ASIAN DEVELOPMENT BANK PPA: MON 28200

# PROGRAM PERFORMANCE AUDIT REPORT

ON

FINANCIAL SECTOR PROGRAM
(Loan 1509-MON[SF])

IN

MONGOLIA

October 2003

## CURRENCY EQUIVALENTS

Currency Unit – togrog (MNT)

| | | In RRP (15 November 1996) | In PCR (17 July 2000) | At OEM (30 April 2003) |
|---|---|---|---|---|
| MNT1.00 | = | $0.0015 | $0.0009 | $0.0009 |
| $1.00 | = | MNT651 | MNT1,070 | MNT1,135 |

## ABBREVIATIONS

| | | |
|---|---|---|
| ADB | – | Asian Development Bank |
| BITI | – | Bank of Investment and Technological Innovation |
| BOM | – | Bank of Mongolia |
| BRB | – | bank restructuring bond |
| BTC | – | Bank Training Center |
| CAMEL | – | capital adequacy, asset quality, management, earnings, and liquidity |
| COS | – | country operational strategy |
| EA | – | executing agency |
| ESAF | – | enhanced structural adjustment facility |
| IMF | – | International Monetary Fund |
| MARA | – | Mongolian Asset Recovery Agency |
| MOFE | – | Ministry of Finance and Economy |
| MOJ | – | Ministry of Justice |
| NPL | – | nonperforming loan |
| OEM | – | Operations Evaluation Mission |
| PCR | – | program completion report |
| PPAR | – | program performance audit report |
| RRP | – | report and recommendation of the President |
| TA | – | technical assistance |
| TDB | – | Trade and Development Bank |

## NOTES

(i) The fiscal year (FY) of the Government and its agencies ends on 31 December.

(ii) In this report, "$" refers to US dollars.

**Operations Evaluation Department, PE-630**

## CONTENTS


| | | Page |
|---|---|---|
| BASIC DATA | | ii |
| EXECUTIVE SUMMARY | | iii |
| I. | BACKGROUND | 1 |
| | A. Rationale | 1 |
| | B. Formulation | 2 |
| | C. Objectives and Scope | 2 |
| | D. Financing Arrangements and External Agency Coordination | 2 |
| | E. Program Completion Report | 3 |
| | F. Operations Evaluation | 3 |
| II. | PLANNING AND IMPLEMENTATION PERFORMANCE | 4 |
| | A. Effectiveness of Design | 4 |
| | B. Policy Reform Measures | 5 |
| | C. Program Management | 6 |
| III. | PROGRAM RESULTS | 7 |
| | A. Performance Indicators | 7 |
| | B. Impact of Policies | 8 |
| | C. Institutional Impact | 13 |
| | D. Socioeconomic and Environmental Impacts | 15 |
| | E. Counterpart Funds | 16 |
| | F. Sustainability | 16 |
| IV. | KEY ISSUES FOR THE FUTURE | 17 |
| | A. Rapid Growth in Loans | 17 |
| | B. Deposit Insurance | 17 |
| | C. Ambiguities in Financial Contracts | 17 |
| V. | CONCLUSIONS | 17 |
| | A. Overall Assessment | 17 |
| | B. Performance of the Asian Development Bank and the Executing Agency | 18 |
| | C. Key Lessons Learned | 19 |
| | D. Follow-Up Actions | 21 |
| APPENDIXES | | |
| 1. | Financial Sector Technical Assistance in Mongolia (1991–1996) | 22 |
| 2. | Policy Matrix for the Mongolian Financial Sector Program Loan | 23 |
| 3. | Status of Second Tranche Conditions | 27 |
| 4. | Prudential Ratios of Commercial Banks | 31 |
| 5. | Commercial Banking Licenses | 32 |
| 6. | Balance Sheet for Commercial Banks | 33 |
| 7. | Income Statement for Commercial Banks | 34 |
| 8. | Outstanding Loans by Commercial Banks | 35 |

## BASIC DATA

## Loan 1509-MON(SF): Financial Sector Program

**Program Preparation/Institution Building**

| TA No. | TA Project Name | Type | Person-Months | Amount[1] ($) | Approval Date |
|---|---|---|---|---|---|
| 2720 | Strengthening the Supervisory and Restructuring Capacity of Bank of Mongolia | ADTA | 38.0 | 1,000,000 | 19 Dec 1996 |
| 1510 | Upgrading Skills and Systems of Commercial Banks | TA Loan | 51.0 | 3,000,000 | 19 Dec 1996 |

| **Key Program Data** ($ million) | **As per ADB Loan Documents** | **Actual** |
|---|---|---|
| Total Program Cost | 35.0 | 35.0 |
| ADB Loan Amount/Utilization | 35.0 | 35.0 |

| **Key Dates** | **Expected** | **Actual** |
|---|---|---|
| Reconnaissance | | 26 Aug–9 Sep 1995 |
| Fact-Finding | | 16–26 Apr 1996 |
| Appraisal | | 20 Aug–6 Sep 1996 |
| Loan Negotiations | | 11–14 Nov 1996 |
| Board Approval | | 19 Dec 1996 |
| Loan Agreement | | 21 Jan 1997 |
| Loan Effectiveness | 21 Jan 1997 | 21 Jan 1997 |
| First Tranche Release | | 10 Feb 1997 |
| Second Tranche Release | 31 Dec 1998 | 30 Jul 1999 |
| Loan Closing | 30 Jun 1999 | 30 Jul 1999 |
| Program Completion | 30 Jun 1999 | 30 Jul 1999 |
| Months (effectiveness to completion) | 29 | 30 |

**Borrower** Mongolia

**Executing Agency** Bank of Mongolia (Central Bank)

**Mission Data**

| **Type of Mission** | **No. of Missions** | **Person-Days** |
|---|---|---|
| Reconnaissance | 1 | 30 |
| Fact-Finding | 1 | 66 |
| Appraisal | 1 | 108 |
| Project Administration | | |
| - Review | 6 | 44 |
| - Policy Consultation | 3 | 66 |
| - Project Completion | 1 | 10 |
| Operations Evaluation[2] | 1 | 24 |

ADB = Asian Development Bank, ADTA = advisory technical assistance, PPTA = program preparatory technical assistance, TA = technical assistance.

[1] Represents approved amount of technical assistance.

[2] The Mission comprised H. Hettige (Senior Evaluation Specialist/Mission Leader) and P. Vonckx (Staff Consultant/Financial Sector Specialist).

## EXECUTIVE SUMMARY

The commercial banks that resulted from the divestiture of the financial system in Mongolia inherited numerous nonperforming loans (NPLs) from the monobanking system. In addition, during the first half of 1990s, the Government requested that commercial banks provide directed loans to poorly performing enterprises. Due to the weak institutional capacity of the banks, many of the other loans they approved also became nonperforming. By the mid-1990s, these factors damaged the solvency and the stability of the banking system, and the banks were unable to meet prudential norms. Five of the 12 banks—and four of the largest five—could not meet the liquidity ratio of 20% set by the Bank of Mongolia (BOM). The Government was concerned that the anticipated closure of major banks would trigger a run on viable banks. To restore confidence in the system quickly, the Government initiated financial sector reforms. In December 1996, the Asian Development Bank (ADB) approved a Financial Sector Program (the Program) loan of $35 million from ADB's Special Funds resources to support the Government's initiatives.

The Program aimed to promote a sound, market-based, and efficient financial system to mobilize and allocate resources. However, the reforms focused only on the banking system instead of the entire financial system, possibly because the banking system was in crisis by 1996. The Program focused on (i) making the legal and regulatory framework for banks consistent with international standards; (ii) reducing the Government's involvement, while encouraging adherence to market principles and commercializing the banking system; and (iii) facilitating bank restructuring to strengthen viable banks and close insolvent banks. The Program comprised 66 policy actions: 41 were preconditions, 12 were linked to the release of a second tranche, and 13 were to be undertaken during the 3-year program period. To help support the Program, ADB provided (i) a technical assistance (TA) grant (TA 2720-MON) of $1 million to strengthen the supervisory capabilities of BOM; and (ii) a TA loan (TA 1510-MON) of $3 million from ADB's Special Funds resources to upgrade the skills and systems of commercial banks to meet program requirements.

The Program's design had positive and negative features. On the positive side, the new Government displayed a willingness to bear the necessary costs of structural adjustments in the banking system, opening a window of opportunity for the Program in the second half of 1996. Within the banking system, the Program was also comprehensive, covering the initial reforms needed in BOM, commercial banks, and the legal and regulatory systems governing the banking transactions. On the negative side, a comprehensive needs assessment for the entire financial sector should have been conducted earlier. The Program then could have focused on a sequence of reforms in each subsystem, rather reacting to address the immediate needs of the banking system. The design also made insufficient arrangements to implement the reforms and generate the desired outcomes. While the TA grant provided consultant support to strengthen the capacity of BOM, the TA loan funding was insufficient to cover the basic training of the commercial banks and the introduction of banking software packages as outlined.

Restructuring was a major component of strengthening financial intermediaries. The closure of two failing banks in December 1996 and the relatively orderly transfer of deposits to two new institutions may have averted a more serious banking crisis in Mongolia in early 1997. The creation of the Mongolian Asset Recovery Agency (MARA) and the issuance of bank restructuring bonds (BRBs) allowed the bad loans to be isolated in a separate institution that could focus solely on their resolution.

However, the creation of the two new banks, Reconstruction Bank and Savings Bank, to absorb the performing loans and the deposits of the two failed banks was implemented poorly. Many of the Reconstruction Bank employees were former employees of the two failed banks. Within a year, Reconstruction Bank built a portfolio of new problem loans, adding to the ones it had unknowingly inherited. Reconstruction Bank was closed in 1999. Meanwhile, Savings Bank absorbed all the household deposits of the failed banks and was backed by BRBs. It was not granted a lending license at the outset to help assure depositors that it was a safe place for their savings. Over the years, however, Savings Bank experienced profitability and cash flow problems, as its loan portfolio and deposits did not grow as quickly as other banks. Savings Bank has loans outstanding amounting to 13% of its deposit base. A feasible resolution would be to create packages of deposits for private sale to other banks accompanied by a corresponding amount of BRBs.

The Program has contributed to deepening the financial system due to the increased confidence in the banking system. While the broad money supply grew by 42% in 2002, compared to 20% in 1997, its ratio to gross domestic product increased to 29% from 20% over the same period. However, inflation remained under control with an annual rate of 1.6% in 2002, compared to 36.6% in 1997. Meanwhile, the total deposits in the banking system grew almost threefold to MNT353 billion in 2002 from MNT123 billion in 1997. The rising confidence in the banking system resulted from the increased regulatory capacity of BOM and the strengthening of financial intermediaries. While the Program spearheaded the initial reforms that contributed to these improvements, the follow-up development assistance helped to sustain the impact of the reforms.

With the foundation built under the Program, BOM has strengthened its regulatory capacity, particularly in the last few years, by upgrading its (i) bank supervision process; (ii) loan classification and loan loss provisioning system; (iii) prudential norms; and (iv) enforcement procedures. The number of staff supervising the 16 banks and their branches has increased significantly, and they have undergone more training than in the past. Bank examinations now are driven more by risk assessment than compliance with regulations. Loan loss reserve requirements have increased. Performing loans now require a 1% reserve, while overdue loan provisions have increased to 5% from 1%. Loans must be classified as overdue if interest is overdue, even if the principal is up to date. These changes reflect greater prudence with a focus on obtaining earlier indications of loan problems. Prudential norms introduced in 1996 closely mirror key international norms, particularly the capital adequacy principle. The minimum capital adequacy ratios for commercial banks are 5% for the tier 1 ratio and 10% for the total capital ratio, compared to 2% and 4%, respectively before the Program. The banking system, as a whole, has been in compliance since 2000.

The banking system is now stronger and all banks have been in substantial compliance with prudential norms for 3 years. Aggregate profit for the system rose to MNT11.0 billion in 2002 from MNT2.3 billion in 1997. Net commercial bank loans, which totaled MNT40 billion in 1997, grew to MNT54 billion in 2000 and to MNT223 billion in 2002, providing a significant boost to economic development through financial intermediation. Reflecting the heightened economic activity, the growth in gross domestic product (excluding agriculture) accelerated to 9.4% in 2002 from 1.7% in 1998. Despite the growth in lending, banks could expand their loan portfolios further, as the liquidity for the banking system in 2002 was at 46% of all deposits—well above the minimum regulatory level of 18%. NPLs have declined as a percentage of total loans to 7.2% in 2002 from more than 40% in 1997. Meanwhile, banks are cautious due to lingering inefficiencies in the intermediation process. The efficiency of the banking system depends on a speedy resolution of NPLs and legal conflicts. Unfortunately, the laws on the foreclosure by

banks on immovable and movable assets they hold as collateral are not satisfactory. This has seriously hampered the banks' ability to recover loans from troubled borrowers.

Several legal reforms in the banking system, such as amendments to the Civil Law to allow banks to foreclose on immovable property without a court decision, were initiated under the Program and carried out in 2001. However, the New Civil Code of September 2002, while including the previous article, introduced another article that is contradictory. The resulting ambiguity was a major step backward for the banks, and removed a strong incentive for borrowers to meet their commitments. Similarly, the initial actions taken under the Program to reform bankruptcy laws related to movable property have not led to the envisaged impact. The delays and changes in the laws and procedures have made banks more conservative, partly explaining the high liquidity and the high spreads in the banking system.

The reduction in the proportion of NPLs is largely a function of the increase in loans outstanding. In absolute terms, NPLs have nearly doubled to MNT20.0 billion in March 2003 from MNT10.8 billion in December 2001. This increased lending raises new concerns, as many of the loans made in 2002 may not have matured by the end of 2002 and could become problems in 2003. Although the high capital and liquidity ratios provide a cushion against a downturn, the BOM must follow this development vigilantly. The growth in loans needs to be accompanied by increases in the trained staff of BOM to supervise the banks. BOM should consider more examinations of the weaker banks and tightening further its classification and provisioning regulations. BOM and the banking system would benefit from being proactive now rather than reactive later.

The institutional development and other impacts under the Program were significant. They were initiated by a TA grant and a TA loan attached to the Program. The TA grant facilitated the preparation of necessary tools for the banking system, such as bank supervision training modules for BOM, accounting manuals for commercial banks, and a regulatory framework for nonbank financial institutions. However, the TA loan had insufficient funds to achieve its multiple objectives. In the end, however, the TA loan contributed to the successful creation of a sustainable banking training center and the introduction of an integrated banking software system in a few banks.

The Program was relevant and urgently needed. However, it had some design weaknesses. Although the soundness of the banking system improved under the Program, it is still inefficient. As a result, the Program is assessed as less efficacious. To improve the efficiency of the banks, problems in the legal system have to be addressed. With persistence and follow-up activities, institutional strengthening appears to have been achieved. If the banking system continues to comply with prudential norms and regulations, its sustainability is likely. Based on the relevance, efficacy, efficiency, institutional development and sustainability of the Program, the overall assessment rating is successful.

Lessons learned include:

(i) Development agencies should assist governments in obtaining early public support for tough reforms to provide a better choice of strategies;
(ii) Early attention should be given to the long-term sustainability of institutions formed during the reform process;
(iii) TAs should be tightly focused to maximize effectiveness and should be accompanied by a strong commitment from senior management to incorporate the results of training into daily activities;

(iv) Senior management should receive special training on software to obtain their support for installing new software;
(v) Coordinated enterprise reform and accounting reform should be used to maximize the benefits of the banking system reform;
(vi) An environment should be established that enables quick debt recovery, shorter realization of collateral, and access to an up-to-date credit bureau to achieve efficiency of financial intermediation; and
(vii) Resident missions should monitor reforms to ensure that there is no backsliding.

Follow-up actions recommended are (i) to immediately assess MARA to determine when collection efforts on this portfolio should cease, (ii) to include overdue legal reforms as preconditions for any new loans to the sector, and (iii) to study the recent loan growth in the banking system to understand the source of the new lending.

# I. BACKGROUND

## A. Rationale

1. Mongolia began the transition to a market economy in 1991. Like other centrally planned economies, Mongolia had adopted a Soviet-style monobanking system in which the State Bank of Mongolia conducted all banking business. The shift to a two-tiered banking system, and the divestiture of the financial and banking services from the former State Bank of Mongolia in 1991, were the Government's first steps in reforming the financial sector. The commercial banks that resulted from the divestiture inherited numerous nonperforming loans (NPLs) from the monobanking system. During the first half of the 1990s, the Government also requested that commercial banks provide directed loans to poorly performing enterprises.[1] In addition, the banks approved a large number of other loans that also became nonperforming. By the mid-1990s, the increase in NPLS had damaged the solvency and the stability of the banking system. Banks were unable to meet prudential norms.

2. In 1996, the banking system in Mongolia had 12 commercial banks, including 5 that were considered large.[2] With many banks facing severe liquidity problems, public confidence in the banking system was very low. Five of the 12 banks—and four of the five largest banks—could not meet the liquidity ratio of 20% set by the Bank of Mongolia (BOM), the central bank. Banks began to rely increasingly on BOM for liquidity support. As of 30 June 1996, BOM loans accounted for about 12% of total liabilities of commercial banks. The Government was concerned that the anticipated closure of some major banks would trigger a run on viable banks. Confidence had to be restored urgently for the banks to attract deposits and effectively intermediate between savers and borrowers. With a banking crisis looming, the Asian Development Bank (ADB) approved the Financial Sector Program (the Program) loan in 1996 to support the Government's reform initiatives. The Program was intended to (i) complement the Government's macroeconomic stabilization and adjustment reforms that were being supported by the International Monetary Fund (IMF);[3] (ii) reform the legal, regulatory, and policy environment for the banks; and (iii) strengthen banks by improving the commercial orientation, efficiency, and prudence of their operations.

3. The Program was compatible with ADB's country operational strategy (COS). Following ADB's interim COS of 1991, which supported the restructuring of the economy, the 1994 COS aimed to utilize resources more efficiently and to support the development of a competitive private sector. These COSs expressed general support for the financial sector, suggesting technical assistance (TA) in policy and regulatory reform. ADB's strategy also (i) recognized the important role of the financial sector in facilitating and supporting growth in other sectors of the economy, and (ii) acknowledged the importance of establishing internationally acceptable accounting standards and practices in commercial banks.[4]

---

1 Directed loans are those which the Government requests the banks to lend, especially to state-owned enterprises despite banks' misgivings about their repayment capability.

2 The five large banks were Agricultural Bank, Bank of Investment and Technology Innovation, Insurance Bank, People's Bank, and Trade and Development Bank.

3 Under IMF guidance, the budget deficit dropped to 11% of gross domestic product (GDP) in 1995 from 23% in 1994. A surplus was recorded in 1996. The current account deficit, however, increased to 6.8% of GDP in 1995 from 5.8% in 1994, but this was offset by external capital flows, most of which were on concessional terms.

4 ADB. 2002. *Country Assistance Program Evaluation in Mongolia*. Manila.

## B. Formulation

4. ADB has been assisting Mongolia with the financial sector since 1991. Before formulating the Program, ADB granted TAs amounting to $4 million for the financial sector (Appendix 1). A major part of the TAs was used to review the loan portfolios of relevant banks. An appraisal mission was approved in August 1996 following parliamentary elections. The new Government showed the political will to undertake banking reforms. To reduce the risk of implementation delays, enactment of the proposed banking legislation—a key component of the Program—was a precondition for Board consideration. The new banking legislation was enacted in September 1996. During processing, management expressed concern that the liquidation of several banks might make it difficult for the small banking subsector to service the needs of the economy.[5] The staff processing the Program eased this concern, indicating that they did not envisage widespread liquidation of banks. Although the IMF's enhanced structural adjustment facility (ESAF) was not finalized in February 1997, ADB was satisfied that the macroeconomic conditions were in place given IMF's support for the Program. By the last quarter of 1996, many of the conditions for Board consideration in the policy matrix had been met, and the Program was approved with full support from the Board in December 1996. Of the Program's 66 policy actions, 41 were complied with by Board approval. Another 12 actions were specified as part of a second tranche release, while 13 actions were to be undertaken during the 3-year program period.[6] In addition to the program loan, ADB provided a TA grant[7] of $1 million to strengthen BOM's bank supervisory capabilities. ADB also provided a TA loan[8] of SDR2.074 million ($3 million equivalent) from its Special Funds resources with the program loan to upgrade the skills and systems of commercial banks.

## C. Objectives and Scope

5. The report and recommendation of the President indicated that the Program aimed to promote the establishment of a sound, market-based financial system that could mobilize and allocate resources efficiently to achieve economic growth. However, the reform measures focused narrowly on the banking system. The Program supported the Government's efforts to introduce a policy, legal, and regulatory framework that encourages the development of a market-oriented banking system. This required a change in the Government's role in the banking subsector—from allocating credit to regulating the banking institutions that allocate credit according to commercial considerations. To achieve these objectives, the Program focused on (i) bringing the legal and regulatory framework for the banks up to international standards; (ii) facilitating bank restructuring to strengthen viable banks and close insolvent banks; and (iii) reducing the Government's involvement, while encouraging adherence to market principles and commercializing the banking system.

## D. Financing Arrangements and External Agency Coordination

6. In December 1996, ADB provided a program loan of SDR24.2 million ($35 million equivalent) from its Special Funds resources to support the policy reforms envisaged in the Program. The loan had a maturity of 40 years, including a grace period of 10 years, and carried

---

[5] At the end of 1995, commercial bank deposits in Mongolia represented only 15% of gross domestic product compared to 40% for the Philippines and 76% for Malaysia.

[6] The only additional action taken during 1999 was to increase minimum tier 2 capital to 4% of risk weighted assets, complying with the Bank for International Settlements' standards.

[7] TA 2720-MON: *Strengthening the Supervisory and Restructuring Capacity of the Bank of Mongolia*, for $1,000,000, approved on 19 December 1996.

[8] TA Loan 1510-MON: *Upgrading Skills and Systems of Commercial Banks*, for $3 million, approved on 19 December 1996.

a service charge of 1% per annum. It was to be released in two equal tranches. The first tranche was to be available upon loan effectiveness, while the second would be released by December 1998 if the Program were implemented satisfactorily. The proceeds of the loan were to be used for a broad range of imports, subject to a negative list of items.

7. ADB keenly followed the negotiations between the Government and IMF on the finalization of a short-term program to address the banking system crisis. The strength of that program had a direct bearing on the ADB program loan and some of its conditions. In addition to coordinating with IMF on ESAF (para. 4), ADB coordinated with the World Bank and IMF regarding the TA for building institutional capacity in the banks. This involved sharing consultant reports, conducting simultaneous missions, and coordinating policy dialogue. Recognizing that successful financial sector reforms require parallel efforts to reform the enterprise sector, the World Bank complemented ADB's focus on banking system reforms by supporting the Government's enterprise and legislative reforms. This coordination generally continued even to the second financial sector program loan,[9] where the World Bank and ADB agreed to review each other's policy matrix and agree on them prior to approval by their boards.

### E. Program Completion Report

8. The Program Completion Review Mission was held in July 2000, and the program completion report (PCR) was circulated in December 2000. The PCR was comprehensive in scope, and rated the Program as successful. It accurately described the bank restructuring effort and its three phases (para. 20). The PCR focused on the flexibility, diligence, creativity, and determination of the ADB staff managing the Program. However, the report overstated the effectiveness of the Program in some areas, especially regarding the legal reforms. For example, it stated that the draft law on secured transactions for movable property was complied with, although a partial waiver of this condition was sought at the time of second tranche release (para. 30). In fact, this law still has not been passed, and a new draft is being prepared. The PCR also gave little emphasis to the complications that occurred during the implementation of the TA loan, which delayed the pilot computerization of the Trade and Development Bank (TDB) by more than 2 years. The PCR measured program success by showing the status of actions taken by the second tranche rather than focusing on outcomes. However, the lessons learned and recommendations identified in the PCR were thoughtful and constructive for future loans in the financial sector.

### F. Operations Evaluation

9. In April 2003, the Operations Evaluation Mission (OEM) met with the Executing Agency (BOM) and other financial sector participants, such as the Ministry of Finance and Economy (MOFE), Agricultural Bank, Anod Bank, Capital Bank, Capitron Bank, Golomt Bank, Mongolia Asset Recovery Agency (MARA), Ministry of Justice (MOJ), State Property Commission, TDB, Mongol Post Bank, and Zoos Bank. The OEM also met with ADB's Mongolia Resident Mission and the resident missions and officers of the European Bank for Reconstruction and Development, IMF, and World Bank. This program performance audit report (PPAR) focuses on the banking system reforms that were the subject of this Program. For a broader evaluation of ADB assistance to Mongolia, see the Operations Evaluation Department's Country Assistance Program Evaluation.[10] The primary purpose of the evaluation was to identify the strengths and the weakness of the Program and to extract lessons for ADB's future operations in Mongolia, as well as in similar sectors of other countries. The Program was assessed based on (i) the need

---

[9] Loan 1743-MON: *Second Financial Sector Reform Program*, for $15 million, approved on 22 June 2000.
[10] ADB. 2002. *Country Assistance Program Evaluation in Mongolia*. Manila.

for the Program and the effectiveness of its design (relevance), (ii) the achievement of program purpose and production of outputs (efficacy), (iii) efficiency, (iv) sustainability, and (v) the Program's contribution to institutional strengthening and other impacts. The draft PPAR was circulated to the relevant departments in ADB and to the Government and other stakeholders. Comments received were considered in finalizing the PPAR.

# II. PLANNING AND IMPLEMENTATION PERFORMANCE

## A. Effectiveness of Design

10. The Program aimed to promote a sound, market-based, and efficient financial system. It contained primarily policy conditions, which were to be supported by TAs for implementation. The design of the Program had several positive features that led to its implementation in a reasonable time and generated a majority of the impacts that were envisaged. However, some weaknesses in the design were also apparent.

11. **Absence of a Holistic Approach.** Although ADB had been working with the financial sector in Mongolia since 1991, little or no comprehensive economic sector work was done at the time of program formulation. The TAs approved for the sector focused solely on identifying the needs of individual banks.[11] There was no needs assessment for financial sector development that focused on the necessary preconditions and the sequencing of reforms. As a result, when the banking system was in crisis, the Program was reactive in addressing the sector's immediate needs and providing crisis support. A proactive financial sector development strategy could have been initiated earlier. More attention should have been paid to strategically sequencing reforms—such as the entry of private banks, the liberalization of interest rates and other regulatory reforms, and capacity building—to ensure that the preconditions were in place for implementing each one.

12. **Comprehensiveness of the Banking Reforms.** Focusing narrowly on the banking system, the Program was comprehensive, covering commercial banking, bank supervision, and legal issues. In addition to restructuring efforts, the conditionalities addressed liquidity problems and the impact of NPLs on the banking system. In terms of strengthening the legal and regulatory framework, several reforms were suggested to facilitate debt recovery and improve banking supervision. The reforms initiated in 1996 included amendments to the Civil Code, the removal of interest rate floors on time deposits, and other steps that gave commercial banks greater autonomy to determine interest rates. The Program also sought to reduce Government influence in the banking system.

13. **A Window of Opportunity.** The Government's banking system reforms began in 1990 with the shift from a monobanking system to a two-tier system. However, the political will to reform the legal and regulatory system, restructure failing banks, and build the capacity of BOM and commercial banks followed a change in the Government in mid-1996. The timing of the Program, therefore, was fortuitous. It was formulated at the time when the Government was willing to bear the costs and implement the structural adjustment to address the urgent need for reforms.

14. **Means to Implement Reforms.** The reforms envisaged were presented in detail in the policy matrix (Appendix 2) with corresponding dates and targets. The means to implement the reforms were expected to be covered under the TAs. The TA grant was intended to strengthen the capacity of BOM to regulate, supervise, and restructure the banks. Because the grant was

[11] The sector development modality was not yet available as a lending instrument.

not sufficient to enhance the capacity of the commercial banks, the TA loan was provided from the Asian Development Fund. The loan was to cover the basic training needs of the commercial banks and the introduction of banking software packages. However, the TA loan also was insufficient to implement the scope of outlined activities (para. 47). The Program could have benefited from a larger TA loan geared to the specific needs of the banks that were to implement the reforms in the policy matrix.

## B. Policy Reform Measures

15. The Program supported the Government's medium-term strategy for financial sector development. The 66 policy actions specified in the Program were separated into three categories.[12] The first category, strengthening the legal and regulatory framework, included 31 policy actions to (i) facilitate debt recovery, (ii) improve banking supervision, establish a framework for regulating nonbank financial institutions, (iv) facilitate the enforcement of financial sector laws, and (v) improve transparency of bank financial positions. The second category, promoting financial intermediation based on market conditions, contained 16 policy actions for (i) curbing government interference in banking activities, (ii) restricting shareholder access to credit, and (iii) establishing market-determined interest rates. The third category, strengthening financial intermediaries, contained 19 policy actions that addressed (i) improving bank policies and systems, (ii) removing unrecoverable directed and inherited loans from bank balance sheets, and (iii) restructuring or closing banks as needed. The policy framework was woven around these short- and medium-term needs of the sector.

### 1. Strengthening the Legal and Regulatory Framework

16. A major component of the Program was the establishment of a clear and well-defined legal and regulatory framework for the banking system based on internationally accepted norms. Through the passage of the new Banking Law, the Program supported the creation of a legal framework that gave BOM the powers to set prudential norms for commercial banks and take corrective action if the banks do not comply. A majority of these actions were complied with prior to board consideration. Recognizing the importance of the enforcement of regulations, the Program also aimed to strengthen the supervision of the banks through (i) the sustained development of supervisory staff skills in BOM, (ii) the recruitment of additional staff, (iii) improved financial reporting, and (iv) the introduction of adequate bank accounting standards based on international norms. It also aimed to improve the corporate governance of banks by clarifying the responsibilities of directors and shareholders and requiring the publication of annual financial statements to promote transparency. Given the substantial portfolio problems of the banks, the Program supported the improvement of the legal and institutional framework for security and debt recovery. By recommending changes to the Bankruptcy Law to recognize secured lenders, the Program established a legal framework governing secured transactions.

### 2. Promoting Financial Intermediation

17. The Program tried to ensure that financial intermediation was market-driven, and that lending decisions were not distorted by noncommercial interference. It supported the ending of government credit directives to BOM and other financial institutions. The Program offered several measures to help establish market-based interest rates. It also developed a strategy for reducing state shareholdings in commercial banks, improving the autonomy of the banks, and

[12] The number of conditions in Appendix 2 is shown to be 65. However, the minimum capital requirements standard was met in two stages and counted as two conditions making up a total of 66 policy conditions.

increasing the accountability of their shareholders and management. The Program encouraged tightening exposure limits to single borrowers, shareholders, etc. (para. 39). To give banks an incentive to make prudent provisions for bad loans, it supported a full tax deduction for loan loss provisions.

### 3. Strengthening Financial Intermediaries

18. To address the immediate liquidity problems of commercial banks, the Program supported issuing cease-and-desist orders to insolvent banks. Under the Program, the Government was to assume the financial responsibility for the inherited and directed bank loans that were classified as unrecoverable. Interest-bearing government securities would be substituted for these NPLs. This was a major rationale for the loan. The policy matrix included specific conditions (not attached to release of second tranche) to address the resolution of People's Bank and Insurance Bank and the transfer of household deposits to Savings Bank. The policy matrix also addressed transferring MARA's performing loans and corporate deposits to the newly established Reconstruction Bank. These conditions were completed by early 1997. The creation of MARA and provision of adequate government funds for bank restructuring were preconditions for the ADB Board to consider the loan for approval. ADB also provided TAs to develop a restructuring strategy for Agricultural Bank, Reconstruction Bank, and Bank of Investment and Technology Innovation (BITI). The restructuring unit established in the Bank Supervision Department of BOM was to be responsible for monitoring restructuring strategies. A condition of the second tranche of the Program was the enforcement of the receivership provisions for insolvent banks that made little progress on restructuring targets.

## C. Program Management

19. A change of Government in the middle of loan processing helped finalize negotiations because the new Government recognized and endorsed the need for reforms. With the banking system in crisis and the situation worsening every day, there was enormous pressure to move forward quickly. Two major banks—People's Bank, the largest commercial bank, and Insurance Bank—were closed and two new ones—Reconstruction Bank and Savings Bank—were established 1 month before the release of the first tranche. As such, the program implementation initially was orderly and efficient.

20. Program management became difficult in the latter part of the implementation period. By April 1997, experts were recruited to provide advice to restructure Reconstruction Bank and Savings Bank, even though these two banks were less than 6 months old. The problem with Reconstruction Bank stemmed from the way it was implemented, not the way it was designed (para. 41). Reconstruction Bank failed by the end of 1999, and Savings Bank remains a problem for the Government (para. 42). Meanwhile, the laws on the rights and duties of bank conservators and receivers were seriously flawed, which significantly delayed the resolution of the three insolvent banks (Agricultural Bank, Reconstruction Bank, and BITI) in the fall of 1998. In short, developments in the legal system did not keep pace with the progress of the banks,[13] BOM, and the regulatory system. As the PCR describes, bank restructuring was carried out in three phases. In the first phase in 1996, two banks were placed under receivership and their assets were sold to MARA, while a third bank was closed. During the second phase in 1997 and 1998, there were difficulties increasing the capital and exchanging inherited and directed loans for government securities. Due to these difficulties, as well as the impact of the Russian financial crisis and terms of trade shocks, NPLs rose to 70% of total loans. In the third phase, the Government adopted a restructuring action plan (para. 21).

[13] TA 1930-MON: *Developing Mongolia's Legal Framework*, for $500,000, approved on 17 August 1993.

21. Consequently, the program implementation and the release of the second tranche, scheduled for 31 December 1998, were delayed. In 1999, recognizing the faltering public confidence in the banks and eroding financial performance, the Government adopted a bank restructuring action plan that was agreeable to the major development agencies.[14] At the time, only one of the second tranche release conditions was not met (Appendix 3), and a partial waiver was provided for it.[15] With the implementation of the restructuring action plan, the second tranche was released in July 1999 after a 7-month delay.

22. ADB showed flexibility during the early stages of implementing the TA loan by adapting it to the specific needs of the Mongolian bankers. However, the implementation of the TA loan would have been more effective with a thorough needs assessment and an evaluation of the banks' ability to share the cost. When the banks indicated they could not pay their share for specialized training, ADB staff allowed funds from the TA to be used to establish the Bank Training Center (BTC), which could conduct systemwide training at a much more affordable price. Subsequently, responsibility for the TA loan was transferred from BOM's Bank Supervision Department to the Administration Department due to organizational changes. It is important to ensure that comprehensive and thorough handovers occur at BOM for such organizational changes. An ADB review mission noted that the Administration Department staff appeared competent, but they were unfamiliar with a TA loan and ADB TA management procedures.

23. A negative list was used to define the imports allowed under the Program, and no significant problems were encountered during the liquidation of claims, imprest accounts, and disbursements. The PCR reported that the imported goods were in accordance with this list. The People's Republic of China provided more than half of the imported goods.

## III. PROGRAM RESULTS

### A. Performance Indicators

24. The policy matrix described a clear plan for strengthening the banking system in Mongolia. However, the monitoring mechanisms were unclear and too general to provide measurable targets. In a number of cases, the monitoring mechanism was described only as "review missions," which implied that each review mission would determine, based on its own criteria, whether the Program was meeting its objectives. More specific mechanisms could have been identified for many activities. For example, under "strengthening of financial intermediaries," the following measurable indicators could have been employed: (i) improvement in capital ratios, (ii) trend of compliance with BOM prudential norms, (iii) growth in net loans, (iv) trend of NPLs, and (v) improvement of aggregate bank profitability. Some numerical targets could have been established based on agreed starting points to measure whether the financial intermediaries were strengthening as the Program progressed.[16]

25. Under "strengthening of the legal and regulatory framework for the financial sector," specific targets could have been designed for the bank supervision-related activities of BOM, such as (i) the number of bank examiners and years of experience; (ii) the frequency of onsite bank examinations; (iii) the record of tightening prudential requirements during and after the

---

[14] In addition to ADB, major external sources of aid involved in the design of the Plan included IMF, the United States Agency for International Development, and World Bank.

[15] The conditionality on secured transactions for movables has not been met some 4 years later. The conditionality on strengthening the bankruptcy legislation to facilitate debt recovery has since backtracked as well.

[16] The PCR uses a series of quantitative benchmarks to measure the improvement in the banking system, even though these benchmarks were not in the logical framework.

Program; (iv) the record of memoranda of agreement and other sanctions filed against banks during the Program; (v) the number of banking licenses granted; (vi) the number of banking licenses revoked, reasons for revocation, and procedures followed in each case; and (vii) the effectiveness of the newly installed capital adequacy, asset quality, management, earnings, and liquidity (CAMEL) rating system to identify early weaknesses in banks.

26. After several years, the developments in the banking system have contributed to the macroeconomic stability in the country. According to the performance indicators in the ADB's 2003 Economic Update for Mongolia,[17] the 42.0% annual growth in the money supply in 2002—compared with 19.8% in 1997 and 27.9% in 2001—was a result of substantial financial deepening[18] and did not affect inflation. The annual inflation rate slowed to 1.6% in 2002, down from 36.6% in 1997 and 8.1% in 2001. Successful efforts to restore macroeconomic stability were also reflected in a fiscal deficit of 5.6% of gross domestic product (GDP) in 2002, which was below the 6.5% target stipulated by the IMF poverty reduction and growth facility. This compares favorably with the 1997 fiscal deficit of 9.1% of GDP. Higher-than-expected revenue collection, partly due to the sale of TDB,[19] was responsible for the improved fiscal position.

## B. Impact of Policies

27. The Program has contributed to the gradual development of a market-based banking system through the implementation of policy reforms, formulation of laws and regulations, and strengthening of the capacity of BOM and commercial banks. While a majority of the positive impacts reflected gradual changes in procedures and practices, most of the strengthening in the banking system has occurred since 2000. This reflected the combined impact of TAs and loans that were directed to the banking system from several development agencies.[20] However, this Program was a pioneering effort that focused on extensive reforms of the banking system. The impacts also reflected the negative external influences of the Asian and Russian financial crises in 1997–1998; the severe terms of trade shocks from plummeting world prices of copper and other primary exports in 1997–1999; and the political turmoil throughout the 1990s. These external shocks might have delayed the anticipated impact of the Program.

### 1. Strengthening the Legal and Regulatory System

#### a. The Legal Framework

28. The laws on foreclosure by banks against immovable assets they hold as collateral are not satisfactory, despite conditions in the Program calling for amendments to them. This legal deficiency has hampered the banks' ability to recover loans from troubled borrowers. In February 2001, the Civil Law was amended to allow banks to foreclose directly against immovable property without a court decision. This was an important change for the banks; the threat of foreclosure allowed them to pursue more aggressively their troubled borrowers for repayment. In September 2002, however, the New Civil Code included another article that contradicted the previous article. As such, borrowers can argue that foreclosure against immovable property should be routed through the court system. This was a major step backward for the banks and removed a strong incentive for borrowers to meet their commitments. At the time of the OEM, MOJ was preparing amendments that were expected to

[17] ADB. 2003. *Country Strategy and Program Update (2004–2006)*. Manila.
[18] Parts of the financial sector outside the banking system are only gradually beginning to develop.
[19] In December 2002, $12.3 million was transferred to seal the TDB's long-delayed privatization.
[20] These include ADB's second Financial Sector Program loan, IMF's ESAF, and World Bank's Banking and Enterprise Sector Adjustment Credit and Financial Sector Adjustment Credit.

speed up the legal process of foreclosure. However, MOJ did not appear to be eliminating the role of the courts in foreclosure proceedings.

29. Although the Program addressed improvements in the operations of the Court Decision Enforcement Agency (Bailiff's Office), a second level of interference in the foreclosure process remains. Once a bank receives a favorable foreclosure decision in the court, the process moves to the Bailiff's Office, which presides over the foreclosure. This process can take months or even years. To the extent that the bank's leverage in foreclosure is weakened by the interjection of the courts and/or the Bailiff's Office, the likelihood of the bank sustaining loan losses increases greatly. Compliance with this conditionality appears to have moved backward.

30. The Program also aimed to establish a working group to review the law and facilitate the retention of banks' preferred status against their collateral once a borrower was placed in bankruptcy. Although the working group was established during the Program, this law has not been changed to provide banks with preferred status in the event of a borrower's bankruptcy. Under current law, once a borrower declares bankruptcy, the secured lender must share its collateral with other creditors. For this reason, most banks will foreclose on their collateral rather than force their borrower into bankruptcy. Similarly, the law on secured transactions for movable property,[21] which was to be approved in 2000, is still pending, and a new draft is being prepared. For most of the legal reforms, the initial actions taken during the Program have not had the envisaged impact. The delays and changes in the laws and procedures have made the banks more conservative, partly explaining the high liquidity (para. 43) and the high spreads (para. 75) in the banking system.

31. On the other hand, the Income Tax Law was changed as expected in 1998, allowing banks to deduct from their profits their provisions for loan losses. This provided an incentive (or mitigated the disincentive) for banks to provide adequate reserves for potential loan losses.

### b. Regulations

32. In contrast to the lack of positive impacts in the legal system, BOM made substantial progress in strengthening its regulatory capacity. With the foundation built under the Program, BOM achieved positive impacts, particularly in the past few years, in (i) loan classification and loan loss provisioning, (ii) bank supervision, (iii) prudential norms, (iv) capital requirements, and (v) enforcement procedures.

33. **Loan Classification and Loan Loss Provisioning.** BOM has upgraded its loan classification and loan loss provisioning system since 1996. Borrower ratings had been based entirely on quantitative considerations, specifically the past due status of the loan. Now, the system includes broader credit risk assessment criteria, such as financial statements, strength of management, experience with the borrower, etc. Regulation strictly limits the rescheduling of loans to hide a borrower's inability to pay. Loan loss reserve requirements have increased. Performing loans now require a 1% reserve, while overdue loan provisions have increased to 5% from 1%. Loans must be classified as overdue if interest is overdue, even if the principal is up to date. These changes focus on obtaining earlier indications of loan problems.

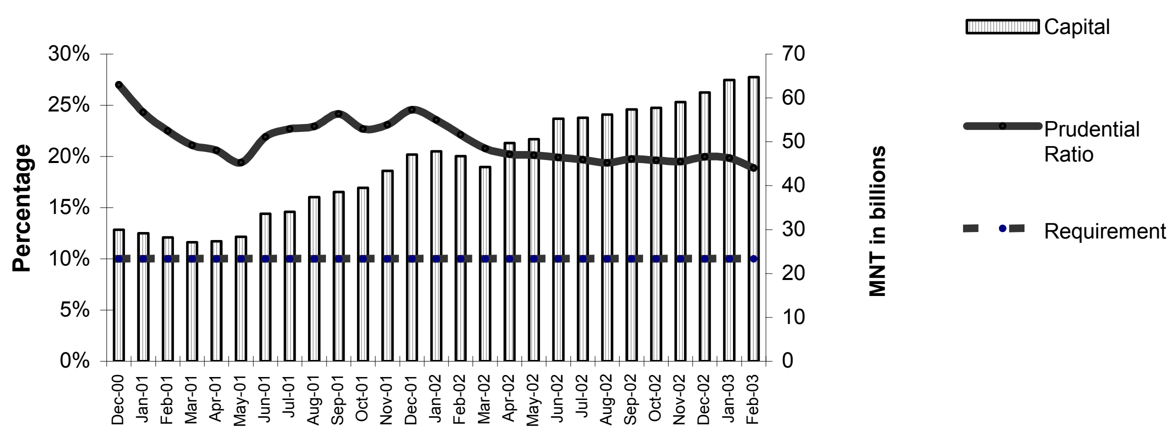
34. **Bank Supervision Process.** The bank supervision and enforcement process also has improved. There are 45 staff members supervising the 16 banks and their branches, and they have undergone more training than in the past. Bank examinations are driven more by risk assessment than compliance with regulations, which leads to earlier identification of

[21] A partial waiver was sought on this condition for the release of the second tranche of the program loan.

deteriorating bank situations. Supervision examinations are performed on each bank at least once a year, more often if circumstances warrant. A comprehensive report is prepared at the end of each examination and shared with bank management. The CAMEL rating system (para. 25) has been introduced for each examination, and BOM has added a sixth rating characteristic to the system—"S" for sensitivity of the risk. In a five-point rating system, with "1" being the highest rating, 13 banks are rated below 2.5 and three banks are rated between 2.5 and 4.0. Despite these positive impacts, the Bank Supervision Department must continue to recruit new examiners and upgrade their experience, especially as banks expand their portfolios.

35. **Prudential Norms.** Prudential norms have been enhanced since 1996 and are now in substantial compliance with many of the core principles of the Basel Accord, including, most importantly, the capital adequacy principle. BOM has increased the minimum capital adequacy ratios to 5% from 2% for the tier 1 ratio and to 10% from 4% for the total capital ratio. The banking system, as a whole, is in compliance (Figure 1). For the capital adequacy requirements, all loans are risk weighted at 100%. A recent IMF assessment of BOM's supervision was quite positive.[22] Appendix 4 shows the trend in the commercial banks' compliance with the prudential norms. While five banks failed to comply with prudential ratios on six items in 2001, this was reduced to three banks on three items in 2002.[23]

**Figure 1: Capital Adequacy in the Banking Sector**




36. **Capital Requirements.** BOM increased the minimum paid-in capital required for commercial banks.[24] This not only improved the safety and soundness of the system, but also induced the shareholders of existing banks to pay closer attention to their investments. In many cases, meeting the minimum paid-in capital required shareholders to invest more in new shares and/or reduce their dividend payout in order to boost the retained earnings of their bank.

[22] The IMF report states "In all the circumstances, the overall standard of banking supervision was reasonable. Mongolia is compliant with four core principles, largely compliant with nine, materially compliant with eight, and noncompliant with two. A number of the downgrades were, however, driven largely by matters outside the supervisors' control, such as the poor state of the legal system and the inadequacies of local accounting and auditing."

[23] One of these was TDB, which had made its classification system more stringent due to its recent privatization efforts.

[24] In September 1999, the minimum capital requirement was raised to MNT1 billion from MNT400 million. In January 2000, it was raised to MNT2 billion, effective immediately for new banks, in June 2001 for existing banks. In September 2001, it was raised to MNT4 billion.

Minimum capital levels, while strictly speaking not a prudential requirement, can be set by a Governor's Order under the banking law. The minimum level was raised to MNT4 billion from MNT2 billion in September 2001. Existing banks have been given until March 2004 to comply, while new banks must comply immediately. Currently, 3–5 banks are not in compliance. If those banks fail to comply by March 2004, their licenses will be revoked. The OEM learned that BOM may raise the minimum capital level again to MNT7 billion or MNT8 billion, although no date has been set for this new increase. This could consolidate the banking system.

37. **Enforcement Procedures.** Enforcement procedures also have improved, putting pressure on banks to comply with the regulations and improve their deficiencies. Since People's Bank and Insurance Bank were closed in December 1996, BOM has closed, merged, or liquidated nine banks due to noncompliance with prudential regulations (Appendix 5). This demonstrates that BOM is serious about enforcing its regulations.

### 2. Strengthening the Financial Intermediation Process

38. Since the formulation of the Program, the financial intermediation process has deepened, but the efficiency can be improved (para. 75). From 1997 through 2002, total deposits in the banking system increased almost threefold, to MNT353 billion from MNT123 billion. This reflected an increasing willingness of customers to entrust their funds to the banking system (Appendix 6). Net loans by commercial banks, which totaled MNT40 billion in 1997, grew to MNT54 billion in 2000 and to MNT223 billion in 2002, providing a significant boost to economic development through financial intermediation.

39. To promote financial intermediation based on market conditions, the Program sought to restrict shareholder access to credit. As a result, regulations on insider lending and credit concentrations were tightened. Loans to any insider or related parties must not total more than 5% of capital, while loans to all insiders combined must not exceed 20% of capital. This limits the ability of corporations to start banks to fund their own needs.

40. Reforms to establish market-determined interest rates were carried out prior to the approval of the loan, and they have since been maintained. With 15 local commercial banks and one branch of a foreign bank in the country, there is substantial competition in the sector.

### 3. Strengthening of Financial Intermediaries

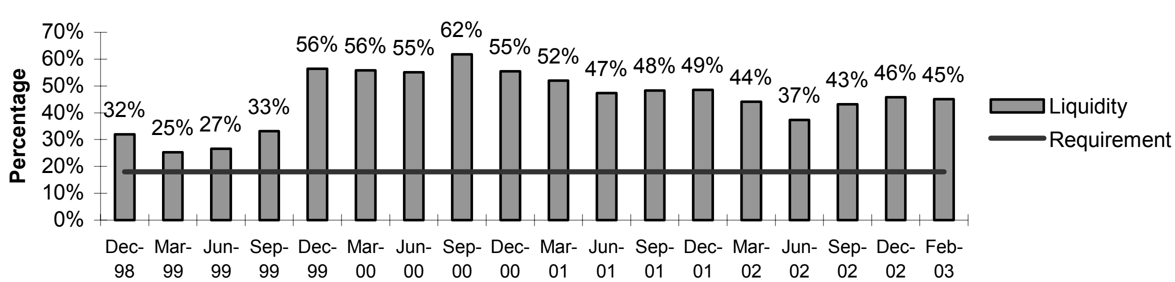
41. Restructuring effort was a major component of strengthening financial intermediaries. The timely resolution of two problem banks was a positive impact of the Program. The closure of two failing banks in December 1996 and the relatively orderly transfer of deposits to two new institutions may have averted a more serious banking crisis in Mongolia in early 1997. The creation of MARA and the issuance of bank restructuring bonds (BRBs) allowed the bad loans to be isolated in a separate institution that could focus solely on their resolution. While the decision to create two new banks to absorb the deposits and performing loans of the two failed banks may have been well intended, it was difficult to implement. Difficulties arose because the new banks hired employees of the two failed banks. Even at the time the proposed structure was not universally popular, ADB recommended the creation of Reconstruction Bank to support real sector activity. Subsequently, Reconstruction Bank, which absorbed the portfolio of purportedly performing loans, turned out to be poorly managed, staffed, and controlled. Within a year, Reconstruction Bank built a portfolio of new problem loans, adding to the ones it had unknowingly inherited. Better planning and monitoring by ADB and BOM might have prevented this problem. Within 18 months, Reconstruction Bank was close to failure. An attempt to merge

the bank with Golomt Bank failed, leading to Reconstruction Bank's closure in 1999. More BRBs were issued and more loans were transferred to MARA.

42. Meanwhile, the other new bank, Savings Bank, developed a different set of problems. It absorbed all the household deposits of the failed banks, which were offset on the asset side by BRBs. It was not granted a lending license at the outset, to help assure depositors that, even without deposit insurance, this institution was a safe place to put their money. Savings Bank, completely government-owned and offering no loans, was very low risk. While asset quality has not been a problem at Savings Bank, profitability and cash flow have been, as its loan portfolio and deposits did not grow as quickly as in other banks. It has loans outstanding amounting to 13% of its deposit base. Efforts are under way to bring Savings Bank into compliance with World Bank's financial sector adjustment credit conditionality, but privatization will be virtually impossible with the bank's current financial structure. A feasible resolution is to create packages of deposits for private sale to other banks accompanied by a corresponding amounts of BRBs.[25] Savings Bank's deposit base—a diversified portfolio of small, low-yielding, and very stable deposits—should be attractive to other banks. This approach could result in a carefully managed disbursement of the deposits throughout the banking system. It would also help to bring Savings Bank's balance sheet mismatch—huge deposit base, small loan portfolio—more into line, so that it might be privatized later.

43. One of the principal objectives of the Program was to strengthen financial intermediaries, particularly the banking system. Except for the problems in creating Reconstruction Bank and Savings Bank, strengthening the other banks appears to have been quite successful. The banking system is now stronger and all banks have been in substantial compliance with prudential norms in the last 3 years. Despite rapid growth in deposits (para. 38), capital adequacy for the system stands at 20%—well above the regulatory minimum of 10%. Aggregate profit for the system rose to MNT11.0 billion in 2002 from MNT2.3 billion in 1997 (Appendix 7). Reflecting the heightened economic activity, gross domestic product growth (excluding agriculture) accelerated to 9.4% in 2002 from 1.7% in 1998. Banks could expand their loan portfolios further, as the liquidity for the system in 2002 was at 46% of all deposits (Figure 2)[26]—well above the minimum regulatory level of 18%.

**Figure 2: Liquidity**




[25] Since the assets being transferred to potential buyers are BRBs and not loans, it is difficult to use other options such as pricing strategies and interest rate margins.

[26] Liquid assets include cash, deposits with BOM and other banks, BOM bills, and government securities (excluding BRBs).

## C. Institutional Impact

44. The institutional capacity-building impacts were initiated by the TAs attached to the loan and fine-tuned by additional TAs from ADB and other development agencies. The TA grant, which aimed to strengthen the supervisory and restructuring capacity of BOM, appears to have been more effective, but the TA loan, however, had limited success in achieving its objectives.

### 1. The TA Grant

45. This TA grant for $1 million, which was attached to the loan, was well defined and aimed to support the Program by strengthening the capacity of BOM to regulate, supervise, and restructure the commercial banking system. The grant components provided international experts to help prepare appropriate regulations for licensing, supervision, and conservatorship; develop a core group of qualified bank supervisors; and organize study tours to learn about foreign banks. The scope also covered assisting BOM in (i) setting up bank examination methodologies and procedures, (ii) bringing bank accounting standards and regulations in line with international practices, and (iii) restructuring or liquidating selected bank. Delays in consultant recruitment, a parliamentary crisis in 1998, and medical emergencies of consultants caused some implementation problems. However, 38 person-months of consulting services were provided—compared with the planned 36 months—and the TA output was in line with the objectives. BOM indicated that the consulting services provided valuable support for implementing the Program.

46. Several training programs and study tours were held for bankers, judges, and other financial sector participants. The consultants prepared operational and financial restructuring plans for Agricultural Bank and BITI, a bank supervision handbook (recently translated into Mongolian), bank supervision training modules, an accounting manual for commercial banks, and a regulatory framework for nonbank financial institutions. By May 1998, the accounting consultant and the working group reviewing the commercial bank accounting regulations drafted new regulations based on international accounting principles. These were reformatted under the guidance of the BOM board and approved for implementation by commercial banks beginning in January 1999. However, upgrading their accounting system came under the TA loan. The work by the legal adviser on conservatorship, licensing, and regulation was completed by the end of 1997, and was adopted by BOM in 1998. Short training programs were also held for MOJ personnel. The TA was relevant and efficacious in achieving and sustaining the intended outcomes. Despite the minor implementation problems, the consultant services were efficient and built institutional capacity. As a result, the TA is rated highly successful.

### 2. TA Loan 1510-MON

47. The TA loan was to (i) provide international consulting services for the operational restructuring of commercial banks as well as advisory and training services to upgrade commercial banking skills, and (ii) finance the procurement of integrated banking software packages for commercial banks. Several components, however, were not well defined. In addition, the loan provided insufficient funds to achieve the multiple objectives. The terms of reference were not prepared at the design stage. The TA loan agreement provided a list of components, including (i) long-term consultants to restructure Agricultural Bank and BITI; (ii) long-term consultants to assist in the divestment of state holdings of commercial banks; (iii) individual banking specialist for commercial banks to provide a strategy for making the transition to commercially-oriented banks; (iv) classroom training for areas identified by commercial banks; (v) exposure of the top management of banks to the operations of commercial banks in developed market economies; (vi) assistance to higher education

institutions, so they can play a more active role in training commercial bank staff; (vii) updated banking software for commercial banks; and (viii) training of staff of commercial banks in the use of integrated banking software. The TA provided for 55 person-months of consulting services. Participating commercial banks (all were eligible) were to pay 50% of the cost of the consulting services and banking software. The banks could receive loans from BOM to cover their share of the expenses.

48. In general, neither the progress reports nor the PCR for the program loan accurately portrayed the problems in the TA loan.[27] Because the Mongolian banks could not afford to hire international experts, the training portion had to be changed at the outset. The resignation of the international consulting firm during TA loan implementation severely hampered the software component.

49. The banks declined to participate in components (i), (ii), and (iii) as they found the consultants' costs, even at 50%, to be prohibitive. This might have been avoided with adequate consultations between ADB and the Borrower during the TA design. Instead, the banks chose to use a system-wide training center sponsored and managed by BOM. As a result, BOM changed the scope of the terms of reference for the TA consultants midstream. BOM as the EA was unfamiliar managing Mongolia's first TA loan and may have needed more support from ADB. When such support was not provided quickly, BOM diverted the funds for the purposes it felt were needed.

50. BTC was formed under the financial umbrella of the TA loan to provide training for commercial bankers in credit policy and analysis, bank accounting, financial management, and asset liability management. At the end of TA implementation, 11 training courses were prepared and tailored to local practice (at a cost of $500,000). They provided an excellent starting point for BTC. The center still offers courses to the banks, with the costs shared collectively. The banks regarded this training generally positively, describing the programs as affordable and useful. They also suggested that more foreign experts be recruited to teach the courses, rather than the local trainers from the banks and the universities. Under component (v), 25 bank staff went on a 45-day study tour to the United States in 1997 (at a cost of $800,000). In addition, a higher education institution received $900,000 under component (vi) to develop a printing unit.

51. Four commercial banks used the banking software-related components, at a cost of about $2 million. According to the TA loan proposal, these software components were to be implemented in two phases. In the first phase, a consultant specializing in banking software was to assess each commercial bank's software requirements, which differed widely. However, insufficient time was allocated for the consultant to undertake individual studies for each interested bank. In addition, after about 3 months of intermittent work, the consultant terminated his services as the software bidding documents were being evaluated. Thus, the consultant was not available to assist in the installation as envisaged, resulting in a prolonged period of uncertainty and implementation difficulties. At this stage, it might have been prudent to seek advice elsewhere, and more support from ADB in obtaining such advice would have been useful. The implementation encountered problems due to the following reasons: (i) creation of a software program that fits many commercial banks was difficult; (ii) the bankers in Mongolia were not conversant with the international accounting concepts; and (iii) the hardware requirements were not readily available. In addition, the accounting systems in the commercial banks first had to be upgraded to reflect commercially oriented banking practices. A software

[27] A PCR is currently being prepared solely for the TA loan (footnote 8), which reflects the related implementation issues. Since the TA loan was closed in June 2003, the preparation of the PCR mission took place in September 2003.

conversion is a very disruptive process that is not generally popular with staff, even when its outcome is successful. In this case, the process was more difficult because the traditional accounting methods had to be changed to adopt the new software. Due to frequent staff changes at ADB, ADB does not appear to have spent adequate effort to resolve the implementation problems as they emerged (para. 67).

52. After a 9-month lapse, a local company was hired as a consultant to assist with the installation of the software in May 2000. Since online telecommunications facilities were not available in Mongolia at the time, the pilot bank, TDB, installed an offline version of the software that was specially adapted by the supplier's engineers. The installation and adaptation of the software took more than 2 years, partly due to a lack of support and understanding by TDB's top management. The offline version of the banking software has been available at all of TDB's branches in Ulaanbaatar since March 2003. In contrast, the online version was installed in Agricultural Bank in 2002 with enthusiastic management support. It is now being used in all of its district branches. The implementation of the software in the Erel Bank and the Mongol Post Bank also experienced some problems. However, despite the difficulties of transition, the new software package has made the preparation of management information more timely and the submission of documents required by BOM more convenient. Two other banks are also considering adopting the same software, although the TA is closed after disbursing 93% of its funds. Although the TA was relevant, it was not efficiently implemented and achieved only some of the intended outcomes. Implementation was prolonged, but the TA had positive institutional impacts that may be sustainable. As such, the TA is rated less than successful.

### 3. Mongolian Asset Recovery Agency

53. MARA was established in late 1996 in anticipation of the closure of People's Bank and Insurance Bank. Between 1997 and 2001, problem loans totaling MNT47 billion were transferred to MARA. Some of these loans dated to the days of the former monobanking system, and were probably uncollectible. BRBs were issued in payment for some of these loans, but not all of them. In all, 8,700 borrowers were transferred to MARA to be managed by a staff of 150, including some employees of the failed banks from which the loans were acquired. At the time of the OEM, MNT7 billion had been collected in cash and an additional MNT5 billion had been recovered through offsets from the Customs Department and the Social Development Fund. The lack of collateral and the prolonged legal procedures made this process time-consuming. With inadequate legal powers and a staff inexperienced in collection techniques, MARA was not equipped to take on such a large volume of troubled loans all at once. This should have been addressed by providing substantial TA support for this important transition at the time of the program loan. Six years after its formation, MARA has an annual operating budget of MNT270 million. Many of its remaining borrowers are probably not worth pursuing. Management indicated it collected MNT2 billion in 2002 (perhaps mostly from the 2001 bank closures). The Government should assess the cost effectiveness of this effort.

## D. Socioeconomic and Environmental Impacts

54. The Program had no discernible environmental impacts. During the initial stages of the Program, the layoffs and loss of deposits due to bank restructuring efforts undoubtedly had socioeconomic impacts. The Government absorbed some of the impact of the loss of deposits by helping troubled banks meet the liabilities of small enterprisers and individual depositors (para. 55). The recent surge in bank credit to the private sector could have a positive socioeconomic impact as it helps create small businesses and new economic activity, as well as employment in a growing economy.

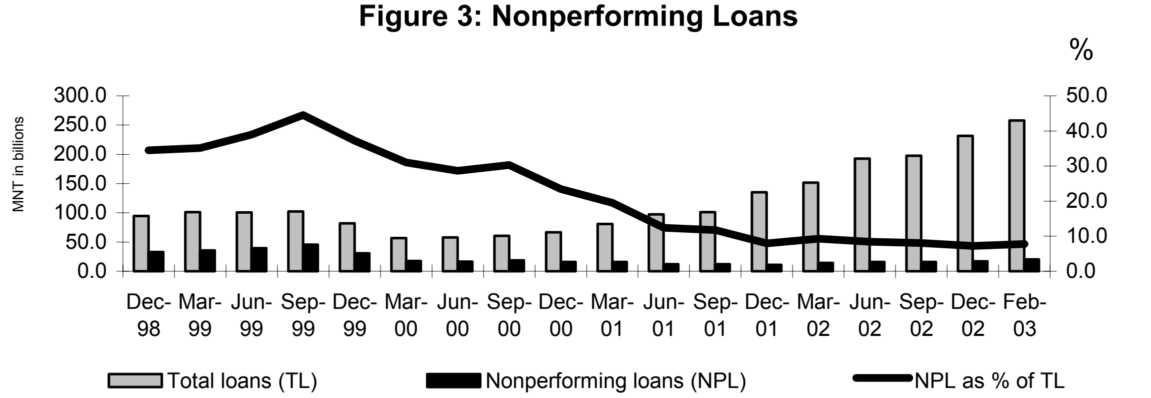
## E. Counterpart Funds

55. Substantial costs were envisaged for the reforms suggested in the Program. At appraisal, the medium-term adjustment costs of the Program were estimated to be about $75 million, including bank recapitalization, liquidation costs, and operational restructuring costs. To facilitate restructuring, the Government—following the advice of multilateral development banks—assumed financial responsibility for the inherited loans from the monobank era and the directed loans made in the first half of 1990s (para. 1). To maintain public confidence, the Government also made a budgetary provision to repay smaller enterprises (with less than 50 employees) for the potential loss of their deposits in liquidated banks. The actual costs of restructuring amounted to about $65 million, and the counterpart funds from this program loan partly financed these costs.

## F. Sustainability

56. Given the positive impacts on the regulatory system, supervision, and enforcement, the OEM believes the banking system is likely to be sustainable if the current prudential practices continue. However, the growth in NPLs remains a concern. The rapid growth in NPLs has been manageable and supported by prudential practices. With such high growth rates in loans, some increase in the percentage of NPLs would have been normal. However, the opposite has occurred: NPLs have declined to 7.2% of total loans in 2002 from more than 40% in 1997 (Figure 3). This reduction is largely a function of the dramatic increase in loans outstanding in almost all banks (Appendix 8). In absolute terms, NPLs have nearly doubled in a little more than a year, to MNT20.0 billion in March 2003 from MNT10.8 billion in December 2001.

**Figure 3: Nonperforming Loans**




57. A further concern is that many of the new loans made in 2002 (an MNT94.5 billion increase from 2001) may not have matured by the end of 2002 and could become problems in 2003. At OEM, the capital and liquidity ratios were high, providing a cushion against a downturn. Still, rapid loan growth needs to be accompanied by an increased capacity of BOM to supervise lending activity. The sustainability of the banking system also relies heavily on the success of its borrowers, the principal source of its revenue. For the banking system to be sustainable in the long run, the enterprise sector in Mongolia has to reform also. Necessary reforms include (i) developing accounting and auditing standards in enterprises, (ii) establishing greater transparency regarding the financial health of firms, (iii) improving law enforcement, and (iv) dealing with governance issues. A coordinated approach to the enhancement of these

building blocks is needed. Complications in the legal system affect the efficiency of financial intermediation as banks retain wide margins and high liquidity as a precaution. These inefficiencies eventually could affect the profitability and sustainability of the banking system.

# IV. KEY ISSUES FOR THE FUTURE

## A. Rapid Growth in Loans

58. This PPAR highlighted the rapid growth in the aggregate loan portfolio since 1999 (para. 38). This pace is worrisome and might presage a massive increase in NPLs.[28] BOM and the banks said they too are worried about the expansion in lending. The good news is that capital and liquidity ratios are high, providing a cushion against a downturn. BOM should consider more frequent examinations of weaker banks and tightening its classification and provisioning regulations further in anticipation of a downturn. BOM and the banking system would benefit from being proactive now rather than reactive later (para. 80).

## B. Deposit Insurance

59. A deposit insurance scheme, which is being studied, should be expedited for three major reasons. First, the best time to install such a system is when things are going well and it does not appear to be necessary. Now is such a time. Since there is no banking crisis, however, Mongolian decision-makers might make this a low priority. Second, if there is a downturn in the banking system, deposit insurance could mitigate the decline in public confidence that would ensue. Third, as mentioned in para. 42, the government-owned Savings Bank is a safe haven for deposits in the country with its low risk assets. However, Savings Bank might not serve that role in the future. Under such circumstances, a deposit insurance scheme would help to sustain confidence in the banking system. Careful consideration, however, should be given to setting up a deposit insurance scheme, keeping in mind the associated moral hazard problems.

## C. Ambiguities in Financial Contracts

60. The unsatisfactory status of the laws on debt collection are highlighted in paras. 28–30. The efficiency and sustainability of the banking system will depend on a speedy resolution of these legal conflicts, particularly if NPLs increase as envisaged. Banks need to be able to gain control of their collateral quickly when a borrower defaults for two reasons. First, borrowers would have a strong incentive not to default if they think the bank will seize their assets. Second, collateral tends to diminish in value or deteriorate when a borrower senses that a bank is about to foreclose. Certainly, borrowers should have the right to run their businesses without interference as long as they meet their obligations on time. However, more balance is needed between the rights of the borrower and the rights of the bank.

# V. CONCLUSIONS

## A. Overall Assessment

61. **Relevance.** The Program, a pioneering effort that focused narrowly on extensive reforms of the banking system at a crucial time, was urgently needed. Its design had several positive features that led to its implementation within a reasonable time, generating a majority of

---

[28] Another concern is the rapid growth in the nonbanking sector, especially the rural cooperatives. For more details, see ADB's 2002 *Country Assistance Program Evaluation* in Mongolia (footnote 1).

the impacts that were envisaged. Some weaknesses in the design also were apparent (paras. 10–14) with the benefit of hindsight. The Program is, therefore, assessed as relevant.

62. **Efficacy.** With the foundations built under the Program, BOM made substantial progress in strengthening its regulatory capacity, particularly in the last few years. BOM upgraded its loan classification and loan loss provisioning system; bank supervision process; prudential norms; and enforcement procedures. Efforts to improve the commercial banking system also appear to have been successful. As a result, the banking system is sound. However, the laws on bank foreclosure of assets they hold as collateral are not satisfactory (despite conditionalities in the Program addressing this issue). That has hampered the banks' ability to recover loans from troubled borrowers. The banking system might be compelled to keep high liquidity ratios and high spreads until these legal deficiencies are resolved, limiting the efficiency of the banking system. The Program, therefore, is assessed as "less efficacious."

63. **Efficiency.** Initially, increasing the capital requirements for failing banks and exchanging directed loans for government securities proved difficult. This was partly due to external shocks and partly to deficiencies in the legal system. Those issues, plus the weakening terms of trade in the late 1990s, caused NPLs as a proportion of total loans to increase substantially. Consequently, the release of the second tranche of the Program was delayed by 7 months. However, all but two conditions were complied with. The Program is assessed as efficient.

64. **Sustainability.** The program outcomes are likely to be sustainable because of the stronger regulations and the increased capacity of the banking system. However, the current legal and regulatory environment is not conducive to the long-term health of the banking system and needs to be reviewed carefully. In addition, over the past 3 years, net loans outstanding have grown from the previous year by 60%, 135%, and 74%, respectively. The banks cautiously have complied with prudential norms, keeping pace with this growth. Continued provisioning for NPLs and vigilant supervision by BOM are needed to ensure sustainability in the future.

65. **Institutional Development and Other Impacts.** The institutional development and other impacts of the Program are assessed as significant. These institutional developments were initiated by a TA grant and a TA loan attached to the Program. Under the TA grant, the necessary tools for the banking system were prepared, such as bank supervision training modules for BOM, an accounting manual for commercial banks, and a regulatory framework for nonbank financial institutions. BOM and the commercial banks have continued to strengthen their efforts on prudential norms and have achieved substantial progress.

66. **Overall Assessment.** The Program was relevant and urgently needed. However, it had some design weakness in adapting traditional ADB assistance for the first time to an economy in transition. It was less efficacious in achieving the objective of a sound and efficient financial system. To improve its efficiency, the weaknesses in the legal system have to be addressed. Implementation of the Program was efficient, though it encountered some delays. With persistence and follow-up activities, institutional strengthening appears to have been achieved. If the banking system continues to comply with prudential norms and regulations, its sustainability is likely. Based on its relevance, efficacy, efficiency, institutional development and sustainability, the overall assessment rating of the Program is successful.

## B. Performance of the Asian Development Bank and the Executing Agency

67. The performance of ADB in terms of program management was satisfactory. However, in terms of the TA loan management, it was partly satisfactory. Early review missions quickly sensed that the two new banks established December 1996–January 1997 were not doing well.

ADB took an appropriately firm stance on most of the program conditions and was constructive in suggesting methods for achieving compliance, including providing clear steps to be taken. Review missions were conducted with regularity during the first year of effectiveness, but there was a long gap between missions from the end 1997 to the end of 1998. Due to the Asian financial crisis, ADB was supporting large financial sector reforms in other countries in the region at the time. The progress report for the second tranche release indicated the implementation of the Program was temporarily disrupted in 1998 by political uncertainties—there was another change of government in December 1998—and the reemergence of the economic troubles in the wake of the Russian and Asian financial crises. A deterioration in the quality of bank assets, a slowdown in deposits, and problems stemming from the unsuccessful merger of Reconstruction Bank with Golomt Bank also hampered the Program. The banking system was extremely fragile during that period, culminating in two more major banks being placed in conservatorship, receivership, and subsequently closing in 1999. The inability of ADB to supervise the implementation closely at this time may have delayed the impact of the Program. The absence of a resident mission in Mongolia until 2000 also hampered the monitoring of conditionalities, some of which have backtracked since the release of the second tranche. Review missions also could have done a better job identifying lingering problems with legal reforms and pushed for better results. Frequent personnel changes at ADB caused some lapses in program management, especially in implementing the bank software component.[29]

68. BOM was the Executing Agency and coordinated the Program for Mongolia. The PCR complimented the support provided by BOM, despite high staff turnover, budgetary constraints, frequent management changes, and reorganizations. In particular, that report noted the strong ownership by top management and their fostering of constructive dialogue with Parliament and other ministries and agencies. Despite these positive aspects, the full implementation of the restructuring program in 1997 and 1998 was delayed substantially. The implementation arrangements called for the establishment of a steering committee chaired by the deputy governor of BOM and including representatives of MOFE and MOJ. The committee was supposed to meet at least once every 3 months “to ensure that the proposed reforms were undertaken in line with the agreed timetable.” There is no evidence that the committee was ever formed or ever met. In view of the unsatisfactory progress on legal reforms during the Program, this committee (and particularly its MOJ member) could have pushed the legal agenda forward to a more successful conclusion. The performance of BOM is assessed as partly satisfactory.

## C. Key Lessons Learned

69. **Early Identification.** Early identification is one of the keys to problem resolution. When a problem is identified and addressed early, several options for resolution frequently can be considered and a carefully thought-out plan can be prepared. However, the closure of People’s Bank and Insurance Bank demonstrate how difficult it can be to generate the political will to address a problem before its becomes a crisis. The problems at the banks had been well known for a year or more, but the Government lacked the political will to address them seriously. If the banks’ problems had been confronted earlier, several options might have been available. Development agencies should provide governments with guidance on winning public support to tackle tough issues early. That would give them more time to consider options and develop sustainable outcomes.

[29] Implementation of the bank training segment of the TA loan was delayed when BOM sent a revised proposal to ADB in December 1997 and had not received a reply by the time of the February 1998 mission. The international consultant company working on this segment of the TA also commented on the lack of support in its final report.

70. **Sustainability of New Institutions.** While ADB is credited with leading the restructuring following the 1996 banking crisis, there is little evidence that adequate analysis was undertaken regarding the new institutions that were created in the process. In hindsight, it appears that more attention should have been given to the fate of the new institutions, or sufficient technical support should have been provided to ensure they were sustainable.

71. **TAs.** TAs should be tightly focused to maximize their effectiveness. For example, as mentioned in paras. 47–52, the TA loan created confusion by intermingling objectives and tasks that were not closely related. Splitting the loan into two TAs—one for bank training and one for banking software implementation—might have been more effective. This approach would have allowed monitoring to focus more directly on specific problem areas.

72. **Effective Training.** For bank training to be effective, senior management must make a strong commitment to follow through and incorporate the results of the training into the bank's daily activities. Otherwise, the benefits are quickly lost as the personnel trained fall back into the old ways of doing things. Before training TAs are undertaken, a needs assessment must be conducted and some assurances given by the recipients about whether the training is needed, wanted, and timely. Most recipients agree that narrowly targeted on-the-job training is very effective. The TA modality should take this into account, especially in a transition environment where changing the traditional concepts and processes takes time.

73. **Software Installation.** The installation of new software in any business environment is disruptive. People are generally used to the old ways of doing things, and many are not receptive to change. Senior management frequently takes a hands-off approach because they are unfamiliar with the technical issues of software installation. However, without senior management's total commitment, motivating the staff to support such dramatic change is difficult. The TA loan should have incorporated a component for senior management training before the introduction of the Program to the staffs of the four banks.

74. **Supportive Building Blocks.** Banks are affected significantly by the capacity of the borrowing customers they serve. Enterprise reform to improve the viability of companies and accounting reform to more accurately reflect their financial condition are two critical ingredients in developing a sound banking system. Enterprise reform and accounting reform should be coordinated in any program that seeks to improve the banking system.

75. **Efficiency of Financial Intermediation.** While inflation has been low, nominal interest rates for loans and deposits have remained high, resulting in substantial real rates. Despite the highly liquid banking system, the lending spreads of the banks also remain high. That indicates inefficient financial intermediation due to banks' cautious approach to lending. Several factors have prompted banks to take this approach, including an environment that does not allow quick debt recovery, the long process needed to realize collateral, weak accounting and financial management of the enterprises, and the absence of an up-to-date credit bureau. Improving the efficiency of financial intermediation by reducing banks' lending spreads will require removing these constraints. In this context, the development agencies should continue to build awareness and understanding of these issues among the policy makers and facilitate solutions.

76. **Follow-Up Process.** Most program loans, by their nature, involve some change in government policy. Since governments do not always act expeditiously, some reform issues might be outstanding at program closure and well afterward. The unfinished legal issues under this Program provide a good example. However, without further review missions after program closure, no mechanism was in place to follow up on unresolved issues. ADB resident missions

should monitor the status of any open issues from previous loans, and those processing new loans need to incorporate these issues into the conditionalities of the new loan.

77. **Monitoring.** As mentioned in para. 51, the bank software installation program did not reach its full potential, partly due to problems with consultants and partly due to the lack of regular monitoring. ADB staff should place a higher priority on the comprehensive and careful handover of monitoring responsibilities during staff changes.

## D. Follow-Up Actions

78. **MARA.** When MARA was established 7 years ago, its mission was to accept the inherited and directed loans of troubled government-owned banks. With only one government-owned bank left, and no apparent inherited or directed loans being made, MARA should be winding down its operations. MARA informed the OEM that there is no intention to transfer any more loans to the agency. The loans in its portfolio dating to the monobanking system 12 years ago clearly would be uncollectible. By March 2004, MOFE and the State Property Commission should assess MARA's debt collection capabilities and determine when collection efforts on this portfolio should cease.

79. **Legal System.** Three major issues remain unresolved in the legal and regulatory framework (paras. 28–30). ADB and MOFE should follow up regularly with MOJ on these long-overdue reforms to ensure that the banking system is given the tools necessary to recover its loans to nonperforming borrowers. At a minimum, these issues should be preconditions for any new loans to the sector.[30] A review of legal impediments to the efficient operation of the financial sector should be considered in the preparatory work leading to future operations. The appropriate legal reforms should be put in place quickly, preferably by mid-2004, as NPLs might increase sharply in the next year.

80. **Loan Growth.** ADB should encourage BOM to conduct a detailed study within 3 months on the source of the recent loan growth in the banking system.[31] By understanding where the loans are coming from, BOM may be better prepared to deal with any adverse consequences of such rapid growth. Based on the results of this study, BOM should consider tightening its classification and provisioning regulations in anticipation of a possible downturn. BOM also should be encouraged to further increase its staff and provide them with appropriate training.

---

[30] A program preparatory TA was approved in June 2003 to prepare the third financial sector program loan.
[31] Characteristics of the borrowers and the success of their investments can be reviewed to shed light on the quality of borrowers.

## FINANCIAL SECTOR TECHNICAL ASSISTANCE IN MONGOLIA (1991–1996)

| TA No. | Project Name | Type | Total ($) | Year Approved |
|---|---|---|---|---|
| **Capital Market Development** | | | | |
| 1536 | Adviser to Mongolian Stock Exchange | A&O | 100,000 | 1991 |
| 1542 | Training for the Mongolian Stock Exchange | A&O | 95,000 | 1991 |
| 1855 | Institutional Strengthening of the Financial Sector | A&O | 595,000 | 1993 |
| 2353 | Strengthening of Financial Intermediaries | A&O | 600,000 | 1995 |
| | **Subtotal** | | **1,390,000** | |
| **Development Finance Institution** | | | | |
| 1643 | Institutional Support to the Mongol Bank | A&O | 100,000 | 1992 |
| 2219 | Strengthening of the Commercial Banking System | A&O | 600,000 | 1994 |
| 2543 | Development of Procedures for the Reconstruction and Liquidation of Insolvent Banks | A&O | 100,000 | 1996 |
| 2605 | Development of Bank Restructuring Strategies | A&O | 100,000 | 1996 |
| 2697 | Implementation of Bank Restructuring Strategies | A&O | 100,000 | 1996 |
| 2720 | Strengthening the Supervisory and Restructuring Capacity of the Bank of Mongolia | A&O | 1,000,000 | 1996 |
| | **Subtotal** | | **2,000,000** | |
| **Privatization** | | | | |
| 1989 | State Privatization Commission | A&O | 490,000 | 1993 |
| 1989 | State Privatization Commission (supplementary) | A&O | 110,000 | 1995 |
| | **Subtotal** | | **600,000** | |
| | **Total** | | **3,990,000** | |

A&O = advisory and operational, TA = technical assistance.
Source: Asian Development Bank.

# POLICY MATRIX FOR THE MONGOLIAN FINANCIAL SECTOR PROGRAM LOAN

| Objective | | Action Program | | Actions to be Completed Prior to Board Consideration | Actions to be Taken for Release of Second Tranche[a] | Other Actions to be Taken During the Program[b] |
|---|---|---|---|---|---|---|
| **I.** | **Strengthening of the legal and regulatory framework for financial sector** | | | | | |
| I.A. | Facilitate debt recovery | I.A.1. | Bank of Mongolia (BOM) to establish working group to draft proposal to rectify deficiencies in the Civil Code pertaining to debt recovery | Nov 1996 | | |
| | | I.A.2. | Amend the Civil Code to remove deficiencies pertaining to debt recovery | | | Dec 1997 |
| | | I.A.3. | Establish a property registration division within the Ministry of Justice (MOJ) to consider strategies for setting up a registration agency | Aug 1996 | | |
| | | I.A.4. | MOJ to prepare action plan acceptable to Asian Development Bank (ADB) for setting up a registry for immovable property | | Jun 1997 | |
| | | I.A.5. | Government to submit draft Law on Secured Transactions (for movables) to Parliament | | Jun 1998 | |
| | | I.A.6. | Enact new banking law to permit banks to exchange credit information on borrowers | Sep 1996 | | |
| | | I.A.7. | MOJ to establish working group to review bankruptcy law | Sep 1996 | | |
| | | I.A.8. | Strengthen bankruptcy legislation to facilitate debt recovery, in particular giving preferred status to secured creditors | | Jun 1998 | |
| | | I.A.9. | MOJ to prepare recommendations on how to improve the structure and operations of the bailiff system | | | Dec 1997 |
| I.B. | Improve banking supervision | I.B.10. | Enact new banking legislation to clarify duties and responsibilities of management of commercial banks | Sep 1996 | | |
| | | I.B.11. | Enact new banking legislation to give BOM the right to replace bank management | Sep 1996 | | |
| | | I.B.12. | Enact new banking legislation to prohibit banks from directly engaging in equity market activities for their own account | Sep 1996 | | |
| | | I.B.13. | Enact new banking legislation to give BOM powers relating to the conservatorship, receivership, and liquidation of commercial banks | Sep 1996 | | |
| | | I.B.14. | BOM to approve regulations and implementation procedures for the liquidation of banks | Nov 1996 | | |
| | | I.B.15. | Enact new banking legislation to prohibit shareholders from taking out their paid-up capital in banks other than through sale of shares | Sep 1996 | | |
| | | I.B.16. | Enact new banking legislation to limit lending to any one borrower or related groups of borrowers to 20% of paid-up capital of bank | Sep 1996 | | |
| | | I.B.17. | BOM to set minimum capital to risk-weighted assets standards for all banks in line with Bank for International Settlements' standards: | | | |

[a] The second tranche release is expected to take place within 2 years of loan effectiveness, i.e., by 31 December 1998.
[b] Program period ends on 31 December 1999.

| Objective | | | Action Program | Actions to be Completed Prior to Board Consideration | Actions to be Taken for Release of Second Tranche | Other Actions to be Taken During the Program |
|---|---|---|---|---|---|---|
| | | | I.B.17.1 2% (tier one capital) | | Jun 1998 | |
| | | | I.B.17.2 4% (tier one capital) | | | Dec 1999 |
| | | I.B.18. | Enact new banking legislation to enhance BOM's powers to enforce prudential regulations | Sep 1996 | | |
| | | I.B.19. | Banks to report the rescheduling of all loans larger than MNT10 million to BOM on a quarterly basis | Nov 1996 | | |
| | | I.B.20. | Banks to provide quarterly status reports to BOM on collection efforts for all loans classified as substandard, doubtful, and loss | Jun 1996 | | |
| | | I.B.21. | Banks to provide monthly status reports to BOM on new lending and loan repayments | Nov 1996 | | |
| I.C. | Establish a framework for regulating nonbank financial institutions (NBFIs) | I.C.22. | Enact new banking legislation to provide BOM with powers to regulate NBFIs (e.g., finance and leasing companies, investment and non-equity funds, and other entities engaging in lending or related activities) | Sep 1996 | | |
| | | I.C.23. | BOM to approve a regulatory framework for NBFIs that is acceptable to ADB | | Dec 1997 | |
| I.D. | Facilitate the enforcement of financial sector related laws | I.D.24. | Develop a long-term program within the Institute of Administration and Management Development to train judges and lawyers in the implementation of laws related to financial sector operations | Oct 1996 | | |
| I.E. | Improve transparency about the financial position of banks | I.E.25. | BOM to enforce full compliance with new accounting standards and regulations based on generally accepted accounting principles for all commercial banks | | Jan 1998 | |
| | | I.E.26. | BOM to require full compliance by all commercial banks with provisions on recognition of interest income under new BOM accounting regulations | Oct 1996 | | |
| | | I.E.27. | BOM and Ministry of Finance (MOF) to issue loan classification and loan loss provisioning requirements acceptable to ADB | Nov 1996 | | |
| | | I.E.28. | BOM to enforce full compliance with loan classification and loan loss provisioning requirements | Nov 1996 | | |
| | | I.E.29. | Enact new banking legislation to permit tax deductibility for loan loss provisions | Sep 1996 | | |
| | | I.E.30. | Enact new banking legislation to subject all banks to an annual external audit and to publish annual financial statements | Sep 1996 | | |

| Objective | | Action Program | | Actions to be Completed Prior to Board Consideration | Actions to be Taken for Release of Second Tranche | Other Actions to be Taken During the Program |
|---|---|---|---|---|---|---|
| **II.** | **Financial intermediation process based on market conditions** | | | | | |
| II.A. | Curtail government interference with banking activities | II.A.31. | Government to stop issuing credit directives to BOM and financial institutions | | | continued compliance |
| | | II.A.32. | Enact new banking legislation to limit the extension of BOM credit to the Government, including public enterprises and local governments | Sep 1996 | | |
| | | II.A.33. | Incorporate Trade and Development Bank under the Company Law | | | Mar 1997 |
| | | II.A.34. | MOF and BOM to clarify ownership of banks and to issue definite lists of shareholders | | | Jun 1997 |
| | | II.A.35. | Government to prepare strategy, acceptable to ADB, for the divestment of direct and indirect state holdings in banks | | Jun 1998 | |
| | | II.A.36. | Establish BOM and MOF Working Group to review taxation of commercial bank branches | Oct 1996 | | |
| II.B. | Restrict shareholder access to credit | II.B.37. | Enact new banking legislation to restrict lending to a single shareholder to no more than 5% of paid-up capital of the relevant bank and lending to all shareholders to no more than 20% of paid-up capital | Sep 1996 | | |
| | | II.B.38. | Banks to report to BOM on a monthly basis all lending to shareholders with shareholdings of more than 1% of bank shares | | | continued compliance |
| II.C. | Establish market-determined interest rates | II.C.39. | Government to discontinue lending by government NBFIs, including funds, unless authorized by BOM | Sep 1996 | | |
| | | II.C.40. | BOM to remove interest rate floor on time deposits | Oct 1996 | | |
| | | II.C.41. | Banks to pay interest on government deposits in line with market conditions and Government to adequately compensate banks for all services rendered in connection with the transfer and distribution of social security, pension, and budget funds | | | Jan 1997 |
| | | II.C.42. | BOM to use auction mechanism for its refinance facility | Mar 1996 | | |
| | | II.C.43. | BOM to enforce its limits on commercial banks' access to its refinance facility | | | continued compliance |
| | | II.C.44. | BOM to provide facility to discount central bank bills | Jun 1996 | | |
| | | II.C.45. | BOM to discontinue clearing loan facility | | Jun 1998 | |
| | | II.C.46. | BOM to restrict the provision of credit or liquidity to commercial banks outside its refinancing or discount facility to emergency support for illiquid banks in accordance with the provisions of the Central Banking Law | | Jun 1998 | |
| **III.** | **Strengthening of financial intermediaries** | | | | | |
| III.A. | Improve bank's policies and systems | III.A.47. | BOM to require all banks to approve credit policies that reflect sound banking principles | Oct 1996 | | |
| | | III.A.48. | BOM to prohibit banks from making new loans to borrowers in default | Mar 1996 | | |

| Objective | | Action Program | | Actions to be Completed Prior to Board Consideration | Actions to be Taken for Release of Second Tranche | Other Actions to be Taken During the Program |
|---|---|---|---|---|---|---|
| | | III.A.49. | BOM to prohibit banks from automatically rescheduling loans to borrowers in default without negotiated repayment schedules that ensure borrowers' debt servicing capacity | Jul 1996 | | |
| | | III.A.50. | All banks to establish adequate loan restructuring departments/units | Sep 1996 | | |
| | | III.A.51. | All banks with assets above MNT10 billion to establish asset and liability management committees | Sep 1996 | | |
| | | III.A.52. | Government to make technical assistance (TA) loan funds provided by ADB available to BOM for onlending to commercial banks for technical assistance to support the upgrading of their skills and systems | | | commencing Jan 1997 |
| III.B. | Remove unrecoverable directed and inherited loans from banks' balance sheets | III.B.53. | Banks to capitalize interest in arrears on unrecoverable inherited and directed loans, and to show loans separately on banks' balance sheets | Mar 1996 | | |
| | | III.B.54. | Government to determine strategy acceptable to ADB for removing these assets from banks' balance sheets | Oct 1996 | | |
| | | III.B.55. | Government to substitute inherited and directed loans with interest-bearing government securities for all banks that qualify under the strategy determined under II.B.38. | | Jan 1997 | |
| III.C. | Restructure banks that have long-term viability | III.C.56. | Enact new banking legislation to prohibit the payment of dividends and any other distribution of profits by banks that do not fully comply with BOM prudential norms and capital adequacy standards | Sep 1996 | | |
| | | III.C.57. | BOM to issue cease and desist orders for all insolvent banks, specifying an interim program of remedial actions | Nov 1996 | | |
| | | III.C.58. | BOM to determine time-bound restructuring strategy for Agricultural Bank that is acceptable to ADB | Nov 1996 | | |
| | | III.C.59. | BOM to determine time-bound restructuring strategy for the Bank of Investment and Technological Innovation (BITI) that is acceptable to ADB | Dec 1996 | | |
| | | III.C.60. | BOM to enforce compliance of Agricultural Bank and BITI with restructuring strategies determined under II.C.42 and II.C.43 | | commencing Jan 1997 | |
| III.D. | Close banks that do not have long-term viability | III.D.61. | BOM to put People's Bank and Insurance Bank into receivership and sell their assets to an asset recovery agency (ARA) in return for government bonds | | | Jan 1997 |
| | | III.D.62. | Receiver to transfer household deposits and an adequate level of bonds to a newly established savings bank | | | Jan 1997 |
| | | III.D.63. | ARA to transfer performing loans to a newly established enterprise bank | | | Feb 1997 |
| | | III.D.64. | Government to make adequate provisions in the 1997 budget to finance the bank restructuring program agreed with ADB | Dec 1996 | | |
| | | III.D.65. | BOM to fully enforce receivership provisions under the Banking Law for insolvent banks | | Jun 1998 | |

Source: ADB. 1996. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grant to Mongolia for the Financial Sector Program*. Manila.

## STATUS OF SECOND TRANCHE CONDITIONS

| Second Tranche Condition | Status of Compliance According to PCR | Status of Compliance According to Mission |
|---|---|---|
| 1. The Ministry of Justice (MOJ) to prepare an action plan acceptable to the Asian Development Bank (ADB) for setting up a registry for immovable property. | **Complied with.** Action plan was approved by the Bank of Mongolia (BOM) and MOJ in late 1996. This included (i) the Law of Registration of Immovable Property approved in January 1997; (ii) a law on taxation of immovable property being prepared by MOJ; (iii) the establishment of the Tax Registration Office; and (iv) the Registration of Collateralized Immovable Property regulation prepared jointly by the Ministry of Finance (MOF), MOJ, and the Board of Registration of Immovable Property. | **Technically complied with.** The Tax Registration Office was set up in 1997 with headquarters in Ulaanbaatar city and offices in each of the 21 aimags (provinces). However, registration is of little value to the banks without appropriate laws on foreclosure. At the moment, there are several conflicting laws governing foreclosure procedures, and MOJ is moving slowly to correct these deficiencies. The banks should be allowed to foreclose against their collateral without interference from the courts or the Court Decision Enforcement Agency. This is not yet in place. |
| 2. Government to submit draft law on secured transactions (for movables) to Parliament.[a] | **Complied with.** Amendments were made to the Civil Code to include a chapter for secured transactions prepared with legal assistance provided by German Agency for Technical Cooperation. The draft Civil Code was submitted to Parliament in December 1999 and first reading was finalized. The second reading was to be done when the new Parliament met. The draft law was expected to be approved in the fourth quarter of 2000. | **Not complied with.** Parliament still has not approved this draft law. MOJ should promptly submit this law for approval to provide the banks with an important tool for the collection of defaulted loans. |
| 3. Strengthen bankruptcy legislation to facilitate debt recovery, in particular giving preferred status to secured creditors. | **Complied with.** The Bankruptcy Law was amended in November 1997 to strengthen debt recovery, and associated regulations were issued concerning financing or dissolving business entities. BOM prepared a separate bank insolvency law that recognized the distinct nature of banks relative to other business entities. To improve the prompt resolution by the courts of cases related to ownership title on guarantee and collateral and assets prior to their deterioration, the regulation was approved binding courts to process such cases within 14 days. | **Not complied with.** Despite the PCR statement, the prevailing Bankruptcy Law still does not give preferred status to secured creditors. As a result, banks are much more inclined to foreclose on their collateral to maintain their preferred status rather than force the borrower into bankruptcy and be required to share the collateral with other creditors. MOJ should promptly submit legislation to correct this deficiency. |
| 4. BOM to set minimum capital risk-weighted assets standards for all banks in line with Bank for International Settlements (BIS) standards:<br>2% (tier 1 capital)[b]–June 1998; | **Complied with.** The standards were first introduced in March 1997 under the Regulation on Prudential Standards (BOM Resolution 114). A new Regulation on Prudential Standards of Banks was approved and became effective on 1 January 1999. Under these more stringent regulations, tier 1 capital has a floor of 5% of the total risk-weighted assets, | **Complied with.** BOM's prudential requirement for capital adequacy is now fully in line with BIS standards. Minimum risk-weighted tier 1 capital is 5% and minimum risk-weighted total capital is 10%. At 31 December 2002, all banks in Mongolia were in compliance with the total capital |

PCR = program completion report.

[a] A partial waiver was sought for this condition for the purpose of the second tranche release.

[b] Tier 1 or "core" capital consists of permanent shareholders' equity and disclosed reserves that are created or maintained by appropriations of retained earnings or other surplus.

| Second Tranche Condition | Status of Compliance According to PCR | Status of Compliance According to Mission |
|---|---|---|
| 4% (tier 2 capital)[c]–December 1999. | while tier 2 capital is not to exceed 50% of the total equity capital of banks. In addition, BOM approved a regulation requiring minimum paid-up capital for all commercial banks of $1 million. This has been tightened to MNT2 billion by a BOM decree on 21 January 2000. Banks licensed prior to this date are required to increase their capital to the required minimum by 30 June 2001. | ratio. In fact, the aggregate total capital ratio for the system was 20% at that date. No further action is necessary. |
| 5. BOM to enforce full compliance with new accounting standards and regulations based on generally accepted accounting principles for all commercial banks. | **Complied with.** Accounting standards and regulations developed with assistance from an ADB adviser became effective on 1 January 1995. BOM approved a revised accounting package (Resolution 537)—to improve accuracy of banks' reported financial position—and that became effective on 1 January 1999. This package has been adopted by all commercial banks. New banking legislation was introduced subjecting all banks to annual external audits and requiring their financial statements be published. Banks have been in compliance with this requirement. | **Complied with.** All commercial banks are now audited annually by approved external auditing firms in accordance with international accounting standards. No further action is necessary. |
| 6. BOM to approve a regulatory framework for nonbank financial institutions (NBFIs) that is acceptable to ADB. | **Complied with.** On 1 April 1999, BOM approved regulations on licensing and examination of NBFIs based on the recommendations of the ADB adviser. The regulations include (i) loan-deposit activities; (ii) currency purchase and sale on behalf of the entity and its customers; (iii) financial leasing; (iv) credit card, wire transfer, and other payment media; and (v) payment and settlement services. BOM revised and updated the licensing regulation of NBFIs on 31 December 1999. The prudential ratios regulation was approved in December 2000 at the following rates: risk-weighted capital ratio, minimum 8%; liquidity ratio, minimum 10%; single borrower exposure, maximum 20%; foreign exchange open position limits, +/-10% for single currency, +/-20% for overall aggregate position. BOM approved a law on accounting regulation for NBFIs on 20 March 2000. | **Complied with.** |
| 7. The Government to substitute inherited and directed loans with interest-bearing Government securities for all banks that qualify under the strategy. | **Complied with.** In 1996, MOF settled inherited and directed loans with Bank of investment and Technological Innovation (BITI) and Agricultural Bank by issuing promissory notes for MNT1.9 billion and MNT3.6 billion, respectively. Further claims are under review, but these are not considered covered under the initial agreement. | **Complied with.** Government has settled all the interest arrears on the Bank Restructuring Bonds (BRB's) and has redeemed the bonds held at Agricultural Bank and BOM. There are still over MNT20 billion in bonds outstanding at Savings Bank; settlement of those depends on the Plan of Resolution for Savings Bank. The Operations Evaluation Mission (OEM) was informed that the |

[c] Tier 2 or "supplementary" capital includes elements such as perpetual securities (for instance, perpetual cumulative preferred shares), undisclosed reserves, subordinated debt with maturity exceeding 5 years, and shares redeemable at the option of the issuer.

| Second Tranche Condition | Status of Compliance According to PCR | Status of Compliance According to Mission |
|---|---|---|
| | | Government does not intend to issue any more BRBs. |
| 8. BOM to enforce compliance of Agricultural Bank and BITI with time-bound restructuring strategies for both banks. | **Complied with.** In December 1996, MOF and BOM negotiated memoranda of understanding (MOUs) with Agricultural Bank and BITI. The actions defined under these MOUs were satisfactorily implemented. However, in 1998, nonperforming loans at these banks increased as corporations faced exogenous shocks resulting from the Asian and Russian financial crises. ADB held fresh consultations with BOM and MOF to develop a strategy for accommodating these effects on the banks' balance sheets. Operational and financial restructuring plans were revised and are being implemented in three problem banks (Agricultural Bank, BITI, and Reconstruction Bank). The plans include staff retrenchment, branch and subbranch closures, and selling of assets. In addition, a list of major loan defaulters was published, and defaulters are being actively pursued through the court system. | **Complied with.** A restructuring plan was prepared for Agricultural Bank. Foreign senior management, brought in under a US Agency for International Development contract, turned the bank around. The bank was sold to HS Securities, a Japanese holding company in early 2003. BITI was placed into receivership and liquidated in 1999. No further action is necessary. |
| 9. BOM to fully enforce the receivership provision under the Banking Law for insolvent banks. | **Complied with.** The Program supported a framework for the resolution of problem banks according to the Banking Law. It entailed appointing conservators, restructuring, sale of banks, and (if necessary) liquidation. The Banking Law was amended on 21 July 1999 (i) defining the powers of receivers, (ii) increasing powers to restructure banks, and (iii) enforcing writing down shareholder capital and increasing penalties for offenders.<br><br>In 1997, People's Bank and Insurance Bank were placed in receivership, restructured, and their assets transferred to the Mongolian Asset Recovery Agency. Two new banks were created as a result of the restructuring: Savings Bank and Reconstruction Bank. Subsequently, BOM placed Agricultural Bank, BITI, and Reconstruction Bank under receivership. In December 1999, following a failure to restructure, BITI and Reconstruction Bank began liquidation procedures. In August 2000, following the preparation of a draft business plan and the appointment of a foreign-led management team, Agricultural Bank was recapitalized for the purpose of privatization. | **Complied with.** Twelve banks had their licenses revoked during the course of the Program, including Central Asia Bank, People's Bank, and Insurance Bank, which were closed at the time of program effectiveness. In most cases, the banks were first placed into receivership and subsequently liquidated. There have been no license revocations since 1999. In fact, all 16 banks in the system meet substantially all prudential norms. No further action is necessary at this time. |

| Second Tranche Condition | Status of Compliance According to PCR | Status of Compliance According to Mission |
|---|---|---|
| 10. BOM to discontinue loan clearing facility. | **Complied with.** Pursuant to BOM Regulation on Refinancing (Resolution 178), the BOM loan-clearing facility was discontinued in May 1997, and the relevant account closed. This condition has strengthened the interbank market by eliminating the implicit guarantee previously provided through the facility. | **Complied with.** In the past, commercial banks had gained liquidity by discounting loans at BOM under a loan clearing facility. With the tightening of the terms of this facility in 1997, banks were expected to manage their liquidity through the interbank market instead. However, this market has not grown as fast as had been hoped due to the banks' concern about counterparty credit worthiness. |
| 11. BOM to restrict the provision of credit or liquidity to commercial banks outside its refinancing or discount facility for emergency support for illiquid banks in accordance with the provisions of the Central Banking Law. | **Complied with.** The regulation on refinancing approved in May 1997 (see above) regulates provision of credit by BOM to commercial banks. The measure has strengthened the interbank market. To refinance loans, commercial banks should provide negotiable instruments as collateral. The interest rate is established by adding a margin of up to 15% to the highest rate of BOM bills. The quality of collateral and the liquidity status of a bank are major factors in the establishment of the margin. | **Complied with.** See item 10 above. |
| 12. The Government to prepare a strategy, acceptable to ADB, to divest direct and indirect state holdings in banks. | **Complied with.** The Government prepared bank privatization guidelines, which were vetted by ADB and approved by Parliament in July 1999. The strategy pursues bank privatization as a means to (i) remove external interference in the conduct of bank business, (ii) foster competition and improved efficiency, and (iii) improve banking sector governance and public confidence. According to the privatization timetable, Agricultural Bank, BITI, Reconstruction Bank, and Trade and Development Bank (TDB) will be put up for sale over the short term. With the valuable commitment of the present administration, bank privatization has been included in the bank restructuring plan of action the Parliament approved recently. The Law on Federal and Local Property has been amended to obligate the Government to reach a consensus with the BOM on a privatization program. | **Substantially complied with.** TDB and Agricultural Bank have been privatized. The only remaining government holdings in the banking sector are Capital Bank (17%), Mongol Post Bank (2.5%), and Savings Bank (100%). The Government is planning to sell its holdings in Capital Bank and Mongol Post Bank in the near future. Its holding in Savings Bank will be subject to the Plan of Resolution for Savings Bank, which is under discussion. |

Source: Operations Evaluation Mission and program completion report.

**PRUDENTIAL RATIOS OF COMMERCIAL BANKS**
(as of December 2002)

| Bank Name | Capital Adequacy (%) | Liquidity (%) | SBE | Connected Lending (%) | Loan Loss Provision (MNT millions) Required | Loan Loss Provision (MNT millions) Provided | Forex Exposure as % of TC | NPL as % of TL |
|---|---|---|---|---|---|---|---|---|
| Agricultural Bank | 12.2 | 36.9 | + | 12.2 | 347 | 347 | 7.3 | 0.8 |
| Trade and Development Bank | 16.4 | 58.9 | - | 2.0 | 5,402 | 5,413 | 33.5 | 14.5 |
| Savings Bank | 14.1 | 35.6 | + | 0.4 | 71 | 65 | 4.3 | 0.0 |
| Golomt Bank | 13.8 | 58.5 | + | 9.0 | 3,667 | 3,669 | 5.6 | 9.7 |
| Post Bank | 16.4 | 34.6 | + | 5.5 | 670 | 726 | 5.5 | 13.0 |
| Erel Bank | 94.3 | 91.9 | + | 13.5 | 40 | 40 | 0.7 | 1.4 |
| Ulaanbaatar Bank | 30.1 | 40.7 | + | 0.2 | 434 | 434 | 21.2 | 7.4 |
| Capital Bank | 43.6 | 48.7 | + | 0.4 | 47 | 47 | (3.5) | 4.1 |
| Transport and Development Bank | 36.1 | 23.9 | + | 4.6 | 52 | 52 | 3.8 | 0.6 |
| Credit Bank | 56.2 | 46.0 | + | 14.5 | 49 | 49 | 8.4 | 2.8 |
| Zoos Bank | 16.3 | 21.4 | + | 6.0 | 262 | 262 | (2.5) | 1.8 |
| Anod Bank | 11.0 | 29.0 | + | 1.7 | 679 | 843 | 1.5 | 6.9 |
| Inter Bank | 29.4 | 54.2 | + | 4.5 | 69 | 69 | 5.6 | 0.0 |
| Capitron Bank | 29.3 | 41.1 | + | 9.0 | 187 | 187 | (12.7) | 4.3 |
| Has Bank | 38.0 | 48.9 | + | 2.4 | 64 | 70 | (0.4) | 0.4 |
| Menatep Bank | 44.6 | 2.3 | - | 0.0 | 84 | 84 | | 0.0 |
| **Banking System** | **20.0** | **45.8** | | | **12,040** | **12,273** | **8.9** | **7.2** |

+ = the bank complied with prudential SBE ratios, - = bank did not comply with prudential SBE ratios, forex = foreign exchange, NPL = nonperforming loan, SBE = single borrower exposure, TC = total capital, TL = total loan.

Notes: (i) Capital to be at least 10% of risk-weighted assets; (ii) liquid assets to be at least 18% of total deposits and borrowed funds; (iii) loan to single borrower should not exceed 20% of capital; (iv) loan loss provisions to be 1% for performing loans, 1% against overdue (30 days) loans, 25% against substandard (90 days), 50% against doubtful (180 days), and 100% against loss (over 1 year); and (v) foreign exchange exposure not to exceed 40% of total capital.

Source: Bank of Mongolia.

## COMMERCIAL BANKING LICENSES

| Year | Issued | Revoked | Net |
|---|---|---|---|
| Before 1993 | 11 | 0 | 11 |
| 1993[a] | 2 | 0 | 2 |
| 1994 | 0 | 1 | (1) |
| 1995 | 2 | 1 | 1 |
| 1996 | 3 | 3 | 0 |
| 1997 | 3 | 0 | 3 |
| 1998 | 3 | 2 | 1 |
| 1999 | 2 | 7 | (5) |
| 2000 | 0 | 0 | 0 |
| 2001 | 2 | 0 | 2 |
| 2002 | 2 | 0 | 2 |
| 2003 | 0 | 0 | 0 |
| **Total** | **30** | **14** | **16** |

[a] Prior to 1993, 11 licensed banks operated in Mongolia.

Source: Bank of Mongolia.

**BALANCE SHEET FOR COMMERCIAL BANKS**
(MNT millions)

| Item | As of 31 December 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Cash in Bank | 82,245 | 44,036 | 68,086 | 85,309 | 86,945 | 125,216 |
| Marketable Securities | 19,055 | 11,697 | 21,200 | 22,847 | 49,675 | 60,770 |
| **Subtotal** | **101,300** | **55,733** | **89,286** | **108,156** | **136,620** | **185,986** |
| Investment Securities | 35,480 | 36,905 | 38,015 | 40,237 | 34,509 | 34,052 |
| Loans to Banks | 388 | 979 | 414 | 1,000 | 200 | 280 |
| Net Loans to Customers | 39,768 | 59,818 | 34,152 | 54,476 | 128,211 | 222,710 |
| **Total Current Assets** | **176,936** | **153,435** | **161,867** | **203,869** | **299,540** | **443,028** |
| Fixed Assets | 11,397 | 12,914 | 12,641 | 15,833 | 20,012 | 26,605 |
| Other Assets | 7,947 | 13,217 | 7,839 | 5,990 | 13,179 | 23,351 |
| **Total Assets** | **196,280** | **179,566** | **182,347** | **225,692** | **332,731** | **492,984** |
| **Memorandum Items** | **16,097** | **5,518** | **0** | **0** | **0** | **0** |
| **Liabilities** | | | | | | |
| Demand Deposit—Customers | 61,828 | 51,495 | 58,751 | 65,223 | 87,296 | 130,982 |
| Demand Deposit—Banks | 2,453 | 1,727 | 613 | 1,444 | 2,389 | 2,300 |
| Savings Deposits | 15,008 | 15,042 | 17,400 | 27,637 | 32,648 | 51,706 |
| Time Deposits—Customers | 43,462 | 44,267 | 50,584 | 65,049 | 101,959 | 166,654 |
| Time Deposits—Banks | 0 | 902 | 2,681 | 0 | 882 | 1,688 |
| **Total Deposits** | **122,751** | **113,433** | **130,029** | **159,353** | **225,174** | **353,330** |
| Loans from Banks | 1,238 | 4,583 | 214 | 0 | 0 | 0 |
| Loans from Nonbanks | 0 | 0 | 0 | 0 | 0 | 0 |
| Deposits and Loans from Government Agencies | 33,258 | 20,081 | 19,621 | 24,607 | 35,927 | 29,665 |
| Other Liabilities | 22,262 | 34,408 | 13,372 | 11,785 | 24,457 | 48,700 |
| **Total Liabilities** | **179,509** | **172,505** | **163,236** | **195,745** | **285,558** | **431,695** |
| Capital | 13,089 | 17,416 | 13,175 | 16,833 | 34,023 | 43,141 |
| Reserves | 3,894 | 4,517 | 5,277 | 6,531 | 8,493 | 9,571 |
| Retained Earnings | (213) | (14,873) | (2,692) | 4,383 | 4,657 | 8,437 |
| Subordinated Term Debt | 0 | 0 | 3,353 | 2,200 | 0 | 141 |
| **Total Equity** | **16,770** | **7,060** | **19,113** | **29,947** | **47,173** | **61,290** |
| **Total Liabilities and Equity** | **196,279** | **179,565** | **182,349** | **225,692** | **332,731** | **492,985** |
| **Memorandum Items** | **16,097** | **5,518** | **0** | **0** | **0** | **0** |

Source: Bank of Mongolia.

## INCOME STATEMENT FOR COMMERCIAL BANKS
(MNT millions)

| Item | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|
| Interest Income | 28,877 | 26,221 | 20,718 | 25,670 | 34,972 | 57,884 |
| Interest Expense | (16,183) | (14,421) | (10,490) | (9,650) | (13,420) | (24,243) |
| **Net Interest Income** | **12,694** | **11,800** | **10,228** | **16,020** | **21,552** | **33,641** |
| Noninterest Income | 5,471 | 6,433 | 6,407 | 10,536 | 17,169 | 26,681 |
| Noninterest Expense | (8,563) | (9,998) | (7,451) | (10,563) | (20,380) | (36,576) |
| **Operating Profit** | **9,601** | **8,235** | **9,184** | **15,993** | **18,341** | **23,746** |
| Provision for Loan Losses | (5,482) | (17,638) | (5,387) | (2,187) | (2,307) | (5,921) |
| Extraordinary Items | 22 | (103) | 38 | 0 | 0 | 0 |
| **Pretax Profit** | **4,142** | **(9,506)** | **3,835** | **13,806** | **16,034** | **17,825** |
| Tax | (1,792) | (4) | (1,184) | (4,822) | (6,179) | (6,835) |
| **Net Profit** | **2,350** | **(9,510)** | **2,651** | **8,984** | **9,855** | **10,990** |

Source: Bank of Mongolia.

**OUTSTANDING LOANS BY COMMERCIAL BANKS**
(MNT millions)

| Name of Bank | Feb 2001 | Feb 2002 | Feb 2003 |
|---|---|---|---|
| Agricultural Bank | 3,201.0 | 13,129.2 | 29,048.3 |
| Trade and Development Bank | 27,018.4 | 41,495.1 | 52,518.6 |
| Savings Bank | 275.6 | 1,936.0 | 7,744.9 |
| Golomt Bank | 14,020.2 | 26,917.3 | 39,263.6 |
| Post Bank | 4,794.0 | 12,802.6 | 19,758.4 |
| Erel Bank | 2,434.9 | 2,688.4 | 2,762.2 |
| Ulaanbaatar Bank | 3,292.7 | 5,615.3 | 6,226.2 |
| Capital Bank | 849.7 | 1,736.5 | 4,630.5 |
| Transport and Development Bank | 1,350.4 | 2,464.0 | 5,136.8 |
| Credit Bank | 780.3 | 2,270.9 | 4,225.4 |
| Zoos Bank | 3,209.8 | 10,169.8 | 21,216.0 |
| Anod Bank | 6,529.7 | 14,489.6 | 29,246.7 |
| Inter Bank | | 3,336.0 | 9,564.4 |
| Capitron Bank | | 4,346.8 | 11,202.6 |
| Has Bank | | 2,710.0 | 6,098.8 |
| Menatep Bank | | | 11,380.0 |
| **Total** | **67,756.7** | **146,107.5** | **260,023.4** |

Source: Bank of Mongolia.