeks of imports, compared to less than 12 in 1998. The primary objective of monetary policy is to keep inflation in single digits. With the deceleration of inflation during 1998 and for most of 1999, the yield on central bank bills was progressively lowered, to 10% per annum. As the Government deficit is reduced, banking reforms advance and inflation decelerates during 2000, reductions in commercial bank lending interest rates should be feasible. Growth in monetary aggregates would reflect increased credit to the private sector (with zero net lending to Government and state enterprises) and the further build-up of net external assets towards an adequate level.

17. **Accelerating Economic Growth and Improving Living Standards.** Real GDP growth over the past few years has grown at a modest pace of 3.5%. With an annual population rate of 2%, per capita GDP has also increased. However, the significant deterioration in the terms of trade since the second-half of 1996 had have a major adverse impact on the purchasing power of exports, which account for about 40% of GDP, and, hence, on income and living standards.

18. **Managing External Shocks.** Managing external shocks has become imperative if Mongolia is going to accelerate economic growth and to be able to translate greater output into higher per capita incomes and declining poverty. Better management of external shocks will lead to higher living standards by reducing fiscal and monetary volatility, reducing uncertainty, enhancing financial sector performance, and mitigating drastic swings in producer and consumer incomes. To this end, under the proposed Financial Sector Adjustment Credit (FSAC), the Government would adopt a time-bound action plan, satisfactory to the Association, to improve management of external shocks. It is envisaged that this action plan will encompass measures to smooth-out fiscal revenues, and measures to manage commodity price risk to shield producer incomes from the full impact of commodity price fluctuations. On the latter, we hope that Mongolia will qualify as an early test case under the World Bank's Commodity Initiative.

Current Situation of the Financial Sector

19. The financial sector in Mongolia is slowly evolving to a market-based system, but is still not able to contribute to the development of the economy, and has instead been a drag on economic development. Consolidated banking sector indicators have improved in the past several months thanks to the implementation of measures taken in connection with the 1996 Financial Sector Program Loan (FSPL) funded by ADB and continued under the Banking Restructuring Action Plan of 1999 and the proposed Financial Sector Adjustment Credit to be funded by the Association. Currently the banking sector also meets the international criteria for capital adequacy (10%) and liquidity (18%). The financial sector, however, remains weak and financial intermediation continues to be severely constrained. Building on ADB's assistance under the FSPL in support of bank restructuring, further restructuring is needed to support the development of viable core private banks.

20. At end-1999, total bank assets amounted to only 18 percent of GDP, while total credit outstanding to the private sector was only about 5 percent of GDP. Four large banks out of 12 currently licensed banks hold 80 percent of total assets of the banking system. The Savings Bank, one of the largest banks, does not perform any financial intermediation functions. The remaining 8 banks have only negligible market shares, have little capacity to compete with the largest 4 banks, and conduct limited financial intermediation activities. The state directly and indirectly owns shares of 6 banks. These include controlling shareholding of 3 banks (Trade and Development Bank, Savings Bank and Agriculture Bank), which together account for 70 percent of total assets of the banking system.

21. Non-bank financial institutions are at an incipient stage of development. The stock market is small and illiquid; and market-based insurance and leasing businesses are only beginning to emerge. Nevertheless, considerable potential exists for development of non-bank financial institutions as a competing force, provided a suitable legal environment is created. Currently, long-term credit exists only in the following two forms: through project financing from some commercial banks that serve as on-lenders of credit extended to the Government by donors, or through establishing relationships with foreign banks and markets.

22. The financial sector has recently witnessed the expansion of credit cooperatives and micro finance companies. These institutions are expected to play a greater role as effective providers of small credit. Finance companies and financial leasing companies are also beginning to emerge. In line with development of these non-bank financial institutions (NBFIs), the Government is committed to providing a suitable legal environment including improving supervisory and regulatory oversight of these institutions by BOM .

23. During the last 10 years the Government of Mongolia has taken an important series of actions aimed at establishing a market-based banking system, its restructuring and development. Mongolia replaced the one-tier banking system by a two-tier one; put in place the foundations of the legal framework for banking operations; licensed private banks; and liberalized interest rates and capital flows, with the assistance of the donor community. Since 1996, a series of actions have been taken to further modernize banking legislation, strengthen prudential norms and bank supervision, and to restructure the banking sector.

24. Although policies on banking sector reforms, restructuring and liberalization of financial transactions have been broadly moving in the right direction, the banking sector has faced several crises on its transition path (1994, 1996, 1998-1999).

25. Despite these efforts, the banking sector remains small, weak and crisis-prone. It is still necessary to considerably improve banking staff skills and capacity, as well as the legal and operational environment for conducting banking activities.

26. Real lending interest rates are extremely high. Despite the deceleration of inflation to single digits, and subsequent reduction in Central Bank bill rates and deposit rates, lending interest rates remain high in both real and nominal terms. This has adversely impacted financial intermediation and the entire economy. The main reasons for high lending interest rates are: the high level of non-performing loans; expectations of currency devaluation resulting from the terms of trade shock; little competition in the financial sector; weak institutional capacity and failure of the Government to make timely payments on its financial obligations. High lending interest rates in turn contribute to deterioration of loan quality.

27. In 1996, the Government issued bonds in an amount equivalent to 5 percent of GDP to protect deposits of customers of two insolvent banks, within the framework of the banking sector restructuring program. Of these bonds, 60 percent is owned by the Savings Bank, and 40 percent is owned by the Central Bank. The Government has failed to make timely payments of interest on these bonds. Moreover, these bonds have not had clearly defined terms and maturities. The fact that the Government has failed to meet its obligations on its bonds on a timely basis is contributing to deterioration of the financial position and efficient decision-making of bond-holders, and is sending an improper message to the general economy by exercising an unhealthy practice of not meeting contract obligations.

28. The rural payments system has had significant, recurring problems due to strained state and local government budgets and lack of creditworthiness of the Agriculture Bank, virtually the only bank servicing rural areas. This bank is currently operating under the receivership of the Central Bank and is undertaking restructuring actions such as renewal of service fees on a contract basis, reduction of operational costs and loan recovery efforts. Currently, operations of the bank are restricted to providing payments of pensions and benefits as well as salaries of government employees in rural areas. Micro-lending institutions in rural areas have been established only recently in three Aimags, and have not started operating at the soum level.

29. The capital markets and contractual savings institutions in Mongolia are at a nascent stage of development. The stock market is small and illiquid; and the pension and insurance systems have played a limited role in terms of developing alternative sources of funds to finance economic growth. Despite the smaller size of the capital markets in relation to the banking sector, the Government recognizes the increasing importance of capital markets in developing the financial sector in Mongolia.

30. Market capitalization at the Mongolian Stock Exchange as of December 1999 was $32 million, or 3 percent of GDP, down from $53 million at the end of 1997. Trading activity has declined sharply over the last year, as evidenced by the drop in average daily trading from $50,000 in 1998 to about $10,000 in 1999.

31. The Government recognizes that the small corporate sector and slow progress with regard to the privatization of the remaining 95 SOEs, the largest of which are likely to be sold to strategic investors outside of the MSE, has constrained the supply of better quality stock. On the demand side, limited capacity of MSEC to serve as an effective policymaker and regulator has dampened investor confidence and necessitates considerable institutional strengthening.

32. The Government is aware that the 1997 Insolvency Law has seldom been applied in the resolution of corporate bankruptcies. Under the IDA-assisted Beltac Project and the IDA IDF Grant for the Insolvency Law, the Government is undertaking measures to strengthen the knowledge and application of the Insolvency Law by creditors. These measures will help improve overall corporate governance and accelerate resolution of non-performing loans in the banking sector and debt recovery. With respect to financial governance, Mongolia is unique in that its stock exchange is owned by the Government, and we are strongly committed to its privatization.

33. The capital markets would further benefit from the development of the pension system. The Mongolian pension system is a pay-as-you-go system where current work force pay for the retired workers. Like other

transition economies, the pension system has been afflicted by (i) growing unfunded liabilities; (ii) contribution arrears, particularly from state-owned bodies; and (iii) a narrow base of pension contributions relative to recipients.

34. To address these issues, Government pension plan aims to introduce notionally defined individual pension accounts. In this regard, the Law on Individual Pension Accounts was adopted by the Parliament on 11 June 1999, under which workers born after 1 January 1960 will be given individual pension accounts indicating their past pension contributions with effect from 1 January 2000. The annual "returns" to the individual contributions will be determined by the Social Security Insurance General Office. While the new system will enable pension payments to be closely linked to contributions, the pension fund will be unfunded for the foreseeable future, although the Government has plans to invest a part of the contributions of the younger workers in the domestic capital markets. The Government also plans to introduce non-state voluntary pensions in Mongolia, to supplement the current "first pillar" pension provisions.

The Government will be preparing draft legislation to allow the development of a voluntary private pension system.

35. While Mongolia has a long history with insurance products, there is a lack of operational and regulatory capacity in the industry. Besides considerable regulatory support, policy and operational assistance is needed to strengthen the sector. Except for minimum capital requirements of Tug. 100 million ($95,000), there are no prudential requirements governing solvency in the industry at present. Investment guidelines for insurance companies need to be strengthened as capital markets gradually develop in the country.

36. Although the recent policy on financial sector restructuring and actions taken to implement this policy have generally been moving in the right direction, it is necessary to take decisive actions to make fundamental changes in the current weak situation, to restore public confidence, and to establish a strong financial sector capable of supporting economic development.

37. With these objectives in mind, the Long-term Vision and the Medium-term Strategy necessary to implement this long-term vision for the development of financial sector is formulated below, and Financial Sector Reform Program Loan. The Government and the Bank of Mongolia and would be implemented with the support of the proposed Financial Sector Adjustment Credit consider that the general policy guidelines and specific actions to be taken to implement the medium-term strategy also should be reflected in the annual Monetary Policy Guidelines that are approved by Parliament at the end of each year, ensuring ownership and consensus on the financial sector reforms as we move forward.

Key Lessons Learned from past efforts to Reform the Financial Sector

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

- It is necessary to build the infrastructure aimed at supporting a market-based financial system, with strong financial discipline and prudential controls.
- The financial sector will not develop without a state that supports contract enforcement, protection and securitization of private property.
- Financial sector restructuring will not be successful unless the sequence of reforms is determined correctly and a stable political environment exists.
- State intervention in allocation of financial resources hinders development of a market-based financial sector.
- The fact that the state recapitalizes insolvent banks and takes their risks increases potential losses in the future.
- Lax entry requirements result in an excessive number of weak, poorly managed banks.
- A sound financial sector cannot be created without an appropriate legal framework and operational structures aimed at strengthening the repayment culture.

- Capital markets and NBFIs should be developed to complement the banking sector and foster a balanced financial structure.
- Investor confidence is crucially dependent on the existence of sound corporate governance systems and practices in the financial sector.

- The role of the Government in the ownership of financial institutions impairs their rapid growth as viable entities.

Long-Term Vision for Financial Sector Development

39. Based on the above lessons and exchange of views with key stakeholders, including members of Parliament from both sides of the aisle and donors active in the sector, the long-term vision for the financial sector in Mongolia for the next 10 years is envisaged as follows:

- The role of the state will be directed to ensuring macroeconomic and financial sector stability, and the state will intervene only in circumstances where market forces patently fail to work.
- There is an effective, autonomous central bank and a legal framework which requires good prudential regulation, corporate governance, and supervision and prompt corrective action (i.e. the closure of banks when the capital adequacy ratio declines below a certain minimum level);
- A relatively few number of sound and efficient domestic and foreign banks would emerge and would be capable of providing efficient banking services in a competitive environment.
- Ownership of all commercial banks will have been transferred to the private sector.
- Basic payment and banking services are available to meet demand outside Ulaanbaatar through a variety of channels (e.g., micro-finance institutions, regional cooperatives, private banks).
- The financial sector will have a cadre of banking and related personnel trained in best international practices.
- The legal environment for conducting financial activities as well as accounting standards will be rigorously enforced, with the aim of strengthening public confidence in the financial institutions.
- There is a growing number of NBFIs (e.g., finance and leasing companies, contractual savings institutions, cooperatives, and micro-finance companies) to help meet the demand for savings and investment.
- A healthy and well governed capital market will be developed to complement the banking sector.

Medium-term Strategy for Financial Sector Development

40. The Government recognizes its Long-Term Vision will take many years to achieve. Consequently, it has devised a Medium-Term strategy that will lay the foundations necessary for achieving this vision over the longer term. The key elements of the medium term strategy for financial sector development are as follows:

- establish the foundations for a market-based financial system, including the development of modern banking skills, the enhancement of auditing and accounting standards, the enforcement of financial contracts and the establishment of an exit policy process for troubled banks;
- signal the government's commitment to uphold rights and obligations under financial contracts, beginning with the timely servicing of interest payments on government bonds held by banks;
- reduce the pervasive role of the state in the allocation of financial resources—until the revocation of the licenses in December 2000 of the deeply insolvent ITI and RB Bank, government controlled banks accounted for about 90% of the assets in the banking system;
- facilitate the development of sustainable rural financial institutions to provide payment systems and banking services appropriate to conditions existing in a sparsely populated country such as Mongolia;
- prompt the consolidation of the banking system by doubling the minimum capital requirement to T2 billion (about US$1.9 million);

- strengthen the legal framework for effective supervision and regulation by the central bank including the requirement for prompt corrective action;
- develop a resolution and liquidation framework for failed banks;
- provide the foundations for the development of a market for government bonds and an inter-bank market;
- strengthen corporate governance in the financial sector by encouraging banks to move towards international standards such as the guidelines on corporate governance in banking institutions issued by the Bank for International Settlements;
- foster a healthy capital market by carrying out reforms in MSE and MSEC to enhance investor confidence; and
- institute a regulatory mechanism to guide the development of the NBFI sector.

41. The proposed Financial Sector Adjustment Credit and Financial Sector Reform Program would support the implementation of the Governments Medium-Term Strategy for the Reform and Development of the Financial System.

Bank Restructuring and Privatization

42. A largely insolvent state-owned banking system impedes .faster economic growth and improvements in living standards. Heavy banking system losses inflate the public sector deficit and debt, diverting funds from poverty reduction, human resource development and infrastructure.

43. **ITI Bank and Reconstruction Bank.** On December 24, 1999, the Bank of Mongolia revoked the licenses, and initiated a resolution dictating the liquidation of, ITI Bank and Reconstruction Bank. With this unprecedented measure, the size of the state banking sector was reduced by about one-fifth.

44. **Agricultural Bank.** AB is deeply insolvent and incurring operating losses averaging nearly T50 billion per month. At present, AB also operates the largest branch network in Mongolia and only one with a presence down to the county (*soum*) level. The accumulated losses of AB amount to T7 billion (equivalent to about 0.7% of GDP on a yearly basis).The Government plans to recapitalize, restructure and eventually privatize AB, in accordance with a Restructuring Plan that would be supplemented in consultation with IDA, to strengthen its provisions relating to corporate governance; commercial viability; the actions required to bring it to the point-of-sale; and the revocation of its license if a sound bank cannot be established. Over the medium-term, AB either will have been brought to the point-of-sale (to owners who can provide appropriate governance and ensure financial viability), or, if AB has become insolvent again, BOM will have revoked its license. In the meantime, the Government will begin to implement alternative arrangements for ensuring payment services to the population outside the capital.

45. **Savings Bank.** The Savings Bank was established as a special purpose vehicle to collect and protect household deposits following the banking crisis of 1996. Savings Bank holds about one-third of the banking system's total deposits. The bank has more than 260,000 accounts with an average size of about US$12 equivalent each. The bank functions essentially as a Government agency with an implicit state deposit guarantee and lacks a banking/lending culture. The Government's failure, until recently, to service the bank restructuring bonds that make up virtually all of its assets resulted in a deficit cash flow and operating losses, causing the Savings Bank to maintain higher deposit rates than otherwise would be needed, further pushing-up economy-wide interest rates. Furthermore, Savings Bank's policy of investing all its assets in non-marketable Government bonds prevents one-third of all deposits (representing approximately 75% of all household deposits) from being intermediated.

46. Savings Bank needs to be made financially viable to limit systemic risk, downsized to reduce state exposure and foster financial intermediation, and eventually, turned into a financial intermediary. Therefore, Government is clearing all interest arrears on its bonds, and will service those bonds in future at an interest rate linked to the BOM bill rate. Clearance of interest arrears has enabled Savings Bank to begin lowering its interest rates. Over the medium-term, Government will replace the stock of bank restructuring bonds with marketable securities that will be regularly serviced. In the meantime, Savings Bank will be downsized, by, inter alia, bringing its interest rate structure in line with market rates, and increasing service fees to levels charged by

other banks. Over the medium-term, the Government will prepare an action plan for the transformation of Savings Bank into a financial intermediary, including its privatization.

47. **Trade and Development Bank.** The Trade and Development Bank (TDB) is Mongolia's largest bank; however, during 1998 and the first half of 1999, the bank incurred significant loan losses from weak governance and poor lending practices.

48. Scarcity of modern banking skills is severely handicapping development of a banking system, and the fastest way to develop these skills is through the training that a reputable international bank could provide. In addition, much greater private ownership and market allocation of resources in the financial system is needed to accelerate growth.

49. Accordingly, Government submitted a bill to Parliament requesting its approval to privatize TDB on January 28, 2000. Government's intention, once it obtains Parliamentary approval of said bill, is to privatize a controlling share holding of TDB to a private strategic investor with recognized international banking experience via international competitive bidding. The Government is exploring with ADB and IFC the possibility of participating, together with a private strategic investor, in the equity of the privatized TDB.

Corporate Governance in Banking Institutions

50. Corporate governance in banking institutions is generally weak, further undermining market discipline. In many instances, state-owned banks are operated by directors, many of whom were trained under the old system based on principles of directed lending. To address some of these issues, initial training has been provided under IDA-assisted projects (BELTAC and Private Sector Development Project). On the other hand, certain private investors are, in some instances, interested in establishing small banks not as a sound investment option but as a means to finance their personal business activities. The closed limited-liability nature of banks together with the absence of effective accountability, in many cases, encourages perpetuation of bad management further undermining the development of sound and efficient private banks. In an effort to improve corporate governance and strengthen internal control mechanisms in banks, BOM will, with technical assistance to be provided by ADB, prepare and issues guidelines on best practices in corporate governance in banking institutions, based on international best practices such as the guidelines issued by the Bank for International Settlements.

Loan Collateral

51. It is recognized that the expected approval of provisions in the Civil Code allowing for movable property to be offered as loan collateral will be an important step towards enhancing the supply of loanable funds in the banking system. A second significant step will involve expanding the types of immovable property that can be used as collateral in secured transactions. A plan will be developed by the Government to analyze the feasibility of using other forms of immovable property as collateral. At another level, the Government will address under the Financial Sector Reform Program issues relating to the Office for Immovable Property Registration relating to the relatively high cost of collateral registering and cumbersome administrative procedures that discourage registration.

Banking Supervision and Prudential Regulation

52. Tightening selected prudential norms, together with a stronger failure resolution framework, will help create a sound banking system, reducing resource misallocation and wastage, improving long-run fiscal balance and contributing to faster economic growth and improved welfare.

53. **Minimum Capital Requirements.** Minimum capital requirements have been low relative to the size of the market and the scarcity of banking skills, allowing easy entry into the market and resulting in an excess number of banks—as many as 18 in August 1998 (currently down to 12), most of which have performed weakly or failed. In this way, BOM supervisory resources and Mongolia's scarce banking skills have been stretched far too thin. On September 1, 1999 the MCR was raised from T400 million to T1 billion. On January 21, 2000, the Bank of Mongolia issued a resolution that raised the Minimum Capital Requirement (MCR) for commercial banks from T1 billion to T2 billion, effective starting June 30, 2001, except for new candidate banks, for which the increase to T2 billion is effective immediately.

54. With the new increase to T2 billion, the MCR has been raised by a multiple of 5 over the course of the past four months, for new banks, and has been raised by a factor of 5 during the August 1999-June 30, 2001 period, for existing banks. On January 21, 2000, the Togrog (T) exchange rate was T1080 per U.S. dollar, so that, as of that date, the new minimum capital requirement was equivalent to about US$1,850,000. A comparison of the new minimum capital requirement in Mongolia with those in other countries shows that Mongolia's new MCR is relatively stringent.

55. This new doubling in the MCR for banks will encourage a consolidation of existing commercial banks into a smaller number of sounder banks that are capable of competing, and help ensure that any new entrants into the market meet much more stringent capital requirements. Also, the Bank of Mongolia intends to adjust the MCR as needed, over the medium-term, to maintain its value in real terms.

56. **Asset Classification.** Current regulations on asset classification deal only with loans. Losses, however, may arise from other assets (including cash items; old outstanding "we debit" items due from other banks; poor quality investments, suspense items; unresolved differences; accounts receivable, foreclosed or repossessed assets; and contingent liabilities). In addition, loans are currently considered past due only when principal and/or interest is 90 days in arrears. The BOM is preparing a resolution that will strengthen the definition of past due criteria and require recognition of losses that occur in asset types other than loans.

57. **Prompt Corrective Action.** Prompt corrective action has not been implemented in the banking system, with the result that banks with shaky financial conditions have deteriorated progressively. Only once banks become insolvent, and often then with lengthy delays, have actions been taken to redress the situation, inflicting large losses on Mongolian society.

58. Over the medium-term, Government intends to amend banking legislation to adopt a prompt corrective action, with trigger points at 75% and 50% of the Capital Adequacy Ratio, to make corrective action much more automatic, to depoliticize bank failure resolution, and to encourage banks to maintain higher levels of capital. The Trigger points at 75% and 50% of the minimum capital adequacy ratio (CAR) would automatically activate mandatory recapitalization actions including the development of a capital restoration program, prohibitions on dividends and restrictions on asset growth, capital-raising activities and changes in the mix of risk assets. The final threshold, at 25% of the minimum CAR, is a recognition that corrective actions have been unsuccessful and would culminate in mandatory closure.

59. **Exit Policy.** The Government intends to adopt a modern banking exit policy framework by amending the current banking legislation on conservatorship and receivership, and including a new failure resolution scheme. This new framework will better preserve the asset values of the ongoing concern; increase the rights and choices of the depositors and other parties concerned; reduce moral hazard; accelerate resolution and liquidation, and reduce resolution costs. In addition, at present, an implicit state guarantee of all deposits is perceived to exist. The soundness and efficiency of the financial system would be improved with a stronger exit policy that reduces moral hazard; limits the state's exposure; permits an effective transfer of assets from troubled banks to sound institutions; and prevents contagion and reduces systemic risk.

60. Over the medium-term, Government intends to strengthen the exit policy framework through amendments to the banking legislation. This framework will require that whenever the capital adequacy ratio falls below 25% of the required level, the resolution framework is automatically activated without any further possibility of action by managers and shareholders, in order to protect depositors. Only the residual balance after resolution will need to be sent to liquidation.

61. **Residual Assets.** An improved framework is needed for liquidation of residual assets. With the July 1999 modification of the Banking Law, a receiver can be appointed to restructure or liquidate a bank. However, the authorities do not have all the legal tools needed to liquidate banks in an efficient manner. Further amendments will be introduced to the Banking Law that provide for the process of liquidation of the residual assets of failed bank after the resolution process has taken place.

Strengthening the Regulation of NBFIs

62. In view of the limited outreach of the banking system and problems affecting financial intermediation, finance companies are expected to quickly assume a greater role in Mongolia. Prudential norms for the various categories of NBFIs need to be developed as the existing regulations are short on details. There is also a need to ensure that the Supervision Department of Bank of Mongolia (BOM) is properly organized to ensure effective supervision of NBFIs.

Appropriate mechanisms need to be introduced including regulations on licensing requirements, risk-based prudential standards and minimum paid-in capital to ensure a healthy non-bank financial system and avoid the fragility characteristic of the banking system. BOM intends to (i) strengthen NBFI regulations requiring finance companies to comply with risk-based prudential regulations; and (ii) assume oversight responsibility over savings and credit cooperatives through second and higher tier credit associations.

Asset Recovery and Nonperforming Loans

63. **Mongolian Asset Recovery Agency.** The Mongolian Asset Recovery Agency's (MARA) ability to recover nonperforming assets is hampered by its insufficient authority; lack of funding, low salaries; and lengthy court delays. Government plans to strengthen the legal status and powers of MARA to collect and dispose of assets by passage of appropriate legislation. This legislation would provide MARA sufficient flexibility to quickly realize assets, while opening-up asset collection to private agencies, in particular, it would enable MARA to sell recovered assets at a discount and at auction, and to operate on a commercial basis.

64. **Credit Information Bureau.** In order to improve loan repayment rates, the Bank of Mongolia also established a Credit Information Bureau. The information base on loan defaulters and mechanisms to share this information with banks is still in process of development. The BOM intends finalize arrangements to enhance the effectiveness of the Credit Information Bureau by focusing data collection on loan defaulters and developing a protocol for the sharing of this information in consultation with commercial banks. In order to strengthen operations and upgrade the capacity of banks, integrated banking information management system software for treasury management, foreign exchange operations and other activities will be introduced on a pilot basis in TDB and then on a bank-wide basis in Mongolia.

Rationalizing the Payments System

65. Bank restructuring needs to be done in such a way so as to avert a disruption in payments services in rural areas. At present, most payment services (government wages and pensions) in rural areas are performed by the Agricultural Bank. Government attaches a high priority to ensuring that payment services are not disrupted. Government also intends to ensure that these services are provided through least-cost means.

66. The monthly cost of operating an AB bank sub-branch limited to providing payment services at the *soum* level is about T160,000. If half of AB's 282 *soum* level sub-branches were considered essential in that these locations could not be serviced from other *soum or aimag* branches of AB or other banks, the cost of maintaining 141 sub-branches to provide payments services only would about T271 million per annum (about US$245,000). Government plans to keep open those AB subranches needed to ensure continuity of payment services in remote areas. Other potential service providers may bid for supplying this service. To this end, Government will define a strategic network of AB sub-branches that are essential to ensure payment services at the *soum* level; on January 1, 2000 AB signed an agreement with the Social Insurance Department, whereby the latter will pay for the transaction costs of distributing government wages and pensions throughout the country. Government also intends to remove any remaining impediments to entrance of new institutions in the distribution of these payments.

Public Debt and Development of Financial Markets

67. Creation of a government bond market would provide an alternative source of investment for banks and the public; increase transparency in the management of budget deficits; and aid in the development of a capital market. At present, there is no legal framework on public debt. Government bonds are issued only to meet extraordinary financing needs. This impedes the creation of a market for government bonds and constrains market liquidity. Government plans to submit to Parliament a law on government debt and government debt instruments. Given the close link to this issue, the Bank of Mongolia supports the development of an inter-bank market. An inter-bank market would provide banks in Mongolia a means to improve asset-liability management through the ability to invest surplus funds and reduce the costs of funding liquidity shortfalls. Legal, regulatory and policy considerations will be analyzed by Bank of Mongolia to help create a conducive environment for the eventual development of an inter-bank market.

Development of Human Resources and Financial Infrastructure

68. Developing the essential infrastructure to complement a market-based financial system including banking skills, auditing and accounting standards, enforcement of financial contracts, and better enforcement of prudential norms is a top priority. There is a dearth of banking skills, especially with respect to credit assessment and loan management processes in commercial banks and regulatory processes in the BOM. In some cases laws are not being enforced or are subject to inconsistent interpretation by the courts. The 1993 accounting law required the adoption of international accounting standards. However, nine years into the transition, most financial statements are still prepared on a cash, rather than an accrual, basis. These statements tend to minimize profits to lessen the tax burden and, since they are prepared on a cash basis, do not reflect the true financial condition of the enterprise.

69. There have been and are numerous programs to upgrade financial infrastructure, but these have lacked the strategic basis and overall coordination needed to systematically develop this infrastructure. To that end, Government is preparing a comprehensive Financial Sector Infrastructure Action Plan for development of human resource skills in all facets of the financial sector and other basic building-blocks needed to support a healthy financial sector including banking and supervision skills, accounting and auditing standards, and enforcement of financial contracts. Government has requested World Bank financial assistance to implement this strategy and action plan, in the form of a Financial Sector Technical Assistance Credit.

Development of the Capital Markets

70. The Government recognizes the importance of capital markets to increase domestic resource mobilization and effectively allocate funds to those most productive activities. The development of the capital markets would also increase the supply of long-term funds available in the economy. Over the short-term the Government will support actions that strengthen the operational and regulatory capacity of the MSEC and improve investor confidence in the MSE. In parallel, to increase the supply of quality stocks, the Government will support the issuing of shares of some of the remaining 95 SOEs. In addition, the Government has incorporated under its Guidelines of the Cabinet for Economic and Social Development the submission to Parliament of a Law on Trusts and a Law on Investment Funds in 2000 as part of efforts to establish the legal framework for new investment products. Finally, the Government is committed to the establishment of MSE, CDS and the securities clearing and settlement system as separate legal entities and subsequent privatization of them; as separate privatized institutions, they will foster the development of a more effective and professional securities exchange.

Consensus-Building on Financial Sector Reform

71. Government recognizes that implementation of its Medium-Term Strategy for Financial Sector Reform and Development requires a broad consensus in Mongolia, as well as the support of our external development partners. To this end, we have created a Financial Sector Development Performance Group (FSDPG as a forum to exchange ideas and reach broad consensus on the long-term vision and medium-term strategy for the financial sector. We expect this forum to monitor progress on a regular basis and determine if there is need to change direction as the program evolves. The FSDPG includes high-level members of Government policy-making bodies (including the Prime Minister's Office, the Ministry of Finance, the Ministry of Justice, the Bank of Mongolia, the Cabinet Secretariat and the State Property Committee); members of Parliament from all parties; NGO and private sector representatives; and donors representatives, including the ADB, GTZ, JICA, IMF, USAID and World Bank.

Ya. Ochirsukh
Minister of Finance
Ministry of Finance

J. Unenbat
Governor
Bank of Mongolia

MONGOLIA: FINANCIAL SECTOR REFORM PROGRAM *

POLICY MATRIX

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	IDA/ ADB Second Tranches	IDA Floating Tranche
Macroeconomic Framework						
• Mongolia needs high, sustained labor-intensive growth to steadily raise living standards and reduce the incidence of poverty. Fiscal sustainability is a major challenge facing Mongolia in achieving macroeconomic stability. The high level of interest rates reflect in part the impact of large fiscal deficits.	• Growth averaged 3.5% during1994-98, according to official statistics. Although actual growth has been higher (because national accounts overestimate the impact of declining sectors and underestimate that of expanding ones), the incidence of poverty also remains high, at 35.6% (36.3% in 1995).	• Government's macro-economic policy framework is designed to maintain inflation in single digits, facilitate adjustment to external shocks, build-up holdings of external assets and bring down real interest rates to sustainable levels.		• Maintain a sound macroeconomic framework as determined on the basis of indicators agreed between the Borrower and IDA.	• Maintain a sound macroeconomic framework as determined on the basis of indicators agreed between the Borrower and IDA.	• Maintain a sound macroeconomic framework as determined on the basis of indicators agreed between the Borrower and IDA.
• Mongolia needs to manage external shocks efficiently to significantly raise its long-term growth and welfare gains. Cyclical banking crises are caused in part by term of trade shocks.	• Mongolia has yet to take measures to manage external price shocks. Commodity price fluctuations have led to the classic boom and bust cycle, with low trend growth. Copper prices plunged 42% in 1998, and a further 17% in January-August 1999. Cashmere and gold prices also are depressed; petroleum prices have more than doubled in the past year. Value of terms of trade shock is estimated at about 9% of GDP in 1998, and an additional possible 4% in 1999.	• Government plans to form a Working Group on managing Commodity Risk to consider measures to mitigate external commodity risk and terms of trade shocks including the adoption of risk management systems by the major producers of commodities most vulnerable to price shocks (copper and gold). Mongolia has been selected as early test case in World Bank's commodity initiative and work is expected to start in early 2000.		• Adoption of a time-bound action plan, agree-able to IDA, to mitigate external commodity risk and terms of trade shocks, including work initiated under the World Bank's commodity initiative and the development of non-traditional exports In particular, the plan will focus on efforts to miti-gate the impact of volatile commodity prices on the fiscal position of the Government.	• Completion of the said action plan, in a manner satisfactory to IDA.	

* For ease of reference, ADB-assisted components under the Financial Sector Reform Program have been italicized; IDA-assisted components have not been italicized.

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	**IDA/ ADB Second Tranches**	**IDA Floating Tranche**
Financial Sector Development Strategy						
• Create a sound and efficient financial system.	• The financial sector is inefficient, loaded with non-performing loans (NPLs) and is not performing its allocative function satisfactorily.		• The Government, in consultation with donors involved in the financial sector, has adopted a long term vision for the development of the financial sector and a medium term strategy to achieve that vision, satisfactory to IDA (Board Condition)			
Corporate Governance in Banking Institutions						
• *Application of corporate governance principles in banking institutions is key to the sustainable development of the banking sector.*	• *Banks are generally poorly managed with limited commercial orientation. Private investors are often interested in banks not as a sound investment option, but as a means to finance their personal business activities. The closed limited-liability nature of banking institutions, together with the absence of effective accountability, encourages perpetuation of bad management practices further undermining the development of sound and efficient private banks.*	• *The Government intends to issue guidelines on best practices in corporate governance for banks, prepare a model charter for banks, and issue guidelines encouraging banks to prepare or amend their charters based on this model.*			• *BOM to prepare and issue guidelines on best practices in corporate governance in banking institutions in Mongolia, including measures to strengthen internal control mechanisms, based on international practices such as the guidelines issued by the Bank for International Settlements.*	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	**IDA/ ADB Second Tranches**	**IDA Floating Tranche**
Improving the efficiency of intermediation: Bank Restructuring, Privatization, Asset Liability Management and Interest Rates						
• The banking system is, in terms of solvency and liquidity, fragile, state-owned and inefficient.	• Heavy banking system losses inflate the public sector deficit and debt, diverting funds from infrastructure, human resource development and poverty reduction. About 90% of banking assets are in state hands.	• Government is implementing a bank restructuring program to strengthen the banking system, reduce fiscal losses, and free resources for priority expenditure.		• Adoption of a plan, satisfactory to IDA, to establish a payment system network to provide payment services to the soum level, which plan may include the use of certain branches and sub-branches of AB or other entities qualified to provide this service.		
• To reverse the current trend towards disintermediation.	• ITI, Reconstruction (RB) and Agricultural Bank (AB) are all illiquid and deeply insolvent.	• Government and BOM plan to liquidate ITI and RB. • BOM has revoked the licenses of ITI bank and RB and issued resolutions to initiate liquidation of ITI bank and RB.				
• *An interbank market would provide banks in Mongolia a means to improve asset liability management by allowing them to invest surplus funds and reduce costs of funding liquidity shortfalls.*	• *There is no functioning interbank market in Mongolia.*	• *The development of financial markets is critical to the development of capital markets .While there are concerns regarding the optimal timing for creating an interbank market, there is an understanding that the monetary authorities have a role in promoting policies conducive to the development of financial markets such as development of an interbank market.*			• *MOF and BOM to prepare a plan acceptable to ADB for development of an interbank market, including establishment of the legal / regulatory and institutional framework.*	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	**IDA/ ADB Second Tranches**	**IDA Floating Tranche**
• To signal Government's commitment to honor financial contracts.				• Government has paid all the interest on its Bank Restructuring Bonds in arrears as of the date of the DCA and issued regulations, satisfactory to IDA, providing for the prompt and timely servicing of all Bank Restructuring Bonds including linkage of their interest rate to those of the Central Bank Bills Rate (CBBR).	• Government has replaced all its outstand-ing bonds with market-able and tradable securities that provide adequate yield, liquidity, and negotiability.	
	• Government plans to recapitalize AB with public and GTZ funds, restructure it, and privatize it. • The cost of providing payment services throughout the country is very low relative to the cost of operating AB as it currently exists. It costs approximately US$160 per month to operate a *soum* level sub-branch providing only payment services. To operate a full service sub-bank branch costs significantly more due to the expense of personnel, security, equipment, etc. Furthermore, all of AB's current sub-branches are not essential to provide payment services, as some of these locations could be serviced by other *soum* or *aimag* branches of AB or other banks.	• Government intends to restructure AB with the objective of creating a viable institution to provide financial services in rural areas.	• Government has adopted for AB a restructuring plan, satisfactory to IDA, that provides appropriate governance, ensures commercial viability, and the actions required to bring it to the point of sale or its closure and revocation of license if a sound financial institution cannot be established. (Board condition)		• Completion of the AB restructuring plan, satisfactory to IDA.	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	**IDA/ ADB Second Tranches**	**IDA Floating Tranche**
• The high level of interest rates encompass monetary and fiscal policy issues, and structural conditions in the banking system.	• Savings Bank (SB) was established as a special purpose state vehicle to collect and protect household deposits It needs to be made financially viable to limit systemic risk. Almost all of SB's assets consist of government bonds which have not been serviced regularly causing liquidity problems for SB. To manage liquidity and meet depositor demand for cash, SB has for significant periods paid higher interest rates than its main competitors. thus raising market rates.	• The Government plans to use technical assistance over the next 18 months, in consultation with IDA, to strengthen Savings Bank in the areas of management, corporate governance, the development of a business plan and staff training consistent.		• Government has issued instructions to SB to adopt and implement an asset-liability management policy, satisfactory to IDA, including prudent management of liquidity and funding needs and payment of interest for deposits at competitive market rates.	• Government has adopted a time-bound action plan, satisfactory to IDA, to privatize SB.	
• Scarcity of modern banking skills is severely handicapping development of a banking system. In addition, much greater private ownership and market allocation of resources in the financial system is needed to accelerate growth.	• Currently, there are no foreign banks operating in Mongolia. In addition, TDB, the largest bank, remains in state hands and its loan portfolio has deteriorated sharply over the past two years.	• Government has presented to Parliament a bill excluding TDB from the list of properties not to be privatized. Attached to the bill is a proposal for the Government to dispose of 51% of the shares of TDB, which would reduce the Government's stake to 19%. Parliamentary approval of the bill is required before the Government can dispose of its stake in TDB. The principles and procedures that will guide the privatization process have not yet been clearly articulated.	• Government has adopted a program, satisfactory to the Association, to bring to TDB to the point of sale and transfer a controlling share-holding to a strategic private sector investor with recognized international banking experience. The program includes the principles and procedures that will guide the privatization process (Board condition).			• A strategic Private Sector investor with recognized international banking experience has acquired a controlling shareholding in TDB.

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	**IDA/ ADB Second Tranches**	**IDA Floating Tranche**
Banking Supervision and Prudential Regulation						
• Tightening selected prudential norms will help create a sound banking system, reducing wastage of resources, improving fiscal balance, and contributing to faster economic growth and improved welfare.	• Minimum capital requirements are too low relative to the size of the market and the scarcity of banking skills, allowing easy entry into the market and resulting in an excess number of banks, most of which have performed weakly. Bank supervisory resources also have been stretched too thin. Consolidation of the banking sector will lead to sounder and more efficient banks.	• The minimum capital requirements recently were raised from T400 million to T1 billion; however, since the increase was originally proposed to Parliament, the value of the new minimum capital requirement has declined from the equivalent of about US$1.4 million to US$850 thousand, and from 1.3% of GDP to 0.9% of GDP. The Government plans to phase-in higher minimum capital requirements to further strengthen the banking sector. • The BOM has raised minimum capital require-ments to $2 million equivalent with the increase phased in over 12 months for banks with licenses issued prior to the date of the DCA.				
• Further tightening prudential norms will help strengthen financial discipline and improve banking sector performance.	• Current regulations on asset classification deal only with loans. However, losses may arise from other assets including off-balance sheet items and other categories of non-loan assets. In addition, loans are currently considered past due only when principal and/or interest is 90 days in arrears.	• The BOM intends to strengthen the definition of past due criteria and require recognition of losses that occur in asset types other than loans. • Government plans to tighten regulations with regard to the norms on past due loans.		• BOM has issued a regulation, satisfactory to IDA, providing for: (a) asset classification criteria to include assets other than loans; and (b) Bank licensing criteria .		

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	IDA/ ADB Second Tranches	IDA Floating Tranche
• Prompt corrective action is needed to help ensure the soundness of the banking system.	• Prompt corrective action has not generally been implemented in the banking system, with the result that banks' with shaky financial conditions have tended to deteriorate progressively. Only once banks become insolvent, and often then with lengthy delays, have actions been taken to redress the situation.	• In addition to measures already contained in Article 31 of the Banking Law, the Government intends to adopt the concept of "Prompt Corrective Action," which would require mandatory action by the BOM to when bank capital falls below certain levels with respect to the minimum capital adequacy ratio (CAR). Trigger points at 75% and 50% of the minimum CAR automatically activate mandatory recapitalization actions. If a bank reaches the final threshold, at 25% of the minimum CAR, corrective actions have failed, and resolution becomes mandatory.			• The Banking Law has been amended to provide for mandatory action ("Prompt Corrective Action") to be imposed automatically by BOM whenever the CAR of any bank falls below 75% and 50% of the minimum CAR required level as determined by BOM, including the development and implementation of a capital restoration plan, restrictions on asset growth and on new activities, and implementation of a management improvement plan. • The Banking Law has been amended to provide for prompt and effective intervention by BOM whenever any one of the objective factors expressly stated in the Banking Law occurs, including legal evidence of fraud by the owners and managers of the bank, legal evidence of incompetent management, and lack of compliance with instructions issued by BOM pursuant to law.	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	IDA/ ADB Second Tranches	IDA Floating Tranche
• The soundness and efficiency of the financial system would be improved with a stronger exit policy combined with an explicit deposit insurance system that reduces moral hazard; protects small depositors' rights while limiting the state's exposure; permits an effective transfer of assets from troubled banks to sound institutions; and prevents contagion and reduces systemic risk.	• The existing banking law provisions on conservatorship and receivership need to be strengthened to better preserve the asset values of the ongoing concern; increase the rights and choices of the parties involved; reduce moral hazard; accelerate resolution and liquidation, and reduce resolution costs. In addition, at present, an implicit state guarantee of all deposits is perceived to exist.	• The Government will strengthen the exit policy framework. This framework will require that whenever the capital adequacy ratio falls below 25% of the required level, the resolution framework is automatically activated without any further possibility of action by the private shareholders, in order to protect small depositors.			• The Banking Law has been amended to provide for an effective failure resolution mechanism, including automatic implementation of system to protect depositors and bank assets, whenever the CAR of any bank falls below 25% of the minimum CAR required level as determined by the BOM or when the bank suspends payments to liability holders.	
• An improved framework is needed for liquidation of residual assets.	• With the July 1999 modification of the Law, a receiver can be appointed to restructure or liquidate a bank. However, the authorities do not have all the legal tools needed to liquidate banks in an efficient manner. An amendment of the banking law is needed to provide for the liquidation of the residual assets of failed bank after the resolution process has been completed. A draft bankruptcy law for banks has been prepared but needs revisions.					

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
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	• It envisions that depositors will be paid through the liquidation of assets rather than through other failure resolution methodologies, thereby delaying depositors access to their funds and potentially increasing contagion risk and moral hazard.	• The Government plans to amend the banking law to allow for the liquidation of residual assets after resolution. Only the residual asset balance after resolution has to be sent to liquidation.			• The Banking Law has been amended to establish the process of liquidation of banks' residual assets after the failure of the resolution mechanism.	
Loan Collateral						
• *Development of the financial sector requires that the types of property that can be used as loan collateral be expanded.*	• *The types of property that can be used as loan collateral are limited and must be expanded. Procedures for registering property must also be improved to allow for proper registration and valuation of the property.*	• *The Government recognizes that financial intermediation (i) is constrained by the limited types of property that can be offered as loan collateral and (ii) that the cost of borrowing is higher given the lack of collateral and uncertainty concerning the value of the collateral and the ability to recover the collateral, if necessary. The Government intends to consider means to expand the types of property that can be used as loan collateral.*			• *Government to prepare a plan acceptable to ADB on the expansion of types of property that can be used as loan collateral.*	
Asset Recovery and reducing the future incidence of non-performing loans						
• A banking system in distress needs an effective vehicle for collecting bad assets accumulated form insolvent financial institutions. At the same time mechanisms need to be put in place to enhance the incentives for repaying future loans.	• The Mongolian Asset Recovery Agency's (MARA) ability to recover nonperforming assets is hampered by its insufficient authority; lack of funding, low salaries; lengthy court delays; and uncooperative debtors.	• Government intends to strengthen the ability of MARA to collect and dispose of assets, including its privatization.			• MARA has been legally empowered to sell recovered assets at discounts, including through auctions , and to operate on a commercial basis.	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	IDA/ ADB Second Tranches	IDA Floating Tranche
	• A credit information bureau has been established at the BOM. However, the information base on loan defaulters and mechanisms to share this information with banks is still in process of development.	• BOM intends to finalize arrangements to enhance the effectiveness of the credit information bureau by focusing the data collection on loan defaulters and developing a protocol for the sharing of this information in consultation with commercial banks.			• BOM has implemented an action plan, satisfactory to IDA, to strengthen its credit information bureau and facilitate sharing of information on loan defaulters among the commercial banks and the BOM.	
Management Information System						
• *To strengthen operations and upgrade the capacity of Mongolian banks, there is a need for banks to adopt an integrated banking management information system.*	• *The existing banking management information systems in banks are rudimentary with limited scope for proper treasury management, foreign exchange operations, and other activities.*	• *Integrated banking management information system software should be introduced in Mongolian banks on a pilot basis and then on a bank-wide basis.*			• *Progress acceptable to ADB has been achieved in the implementation of the program to introduce and operationalize integrated banking management information system software in the Mongolian banks participating in such program.*	
Rationalizing the Payments System						
• Bank restructuring needs to avert a disruption in payments services in rural areas.	• At present, most payment services (government wages and pensions) in rural areas are performed by the Agricultural Bank.	• Government attaches a high priority to ensuring that payment services are not disrupted. Government also intends to ensure that these services are provided through least cost means. • MOF has issued instructions to all budget entities to arrange to pay fees to commercial banks for any payment services said banks provide, such as distributing government wages and pensions throughout Mongolia.				

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	IDA/ ADB Second Tranches	IDA Floating Tranche
Development of Human Resources and Financial Infrastructure						
• Developing the essential infrastructure to complement a market based financial system including banking skills, auditing and accounting standards, the legal framework supporting financial contracts, and enforcement of prudential norms.	• There remains a crippling shortage of banking skills especially with respect to credit assessment and loan management processes in commercial banks and regulatory processes in the BOM. • There is a need to strengthen the legal and associated institutional framework for the development of a robust private sector and contract based financial system. Even where laws have been introduced they are not being enforced or subject to inconsistent interpretation by the courts. • The 1993 accounting law required the adoption of international accounting standards. However, nine years into the transition, most financial statements are still pre-pared on a cash, rather than an accrual, basis. These statements tend to minimize profits to lessen the tax burden and, since they are prepared on a cash basis, do not reflect the true financial condition of the enterprise.	• Government plans to develop a comprehensive strategy for development of human resource skills in all facets of the financial sector. It intends to ask donors for technical assistance to support the strategy. The Government has requested a technical assistance project for capacity building in parallel with FSAC.		• Government has implemented an action plan, satisfactory to IDA, to develop a comprehen-sive program to strength-en the financial sector, including banking and supervision skills, accounting and auditing standards, and enforce-ment of financial con-tracts.	• Government has implemented the said action plan.	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	IDA/ ADB Second Tranches	IDA Floating Tranche
Development and Strengthening of Non-Bank Financial Institutions						
• *A well-functioning financial sector requires that nonbank financial institutions (NBFIs) play an important role in the sector.*	• *NBFIs currently play an insignificant role. This role is, however, expected to increase quickly in view of the limited outreach of the banking system and problems affecting financial intermediation. Existing regulations relating to NBFIs lack detail, and specific measures such as the development of prudential norms for the different categories of NBFIs need to be developed.*	• *BOM intends to (i) strengthen NBFI regulations, including requiring finance companies and financial leasing companies to comply with risk-based prudential regulations; and (ii) assume oversight responsibility over savings and credit cooperatives through second and higher tier credit associations.*		• *BOM to issue risk-based prudential regulations to govern licensing of finance companies for capital adequacy (8 percent), liquidity ratio (10 percent), foreign exchange exposure (20 percent), and single borrower limit (20 percent).* • *BOM to issue guidelines on the calculation of capital adequacy and liquidity ratios and foreign exchange exposure for finance companies.* • *BOM to create an organizational system and procedures acceptable to ADB within the Supervision Department to monitor and enforce prudential regulations of finance companies and financial leasing companies.*	• *Enactment of amendments to the Law on Cooperatives and any other necessary legislation to provide for the regulation of second and higher tier credit associations by BOM.*	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	IDA/ ADB Second Tranches	IDA Floating Tranche
Development and Strengthening of the Capital Markets						
• *The capital market must be further developed and strengthened to enhance domestic resource mobilization and improve efficiency in resource allocation.*	• *The capital market is still in a nascent stage of development. For balanced development of the financial sector, it is necessary that the efforts already undertaken to develop the capital market be sustained and strengthened. Further development of the market depends on progress in the privatization of the remaining 95 state-owned enterprises (SOEs). The operational and regulatory capacity of the Mongolian Stock Exchange Commission (MSEC) needs to be strengthened considerably. Market capitalization of the Mongolian Stock Exchange (MSE) has fallen 25 percent over the past two years, partly reflecting the decreasing supply of quality stocks.*	• *New capital market products must be created under a proper legal and regulatory framework. MSEC must be strengthened to ensure the proper operation of the MSE and increase public confidence in and use of the MSE.*		• *Government to submit to Parliament for approval draft amendments to the Securities Law, including provisions to enhance transparency of securities trading and strengthen disclosure requirements and enforcement provisions.*	• *MSE and MSEC to increase the minimum capital requirements for securities brokers and dealers to at least 20 million tugrigs.* • *Government to submit a draft Law on Trusts acceptable to ADB to Parliament for approval.* • *Government to submit a draft Law on Investment Funds acceptable to ADB to Parliament for approval.* • *Government to prepare a plan to establish the Mongolian Stock Exchange (MSE) as a separate entity, and the Central Depository System and the Securities Clearing System as a separate legal entity or entities, with each having separate financial and accounting records and no MSE officials on its staff, in preparation for their eventual privatization.* • *MSEC in collaboration with the MSE to develop a marketing and public awareness campaign to increase public knowledge of equity markets.*	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	**IDA/ ADB Second Tranches**	**IDA Floating Tranche**
					• *Government to submit to Parliament for approval a draft amended and restated Securities Law acceptable to ADB, with provisions to improve financial governance (including protection of minority shareholder rights, increased penalties for Securities Law violations, stricter auditing requirements for companies to be listed, and broader representation among MSEC members) in line with international best practices.*	
Development and Strengthening of Contractual Savings Institutions – Pension and Insurance Systems	• *The pension system needs to be strengthened, so that the transition to partial funding can take place over the medium term. The process and timing of this transition and the associated costs need to be carefully worked out. There is currently no law governing supplementary non-state pensions. Such a law is critical in light of plans by NBFIs to offer voluntary retirement savings products.*	• *Preparation of a plan for introducing partial funding is required. A law on voluntary private pension plans also must be prepared.*			• *Social Security Insurance General Office (SSIGO) to prepare a plan acceptable to ADB for introducing partial funding to the pension system.*	

Development Objectives/Key Issues	Diagnosis	Government Strategy/ Actions	IDA Board Conditions/Status	Tranche Policies		
				IDA First Tranche/ Condition of effectiveness; ADB Board Consideration / First Tranche	**IDA/ ADB Second Tranches**	**IDA Floating Tranche**
• *The pension system needs to be promoted and strengthened as a vehicle for savings and a means to improve the allocative efficiency of investments.*	• *The operational and regulatory capacity of the insurance industry must be strengthened. Proper regulation is required, as well as policy and operational assistance. Except for minimum capital requirements, there are no other prudential requirements. Investment guidelines for insurance companies need to be strengthened as capital markets gradually develop.*	• *The regulatory framework must be strengthened, and additional investment regulations and guidelines issued.*			• *MOF to draft and submit to Parliament for approval draft amendments to the Law on Insurance to (i) introduce risk-based solvency requirements in the industry; (ii) strengthen the minimum capital requirements; and (iii) increase the percentage of premium incomes that can be invested by the insurance companies.*	
• *The insurance system needs to be strengthened as a vehicle for savings and a means to improve the allocative efficiency of investments.*						

POLICY MATRIX
FOR THE SECOND FINANCIAL SECTOR PROGRAM
MONGOLIA

GOAL: The Second Financial Sector Program (FSP II) supports the development of a competitive, stable, and broad-based financial system to strengthen financial intermediation, enhance domestic and external resource mobilization, and promote sustainable economic growth.

Objectives	Actions Planned	Actions Completed	Actions to be Completed	
		Prior to Board Consideration	Prior to 2nd Tranche	End of Program
I. Develop and Strengthen Financial Intermediation				
A. Application of corporate governance principles in banking institutions is key to the sustainable development of the banking system.	1. Bank of Mongolia (BOM) to prepare and issue guidelines on best practices in corporate governance in banking institutions in Mongolia, including measures to strengthen internal control mechanisms, based on international practices such as the guidelines issued by the Bank for International Settlements		Dec 2001**	
	2. BOM to prepare a model charter for banks that is acceptable to the Asian Development Bank (ADB)		Dec 2001	
	3. BOM to issue guidelines recommending that all banks have charters in accordance with the model charter			Mar 2002
	4. Banks to adopt best practices in corporate governance under the BOM Guidelines on Best Practices in Corporate Governance in Banking Institutions			Dec 2003
B. Development of the financial sector requires that the types of property that can be used as loan collateral be expanded.	1. Government and BOM to prepare a plan acceptable to ADB on the expansion of types of property that can be used as loan collateral		Dec 2001**	
	2. With respect to the Office for Immovable Property Registration, Government to reduce the cost of collateral registration and simplify the administrative procedures for registering collateral in a manner acceptable to ADB		Dec 2001	
C. To strengthen operations and upgrade the capacity of Mongolian banks, banks need to adopt an integrated banking management information system (MIS).	1. Operationalization, in a manner acceptable to ADB, of integrated banking (MIS) software at a pilot commercial bank (i.e., Trade and Development Bank)		Dec 2000	

* Board consideration condition
** Second tranche release condition

Objectives	Actions Planned	Actions Completed	Actions to be Completed	
		Prior to Board Consideration	Prior to 2nd Tranche	End of Program
	2. Progress acceptable to ADB has been achieved in the implementation of the program to introduce and operationalize integrated banking MIS software in the Mongolian banks participating in such program.		Dec 2001**	
D. A well-functioning financial sector requires that nonbank financial institutions (NBFIs) play an important role.	1. BOM to issue risk-based prudential regulations to govern licensing of finance companies for capital adequacy (8 percent), liquidity ratio (10 percent), and foreign exchange exposure and single borrower limit (20 percent)	Dec 1999*		
	2. BOM to issue accounting standards for NBFIs	Feb 2000		
	3. BOM to issue guidelines on the calculation of capital adequacy and liquidity ratios, and foreign exchange exposure for finance companies	Jun 2000*		
	4. BOM to create an organizational system and procedures acceptable to ADB within the Supervision Department to monitor and enforce prudential regulations of finance companies, financial leasing companies, and other relevant NBFIs	Jun 2000*		
	5. Government to submit to Parliament for approval draft amendments to the Law on Cooperatives and any other necessary legislation to provide for the regulation of second- and higher-tier credit associations by BOM		Jun 2001	
	6. Enactment of amendments to the Law on Cooperatives and any other necessary legislation to provide for the regulation of second- and higher-tier credit associations by BOM		Dec 2001**	
	7. BOM to issue prudential regulations governing second- and higher-tier credit associations based on capital adequacy standards and best practices in corporate governance			Mar 2002
II. Development of an Interbank Market				
A. An interbank market would provide banks in Mongolia with a means to improve asset liability management by allowing them to invest surplus funds and reduce costs of funding liquidity shortfalls.	1. Ministry of Finance (MOF) and BOM to prepare a plan acceptable to ADB for development of an interbank market, including establishment of the legal, regulatory, and institutional framework		Jun 2001**	

* Board consideration condition
** Second tranche release condition

Objectives	Actions Planned	Actions Completed Prior to Board Consideration	Actions to be Completed Prior to 2nd Tranche	Actions to be Completed End of Program
III. Develop and Strengthen the Capital Markets				
A. The capital market must be developed and strengthened to enhance domestic resource mobilization and improve efficiency in resource allocation.	1. The Government to submit to Parliament for approval draft amendments to the Securities Law, including provisions to enhance transparency of securities trading and strengthen disclosure requirements and enforcement provisions	May 2000*		
	2. Mongolian Securities and Exchange Commission (MSEC) to prepare a draft law on trusts to provide for the requirements of establishing trusts, including investment trusts, and the fiduciary duties of a trustee		Mar 2001	
	3. MSEC to prepare a draft law on investment funds to stipulate procedures for the formation and to govern the operations of investments funds		Mar 2001	
	4. The Government to submit a draft law on trusts acceptable to ADB to Parliament for approval		Dec 2001**	
	5. The Government to submit a draft law on investment funds acceptable to ADB to Parliament for approval.		Dec 2001**	
	6. The Government to prepare a plan to establish the Mongolian Stock Exchange (MSE) as a separate legal entity, and the Central Depository System (CDS) and Securities Clearing System (SCS) as a separate legal entity or entities, with each entity having separate financial and accounting records and no MSE officials on its staff, in preparation for their eventual privatization		Dec 2001**	
	7. MSE and MSEC to increase the minimum capital requirements for securities brokers and dealers to at least Tug20 million		Dec 2001**	
	8. MSEC to issue regulations (i) requiring that all trades be undertaken on the MSE through licensed securities dealers, brokers, subbrokers, and salespersons; and (ii) providing for sanctions for unauthorized trading		Mar 2001	
	9. Association of Mongolian Dealers and Brokers to prepare revised articles of association reflecting its independence from the MSE and governance by its internal rules		Mar 2001	
	10. MSEC to strengthen its audit and inspection functions pursuant to a plan acceptable to ADB		Jun 2001	
	11. The State Property Committee to sell Tug200 million equivalent of shares from the privatization of state-owned enterprises (including most valued and second-tier companies) annually through the MSE		Jun 2001	onwards

* Board consideration condition
** Second tranche release condition

Objectives	Actions Planned	Actions Completed	Actions to be Completed	
		Prior to Board Consideration	Prior to 2nd Tranche	End of Program
	12. MSEC, in collaboration with the MSE, to develop a marketing and public awareness campaign to increase public knowledge of equity markets		Dec 2001**	
	13. The Government to submit to Parliament for approval a draft amended and restated Securities Law acceptable to ADB, with provisions to improve financial governance (including protection of minority shareholder rights, increased penalties for Securities Law violations, stricter auditing requirements for companies to be listed, and broader representation among MSEC members) in line with international best practices		Dec 2001**	
	14. MSEC to review and strengthen the existing (i) Regulations on Brokers, Stock Dealers, and Subbrokers; (ii) Insider Trading Regulations; and (iii) Appeals Regulations; and to prepare and issue a code of ethics and guidelines for MSEC and MSE employees			Jun 2002
	15. Government to privatize the MSE, CDS, and SCS in a manner acceptable to ADB			Jun 2003
IV. Develop and Strengthen Contractual Savings Institutions				
A. The pension system needs to be promoted and strengthened as a vehicle for savings and a means to improve the allocative efficiency of investments.	1. State Social Insurance General Office (SSIGO) to prepare a plan acceptable to ADB setting forth measures to be taken to (i) strengthen administrative processes within the existing pension system, (ii) facilitate the change to a notionally defined contribution system, (iii) improve capacity in pension payments collection, and (iv) strengthen financial management of the pension system		Sep 2001	
	2. SSIGO to prepare a plan acceptable to ADB for introducing partial funding to the pension system		Dec 2001**	
	3. SSIGO to (i) prepare a draft law on voluntary private pension plans, setting forth the procedures and terms and conditions for establishment of, and participation in, such plans; and (ii) establish an appropriate regulatory framework to govern voluntary pension plans			Jun 2002
	4. Government to submit draft law on voluntary private pension plans to Parliament for approval			Dec 2002

* Board consideration condition
** Second tranche release condition

Objectives	Actions Planned	Actions Completed	Actions to be Completed	
		Prior to Board Consideration	Prior to 2nd Tranche	End of Program
B. The insurance system needs to be promoted and strengthened as a vehicle for savings and a means to improve the allocative efficiency of investments.	1. MOF to prepare and issue investment guidelines for the insurance industry, including (i) types of investment instruments, and (ii) minimum share of reinvestable resources under the reserve fund		Jun 2001	
	2. MOF to draft and submit to Parliament for approval draft amendments to the Law on Insurance to (i) introduce risk-based solvency requirements in the industry; (ii) strengthen the minimum capital requirements; and (iii) increase the percentage of premium incomes that can be invested by the insurance companies		Dec 2001**	
	3. The Insurance Supervisory Unit to develop and establish, pursuant to MOF regulations and guidelines a sound regulatory framework acceptable to ADB and based on prudential norms and with adequate guidelines and standards, reporting and disclosure requirements, accounting, auditing and prudential norms, investment guidelines, and other requirements in accordance with international best practices			Jun 2002

***** Board consideration condition
****** Second tranche release condition

PROGRAM FRAMEWORK – SECOND FINANCIAL SECTOR PROGRAM

Design Summary	Targets	Monitoring Mechanisms	Assumptions and Risks
Goal Develop a competitive, stable, and broad-based financial system to strengthen financial intermediation, and enhance domestic and external resource mobilization.	• A sound, well-functioning, and resilient banking system. • Strengthened and enhanced role for nonbank financial institutions (NBFIs) in financial intermediation. • Capital market development. • Increased total bank assets. • Credit and deposit growth. • Increased bank profits. • Fewer nonperforming loans in banking system. • Prudential regulations for NBFIs developed. • M2/Gross Domestic Product. • M1/M2. • Loan tenure profile. • Interest rate spread. • Growth of NBFIs including finance companies and savings and credit cooperatives (SCCs). • Market capitalization in the Mongolian Stock Exchange (MSE). • Increased number of listed companies in the MSE. • Decreased share of unfunded liabilities in pension system. • Increase in insurance sector (assets/GDP).	The Government's economic reports Policy dialogue	The Government's financial sector strategy is implemented. Macroeconomic adjustments and stabilization measures are adhered to. There is political resolution to deepen reforms. Containing power of vested interests.
Purpose 1. Improve the soundness and efficiency of the banking system.	• Strengthen regulation and supervision in the sector. • Improve corporate governance in the banking system. • Improve and facilitate use of collateral. • Strengthen Management Information System (MIS). • Develop the interbank market. • Improve efficiency in resource allocation.	Progress reports Review missions	The World Bank's restructuring program is in tandem with this Program. The Government is committed to reform. The Bank of Mongolia (BOM), Mongolian Securities and Exchange Commission (MSEC), MSE, Central Depository System (CDS), State Property Committee (SPC), State Social Insurance Office, Insurance

Design Summary	Targets	Monitoring Mechanisms	Assumptions and Risks
			Supervision Agency, the commercial banks involved, Association of Brokers and Dealers, and other stakeholders are committed to the reform.
2. Enhance role of NBFIs in financial intermediation	• Strengthen regulation and supervision of nonbank financial institutions.		
3. Support and facilitate capital market development.	• Improve governance in equity markets. • Establish a legal infrastructure to facilitate resource mobilization in capital markets.		
4. Promote and strengthen contractual savings institutions.	• Improve the operations of the existing pension system, and prepare for transition to a reformed system. • Improve regulations and supervision of the insurance industry		
Outputs 1. Banking system Strengthen corporate governance in the banking system.	• Issue guidelines for corporate governance, in line with BIS (Dec 2001). • Strengthen internal control mechanisms (Dec 2001). • Develop a model charter for banks (Dec 2001).	Progress reports Review missions	The Government is committed and supports the reforms. The Government facilitates coordination between the various Government agencies involved.
Increase secured collateral.	• Prepare plan to expand types of property that can be used as loan collateral (Dec 2001). • Simplify collateral registration and administration procedures (Dec 2001).		Counterpart agencies have adequate capacity to manage the reforms.
Strengthen MIS in commercial banks.	• Develop and operationalize an integrated MIS at a pilot commercial bank (Dec 2000). • MIS operational in other banks participating in MIS program (Dec. 2001).		The quality of consulting services is appropriate. Counterpart support is available, and consultants and counterpart staff cooperate fully.
Develop an interbank market.	• Develop a legal, regulatory, and institutional framework for an interbank market (Jun 2001).		
2. Enhance the role of NBFIs.	• Issue and document risk-based prudential regulations for NBFIs (Dec 1999). • Issue accounting standards for NBFIs (Feb 2000). • Provide institutional strengthening for the	Progress reports Review missions	Parliament supports reform proposals, and draft laws to be enacted.

Design Summary	Targets	Monitoring Mechanisms	Assumptions and Risks
	Supervision Department, including organizational structure and procedures, to enable it to effectively monitor and enforce compliance with prudential regulations (Jun 2000). • Enact amendments to the Law on Cooperatives to provide for the regulation of second- and higher-tier credit associations by BOM (Dec 2001). • Develop prudential regulations for second- and higher-tier credit associations (Mar 2002).		
3. Capital markets Improve governance in equity markets, by improving the legal and regulatory framework.	• Enhance reporting and disclosure requirements related to trades in the securities market (May 2000). • Increase capital requirements for brokers and dealers (Dec 2001). • Prepare and submit to Parliament laws on trust funds and investment funds, and amendments to the Securities Law (Dec 2001). • Establish the MSE as a separate legal entity and the depository, and settlement and clearing systems as a separate legal entity or entities (Dec. 2001). • Privatize the MSE, CDS, and the settlement and clearing system (Dec 2001). • Enhance regulations at the MSE and provide for sanctions against unauthorized trading, and noncompliance with regulations (Jun 2003). • Make the Dealers and Brokers Association a separate entity from MSE (Mar 2001). • Strengthen audit and inspection functions of MSEC (Jun 2001). • Strengthen regulations for brokers, dealers, and subbrokers; insider trading rules; appeals regulations; and a code of ethics for staff of MSEC and the MSE (Jun 2002).	Progress reports Review missions	
Increase supply of equities.	• Sell Tug200 million equivalent of shares through the stock exchange annually (Jun 2001).		
Build public awareness and confidence in capital markets.	• Provide public information campaign to raise public knowledge about equity markets (Dec 2001).		

Design Summary	Targets	Monitoring Mechanisms	Assumptions and Risks
4. Contractual Savings Promote the pension system to increase savings.	• Strengthen administrative processes within the existing pension system (Sep 2001). • Draft a plan for transition to notionally defined contributions system (Dec 2001). • Improve collections of pensions (Sep 2001). • Strengthen the financial management of the pension system (Sep 2001). • Prepare and submit law on voluntary pensions, including procedures and terms for the establishment of such plans, and a proposed regulatory framework (Jun 2002).		
Promote insurance and strengthen regulation and supervision.	• Draft amendments to the Law on Insurance to introduce risk-based solvency requirements, increased minimum capital requirements, and increased minimum percentage of income that can be invested (Dec 2001). • Insurance Supervision Unit to develop and introduce prudential norms, investment guidelines, reporting, accounting and disclosure requirement sin line with international best practice (Jun 2002).		
Inputs Program loan	Amount: $15 million Maturity: 24 years including 8-year grace period Annual interest: 1 percent during grace period, 1.5 percent during the amortization period Executing Agency: Bank of Mongolia piggybacked TA: Strengthening Financial Sector Development Consulting Services: under *ADB's Guidelines for the Use of Consultants*		

POVERTY IMPACT ASSESSMENT

I. Introduction

1. This appendix provides an assessment of the poverty impact of the Second Financial Sector Program (FSP II).

A. Demographic Information and Human Development Indicators

2. Mongolia has a population of 2.4 million people. About 1.2 million are of working age. The average life expectancy is 64 years for both men and women. The infant mortality rate is 53 per 100,000 live births. The average literacy rate is 96 percent.

B. Poverty

3. In 1991, the incidence of poverty was estimated at 15 percent of households. This increased during the early 1990s as trade was disrupted following the breakup of the former Soviet Union. Subsequent economic developments with worsening terms of trade and the transition to a market-oriented economy may have contributed to the rise in poverty.

4. The World Bank undertook a living standard measurement survey in 1995, and introduced an expenditure-based poverty line to meet a calorie intake of 2,100 comparable with other developing countries. This study was replicated in 1998, and showed that the incidence of poverty remained stable at 36.3 percent of households in 1995, and 35.6 in 1998. The slow decline follows from population growth.

5. Poverty is found mainly in the small towns where workers are laid off from state-owned enterprises, and few other employment opportunities exist. Ulaanbaatar, with 25 percent of the population, is home to 17 percent of the poor; the incidence of poverty is lower here, than in the countryside. Poverty is particularly severe among households headed by women (18.4 percent of all households and a poverty incidence of 60 percent), early pensioners (40 percent poverty incidence for men and 55 percent for women), unemployed, and herdsmen. Among people in wage employment and public servants, 48 percent are estimated to be moderately poor, which is higher than in the informal and agriculture sectors.

6. In 1994, the Government introduced the National Poverty Alleviation Program with the objectives of (i) reducing poverty through employment creation, (ii) protecting human capital through social infrastructure rehabilitation, (iii) addressing poverty among households headed by women, and (iv) strengthening the social safety net. The program is financed by aid. The major components are (i) income generation and microfinance, (ii) public works, (iii) targeted assistance, and (iv) capacity and institution building. During 1994-2000, $15.3 million was allocated for the program. Income-generating activities and microfinance has had little effect on poverty reduction as most of the credit tended to be used for consumption. While community-based public works programs have been successful for income generation and social infrastructure rehabilitation, these do not contribute to a sustainable reduction of poverty. Various other program have been initiated to reduce unemployment, but there are no clear data available that measure the impact of these.

C. Labor Force Participation and Unemployment

7. The official labor force is relatively small. By the end of 1998, only 809,500 workers were registered, amounting to 67 percent of working age population and 34 percent of the total population. Each year, 25,000 people officially enter the labor force. However, there appear to be growing job opportunities in the informal sector.

8. At the end of 1998, 49,837 people were registered as unemployed and by July 1999, this had fallen to 45,300. This can be explained by inaccurate statistics, and/or a reluctance among the unemployed to register. Anecdotal evidence suggests that the unemployed are absorbed into the informal sector.

D. The Financial Sector

1. Financial Services Used by the Population

9. Financial services in Mongolia are rudimentary, just as they are in other transition economies. Banks engage in basic deposit taking and lending, and capital markets are underdeveloped. Banking facilities tend to be concentrated in urban areas.

10. Public confidence in banks is relatively low, as evidenced by the low deposit to gross domestic product.

2. Employment in the Financial Sector

11. The employment potential in the financial sector is limited. Banking employed 4,000 persons as of May 2000 down from close to 4,000 at mid-1998. The reduction reflects the restructuring and closure of eight banks. Three banks, Bank of Investment and Technological Innovation and Reconstruction Bank, currently under liquidation and Agricultural Bank, under restructuring account for the share of retrenched workers. The average number of employees per bank is 170. In the longer term, employment opportunities should arise in the financial sector as nonbank financial institutions (NBFIs) develop, and the demand for financial services grows, but during the FSP II period, the employment level is likely to remain stable or possibly expand moderately.

E. Policy Actions and their Impact on the Poor

1. Improve the Soundness and Efficiency of Banking

12. The objectives are to restructure and rehabilitate banks, strengthen regulation and supervision of banks, improve corporate governance for banking sector, strengthen the management information system for banks, and develop an interbank market.

13. Implementation of this policy should improve the soundness and reliability of banks. Properly regulated and supervised banks that supply adequate and timely information to authorities and the population should increase public confidence in banks, and thereby increase demand for services. However, banking employs few people and therefore the effect on employment will be limited.

Table A3.1: Poverty Impact of Improving the Soundness and Efficiency of the Banking System

Item	Direct Effect	Indirect Effect	Macro	Mitigation Measures
Labor	Liquidation of banks will lead to job losses			Severance payments should mitigate the effect
Prices			Reduced cost of capital	
Access for the poor			Government resources used to support banks will be freed for productive purposes	
Transfers				
Assumptions	A sound and efficient banking system will support economic growth	Stronger and better managed banks will decrease the incidence and disruptions due to banking crises	Improved access to credit	
Net effect	Overall positive			

2. Enhance the role of NBFIs

14. The objective is to strengthen regulation and supervision of NBFIs. At present, NBFIs play a minor role in financial intermediation. However, as the economy grows and the demand for financial services increases, their role will expand. It is imperative that NBFIs grow in a well-regulated and supervised environment. In the longer term, NBFIs will also provide employment opportunities.

Table A3.2: Poverty Impact of Enhancing the Role of NBFIs in Financial Intermediation

Item	Direct Effect	Indirect Effect	Macro	Mitigation Measures
Labor	None			
Prices				
Access for poor				
Transfers				
Assumptions	Well-regulated and supervised NBFIs will contribute to improved financial intermediation and efficient allocation of resources		Improved access to credit	
Total net effect	Poor-neutral/positive			

NBFI = nonbank financial institution.

3. Support and Facilitate Capital Market Development

15. The objectives of this policy are to improve governance in equity markets, and establish a legal infrastructure for capital market development.

16. In the longer term, the development of capital markets will contribute to improved financial intermediation and resource allocation. The FSP II will ensure that capital markets

develop in a sound legal environment, and that proper reporting and disclosure arrangements are in place to enhance transparency and contribute to good governance. While direct impacts on the poor are negligible, there should be long-term indirect benefits in terms of employment creation.

Table A3.3: Poverty Impact of Supporting and Facilitating Capital Market Development

Item	Direct Effect	Indirect Effect	Macro	Mitigation Measures
Labor	none	Longer-term, employment opportunities should arise		
Prices			Improve efficient allocation of capital	
Access for poor				
Transfers				
Assumptions	The Government agencies concerned, and capital market participants will properly implement the required policy actions		Improve resource mobilization	
Total net effect	Poor to neutral/positive			

4. Promote and Strengthen Contractual Savings Institutions

17. The objectives are to improve the administrative processes in the existing pension system, prepare for transition to a reformed pension system, and improve regulations and supervision of the insurance industry.

18. Improvement of the administrative processes in the pension system should benefit pensioners directly through more timely payment of pensions (assuming that pensions are paid). Reforms in the pension system will make it more sustainable in the long run, and thereby benefit future pensioners. Improved regulation and supervision of the insurance industry will allow it to develop in an orderly manner that will indirectly benefit the population at large.

Table A3.4: Poverty Impact of Promoting and Strengthening Contractual Savings Institutions

Item	**Direct Effect**	**Indirect Effect**	**Macro**	**Mitigation Measures**
Labor	None			
Prices				
Access for poor	Timely payment of pensions	Longer term viability of pension system		
Transfers				
Assumptions	Timely implementation of policy actions by concerned agencies			
Total net effect	Poor to neutral/positive			

E. Conclusion

19. The benefits of this program can be summarized as follows:

(i) A consolidated, restructured, and well-regulated banking system should contribute to increased confidence in banking. Furthermore, Government resources will be freed to invest in infrastructure and social sector spending that which could otherwise be tied up in banking rehabilitation and which will benefit the population as a whole.

(ii) A well-functioning and resilient financial sector, including banks and a capital market, will provide resources for real economic activity that will create employment opportunities for the population at large.

(iii) In the longer term, efficient financial intermediation and allocation of resources will support growth, a necessary condition for sustainable poverty reduction.

INELIGIBLE ITEMS

1. The proceeds of the loan will be utilized to finance the foreign currency expenditures for the reasonable cost of imported goods (excluding any duties or taxes) required during implementation of the Second Financial Sector Program. All imported goods financed from the proposed loan must be produced in, and procured from, member countries of the Asian Development Bank (ADB).

2. Notwithstanding the provision of para. 1, no withdrawals will be made for

(i) expenditures for goods included in the following groups or subgroups of the United Nations Standards International Trade Classification, Revision 3, or further revisions as designated by ADB by notice to the Borrower:

Group	Subgroup	Description of Items
112	—	Alcoholic beverages
121	—	Tobacco, unmanufactured tobacco refuse;
122	—	Tobacco, manufactured (whether or not containing tobacco substitutes)
525	—	Radioactive and associated materials
667	—	Pearls; precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
897	897.3	Jewelry of gold, silver, or platinum group metals (except watches and watch cases); goldsmiths' or silversmiths' wares (including set gems)
971	—	Gold, nonmonetary (excluding gold ores and concentrates)

(ii) expenditures for goods intended for a military and paramilitary purposes or for luxury consumption; and

(iii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a or 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification.

PROPOSED TERMS OF REFERENCE FOR CONSULTING SERVICES FOR THE TECHNICAL ASSISTANCE FOR STRENGTHENING FINANCIAL SECTOR DEVELOPMENT

A. Banking Sector Development—Banking Supervision and Secured Collateral (4 person-months)

1. Strengthening Supervision (2 person-months)

1. A banking supervision specialist with expertise in the development of Core Principles of Banking Supervision of the Bank for International Settlements (BIS) and familiarity with the Code and Good Practices in Transparency in Monetary and Financial Policies will have the following activities:

(i) In anticipation of the medium-term developments in the financial sector, prepare a needs assessment of the Supervision Department (on-site and off-site) to ensure the ability of the Bank of Mongolia (BOM) to safeguard the development of a properly supervised banking (and nonbank) system. In particular, analyze the implementation of qualitative analysis of loans, use (and strengthening) of CAMEL as a bank early-warning system, review and evaluation of credit, risk management, and internal control systems and procedures of commercial banks.

(ii) Develop a system for the Supervision Department of BOM to ensure a satisfactory level of bank transparency by monitoring major parameters including (a) financial performance, (b) financial position, (c) risk management strategies and practices, (d) risk exposure, (e) accounting policies, and (f) basic business, management, and corporate governance information.

(iii) Build the capacity of the Banking Supervision Department of BOM to conduct regular reviews of the quality of all aspects of public disclosure of banks indicated under (ii) and take action against banks that provide insufficient or misleading disclosures (i.e., by initiating discussions with banks, by informing the public or by imposing monetary fines).

(iv) Formulate and implement a supervisory framework for credit cooperatives and credit unions based on delegated supervision through the association of second- tier and higher credit institutions. The framework will stress simplified administrative management and streamlined reporting requirements bearing in mind limited resources available from the Supervision Department.

(v) Strengthen the supervisory framework for finance companies and financial leasing companies and prepare an implementation plan.

2. Strengthening Secured Collateral (2 person-months)

2. A banking specialist with expertise in developing frameworks to facilitate the use of collateral will be responsible for the following activities:

(i) Review and identify the major legal, regulatory, and institutional constraints that have hindered the development of use of immovable property as collateral.

(ii) Review and identify deficiencies including the operations of the Registration Office, the fee schedule, and the process of valuation (if any).

(iii) Based on (i) and (ii), prepare a set of recommendations on how to strengthen the use of collateral by streamlining the registration process, and reduce distortions by improving incentives realignment in the fee schedule and other items such as repeated use of some collateral for multiple purposes including a specific set of administrative guidelines.

(iv) Prepare guidelines on the use of movable property on collateral following the approval of the Secured Transactions Law under the forthcoming amendments to the Civil Code.

(v) Prepare a time-based action plan to include extending the use of other forms of immovable property including land (based on land-use rights), and to comprise implementation guidelines for a pilot experience in the first stage and extending coverage to urban centers at the second stage.

B. Capital Market Development (8 person-months)

1. Capital Markets Expert (Operational, Institutional, Policy, and Regulatory Areas) (4 person-months)

3. The expert will

(i) provide overall advisory support on operational, management, administrative, policy, and institutional development issues to the Mongolian Securities and Exchange Commission (MSEC);

(ii) evaluate the current regulatory capacity and recommend measures to strengthen MSEC in the areas identified in (i), as well as in the regulatory sphere;

(iii) examine the modalities through which the capital market can be fostered and developed;

(iv) assess the potential for introducing debt instruments;

(v) examine the privatization of the Mongolian Stock Exchange (MSE) as a priority measure, and formulate a privatization plan to ensure a transparent and competitive process; further, examine MSE's professional competence to function as a self-regulatory organization;

(vi) review and strengthen the listing criteria, bearing in mind market development objectives;

(vii) review the current minimum capital requirement for securities brokers and dealers, and the membership fee structure and any other dues; and

(viii) prepare a comprehensive report focusing on items (i) - (vii).

2. Capital Markets/Enterprise Sector Legal and Regulatory Expert (4 person-months)

4. The expert, working in tandem with the capital markets expert, will have the following responsibilities:

(i) Critically review the overall legal framework for the securities market, governing both public and private equity and debt instruments, and identify any areas for reform.

(ii) Based on (i), assess the need to strengthen the Securities Law in order to assist in developing a competitive and well-supervised securities industry. Critical issues to focus on will include corporate governance and protection of minority shareholders rights and the role and powers of MSEC.

(iii) Draft a law to govern and regulate investment funds and companies; and a law on trusts. Evaluate if MSEC can provide the required regulatory support to investment funds and trust companies.

(iv) Critically review the existing provisions in the legal framework with regard to investor protection.

(v) Assess recent trends relative to the conversion of the legal status of a number of companies from joint-stock structure to limited liability status. Offer recommendations to strengthen the law(s) in this regard, as this practice has important implications for corporate governance in privatized enterprises.

(vi) Evaluate the Company Law for consistency with international practices.

(vii) Formulate a time-bound plan to establish the MSE as a separate legal entity, and the Central Depository System and the Securities Clearing System as a separate entity or entities. The plan will specify the rules and regulations governing each institution.

(viii) Design the preparatory work for the privatization of the MSE.

(ix) Prepare a comprehensive report focusing on items (i) - (viii).

C. Development of Contractual Savings Institutions (6 person-months)

1. Pension Systems Expert (2 person-months)

5. The expert will undertake the following:

(i) Undertake comprehensive operational, demographic, economic, and fiscal analysis of the timing of introduction of partial funding, and of the associated transition costs.

(ii) Based on (i) and the actuarial analysis previously prepared under the United States Agency for International Development (USAID) project, calculate (a) the resulting intergenerational gains and losses, and (b) an accurate assessment of the sustainability of the pension fund.

(iii) Support the State Social Insurance General Office (SSIGO) to reform its administrative and management processes relative to collection and payment of pensions as the transition to partial funding takes place.

(iv) Assess, in coordination with and based on the work done by the capital markets expert, the depth of capital markets and the potential scope for privatization program to absorb long-term savings through partial and voluntarily funded pensions.

(v) Examine if there is scope for occupational or industry-based voluntary pension plans.

(vi) Prepare a comprehensive report focusing on items (i) - (v), including relevant features to be included under a public awareness campaign.

2. Pension Systems Legal and Regulatory Expert (2 person-months)

6. The expert will

(i) review the legal and regulatory frameworks with regard to state provision of pensions, and recommend any reforms, if needed;

(ii) draft the law on non-state voluntary pensions in a manner conducive to the conditions in Mongolia, and formulate an accompanying regulatory framework; and

(iii) review the conformity of existing and new pension legislation with other major laws of Mongolia (e.g., Law on Securities Markets, Law on Companies, and Law on Insurance).

3. Insurance Industry Expert (2 person-months)

7. The expert will

(i) examine the overall business environment facing the insurance system, and assess the potential for the industry's development;

(ii) review the operational and regulatory capacity of the Insurance Supervision Unit (ISU), and offer recommendations to strengthen its capacity;

(iii) formulate guidelines to govern new insurance and voluntary retirement-savings products;

(iv) evaluate the Law on Insurance for conformity with international standards, and with other relevant laws in Mongolia;

(v) draft prudential guidelines to ensure adequate solvency of the insurance industry, commensurate with the risks taken;

(vi) draft investment guidelines to allow investment of the insurance fund in the equity markets;

(vii) prepare a comprehensive report focusing on all of these.

D. Domestic Consulting (10 person-months)

8. It is proposed that about 10 person-months of domestic consulting services be provided under the TA. The allocation across the areas will be decided at a later stage. The terms of reference will be drafted by the concerned international experts.

COST ESTIMATES AND FINANCING PLAN FOR THE TECHNICAL ASSISTANCE FOR STRENGTHENING FINANCIAL SECTOR DEVELOPMENT

($'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing			
1. International Consultants			
a. Remuneration	400.00	0.00	400.00
b. Per Diem and Subsistence	60.00	0.00	60.00
c. Travel	50.00	0.00	50.00
2. Domestic Consultants	0.00	20.00	20.00
3. Communication, Translation, and Report Production	5.00	0.00	5.00
4. Equipment	5.00	0.00	5.00
5. Contract Negotiations	7.00	0.00	7.00
6. Contingencies	53.00	0.00	53.00
Subtotal (A)	**580.00**	**20.00**	**600.00**
B. Government Financing			
1. Office and Communication Facilities	0.00	50.00	50.00
2. Administrative, Secretarial and Translation Support	0.00	60.00	60.00
3. Local Transportation	0.00	20.00	20.00
Subtotal (B)	**0.00**	**130.00**	**130.00**
Total	**580.00**	**150.00**	**730.00**

Source: Staff estimates.