



Extended Annual Review Report

CONFIDENTIAL

Project Number: 35913
Loan Number: 2081
December 2008

Loan and Equity Investment Mongolia: The Trade and Development Bank of Mongolia

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Asian Development Bank

CURRENCY EQUIVALENTS

Currency Unit – togrog (MNT)

		At Appraisal	At Project Completion
		31 January 2004	31 December 2008
MNT1.00	=	\$0.000854	\$0.000783
\$1.00	=	MNT1,171	MNT1,276.50

ABBREVIATIONS

ADB	–	Asian Development Bank
BCL	–	Banca Commerciale Lugano
CAR	–	Capital Adequacy Ratio
EBRD	–	European Bank of Reconstruction and Development
EMTN	–	Euro medium-term note
FDI	–	foreign direct investment
FIFTA	–	Foreign Investment and Foreign Trade Agency
FIRR	–	financial internal rate of return
GDP	–	gross domestic product
Globull	–	Globull Investment and Development
GMI	–	Gerald Metals Inc.
IFC	–	International Finance Corporation
IGA	–	ING Institutional and Government Advisory Services
JBIC	–	Japan Bank for International Cooperation
KfW	–	Kreditanstalt für Wiederaufbau
NPL	–	nonperforming loan
PSOD	–	Private Sector Operations Department
ROIC	–	return on invested capital
SINOSURE	–	China Export & Credit Insurance Corporation
SMEs	–	small and medium-sized enterprises
TDB	–	Trade and Development Bank of Mongolia
US Global	–	US Global Investment
WACC	–	weighted average cost of capital

NOTE

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

Vice-President	X. Zhao, Operations 1
Director General	P. Erquiaga, Private Sector Operations Department (PSOD)
Director	R. van Zwieten, Capital Markets and Financial Sectors Division, PSOD
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BASIC DATA
The Trade and Development Bank of Mongolia (7197-MON)

A. Investment Identification			
1.	Country	Mongolia	
2.	Loan Number	2081	
3.	Type of Business	Bank	
4.	Project Title	Loan and Equity Investment in the Trade and Development Bank of Mongolia	
5.	Name of Borrower	Trade and Development Bank of Mongolia	
6.	Amount of Approved ADB Assistance	(i) \$4.5 million subordinated loan and (ii) an equity investment not to exceed \$1.6 million	
7.	Project Number	35913	
ADB = Asian Development Bank.			
B. Investment Data			
1.	Concept Clearance Approval	23 August 2001	
2.	Date of Board Approval	20 April 2004	
3.	Signing Date of Subordinated Loan Agreement	9 December 2004	
4.	Signing Date of Subscription Agreement and Shareholders Agreement	9 December 2004	
5.	Date of Loan Effectiveness	9 December 2004	
	In Loan Agreement	9 December 2004	
	Actual	9 December 2004	
	Number of Extensions	None	
5.	Loan Closing Date (end of availability period)	31 December 2004	
	In Loan Agreement	31 December 2004	
	Actual	31 December 2004	
	Number of Extensions	None	
6.	Disbursements		
	Loan	Initial Disbursement	Final Disbursement
		23 December 2004	23 December 2004
		Effective Date	Time Interval
		9 December 2004	None
		Amount Disbursed: \$4,500,000	
	Equity	Initial Disbursement	Final Disbursement
		23 December 2004	23 December 2004
		Effective Date	Time Interval
		9 December 2004	None
		Amount Disbursed: \$1,391,000	
7.	Loan Repayment	15 December 2009 (bullet repayment)	
	Final Repayment Date	15 December 2009 (bullet repayment)	

LIBOR = London interbank offered rate.

EXECUTIVE SUMMARY

The Trade and Development Bank of Mongolia (TDB) was established in 1990 as a commercial bank and began operations in January 1991. It was the largest and most profitable bank in Mongolia. At the time of establishment, the Government of Mongolia (the Government) held 76% of the shares, and the remaining 24% was owned by the bank's employees.

Pursuant to the Government's privatization program, TDB was fully privatized in 2002, with Globull Investment and Development (Globull) acquiring 100% of the Government's stake. Globull is a consortium of Gerald Metals Inc. (GMI) and Banca Commerciale Lugano (BCL). In December 2004, under a joint venture agreement, the Asian Development Bank (ADB) and the International Finance Corporation (IFC) each invested, \$1.39 million as equity. ADB and IFC each additionally approved a subordinated loan of \$4.5 million with a 5-year tenor and a bullet repayment maturing on 15 December 2009.

In December 2006, GMI and BCL were acquired by US Global Investment (US Global), a US-domiciled entity owned by a consortium of Mongolian investors.

The shareholder agreement between GMI and the ADB-IFC joint venture provided the latter institutions with a put option. ADB and IFC exercised this option, as the offer was good for only 30 days and ADB and IFC deemed this period to be insufficient for a background check on the identity of the new shareholders. ADB and IFC divested 100% of their shareholding in TDB.

The investment in TDB is evaluated using criteria defined in ADB's *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations* (2007). The investment is appraised in light of (i) its development impact, (ii) ADB investment profitability, (iii) ADB work quality, and (iv) ADB additionality. On these bases, the overall rating of the Project is "successful."

The development impact of ADB's support to TDB is rated "satisfactory" when evaluated against four criteria: (i) private sector development; (ii) business success; (iii) economic development; and (iv) environment, social, health and safety performance. With respect to private sector development, ADB's intervention acted as a catalyst in reducing the size of the public sector and increasing the role of the private sector in Mongolia. Whereas only five state-owned banks operated in Mongolia in 1999, there are currently 16 private banks. Banks in Mongolia granted MNT60 billion in loans to about 1,700 borrowers in 2000. By the end of 2007, the outstanding loans of the 16 commercial banks reached a total of MNT2,100 billion granted to about 500,000 borrowers. This figure is 35 times higher than the outstanding loans granted in 2000. The successful privatization of local banks in Mongolia increased foreign direct investment (FDI) as it renewed foreign investors' confidence in Mongolia's improved regulatory framework, operating environment, and financial fundamentals. FDI received in the 3 years from 2005 to 2007 totaled almost \$800 million, an amount equal to the total FDI received over the 14 years from 1990 to 2004. Increased competition in Mongolia paved the way for the development of new products and services. TDB currently offers 60 types of international-standard banking products, including mortgage lending, financing to small businesses, and microcredit lending. Banks in Mongolia have expanded their departments to include corporate and retail banking, providing financial support to small and medium-sized enterprises (SMEs) and international relations and investment banking. TDB truly served as a catalyst during the development of a legal framework for new financial products, particularly in mortgage lending. Furthermore, ADB's investment in TDB helped it expand its operations from only 15 branches in 2003 to 24 branches in 2008. However, Mongolia's financial sector remains in a nascent stage,

requiring further financial and technical support from international financial institutions to develop other financial products and securities in accordance with international best practices. In this regard, the private sector development impact is rated "satisfactory."

TDB business success is rated "excellent." Although TDB was overtaken by other banks and is no longer the market leader in terms of assets or loans, its asset quality has significantly improved, with nonperforming loans currently at 1.85%, down from a high of 9.5% in 2004. Liquidity is strong, based on access to a pool of diversified funding sources including foreign international institutions. TDB was the first bank to successfully issue a \$75 million Euro medium-term note (EMTN) program in the international capital markets. The total capital to risk-weighted assets ratio (CAR) declined from 18.5% in 2006 to 13% in 2007 but is still within the minimum required 10% benchmark. This decline is primarily due to the rapid growth of the bank's loan portfolio, which increased from \$206 million in 2006 to \$411 million by June 2008. Risk-weighted assets have grown faster than internal capital. The return on invested capital (ROIC) was 23.5% in 2007 and an annualized 20.7% in 2008. Taking into account the robust ROIC, business success is rated "excellent."

To quantitatively assess the project's contribution to economic development, economic ROIC was calculated. The ratio of loans to gross domestic product (GDP) showed a significant increase from 28.2% in 2004 to 45.1% in 2007, as the ratio of deposits to GDP rose from 24% to 32.7%. As one of the largest banks in Mongolia, TDB currently holds the largest portfolio of foreign assets and is one of the lead players in the foreign exchange market, handling 47% of all foreign exchange transactions. Economic ROIC is calculated based on the ROIC adjusted for tax by using earnings before tax divided by shareholder equity plus subordinated loans—the logic being that earnings before tax represent the revenue produced (net of all expenses), which is the basis for tax contribution. Therefore, the larger the revenue before tax, the higher the tax contribution. The economic ROIC in 2007 was 28.6% and, annualized for 2008, 26.0%. As the average economic ROIC is greater than 20%, it is rated "excellent" according to the evaluation guidelines.

Environment, social, health, and safety performance is given a "satisfactory" rating. TDB has been proactive in financing projects with environmental and social benefits, such as expanding classroom capacity to accommodate additional students, financing agricultural projects that will produce ecologically friendly organic products, providing a credit guarantee for the supply of 1,000 solar panels to rural areas, and financing hospital projects that will improve diagnostic and precautionary measurements using the latest technology accepted by international standards. Further, TDB participated in the Two-Step Loan Project for SME Development and Environmental Protection financed by the Japan Bank for International Cooperation (JBIC). This program encouraged SMEs to promote environmental protection in their projects, such as reducing air pollution. To monitor compliance, TDB requires its clients to submit an environmental assessment report, and TDB conducts on-site inspections to verify and substantiate the information. TDB has adhered to a lending policy of not financing any projects related to gambling or the production of alcohol or tobacco. TDB's monitoring of environmental and social compliance indicates that no indigenous people have been adversely affected by its lending activities.

Investment profitability is rated "excellent." ADB and IFC sold all of their shareholdings in TDB as a result of the sudden change in ownership and management. The annualized net equity earnings multiple was computed to be 2.38. This multiple far exceeded the guideline benchmark of 1.3.

ADB's work quality is rated "satisfactory" based on the following three categories: (i) screening, appraisal, and structuring the project; (ii) monitoring and supervision; and (iii) ADB's role and contribution. ADB's performance in screening, appraisal and structuring is rated "satisfactory." ADB's Private Sector Operations Department (PSOD) identified and screened TDB for development impact and profitability prior to embarking on this project. The project was determined to be consistent with ADB's country strategy for Mongolia and was well supported by other departments, since it would promote the development and privatization of the banking system in Mongolia. ADB appraised the financial capability of the bank by developing an independent set of financial projections and applied stress testing to a worst-case scenario, with the financials still exhibiting positive returns. The project was considered well structured with the combination of subordinated loan and equity investment. The structure addressed the objectives of both TDB and ADB because the loan provided TDB with tier 2 capital to onlend to SMEs and the equity investment allowed ADB to promote good corporate governance within TDB. TDB's performance has been good and was validated to have a positive result.

ADB's performance in monitoring and supervision is rated "satisfactory." PSOD was vigilant in supervising and administering the project. An external consultant was hired to represent ADB and IFC on the board and to provide guidance for the creation and improvement of standard practice in accordance with good governance. IGA was contracted to provide the bank with senior managers, incorporate a strategic business plan, and instill a sound management culture and process. The project administration unit of PSOD has closely monitored operational and financial performance against covenants and financial trends since the project was approved. A private sector investment management note is prepared every quarter, and an annual review was completed in July 2007.

ADB's role and contribution is rated "satisfactory." ADB's participation in the privatization of TDB made possible the Government's successful divestiture of TDB and, as such, boosted confidence in the Mongolian banking system. This was evidenced by an increase in total deposits in the banking sector by a significant 44% at the end of 2005 from a growth rate of only 24% at the end of 2004. Tracking savings deposits in TDB, mainly of individuals, growth jumped from 13.6% in 2004 to 66.7% in 2005. The growth rate of TDB's deposits in 2005, the year after ADB's intervention in TDB, was higher than the total deposit growth rate of the Mongolian banking sector, which was 34.1% at the end of 2005. The recovery of public confidence in TDB, as well as in the broader banking sector, helped fuel the growth in assets and deposits in TDB, which effectively contributed to the upward trend of the bank's profitability and of the economy as well.

ADB's additionality is rated "satisfactory," with ADB's investment in TDB serving as a catalyst for TDB's sourcing of external funding from foreign banks. The additional funding from the World Bank, IFC, and JBIC allowed TDB to expand its loan portfolio, particularly to SMEs, from \$2 million at the end of 2005 to \$20 billion in June 2008—a tenfold increase in 2.5 years. In addition, ADB's presence in TDB gave the bank the confidence to launch Mongolia's first public placement of debt in the international capital market. It issued \$75 million in registered notes with an 8.625% coupon rate and maturity in 2010. This debut issuance was a major achievement for the bank and the country and was several times oversubscribed. ADB's investment in TDB had a positive impact on TDB in many ways.

I. THE PROJECT

A. Project Background

1. A few years prior to Mongolia's transition to a market economy, the banking sector struggled with rocketing interest rates, poor banking practices, an underdeveloped legal system, and defaulting borrowers. A new banking law introduced in 1992 enabled the reorganization of the banking system into a two-tier structure with the Bank of Mongolia acting as the central bank implementing monetary policy and the other banks providing commercial services. In 1996, the rate of nonperforming loans in the banking system was 47%. Two of the four largest banks became insolvent, and the other two were on the edge of insolvency. In 1999, a highly fragmented banking sector was encouraged to consolidate into five large state-owned banks, one of which was the Trade and Development Bank of Mongolia (TDB).

2. The Government of Mongolia (the Government) implemented a complex set of measures toward stabilizing the banking sector, including a sound medium- and long-term development strategy for the financial sector and a privatization policy for state-owned assets, thereby improving the sector's potential to attract investors. By the end of 2002, total loans as a percentage of gross domestic product (GDP) hit 18.8%, up from 12.0% the year before. Similarly, total deposits as a percentage of GDP climbed to 22.9% from 15.5%. It was a clear sign of growing financial intermediation. The highlight of this period was the successful privatization of the country's two largest banks: TDB, the largest in terms of assets, and the Agricultural Bank of Mongolia, which had the most branches.

3. TDB is the oldest commercial bank in Mongolia. Established in October 1990 by government resolution under the name of State Bank of Mongolia (International), TDB started operations in January 1991 with the main purpose of managing the foreign trade and commercial activities of the Government. In April 1998, the Government sold 24% of its shares to its employees while retaining 76%. In December 2002, as part of the 2001–2004 privatization strategy, TDB was totally privatized, with the Government selling the remaining 76% of the shares to Globull Investment and Development (Globull).

4. Globull was owned by Gerald Metals Inc. (GMI) in the United States and Banca Commerciale Lugano (BCL) in Switzerland. GMI, the lead partner in the consortium, has over 30 years of trading and merchant banking experience in Asia, including a 20-year physical presence in the region, and its interest in TDB stemmed from its historical links to the Mongolian copper and gold trade. BCL, by contrast, is a small private bank that specializes in asset management and trade finance. It is expected that BCL will eventually transfer its asset management expertise to TDB.

5. From privatization in 2002 until the end of 2006, Institutional and Government Advisory Services (IGA), a wholly owned subsidiary of ING, was appointed manager of TDB, and a management and technical assistance agreement was signed by all parties. During this time, TDB focused on maintaining its lead position in the local banking sector and expanding internationally.

6. In December 2004, the Asian Development Bank (ADB), in a joint venture with IFC, supported private sector development in Mongolia by acquiring an equity stake in the privatized TDB and provided a subordinated loan to support its anticipated strong growth.

7. In December 2006, Globull was bought by US Global, a company newly established in the United States owned by a consortium of Mongolian investors.

8. As a consequence of the sale of GMI to US Global, and in accordance with the terms of the shareholders agreement, the put option of the ADB-IFC joint venture was triggered. However, ADB and IFC were given only 30 days to decide after GMI decided to sell its equity stake in TDB to US Global. ADB and IFC therefore decided to sell all of their shares in TDB, as a thorough background check on the new shareholders could not be done within this short period.

B. Project Features

9. The agreement between ADB and TDB consisted of (i) an investment of \$1.39 million in an equity participation (ii) a US dollar-denominated subordinated loan of \$4.5 million with a tenor of 5 years and a bullet repayment maturing on 15 December 2009.

10. In connection with the subscription agreement between TDB and ADB dated 9 December 2004, ADB entered into a put option agreement with GMI whereby ADB has the right, but not the obligation, to sell to GMI any or all of ADB's shares in TDB. The put option would expire in June 2009, 54 months from the date of agreement.

C. Progress Highlights

11. In August 2006, TDB joined the IFC's Global Trade Finance Program, making TDB the program's first issuing bank in Mongolia. Under the program, TDB was able to issue various trade finance instruments guaranteed by IFC for up to \$5 million with tenors of up to 3 years, allowing TDB to be more active in financing its clients' international trade. The signing of this agreement was an important part of TDB's strategy to diversify and develop its financial services and banking products.

12. In the same year, China Export and Credit Insurance Corporation extended to TDB a 3-year, \$27 million credit line to support trade transactions between the People's Republic of China and Mongolia. With the increased direct and unsecured lines, TDB's trade finance potential would further reach the global market and allow TDB to expand geographically. TDB believed that this would positively affect the development of its trade finance business.

13. In January 2007, TDB registered its inaugural \$150 million Euro medium-term note (EMTN) program and successfully issued \$75 million in registered notes with a 8.63% coupon rate due in 2010. The bond sale was considered the country's first dollar bond sale. Moody's Investor Services rated the program Ba2 for a senior unsecured foreign currency issue and Ba3 for a subordinated foreign currency issue. TDB's ratings reflect its dominant position in the domestic corporate banking market, strong profitability, experienced management team, and improving asset quality. This debut issuance was Mongolia's first public placement of debt—a major achievement of TDB in the international capital market. The transaction was several times oversubscribed, with participation from 96 investors from 13 countries. By successfully raising these funds, TDB was able to provide longer-term loans to its clients at lower interest rates.

14. TDB became the first commercial bank in Mongolia rated by an international rating agency, and this has helped distinguish the bank as a trustworthy and reliable partner for foreign counterparts. Moody's upgraded the bank's credit rating in November 2007, giving TDB a B2 rating for long- and short-term foreign currency deposits, Ba1 for long- and short-term local currency deposits, Ba2 for long- and short-term foreign currency issues, Ba1 for long- and short-term local currency issues, and a "stable outlook" overall.

15. In June 2007, TDB signed a general cooperation agreement with Bayerische Landesbank, which provides long-term financing and insurance for capital goods imported by TDB customers from the European Union. Bayerische Landesbank is a large international commercial bank based in Munich, Germany.

16. On 29 February 2008, the Government and the Mongolian Chamber of Commerce and Industry named TDB "best bank" among the top five commercial banks in Mongolia. This recognition was made during the award ceremony for Mongolia's top 100 enterprises held in the Sunjin Grand Hotel. The best bank award honors TDB for successfully expanding its business in corporate finance and capital markets.

17. On 17 March 2008, a cooperation agreement was signed between TDB and the Foreign Investment and Foreign Trade Agency (FIFTA) for TDB to assist FIFTA with information technology services using programs it had created and to sponsor business forums, conferences, and bilateral meetings. FIFTA is the government agency responsible for promoting and facilitating foreign direct investment and promoting foreign trade. This cooperation agreement offers reciprocal advantages for both organizations toward increasing TDB's contribution to the country's economy, rendering comprehensive and real support to Mongolia's economic development, and enhancing the two organizations' collaboration to attract foreign investment.

II. PROJECT EVALUATION

A. Overview

18. The investment in TDB is evaluated using criteria defined in ADB's *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations*.¹ The project rationale and objectives are presented to provide context. The investment is then appraised under (i) development impact, (ii) ADB investment profitability, (iii) ADB work quality, and (iv) ADB additionality. Table 7 provides an overall evaluation of the project.

19. The purpose and objective of ADB's investment in TDB was to have development effectiveness by:

- (i) demonstrating to the public that privatization has produced clear and tangible positive results and thereby increasing confidence in the banking sector;
- (ii) catalyzing foreign direct investment by making foreign investors more comfortable entering the Mongolian banking sector;
- (iii) promoting financial sector reform and development.

20. TDB expects to catalyze the development of a legal framework for mortgage lending, general and life insurance, and leasing and factoring, as well as other aspects of financial sector reform and development. ADB's involvement aims to enhance TDB's contribution to financial sector reform and development.

B. Development Impact

21. Development impact is rated "satisfactory" in terms of (i) private sector development; (ii) business success; (iii) contribution to economic development; and (iv) environment, social, health and safety performance.

¹ ADB. 2007. *Guidelines for Preparing Performance Evaluation Reports on Nonsovereign Operations*. Manila.

1. Private Sector Development

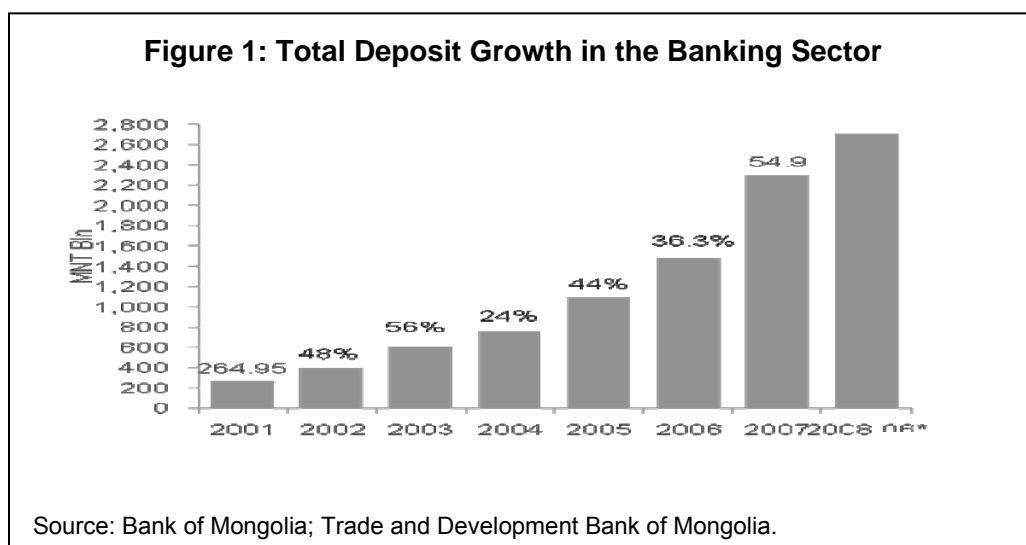
a. Beyond Company Impact

22. Since TDB's privatization in December 2002, both the consortium and ING representatives have commented favorably on the constructive role that ADB and IFC representatives have played.

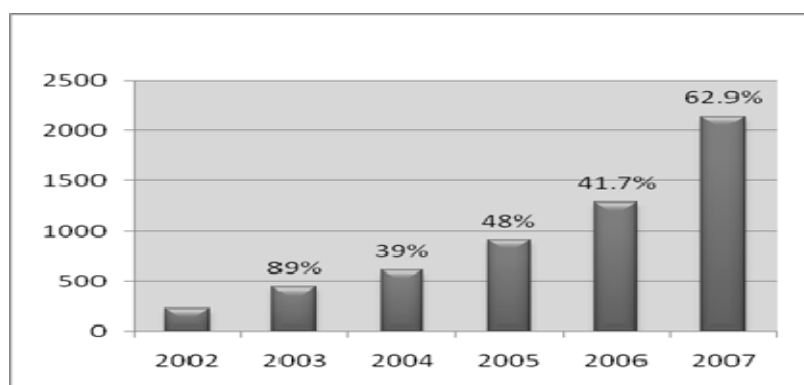
i. Catalytic and Demonstration Effect

23. The successful privatization of TDB has led to the full privatization of other banks in Mongolia. The last state-owned bank to be privatized, in 2006, was the Savings Bank of Mongolia. There are currently 16 private banks operating in Mongolia. In 1999, there were only five state-owned banks.

24. Privatization has earned public trust in Mongolia's banking sector, as demonstrated by the growth in customer deposits as shown in figure 1 from MNT264.95 billion in 2001 to MNT2,707 billion in June 2008, for a compounded annual growth rate of 43% for the past 6.5 years.



25. ADB, in conjunction with other development partners such as the World Bank, Japan Bank for International Cooperation, and IFC in Mongolia, has helped reduce the size of the public sector and increased the role of the private sector. Loans to the private sector have steadily increased. Banks granted MNT60 billion in loans to 1,700 borrowers in 2000. By the end of 2007, the outstanding loans of 16 commercial banks had reached a total of MNT2,100 billion granted to 500,000 borrowers, or 35 times the outstanding loans in 2000. Year-on-year loan growth was 62.9% in 2007 (Figure 2).

Figure 2: Total Loan Growth in the Banking Sector

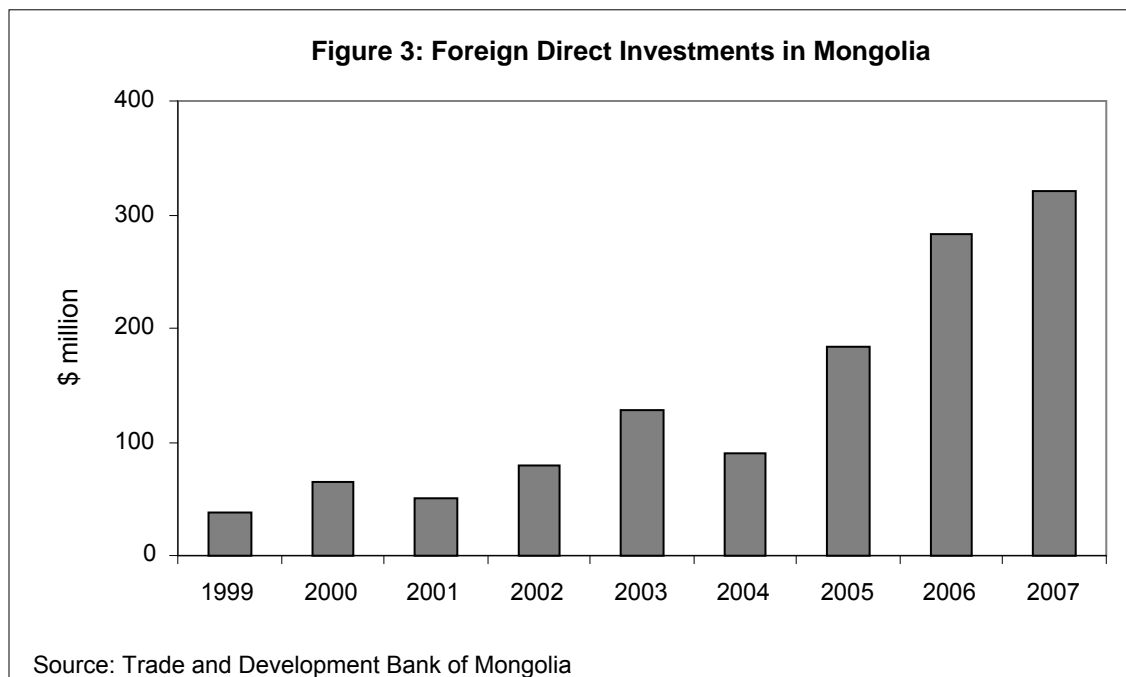
Source: Trade and Development Bank of Mongolia.

26. Mongolia's banking sector continues to evolve with public's trust and confidence. This was evidenced by increased demand for other banking products and services in addition to the significant growth in loans and deposits.

ii. Catalytic Foreign Direct Investment

27. Mongolia received limited foreign direct investment (FDI) prior to privatization. ADB's involvement in TDB helped expand the country's fledgling private banking sector, while bringing into the country a much-needed dose of FDI. FDI jumpstarted in 2005—the year after ADB invested in TDB (Figure 3), highlighting that the awareness of international foreign investors was raised. Investors felt less exposed to risk and more confident to invest in the new Mongolian banking sector.

28. FDI in the 3 years from 2005 to 2007 totaled almost \$800 million, which is equal to FDI received in the previous 14 years. The inflow of FDI in 2007 rose by \$38.1 million over that of 2006, reaching \$327.7 million, of which \$81.9 million, or 25%, was in the form of loans to the Government. Loans from ADB and the World Bank accounted for 60.2% of the total loans. According to FIFTA, 1,505 foreign and joint-venture companies registered to invest \$366.5 million in Mongolia. Companies from the Belgium, Canada, Cayman Islands, China (People's Republic of), Germany, Japan, Korea (Republic of), Russian Federation, Switzerland, United Kingdom, United States, Viet Nam, Virgin Islands, accounted for 98.8% of the total investment.



29. In May 2008, the European Bank of Reconstruction and Development (EBRD) increased its support for the development of the Mongolian financial sector by acquiring an equity stake, extending a loan for small businesses, and providing a trade finance facility to Zoos Bank, the country's sixth largest bank.

30. The bank's privatization effort spurred new growth and additional competition, as foreign investors saw that such projects could reap strong returns, and as Mongolian authorities built the kind of legislative and regulatory infrastructure that encourages business development and new investment.

iii. Catalytic Financial Reforms and Development

31. TDB expects to act as a catalyst for the development of a legal framework for new financial products such as mortgage lending, leasing, factoring, general and life insurance, and other basic financial services, which are currently at the inception stage or nonexistent.

32. TDB started mortgage lending in August 2005, offering to Mongolian residents loans for purchasing apartments or houses, house construction, and renovations at very competitive rates, with a maximum loan-to-value ratio of 80%. TDB does not charge an origination fee.

33. In addition, TDB has extended commercial mortgage lending to SMEs, using real estate as collateral to secure repayment. Commercial mortgage loans are offered at very competitive rates.

34. The growth in mortgage lending from MNT1.2 billion in 2005 to MNT27.34 billion as of the first half of 2008, for a compounded annual growth rate of roughly 250%. The growth in mortgage lending shows that the market is moving away from traditional lending to more sophisticated forms.

b. Direct Company Impact

35. TDB is one of the three largest commercial banks in Mongolia, with 18% of market share in loans and 17% in customers' deposits. In 2003, prior to ADB's investment in TDB, it operated only 15 branches. TDB currently operates 24 branches strategically located to serve SMEs (Table 1).

Table 1: Branch Locations of the Trade and Development Bank of Mongolia

Location Focus	2003	2008
Business Districts	3	13
Regional Centers	5	6
Settlement Centers	7	5
Total	15	24

Source: Trade Development Bank of Mongolia

36. TDB has kept up with rapid growth and increased competition in the banking sector by introducing a wider range of services. It currently offers 60 types of international-standard banking products for domestic and international markets, including capital market services, consulting, liability management, real estate financing, and structured debt instruments.

c. Overall Assessment of Private Sector Development

37. Despite meeting the objectives of ADB investments, Mongolia's financial sector remains in a nascent stage. Mongolia's financial sector still requires support from international financial institutions to develop in accordance with international best practices, particularly in the fields of mortgage finance, leasing, currency hedging, loan syndication, metals price risk, and insurance. The contribution of the project to private sector development is rated "satisfactory."

2. Business Success

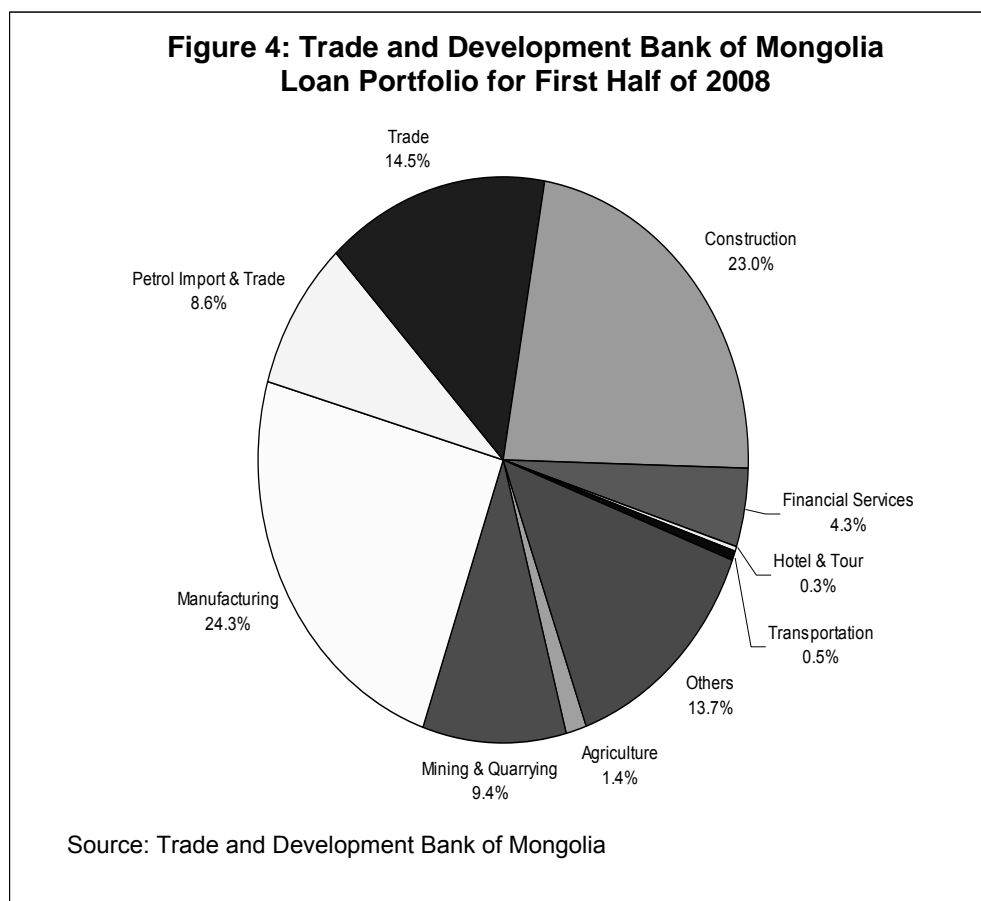
38. As a result of growing competition in the banking industry, TDB has since 2004 been overtaken by Golomt Bank in terms of assets and Khan Bank in terms of loans. This is evidenced by the slowing growth in the loans portfolio (Table 2).

Table 2: Key Performance Highlights
(MNT million)

Item	2004	2005	2006	2007	Jan–Jun 2008
Loans (Net)	71.8	127.6	206.1	326.9	411.2
Deposits	114.4	193.0	286.9	332.0	392.3
Borrowings	17.1	18.1	30.7	88.4	88.4
Shareholder's Equity	18.8	30.8	42.7	51.5	58.5
Total Revenue	13.3	17.8	30.9	40.5	27.8
Net Profit After Tax	4.4	6.0	10.1	14.0	6.9
Ratios					
Loan Growth Per Annum (%)	47.9	77.7	61.5	58.6	25.8
Nonperforming Loans/Gross Loans (%)	9.5	7.2	4.4	2.0	1.8
Return on Assets (%)	2.9	2.4	2.8	2.9	1.2
Return on Equity (%)	23.6	19.5	23.7	27.2	11.8

Source: Trade Development Bank of Mongolia

39. TDB's earnings stream comes from a range of business, with no single business accounting for more than 50% of revenue (Figure 4), thereby diversifying risk exposure.



40. TDB has adequate liquidity from its access to a pool of diversified funding sources, such as depositors and domestic and foreign financial institutions.

41. TDB's current capital position is considered adequate, with a capital to risk-weighted assets ratio (CAR) at 13% on 30 June 2008. This ratio is significantly higher than the minimum 10% required in financial covenants.

42. TDB's nonperforming loan (NPL) rate declined from 9.5% in 2004 to 1.85% at the end of June 2008. This is a significant improvement in the quality of the bank's portfolio.

43. Since ADB provided a corporate loan and equity investment in TDB, the return on invested capital (ROIC) was used as a proxy indicator and evaluation standard. The ROIC of 23.5% in 2007 and an annualized 20.7% in 2008, yields an "excellent" rating, as both years exceeded the 700 basis points above WACC stipulated in evaluation guidelines. In addition, all ratios are above the projected ratios as indicated in the report and recommendation of the President.

3. Contribution to Economic Development

44. The banking sector is one of the main drivers in Mongolia's economic growth. It finances all major economic activities in the country such as mining, petroleum imports, construction, manufacturing, energy, transportation, communications, and trade activities.

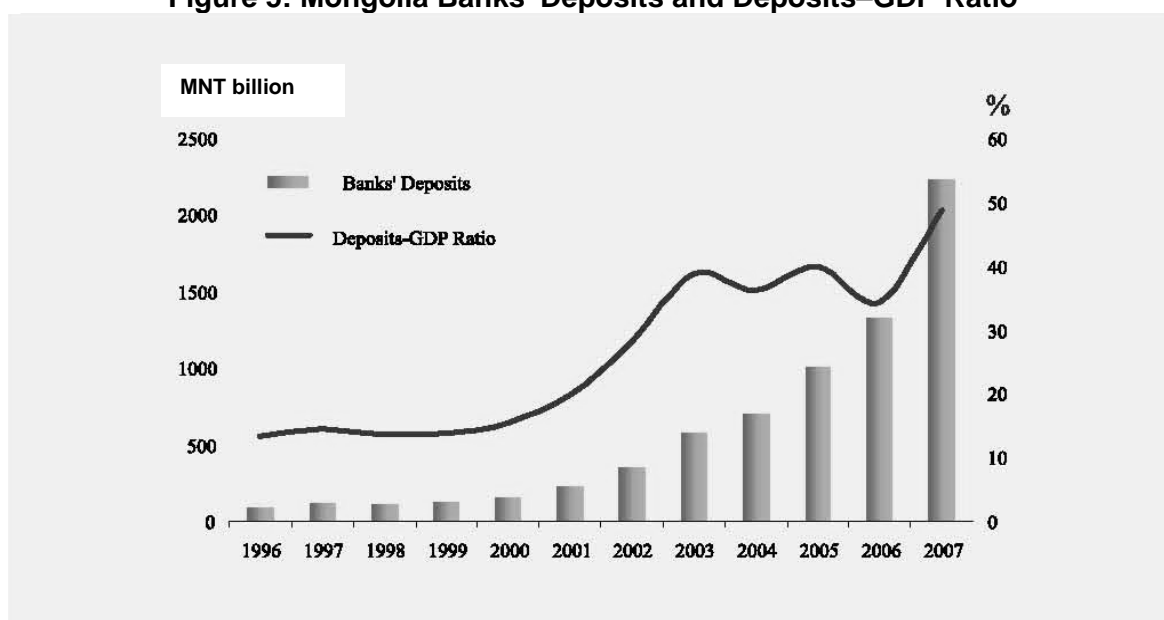
45. The increase in deposits into, and loans from, banks in Mongolia raised banking sector assets by 51.2%, or MNT1.11 trillion, in 2007, to MNT3.3 trillion, which is equal to 71.9% of GDP. This growth contributed to expanding the role of banks in intermediation.

Table 3: Mongolia Macroeconomic Indicators

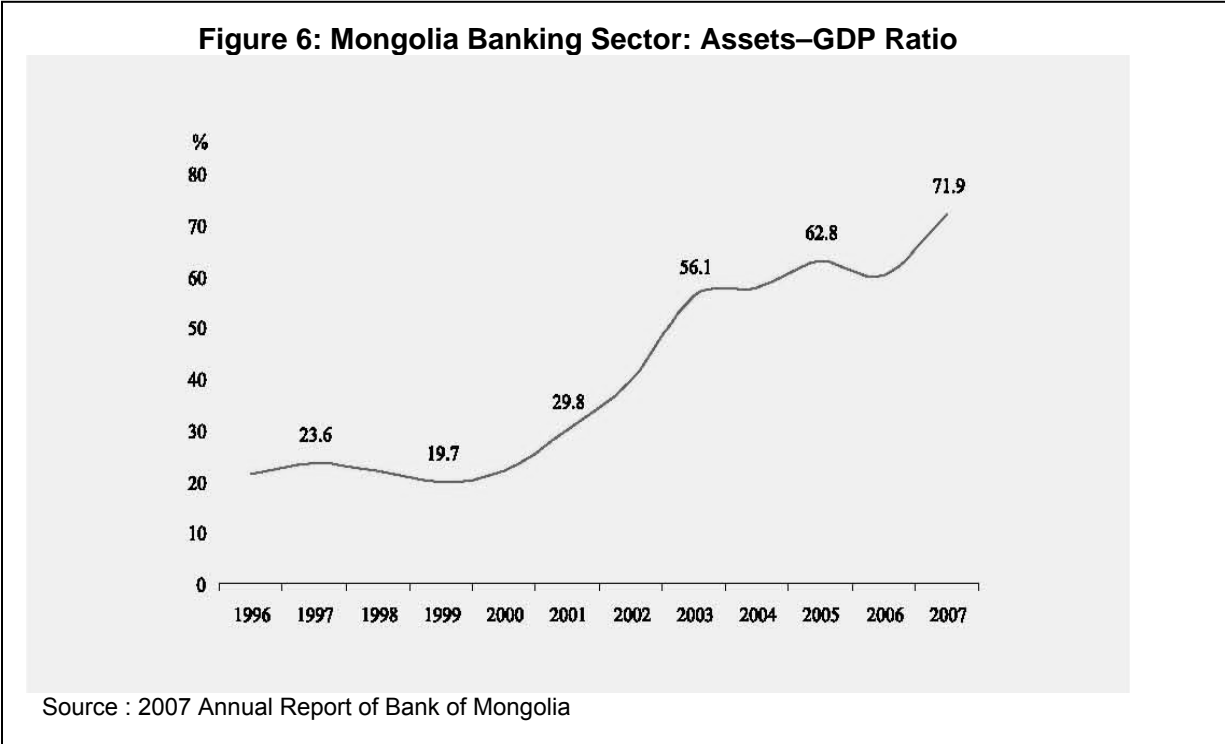
Item	2004	2005	2006	2007
GDP (MNT billion)	2,152.1	2,779.6	3,715.0	4,557.5
Real GDP growth (%)	10.4	7.1	8.4	9.9
Loans / GDP (%)	28.2	30.9	32.9	45.1
Deposits / GDP (%)	24.0	24.2	26.8	32.7
Total Loans (MNT billion)	606.8	859.9	1,223.3	2,056.1

Source: 2007 Annual Report of Bank of Mongolia.

Figure 5: Mongolia Banks' Deposits and Deposits–GDP Ratio



Source: 2007 Annual Report of Bank of Mongolia.



46. As the deposits of the banking sector have risen, as shown in Figure 5, loans and financing to the private sector have steadily increased (see Figure 6). It was reported that banks granted MNT60 billion in loans to 1,700 borrowers in 2000. By the end of 2007, the outstanding loans reached a total of MNT2,100 billion lent to 500,000 borrowers, which is 35 times the outstanding loans in 2000.

47. By the end of 2007, Mongolia’s banking sector had 16 private commercial banks with 981 branches. In 2005, only 14 banks with 731 branches were fully privatized. The addition of 250 branches in 2 years was an average growth rate of 17.1% per annum. The aggressive expansion in the number of branches operated by Mongolia’s financial institutions generated 3,584 new employments in 2007 alone. This effectively reduced unemployment in 2007 by 3%.

48. In recent years, TDB not only intensively raised its lending but also made certain progress in expanding its types of product. Its wide range of trade finance instruments and services, such as international investment banking, syndicated and non-syndicated lending, and trade finance and remittance, among others, are expected to attract more investors, depositors, and borrowers both locally and internationally. TDB currently holds Mongolia’s largest portfolio of foreign assets and is the lead player in the foreign exchange market, handling 47% of the foreign exchange transactions.

49. The banks’ reputation as a major corporate banking service provider in Mongolia with a long-established presence and experience in the market, as well as a wide array of trade-related products and services, exemplifies its contribution to the economic development of Mongolia. To quantify TDB’s contribution to economic development, economic ROIC is used. Economic ROIC is calculated as ROIC adjusted for tax by using earnings before tax divided by shareholder equity plus subordinated loans. The logic is that earnings before tax represent the revenue produced, net of all expenses, which is the basis for tax contribution. Therefore, the

larger the amount of revenue before tax, the higher the tax contribution. Economic ROIC was 28.6% in 2007 and 26.0% in annualized 2008. Since the economic ROIC is greater than 20%, it is therefore rated "excellent" according to evaluation guidelines.

4. Environment, Social, Health, and Safety Performance

50. The investment in TDB is categorized "F1," as having little or no environmental impact. In this regard, environment, social, health, and safety performance is interpreted as applying not only to direct investment and lending by ADB to TDB but also to the investment and lending activities of financial intermediaries that it finances wholly or in part.

51. TDB has been proactive in financing projects with environmental and social benefits, such as (i) providing a credit guarantee on the supply of 1,000 solar panels to the countryside, (ii) financing hospital projects that will improve diagnosis using the latest technology applied to international standards, (iii) financing school projects to expand classroom capacity to accommodate additional schoolchildren, (iv) financing agricultural projects that will produce ecologically friendly organic products, (v) financing the renovation of carpet-weaving equipment to improve the quality of carpets and incorporate energy-saving features, and (vi) financing mining projects to create employment opportunities for rural residents.

52. TDB participated in the Two-Step Loan Project for SME Development and Environmental Protection Program financed by the Japan Bank for International Cooperation (JBIC). The program encourages SME projects geared toward environmental conservation and protection.

53. TDB monitors the environmental and social compliance of its clients by requiring them to submit an environmental assessment report, and it is particularly strict with miners of gold, coal, flourspar, iron, etc., and manufacturers in food processing, cashmere processing, tanning, etc.

54. For mining projects, TDB is specifically concerned about erosion and damage from digging, as well as safeguarding water resources against pollution from mine tailings. TDB expects minimal environmental risks from manufacturing projects because most are located in industrial and economic zones, which have central plants for treating effluents.

55. The Government of Mongolia requires all mining companies to submit a report on restoring and maintaining damaged and eroded area. Only companies with acceptable reports have their mining plans for the following year approved. Without an approved mining plan, the mining company is unable to operate.

56. Aside from requiring reports, TDB conducts on-site monitoring and inspection to verify environmental, social, health, and safety compliance. TDB further adopted a lending policy of not financing any projects related to gambling or the production of alcohol or tobacco. In addition, TDB's monitoring of environmental and social compliance indicates that no indigenous people have been adversely affected in their lending activities.

57. TDB believes that, to successfully implement a project, initiatives should start from within the organization. It organizes a campaign program every year in which all TDB staff plant trees and clean the Tuul riverbank and Ulaanbaatar area.

58. TDB thus met all of ADB's environmental and social requirements and as such is rated "satisfactory."

C. ADB's Investment Profitability

59. The investment outcome is rated "excellent." On 23 December 2004, ADB disbursed the subordinated loan of \$4.5 million and invested \$1.39 million equity interest in TDB. GMI was the major shareholder of TDB, owning 65% of the bank.

60. On 16 November 2006, GMI notified both ADB and IFC that it had reached an agreement to sell its interest in Globull to US Global, a company newly established in the United States owned by a consortium of Mongolian investors. As a consequence of the sale, and as per shareholder's agreement, ADB and IFC exercised their put options to sell their holdings in TDB to GMI.

61. The annualized net earnings multiple was computed at 2.38. The project is therefore given an "excellent" rating, as the multiple exceeded the guideline benchmark of 1.3.

D. ADB's Work Quality

1. Screening, Appraisal, and Structuring

62. ADB and IFC jointly conducted a preliminary review of TDB and understood the position of the Government with respect to the privatization plan for the bank. The fact-finding mission that screened the bank concluded that TDB was well managed and financially sound and offered an attractive opportunity for a strategic investor. This was the reason TDB was selected over other banks. A number of issues and risks were identified but were resolved by the Government as a condition to ADB's moving toward concept clearance. The transaction was considered to be consistent with ADB's country strategy for Mongolia and was a critical element of ADB's existing program of reform in the financial sector. The investment was deemed an important opportunity for the Private Sector Operations Department to help facilitate and implement ADB's private sector development strategy.

63. ADB appraised the bank by developing an independent set of financial projections based on the (i) operating assumptions as per TDB's business plan of 2003; (ii) result of discussions with management and shareholders; and (iii) market trends and development prevailing at that time. While magnitudes are inherently difficult to project, the ADB team was confident that TDB had clear potential for continued profitable growth. Stringent stress testing based on a worst-case scenario was developed, and TDB still exhibited potential for generating positive returns for ADB.

64. The project was considered well structured with the combination of a subordinated loan and an equity investment. The loan provided tier 2 capital for TDB, a key element for realizing the business objective of lending to SME projects because subordinated debt is much cheaper than equity from a bank's point of view. On the other hand, subscription to TDB shares paved the way for ADB to promote good corporate governance in TDB. Taken as a whole, the combination of loan and equity structure promoted the development of a commercially oriented banking system in Mongolia.

65. In this regard, ADB's performance in project screening, appraisal, and structuring is rated "satisfactory."

2. Monitoring and Supervision

66. ADB's performance related to monitoring and supervision is rated "satisfactory."

67. ADB hired a consultant to serve as a board member of TDB. The consultant regularly attended board meetings and shareholders meetings and provided to ADB reports on the matters discussed and approved and other activities of the bank. He was a member of the steering committee and (i) contributed to formulating TDB's strategy, business plan, and new business initiatives; (ii) assisted in hiring new staff; and (iii) provided inputs on good corporate governance and internal control issues.

68. Further, ADB's project administration unit closely monitored TDB's operational and financial performance after the loan and equity were approved and disbursed. An annual review on TDB was completed in July 2007. In addition, a quarterly private sector investment management note was prepared by project administration unit staff reporting financial ratios and analysis of financial results against covenants and financial trends.

3. ADB's Role and Contribution

69. ADB's participation in the privatization of TDB made it possible for the Government to (i) successfully divest itself of TDB and thereby provide a much-needed catalyst to the development of the Mongolian financial sector, (ii) lent credibility to the transaction and provided comfort to strategic buyers, (iii) provided greater confidence in the banking system with the introduction of a major foreign institution, and (iv) established a benchmark for its privatization program that enhanced the prospects of selling off further state-owned enterprises in an orderly and transparent manner while facilitating the attraction of credible strategic investors.

70. In addition, the successful privatization attracted new FDIs, which increased the confidence of depositors and thereby increased competition. This was evidenced by increased total deposits in the banking sector by a significant 44% at the end of 2005, or nearly double the growth rate of 24% in 2004. Further, savings deposits, mainly by individuals, in TDB jumped from 13.6% in 2004 to 66.7% in 2005. This rate of growth was higher than that of all banks in Mongolia, which registered only 34.1% growth at the end of 2005.

71. The positive developments brought by rivalry among competitors was that banks became more aggressive in branch expansion, competitive pricing, improving customer service quality, and intensifying advertising, thus creating jobs in other industries as well.

72. ADB helped TDB adopt international best practices and standards for operations and corporate governance by way of its board representation. However, ADB was not able to see through the transition and successful implementation of good corporate governance in TDB because of the unexpected divestment of equity.

73. ADB's performance related to its role and contribution is rated "satisfactory."

E. ADB's Additionality

74. ADB's investment in TDB served as a catalyst for TDB's sourcing of external funding from foreign banks. TDB was the first Mongolian bank to be included in the Global Trade Finance Program managed by IFC. Under this program, TDB lent to SME clients up to \$5 million per transaction with tenors of up to 3 years. The program allowed TDB to expand its trade finance transactions in an extensive network of countries and enhanced its trade finance coverage. In addition, China Export & Credit Insurance Corporation (SINOSURE) extended to TDB a 3-year, \$27 million credit line to support trade transactions between the People's

Republic of China and Mongolia. With an additional unsecured line, TDB's trade finance business increased by 33.7% year-on-year from \$63.02 million in 2006 to \$84.3 million in 2007.

75. TDB participated in onlending programs of the World Bank amounting to \$10 million and of JBIC amounting to \$25 million, with tenors of up to 10 years. The objective of the programs is to provide long-term financing to SMEs. TDB currently has onlending of \$9 million to 12 SMEs from the line extended by the World Bank and of \$1.5 million to three SMEs from the line extended by JBIC. These foreign borrowings have allowed TDB to expand its loan portfolio, particularly to SMEs, from \$2 million at the end of 2005 to \$20 billion as of June 2008, a tenfold increase in only 2.5 years.

76. ADB's presence in TDB gave the bank the confidence to launch Mongolia's first public placement of debt in the international capital market. It issued \$75 million in registered notes with an 8.63% coupon rate and maturity in 2010. ING Bank N.V. was the sole arranger, dealer, bookrunner, and lead manager of the notes issuance. Moody's rated it Ba2 for a senior unsecured foreign currency issue and Ba3 for a subordinated foreign currency issue. This debut issuance was a major achievement of the bank and was several times oversubscribed.

77. Had ADB not invested in TDB to support the privatization program of the Government, the privatization might not have been as successful as it was and may have taken longer to materialize. Foreign direct investors may have hesitated to put their money into what they perceived to be a risky market. Alone, TDB would have had difficulty accessing the international capital market and might not have been able to obtain a good credit rating.

78. ADB's additionality is therefore rated "satisfactory."

F. Overall Evaluation

79. Based on the analysis above, the project is rated "successful." A summary of the individual category ratings is provided in Table 7.

Table 7: Evaluation of the Project

Item	Partly Satisfactory			
	Unsatisfactory	Partly Satisfactory	Satisfactory	Excellent
A. Development Impact			√	
1. Private Sector Development			√	
2. Business Success				√
3. Economic Sustainability				√
4. Environment, Social, Health and Safety Performance			√	
B. ADB's Investment Profitability				√
C. ADB's Work Quality			√	
1. Screening, Appraisal and Structuring			√	
2. Monitoring and Supervision			√	
3. ADB's Role and Contribution			√	
D. ADB's Additionality			√	
	Unsatisfactory	Partly Successful	Successful	Highly Successful
Overall Rating			√	

Source: Trade and Development Bank of Mongolia.

III. ISSUES, LESSONS, AND RECOMMENDATIONS

80. Two good practices in this project are worth repeating in future projects. One is the introduction of a put option, which serves as a good exit strategy. Second is the combination of a loan and equity investment. The loan allows the bank more room to expand its portfolio, while the equity helps strengthen the bank's capital base. Further, direct equity investment provides to ADB a board seat that facilitates helping the bank to adopt standard practices for good corporate governance.

**PRIVATE SECTOR DEVELOPMENT INDICATORS AND RATINGS:
FINANCIAL INTERMEDIARIES**

Indicators	Ratings ^a	Justifications
1. Wider Sector and Economy Impact Beyond Intermediaries and Sub-borrowers		
1.1 Private sector expansion and institutional impact		
1.1.1 Contribution to an increased private sector share and role in the economy and to sustainable jobs or self-employment	Satisfactory	<p>Financial institutions and in particular banks were successfully privatized in Mongolia in 2006. The success is evidenced by increased GDP growth from 7.1% in 2005 to 8.4% in 2006 and 9.9% in 2007 (main text, Table 3). This growth has been purely driven by growth in the private sector, as evidenced by the following:</p> <ul style="list-style-type: none"> (i) Loans and financing to the private sector have steadily increased. In 2000, MNT60 billion in loans were granted to 1,700 borrowers. By the end of 2007, MNT2,100 billion in loans were lent to 500,000 borrowers. This is 35 times more than the total outstanding loans given in 2000. (ii) These figures show that lending to the private sector has intensified. The loans are allocated to finance the following sectors: trade (28% of all loans), manufacturing (13%), agriculture and mining (14%), construction (16%), and others (29%). (iii) The number of branches increased from 731 in 2005 to 981 by the end of 2007. The addition of 250 branches in 2 years is an average growth of 17.1% per annum. (iv) The number of people employed by financial institutions increased. In 2007 alone, 3,584 new jobs were generated by the banks and this effectively reduced unemployment by 3%. <p>At the time of TDB's privatization in 2003, its employees numbered 396. By 2007, this had increased to 615, reflecting an average increase of 13.8% per annum over 4 years. This a significant change. Importantly, over 55% of TDB's employees are women.</p>
1.1.2 Contribution to expanded SME lending with good portfolio and sub-borrower performance	Satisfactory	<p>The ADB loan to TDB was based on its being among the early entrants in financing and supporting SMEs. Its portfolio of \$2 million in 2006 multiplied by 10 times to \$20 million by the end of June 2008. This portfolio has over 200 individual customers and is regarded as among the top five in Mongolia.</p> <p>TDB's nonperforming loan (NPL) portfolio stood at MNT8.9 billion in June 2008. This represents 1.85% of its total lending portfolio and significantly improved from high of almost 10% in 2004. 0.8% were contributed by NPLs that are directly related to the SME businesses. TDB has been able to achieve this improvement by following a strict selection and screening process. All employees involved in SME financing are trained in lending principles, and all loans are approved by senior management. Furthermore, TDB's SME program requires close monitoring, including site visits and monthly reports. All accounts past due beyond 30 days are passed on to branch managers who, because of their proximity to the SME business or residence, are then made responsible for getting the SME back on track and or agreeing to a minor rescheduling.</p> <p>For accounts past due beyond 90 days, a special asset unit is in</p>

Indicators	Ratings ^a	Justifications															
<p>1.1.3 Contribution to institutional change by</p> <p>(i) improving SMEs' access generally to formal credit and banking service and</p> <p>(ii) creating a more enabling environment for SMEs through policy dialogue or otherwise making participant bank(s) more engaged</p>	Excellent	<p>charge of handling the accounts, starting with the restructuring of the loans and filing of court cases up to collateral realization.</p> <p>The Mongolian banking sector had 731 branches in 2005. By the end of 2007, this number had increased to 981, for an addition 250 branches in 2 years.</p> <p>TDB expanded its branch network from 15 branches in 2003 to 24 in 2008. All of these branches are concentrated in areas typically occupied by traders and small business.</p> <table border="1" data-bbox="764 533 1349 674"> <thead> <tr> <th>Location Focus</th> <th>2003</th> <th>2008</th> </tr> </thead> <tbody> <tr> <td>Business Districts</td> <td>3</td> <td>13</td> </tr> <tr> <td>Regional Centers</td> <td>5</td> <td>6</td> </tr> <tr> <td>Settlement Centers</td> <td>7</td> <td>5</td> </tr> <tr> <td>Total</td> <td>15</td> <td>24</td> </tr> </tbody> </table> <p>Regional branches are in rural areas usually located along a railroad. Settlement centers are deposit counters that provide all kinds of financial services except lending.</p> <p>To further demonstrate its commitment to the SME sector, in 2006 TDB set up a dedicated SME department. It established an SME toolkit that provides SMEs with online help that walks them through all of TDB's requirements to qualify for SME financing. The success of this strategy encouraged several other banks to duplicate TDB's model.</p> <p>TDB has qualified for an onlending program from the World Bank and Japan Bank for International Cooperation (JBIC). This program provides TDB with long-term funds for 10 years below market rates but requires that each SME loan application be first reviewed and approved by the World Bank and JBIC. TDB has been able to utilize \$9 million under the World Bank program of \$25 million, onlending to 12 SMEs. The JBIC program was launched early 2008 and TDB has utilized almost \$2 million for three SMEs. Other local banks are in the process of negotiating with foreign sources for external funding. This has changed the manner of sourcing funds.</p>	Location Focus	2003	2008	Business Districts	3	13	Regional Centers	5	6	Settlement Centers	7	5	Total	15	24
Location Focus	2003	2008															
Business Districts	3	13															
Regional Centers	5	6															
Settlement Centers	7	5															
Total	15	24															
<p>1.2 Competition: Contribution to new competition for SME business among local banks, including new product and service offerings and local currency products, and/or contribution to increased competition in key sub-borrower markets</p>	Excellent	<p>The balance sheets of all major banks reveal that at the center of their lending programs is the SME sector. All banks have dedicated branches or teams targeting this business segment. The resulting competition for SME business among local banks has enabled SMEs to get lower borrowing rates.</p> <p>To differentiate itself from other banks, TDB implemented a dedicated account manager approach for dealing with SMEs. The account manager is supported by a monitoring unit from the front office and a dedicated risk management department analyst. Further, TDB has, in cooperation with IFC, started hosting a special website called SME toolkit. This website provides free advice to SMEs on issues relating to planning and managing their business, calculating cash flows, accounting, legal issues, and developing sales and marketing policies.</p> <p>TDB's credit pricing is dependent on the risk-rating model initially developed by IGA. It also offers tiered interest lending rates to SMEs, offering lower interest rates to SMEs with repeat transactions or excellent business and past credit performance.</p> <p>TDB loans to SMEs generally have a maturity of 2 years or less</p>															

Indicators	Ratings ^a	Justifications
		and are used for capital expenditures and working capital. TDB stands out among banks operating in Mongolia in its recent introduction of the “investment loan” product. This provides longer-term funding to SMEs by allowing them to extend the term of the loan to 3 years and purchase imported capital equipment using the TDB’s trade finance product.
<p>1.3 Innovation: Contribution to new ways of offering effective banking services to clients in ways that are replicated by other banks and in the financial system</p>	Excellent	<p>The risk-rating model is a system developed by IGA for corporate loans and was modified and refined by TDB to suit SME loans. The systemized internal rating model is 40% quantitative factors and 60% qualitative factors. The borrower’s risk rating, sufficiency of collateral, and other factors determine the pricing of credit. TDB is the only bank in Mongolia using a systemized risk-rating model for pricing credit.</p> <p>Different banks in Mongolia use different models for pricing credit. Some banks use the scorecard system and calculate interest rates case by case, while other banks base it on the risk profile of the borrower and adjust the price within the predefined range.</p>
<p>1.4 Linkages: Contribution to local savings’ and deposits’ mobilization via networks of participant bank(s) and/or relative to size of subportfolios; contribution to notable upstream or downstream link effects to sub-borrowers’ businesses in their industries or the economy.</p>	Satisfactory	<p>The investments by ADB and IFC in December 2004 acted as catalysts by providing much-needed confidence in the banking system in Mongolia. This is evidenced by the growth in savings deposits, which increased by 44% in 2005 (main text, Figure 1). Furthermore, total FDI (main text, Figure 3) received in the 3 years from 2005 to 2007 totaled almost \$800 million, an amount equal to the total FDI received over the 14 years from 1990 to 2004. The inflow of FDI in 2007 rose by \$38.1 million from that of 2006, reaching \$327.7 million, of which \$81.9 million, or 25%, was loans to the Government of Mongolia. Loans from ADB and the World Bank accounted for 60.2% of the total loans.</p> <p>TDB was able to access international funding from foreign sources such as the World Bank, JBIC, EBRD, KfW, SINOSURE, USAID and IFC starting in 2006. In January 2007, TDB tapped the international capital markets, by issuing its first Euro medium-term note program, aggregating \$75 million with a 3-year maturity.</p> <p>Unfortunately, following the ADB and IFC exit from TDB in November 2006, year-on-year growth in deposits started to decline, from 43.5% in 2006 to only 14.9% in 2007.</p>
<p>1.5 Catalytic element: Contribution to the mobilization of other local or international financing to SMEs and, by positive demonstration, to market providers of debt and risk capital to SMEs.</p>	Excellent	<p>TDB is the first Mongolian bank to be included in the Global Trade Finance Program managed by IFC. Under this program, TDB was provided a transaction limit of \$5 million with a tenor of up to 3 years. As of the end of 2007, the turnover of TDB’s trade finance business amounted to \$84.3 million, representing an increase of 33.7% from \$63 million as of the end of 2006.</p> <p>TDB has an onlending program with the World Bank and JBIC to provide long-term financing to SME and other private sector clients. From the World Bank lending program, TDB has onlent \$9 million to 12 SMEs. The JBIC program, which was launched early 2008 has made \$1.5 million in loans to three SMEs.</p> <p>In 2007, TDB became the first Mongolian bank to successfully launch a public placement of debt in the international capital market. TDB pursued a high degree of reliance on wholesale funding. It issued \$75 million in registered notes through the EMTN program, to which Moody’s assigned a Ba2 rating, at a 8.63% coupon rate with maturity in 2010. The offering was several times oversubscribed and participated in by 96 investors from 13 countries. This activity of the bank contributed substantially to lowering interest rates and enabled extending longer-loan terms in</p>

Indicators	Ratings ^a	Justifications
<p>1.6 Affected laws, frameworks, regulation: Contribution to improved laws, regulation, and inspection affecting formal SME banks and banking services to SMEs in the local financial system</p>	Partly Satisfactory	<p>the financial market of Mongolia.</p> <p>There are currently no pending regulations that will further improve SME banking services. However, TDB advocates streamlining the collateral registration method, which would help alleviate logistics and legal issues. The proposed system will electronically process applications and thus reduce the number of processing days from 5 to 1.</p>
<p>1.7 Wide demonstration of new standards: Contribution to raised standards in the financial sector in corporate governance, transparency, and stakeholder relations</p>	Satisfactory	<p>TDB is focused in raising standards in risk management. It was the first bank in Mongolia to establish a dedicated risk-management department with duties segregated from the operating department or branches. It was also the first and only bank in Mongolia to utilize a risk-rating model to objectively determine the pricing of credit.</p> <p>TDB used foreign advisors to develop its risk-management and internal controls systems. From 2003 to 2006, TDB obtained managerial and technical assistance from IGA. This is how TDB initially obtained the risk-rating model, which it later modified and refined to suit credit-rating requirements for SMEs.</p> <p>TDB encourages its employees to take postgraduate courses and sends them to trainings within and outside the country to further improve their knowledge and contribute to raising Mongolia's banking sector toward world-class standard.</p> <p>TDB has no overall corporate governance structure in place. It is focused on upgrading its internal operating system to improve transaction documentation and risk management, and thereby improve the quality of the loan portfolio.</p>
<p>2. Participant Banks and Sub-borrower Impact</p>		
<p>2.1 Skills with wider impact potential: (i) Contribution to an improved SME credit approach at all stages in the participant bank(s) in ways that will be replicated by other providers of SME finance and banking service; (ii) contribution via the participant bank(s) to improved sub-borrower skills in operating their businesses, e.g., via good appraisal, conditioning, and monitoring by the bank(s).</p>	Excellent	<p>Among the first steps that TDB took to improve its SME credit approach was expanding its branch network and opening branches in areas in which SMEs mainly operated. This allowed SMEs easier access. TDB plans to expand in the next 2 years from its existing 15 branches to 30 in the city of Ulaanbaatar. In all of its SME branches, it has established a dedicated account manager, supported by both the SME and risk-management department at the head office. A unique feature that TDB introduced to the SME business model in Mongolia is the toolkit for SMEs, which is a website hosted in cooperation with IFC to provide SMEs with the latest information and communication technologies to help them learn sustainable business management practices. The SME toolkit consists of four major components: (i) An easy-to-use web and CD-ROM interface allows users to search or browse to locate the content they need. (ii) A large set of small-business tools, business forms, news items, and how-to articles is available. The articles cover the following in-demand areas of business management: accounting and finance, international business, marketing and sales, human resources, legal and insurance, operations, and technology. (iii) A content-management tool allows users to manage the website locally. (iv) A business training curriculum is available for business development service providers and SMEs.</p> <p>TDB established an investment banking department to help SMEs access funds from other sources such as the capital market. This department will enlighten SMEs on the rationale and the process of opening the company to public ownership.</p>

Indicators	Ratings ^a	Justifications
		<p>TDB was among the first institutions to introduce a credit risk-rating model. The model determines the risk rating of the SME based on the following criteria:</p> <ul style="list-style-type: none"> (i) 40% weight to quantitative factors such as profitability, liquidity, capital adequacy, asset quality, and market share, among others, and (ii) 60% weight to qualitative factors such as management experience and overall quality, retention policies and a defined career path, market and product positioning, and corporate governance and transparency. <p>The direct impact of these rating scores is translated into lower borrowing costs and lesser collateral for SMEs scoring a high rating. Prior to this model, TDB would generally require 200% collateral coverage, as opposed to 60–100% now, which provides SMEs with additional borrowing capacity.</p> <p>To help improve the skills of SMEs in accounting and financial reporting, TDB usually requests accountants of SMEs to join the account manager during due diligence sessions. The account manager gives the accountant a basic briefing on proper accounting policies and procedures based on the new financial reporting format in accordance with Mongolian Accounting Standards.</p> <p>Monitoring of SME accounts is done every 6 months by risk management analysts.</p>
<p>2.2 Demonstration and new standards-setting potential: As evident in affected and achieved standards in corporate governance and transparency, stakeholder relations, and in ESHS spheres</p>	Partly Satisfactory	<p>TDB is considered a leader in setting the standard for risk management. However, in areas of corporate governance and internal controls, TDB still needs to make more effort.</p> <p>Despite obtaining managerial and technical assistance from IGA to assist in areas of corporate governance, corporate lending, treasury and operational risk management, TDB has not produced a formal corporate governance policy. Board structure has neither an independent director nor a chairman.</p>
Overall Rating	Satisfactory	<p>ADB's role in the project was consistent with Government priorities as well as ADB strategy for private sector development. TDB can be considered a leader in support of SME activities. It acted as a catalyst in sourcing external funds to provide financing to growing SMEs. However, TDB needs to improve its governance structure by articulating a corporate governance policy, electing an independent director to its board, and preparing operating procedures that address not only risk management but also operating controls.</p>

EBRD = European Bank of Reconstruction and Development, ESHS = Environmental, Social, Health, and Safety, EMTN = Euro medium-term note, FDI = foreign direct investment, GDP = gross domestic product, IAS = International Accounting Standards, IFC = International Finance Corporation, IGA = ING Institutional and Government Advisory Services, JBIC = Japan Bank for International Cooperation, KfW = Kreditanstalt für Wiederaufbau, MNT = Mongolian togrog, nonperforming loan, SINOSURE = China Export & Credit Insurance Corporation, SMEs = small and medium-sized enterprises, TDB = Trade and Development Bank of Mongolia, USAID = United States Agency for International Development.

^a Ratings scale: excellent, satisfactory, partly satisfactory, unsatisfactory. The rating is not an arithmetic mean of the individual indicator ratings, which have no fixed weights. It considers manifest actual impact, positive or negative; the potential impact; and the risk to its realization.

INDUSTRY REVIEW

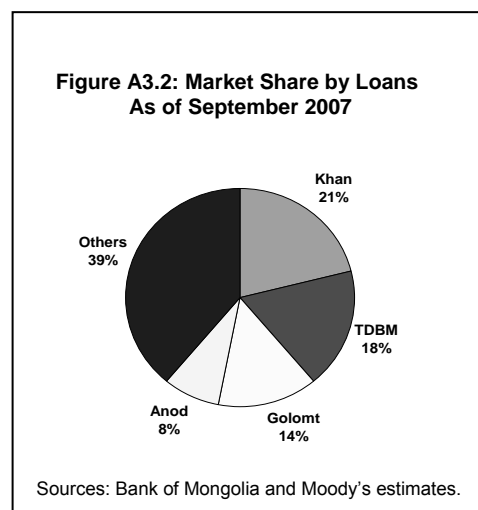
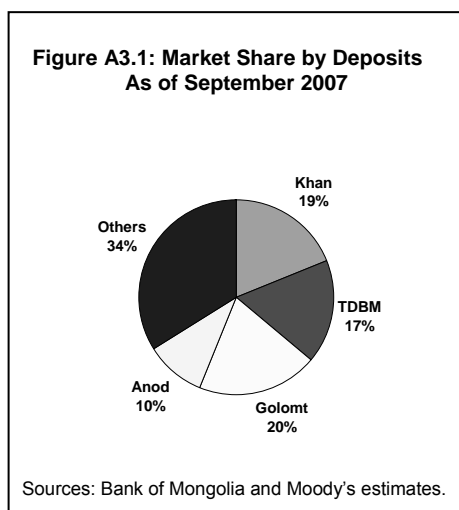
1. In the early 1990s, the state mono-bank¹ split into one central bank and several commercial banks and issued licenses to some small private commercial banks. Because of the lack of effective regulations or expertise, poor practices, mismanagement, and external shocks such as volatility in commodity prices and bad weather, three major banking crises occurred between 1992 and 1999. In 1999, reported nonperforming loans in the banking system reached 51%. The crises seriously undermined public confidence and the system.

2. The regulator, Bank of Mongolia, made massive changes to the system including licensing structure, disclosure, internal controls, prudential ratios, and on-site examinations. By the end of 2006, nonperforming loan ratios had declined to 5%.

A. Competition in the Banking Sector

3. The Mongolian financial sector has 16 commercial banks, 150 nonbank financial institutions and 700 savings and credit cooperatives. Banks represent most of the country's financial services. Competition is high as a result of excessive liquidity and a limited corporate customer base. This has undermined interest margins for the past 3 years.

4. The four largest banks—Khan Bank, Trade and Development Bank of Mongolia (TDB), Golomt Bank, and Anod Bank—dominate the banking sector with a market presence of 60%. Consolidation, encouraged by the regulator, is likely to continue and create larger and potentially stronger banks.



B. Profitability in the Banking Sector

5. The Mongolian banking sector has expanded rapidly. In 2007, money supply increased by 56.3% and currency in circulation by 48.5%. Total loans outstanding increased by 68.1%, of which loans to private sector increased by 83.3%.

6. Aggregate banking system profit rose to MNT54.9 billion in 2007 from MNT11 billion in 2002, for a compounded annual growth rate of 38% for the 5-year period. During 2000–2007, total deposits in the banking system increased fourteenfold to MNT2,225.7 billion from MNT157.9 billion. Loans, on

¹ A monobank system is a state-owned bank that functioned as a country's central bank as well as nationwide commercial and investment bank.

the other hand, which totaled to MNT66.8 billion in 2000, grew to MNT2,055.3 billion in 2007 at a compounded annual rate of 63.1% for the 7-year period.

Table A3: Year-on-Year Credit and Deposit Growth of the Banking Sector
(MNT million)

Item	2000	2001	2002	2003	2004	2005	2006	2007
Loans	66,757	135,071	231,450	442,148	606,799	859,852	1,222,342	2,055,278
% year-on-year	(13.9)	102.3	71.4	91.0	37.2	41.7	42.2	68.1
Deposits ^a	157,909	221,904	349,342	571,836	703,520	1,017,769	1,351,613	2,225,730
% year-on-year	18.8	40.5	57.4	63.7	23.0	44.7	32.8	64.7
Loan to Deposit ratio (%)	42.3	60.9	66.3	77.3	86.3	84.5	90.4	92.3

^a Deposits include current, savings, and time deposits.

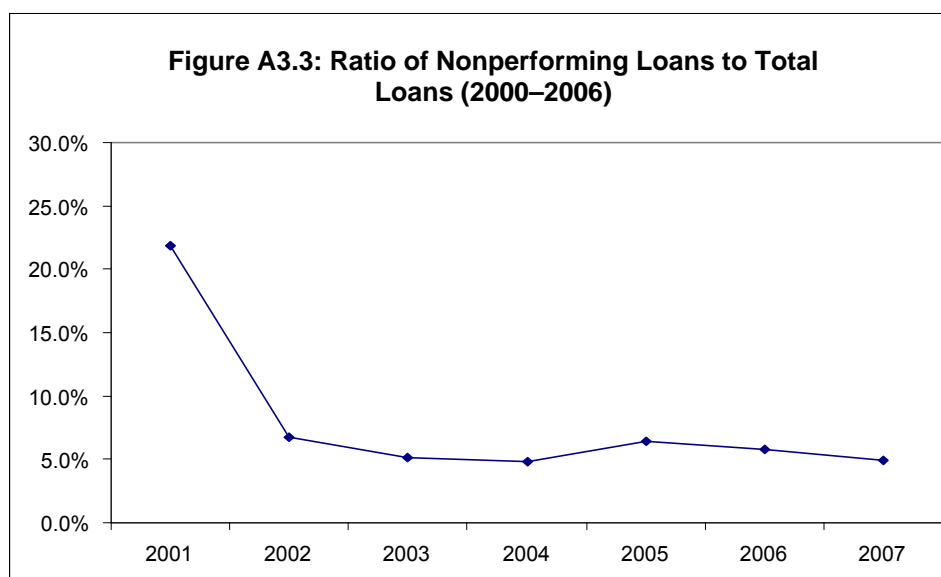
Source: Bank of Mongolia.

7. However, the sustainability of this profitable banking system has faced challenges in recent years as competition has risen due to excessive liquidity. Margin compression has appeared, prompting banks to pursue high-volume growth and offer differentiated products. The former is relatively easy to achieve, but the latter may require some time to bear fruit.

C. Asset Quality in the Banking Sector

8. The banking sector has shown substantial improvement in asset quality. Its nonperforming loans (NPLs) fell to 3.6% in the first half of 2007 from 21.9% in 2001. The NPL coverage ratio—or loan provisions over NPLs or over NPLs plus loans past due—has exhibited a downward trend. However, loan provisioning should catch up with significant loan growth and the expected emergence of past-due and nonperforming loans.

9. Overall, the sector's asset quality may be weaker than reported if one considers credit costs to the business cycle and the dilution effect on its NPL ratio due to the remarkable growth in loans.

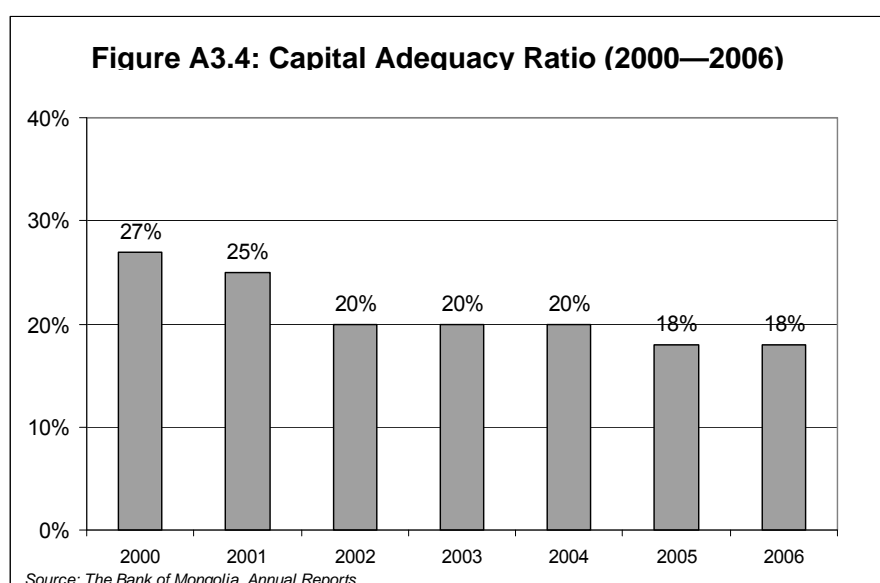


D. Capital Position of the Banking Sector

10. The Mongolian economy is highly reliant on a few sectors: commodities, wholesale and retail trade, and agriculture. Therefore, strong capital coverage is an important consideration in terms of its ability to absorb unexpected losses during any downturn, particularly after a substantial high-growth stage.

11. Currently, banks generally have adequate capital positions, partly strengthened by equity raisings and improvements in earnings.

12. However, the growth in the sector's risk-weighted assets is much faster than the pace of internal capital formation. If this assets-to-capital mismatch continues, many banks will need to supplement their capital in the next 5 years. The sector's average capital to risk-weighted assets ratio (CAR) declined to around 18% in 2006, from over 20% in 2004.



E. New Banking Regulations

13. The Bank of Mongolia is responsible for regulating and supervising banking in Mongolia. Currently, the Bank of Mongolia is attempting to strengthen its regulatory capacity by (i) upgrading its bank supervision process, (ii) introducing a loan classification and loan loss provisioning system, (iii) introducing prudential norms, and (iv) improving enforcement procedures.

14. Loan loss reserve requirements have tightened. Performing loans require 1% reserve, while overdue loan provisions have increased to 5% from the previous 1%. Loans must be classified as overdue once interest is overdue even if the principal payment is up to date. These changes reflect a more prudent regulatory system.

15. Prudential norms, particularly the CAR, closely mirror key international norms. The minimum CAR for commercial banks is 5% for tier 1 ratio and 10% for the total capital ratio, or more than double the 2% and 4% before reform. Additionally, the minimum capital requirement of each bank was

raised from MNT4 billion to the current MNT8 billion. This is to enhance financial stability and competitiveness.

16. There are reports that total capital ratio will be increased to 12% in 2009 to further improve the capital bases of the banks and precipitate consolidation among smaller banks.

FINANCIAL STATEMENTS

1. The summary of income statement, balance sheet, and cash flow statement of TDB between 2004 and first half of 2008 are presented in Table A4. Also reported are the key financial ratios and net asset value per share for the same period.

Table A4: Trade and Development Bank of Mongolia Financials, First Half of 2008

Income Statement (MNT million)	2004		2005		2006		2007		6 months ending 30Jun08
	Actual	Plan	Actual	Plan	Actual	Plan	Actual	Plan	Actual
Interest Income	16,163	16,117	21,892	20,752	36,037	20,752	47,323	22,318	32,184
Interest Expense	4,262	5,117	6,291	6,390	14,589	6,390	26,676	6,229	15,614
Non Interest Income	5,535	5,765	7,069	8,265	8,862	8,265	10,426	9,322	105
Non Interest Expense	8,692	8,061	10,255	9,692	12,190	9,692	13,697	11,100	6,608
Net Provisions	1,354	1,203	2,093	1,325	1,631	1,325	(2,572)	419	54
Tax	2,033	2,250	2,943	3,483	4,716	3,483	3,552	4,167	2,050
Net Income	5,357	5,251	7,379	8,127	11,773	8,127	16,396	9,725	7,963
Balance Sheet									
(MNT million)									
Net Loans	87,032	80,698	156,727	108,508	240,106	126,221	382,308	138,065	476,018
Total Assets	184,273	250,260	302,778	286,112	426,292	318,074	563,503	349,234	644,434
Deposits	135,374	207,200	226,233	236,909	324,669	260,600	373,019	281,869	397,983
Subordinated Loan	9,672	10,512	9,768	10,512	9,320	10,512	9,360	10,512	9,265
Total Liabilities	161,543	228,526	264,937	258,361	376,592	282,196	503,233	303,631	576,737
Shareholders Equity	22,731	21,734	37,841	27,752	49,700	35,878	60,270	45,602	67,698
Ratio Analysis (%)									
Return on Assets	2.9	2.3	3.0	2.2	3.2	2.7	3.3	2.9	1.3
Return on Equity	23.6	29.6	24.4	24.0	26.9	25.5	29.8	23.9	12.4
Interest Margin	6.5	4.9	6.4	5.0	5.9	4.8	4.2	4.8	2.7
NPL/Gross Loans	9.5	18.0	7.2	17.0	4.4	16.0	2.0	15.0	2.3
Growth in Net Loans	59.1	47.6	80.1	34.5	53.2	16.3	59.2	9.4	24.5
Growth in Deposits	-22.9	16.0	67.1	14.3	43.5	10.0	14.9	8.2	6.7

NPL = Non performing loan.

Source: Trade and Development Bank of Mongolia.