ADB

Validation Report

Reference Number: PVR-249
Project Number: 34135-013
Loan Number: 2218
October 2013

Mongolia: Financial Regulation and Governance Program

Independent Evaluation Department
Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
AML	–	anti-money laundering
FRC	–	Financial Regulatory Commission
FRGP	–	Financial Regulation and Governance Program
GDP	–	gross domestic product
MNT	–	*togrog* (Mongolian currency)
MOF	–	Ministry of Finance
MSE	–	Mongolian Stock Exchange
NBFI	–	nonbank financial intermediary
PCR	–	program completion report
SCC	–	savings and credit cooperative
SFSP	–	Second Financial Sector Program
TA	–	technical assistance
WB	–	The World Bank

NOTE

In this report, “$” refers to US dollars.

Key Words

anti-money laundering, asian development bank, bank of mongolia, capital market, financial depth, financial regulatory commission, financial markets development, financial sector, market efficiency, mongolian stock exchange, nonbank financial intermediaries, policy reform

PROGRAM BASIC DATA

Project Number:	34135-013	**PCR Circulation Date:**	Jan 2012	
Loan Number:	2218	**PCR Validation Date:**	Oct 2013	
Project Name:	**Financial Regulation and Governance Program**			
Country:	Mongolia		**Approved** ($ million)	**Actual** ($ million)
Sector:	Finance	**Total Project Costs:**		
ADB Financing: ($ million)	**ADF:** 10.00	**Loan:** (SDR equivalent, million)	10.00 6.92	5.15 3.46
		Borrower:	0.00	0.00
	OCR: 0.00	**Beneficiaries:**	0.00	0.00
		Others:	0.00	0.00
Cofinancier:		**Total Cofinancing:**	0.00	0.00
Approval Date:	15 Dec 2005	**Effectiveness Date:**	4 Oct 2006	18 Sep 2006
Signing Date:	4 Jul 2006	**Closing Date:**	30 Jun 2010	30 Jun 2010
Project Officer(s):	 S. Shrestha M. Tanabe Y. Zhang J, Hansen	**Location:** ADB headquarters ADB headquarters ADB headquarters ADB headquarters	**From:** Jan 2006 May 2006 Jun 2007 Feb 2008	**To:** Apr 2006 May 2007 Jan 2008 Dec 2010
Validators:	R. Limjoco, Consultant F.D. De Guzman, Evaluation Officer, IED2	**Peer Reviewer:**	B. Nguyen, Senior Evaluation Specialist, IED2	
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ADB = Asian Development Bank, ADF = Asian Development Fund, IED2 = Independent Evaluation Department (Division 2), OCR = ordinary capital resources, PCR = project completion report, SDR = special drawing rights.

I. PROJECT DESCRIPTION

A. Rationale

1. Mongolia underwent a transition from monobanking to a two-tiered banking system in 1991. However, the transition was not smooth with the Mongolian financial system being beset by a number of financial crises in 1994, 1996, and 1999. In 2008, Mongolia was also affected by the global financial crisis and a drop in copper prices. The latter prompted the government to enter into a standby arrangement with the International Monetary Fund (IMF), which ended in October 2010.

2. The development of the financial sector has been central to achieving the transition from a centrally planned to a market-based economy due to the financial system's critical role in mobilizing and allocating resources within the economy in a market-oriented system. Thus, the Asian Development Bank (ADB) has supported the development of the financial sector in Mongolia through loans and technical assistance (TA). The first phase of comprehensive financial sector reforms was launched in 1996 against the backdrop of a fragile banking sector with a number of illiquid and insolvent banks. Supported by ADB's

Financial Sector Reform Program loan,[1] these reforms primarily focused on (i) bank restructuring and resolution, (ii) strengthening prudential regulations and supervision, and more generally, (iii) developing a market-oriented banking sector. The Second Financial Sector Program (SFSP) loan aimed to improve the soundness and efficiency of the banking system and enhance domestic resource mobilization by (i) strengthening corporate governance and internal control mechanisms; (ii) upgrading the management information systems in banks; (iii) introducing an interbank market; (iv) strengthening prudential regulations and accounting standards for nonbank financial intermediaries (NBFIs), the securities market, and the contractual savings institutions; and (v) privatizing the Mongolian Stock Exchange (MSE), Central Depository System, and the settlement and clearing system while increasing the supply of securities by requiring the government to unload shares worth about MNT200 million annually through the stock exchange from companies for privatization.

3. The Financial Regulation and Governance Program (FRGP),[2] building upon reforms undertaken in the previous programs, aimed to develop a sound and broad−based financial sector that effectively channels resources to productive investments. This was to be done by (i) improving access and removing impediments to the more efficient use of collaterals and eliminating tax distortions among financial investments; (ii) restoring and raising investor confidence by compensating investors for losses sustained from the failure of two custodian banks holding clearing funds and strengthening investor protection, among other things; (iii) allowing banks to be listed on the stock exchange to improve transparency and broaden ownership, clarifying the role of the board of directors, and improving the reporting and disclosure of related party transactions; (iv) implementing an effective anti-money laundering (AML) regime; and (v) laying the foundation for the development of other segments of the financial markets by establishing the Financial Regulatory Commission (FRC) to oversee the operations of nonbank financial institutions (NBFIs) and strengthening the legal and regulatory framework for NBFIs, including insurance companies, securities companies, and savings and credit cooperatives (SCCs), and drawing up of a medium-term strategy for capital market development.

B. Expected Impact

4. The expected impact was the development of a sound financial system with increased efficiency and outreach. Performance indicators were (i) increased financial depth as shown in an increase of broad money (M2) to gross domestic product (GDP) from 47% in 2004 to 65% by 2012; (ii) rise in the savings rate as percentage of GDP from 18% in 2003 to 25% by 2012; increase in the investment rate from 27% of GDP in 2003 to 31% by 2012; and (ii) reduced spread between the average interest rate of loans and deposits from 11% in 2004 to 4% by 2012.

C. Objectives or Expected Outcomes

5. The expected outcome was a broad−based financial sector with alternative channels of financial intermediation. Growth was projected in other segments of the financial markets, such as (i) increase in equity (from 1.4% to 4.5% of GDP) and market capitalization (from 2.2% to 15%) and turnover by 2009; (ii) increase in initial public offerings (from none in 2004 to 20% by 2006–2009); (iii) rise in NBFI assets (from 1.6% in 2004 to 4.5% in 2009) and diversified range of services; (iv) rise in insurance premiums (from 0.5% of GDP in 2004 to 3% in 2009); and (v) improved array of insurance products; and (vi) SCCs providing finance to low-income households in urban and rural areas.

[1] ADB. 1996. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Mongolia for the Financial Sector Reform Program*. Manila.
[2] ADB. 2005. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to Mongolia for the Financial Regulation and Governance Program.* Manila.

D. Components and Outputs

6. Six outputs were envisaged, as follows: (i) improved procedures for collateral foreclosure and registration, (ii) strengthened corporate governance and disclosure by financial intermediaries and securities issuers, (iii) strengthened capacity of nonbank financial regulator, (iv) improved legal and regulatory framework for the finance sector, (v) established tax policies conducive to corporate sector and finance sector development, and (vi) operation of an effective AML regime for reporting and prosecuting suspicious financial transactions.

E. Provision of Inputs

7. A program loan of $10 million was extended to the government to support policy reforms and a technical assistance grant for $900,000 to assist the FRGP in building capacities and in implementing the required policy actions. Two other TA grants supported the program: TA 4393-MON Establishing an Effective Anti-Money-Laundering Regime for $500,000 to help establish an AML regime in the country, and TA 7112-MON: Capital Markets Development, which was redirected to support implementation of the policy reform agenda in the capital market.

F. Implementation Arrangements

8. The Ministry of Finance (MOF) was the executing agency for the FRGP and responsible for its overall implementation. The Bank of Mongolia was the implementing agency for the banking sector and AML components while the FRC was responsible for the NBFI component. An interagency coordination committee was to be set up headed by the MOF. The committee was to meet every quarter to coordinate and ensure the realization of reforms. ADB was to be a member of the committee to oversee FRGP's implementation.

II. EVALUATION OF PERFORMANCE AND RATINGS

A. Relevance of Design and Formulation

9. The program completion report (PCR)[3] rated the FRGP *relevant* but on the lower side. Its rationale was consistent with the government's National Development Strategy and reform program, and to ADB's country strategy and program and Strategy 2020,[4] which is ADB's long-term strategic framework. However, its design was deemed overly ambitious given an implementation period of 4 years, the available financial resources under the program, the attached TA grants, and in particular, Mongolia's human resource and institutional capacities. While the thrust of the program in developing the domestic capital market was considered highly relevant, it was recognized that capital market development is a gradual process and would take time to implement, especially given the country's lack of market infrastructure and capacity. Moreover, some experiences and lessons from the implementation of the SFSP were not properly taken into account, in particular the drafting and enactment of various legislations. Similarly, attempts to reform the MSE in the past had been without much success.

10. This validation rates the program *relevant* and would like to add the following considerations. First, since financial sector development is a continuing process, it is not mentioned whether ADB or other donors have prepared a road map for the financial sector in Mongolia based on a diagnostic assessment as a guide to policy and the proposed financial sector interventions. The support from ADB and from other donors would have

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[3] ADB. 2012. *Completion Report: Financial Regulation and Governance Program in Mongolia*. Manila.
[4] ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank*, *2008–2020*. Manila.

been aided by a road map early on, and following an in-depth diagnostic assessment, agreed with the government on how to develop the country's financial sector, and based on these, various development policy actions could have been carved out and supported by program loans. This would have guided the government, especially in a transition economy, in establishing priorities, defining the roles of various government agencies in the process, and coordinating funding support. It would also show the government the effects of a delay in one reform action in the overall development process. Second, the FRGP reform conditions largely consisted of drafting and amending legislations and implementing regulations (14 items, based on the policy matrix). It is not clear whether these were buttressed by a political−economic analysis of the proposed reforms, given the situation in Mongolia at the time and possible risks mitigated. And third, in terms of modality, given the first observation, the impreciseness of the timing of the proposed legislations and reforms, the relative instabilities faced by the country during the transition period, and the possible change of Parliament midway into the reform program, it is unclear whether a different modality like the cluster approach[5] configured as a series of single tranche loans would have been a better option. This approach is to allow the review and recalibration of the program after the first release and to allow more intensive hand-holding that is apparent in the government's various requests, including the major change in scope for the TA in Capital Markets Development, which was redirected to support the implementation of reforms under the FRGP. It is also uncertain whether the use of floating tranches similar to the World Bank programs would have been a useful device.

11. Notwithstanding these observations, this validation assesses the program intervention *relevant* to the country and the sector and to ADB's own assistance strategy.

B. Effectiveness in Achieving Project Outcome

12. The FRGP was rated by the PCR *less effective,* citing the nonachievement of performance indicators. M2/GDP increased from 35.9% to 56.7% from 2004 to 2010 indicating some improvement in financial deepening but not as envisaged by the program. Interest spread, however, still hovered at 13% on average, which is still high, and commercial banks still accounted for 96% of total financial assets by 2010, while insurance premiums as a share of GDP comprised a mere 0.38%. Stock market capitalization as a share of GDP increased from 1.3% in 2004 to 11.1% in 2008 and 19.3% in 2010. Annual turnover as a percentage of GDP was 1.1% in 2010. The increase in market capitalization, however, was principally due to an increase in share prices.

13. This validation also rates the program *less than effective.* In addition to the low-level outcomes, there was no clear linkage between the proposed reforms and the targeted outcomes. For example, simply improving the foreclosure process by allowing nonjudicial foreclosures is not likely to lower intermediation costs substantially as there are other factors influencing spreads. Strengthening regulation and supervision, by itself, will not likely lead to improved financial depth and more intensive resource mobilization without addressing the market incentive structure and market impediments at the same time, and the overall market infrastructure.

C. Efficiency of Resource Use in Achieving Outcome and Outputs

14. The PCR rated the program *less efficient.* Firstly, it did not address earlier deficiencies prior to embarking on a new program. Several policy measures under the program were already included as part of the SFSP—developing guidelines for corporate governance, improving the collateral framework and registration process, and strengthening the governance of the MSE. Several TA tasks, including drafting of the new

[5] This had been effectively applied by ADB in Cambodia's financial sector.

Securities Market Law and Company Law had to be repeated. Secondly, counterpart funds for the program were not used to finance program expenditures resulting in noncompliance with policy actions. Thirdly, delayed implementation is reflected in the low compliance with the policy matrix.

15. This validation also rates the program *less than efficient*. The cancellation of the second tranche of this program loan indicates the inability to leverage available resources to achieve the projected outcome and outputs. Two review missions on average since 2006 and three TA grants were not sufficient to keep the program on track. It begs the question of whether (i) placing a long-term consultant in the country to oversee the day-to-day implementation of crucial reforms, or (ii) a revolving TA grant where the government could draw the expertise it may require on short notice, or (iii) delegating the functions of monitoring the FRGP to the ADB resident mission with appropriate staffing support could have proven to be more responsive and efficient approaches.

D. Preliminary Assessment of Sustainability

16. The PCR rated the FRGP *likely to be sustainable* on the lower side. It indicated that ongoing improvements in the legal and regulatory framework might be able to support medium−term financial and capital market development. Progress had been reported on establishing an effective AML and counter-financing of terrorism regime and in the removal of tax distortions. However, these reforms are often fragmented and delayed.

17. The PCR provided a conflicting view on the government's commitment. On para. 48, it stated that "Ownership and commitment of the MOF to implement the program, while in line with policy priorities, diminished during implementation and was low when the program expired." Yet on para. 57, it stated "Government commitment to and ownership of the financial and capital markets reforms supported under the program are generally high."

18. What is not clear from the back-to-office reports is to what extent the crisis in 2008, the IMF intervention, and the results of Parliamentary elections have affected the implementation of the program or the government's resolve to pursue the program. While review missions pointed out the noncompliance with policy conditions, they did not spell out the reasons behind the noncompliance. Given that the reforms are slow and the ownership to implement the program remains low, this validation rates the program *less than likely to be sustainable*.

E. Impact

19. The PCR did not rate the program impact. Since 1991, financial intermediation has deepened with broad money (M2) to GDP rising from 18.5% at its lowest level in 1995 to 56.7% in 2010. Private sector credit, nonexistent in 1991, accounted for 45% of GDP by 2010 at the time of the PCR's release. Nonetheless, the financial sector remains heavily concentrated with limited access and few instruments.

20. While it is not possible to measure directly the contribution of the FRGP reforms to overall financial sector development, this validation concedes that incrementally, the reforms constitute part of the necessary market infrastructure (legal and regulatory framework) and building blocks (raising capacity) for financial markets development. A number of key legislations were adopted under the program, such as the law on nonjudicial foreclosure, code of corporate governance, law establishing the FRC, new banking law, new company law, law on accounting and auditing, and AML regulations. Amendments to the law on cooperatives were prepared but yet to be adopted. Of the total allocation of MNT560 million, MNT430 million has been released to compensate investors for the failure of two custodian banks holding clearing funds. Given the incremental nature and lag effects of these reforms, this validation rates the project impact *moderate*.

III. OTHER PERFORMANCE ASSESSMENTS

A. Performance of the Borrower and Executing Agency

21. The performance of the borrower and the MOF, as the executing agency, was rated by the PCR *partly satisfactory*. This is evident in the non-completion of key policy actions. While lack of capacity may be at the root of this and waning commitment on the part of the executing agency as noted by the PCR, it appears that lack of proper coordination, especially in a small growing economy, is an important factor. The Bank Training Center, for example, does not conduct trainings due to a dispute between the Bank of Mongolia and the commercial banks. Reform measures not complied with refer to joint drafting of regulations to implement consolidated supervision, and supervisory coordination for the oversight of holding companies among different implementing agencies, and establishment of a Financial Sector Liaison Committee comprising members of the National Coordination Committee and representatives of financial institutions, among others. Moreover, too many agencies that are not within MOF's control were involved in advancing the reforms. Reform programs of this nature are best kept within manageable parameters. This validation rates the performance of the borrower and the executing agency *less than satisfactory.*

B. Performance of the Asian Development Bank

22. The PCR rated ADB's performance *partly satisfactory*. The main reason cited was the focus of program monitoring, which was geared toward technical compliance rather than on policy dialogue. Also, when delays in implementation and diminishing government commitment started to become apparent in 2008, ADB took corrective actions by fielding more legal consultants but appeared to be a bit short and a little too late.

23. Areas where improvements could have been made during early and advance preparation to improve performance—barring a redesign and change in modality—in a complex and wide-ranging program of this nature, would have been on legislative actions to be taken, on assessing the political economy and risks, closer monitoring, and more intensive policy dialogue. In view of this, this validation also rates ADB's performance *less than satisfactory*.

C. Others

24. There was no adverse environmental impact cited, nor were there issues on safeguards, governance, resettlement, or fiduciary.

IV. OVERALL ASSESSMENT, LESSONS, AND RECOMMENDATIONS

A. Overall Assessment and Ratings

25. Overall, the PCR rated the program *partly successful*. This validation also rates the program *less than successful* (see table). This validation rates the program *relevant* as the program intervention remains relevant to the country and the sector and to ADB's own assistance strategy. This validation rates the program *less than effective* as there was no clear linkage between the proposed reforms and the targeted outcomes. This validation rates the program *less than efficient* as the cancellation of the second tranche of this program loan indicates the inability to leverage available resources to achieve the projected outcome and outputs. The sustainability rating is downgraded to *less than likely sustainable* as the reforms undertaken were often delayed and fragmented and the ownership remains low.

Overall Ratings

Criteria	PCR	IED Review	Reason for Disagreement and/or Comments
Relevance	Relevant	Relevant	
Effectiveness in achieving outcome	Less effective	Less than effective	
Efficiency in achieving outcome and outputs	Less efficient	Less than efficient	
Preliminary assessment of sustainability	Likely sustainable	Less than likely sustainable	Reforms undertaken were often delayed and fragmented, and the ownership remains low (paras. 16–18).
Overall Assessment	**Partly successful**	**Less than successful**	
Borrower and executing agency	Partly satisfactory	Less than satisfactory	
Performance of ADB	Partly satisfactory	Less than satisfactory	
Impact	Not rated	Moderate	A number of key legislations were adopted under the program, such as the law on nonjudicial foreclosure, code of corporate governance, law establishing the FRC, new banking law, new company law, and AML regulations. However, reforms entail time lags and their effects could not be readily realized (para. 20).
Quality of PCR		Satisfactory	PCR was well prepared with sufficient research and analyses**.**

ADB = Asian Development Bank, AML = anti-money laundering, IED = Independent Evaluation Department, PCR = program completion report.
Note: From May 2012, IED views the PCR's rating terminology of "partly" or "less" as equivalent to "less than" and uses this terminology for its own rating categories to improve clarity.
Source: ADB Independent Evaluation Department.

B. Lessons

26. A number of lessons had been drawn from the program, as follows: (i) proper matching of the scope and time frame in implementing proposed reforms with assessed institutional capacity; (ii) link appropriately expected consequences of proposed reforms with expected impact and outcomes; (iii) in complex, time-bound programs, early response and timely corrective action is critical; (iv) TA support should consider carefully the nature and extent of proposed policy reforms and the capacity of the implementing agencies; (v) ADB should also strengthen its internal capacity for rendering policy advice and not simply rely on consultants, and provide adequate budget to support supervision needs, including provision of staff incentives.

27. This validation supports these views. In addition, particularly among small, transition economies, it may be more prudent to take a gradual approach to financial market development, taking small slices of the development pie within a development continuum supported by an agreed road map, within a short time frame, with enough flexibility for continuing review and taking of corrective actions, and supported by technical assistance until such time as the country exhibits maturity of institutions, strong internal capacity, and political and economic stability.

C. Recommendations for Follow-Up

28. Moving forward, the PCR envisions the capital market to play a key role in the efficient allocation of revenues, especially from the mining sector. Reforms should be structured to produce intermediate improvements while strengthening implementation capacity. TA grants should provide not only for the drafting of laws but also for sensitizing stakeholders to the proposed reforms. Adjustment costs and investments needed to pursue policy reforms may be considered for funding through project provision rather than through indirect budget support. Future ADB interventions should consider TA support for the pending new Securities Market Law and Law on Investment Funds, and in the area of corporate governance. ADB should also consider projects that combine investments in key financial infrastructure while strengthening staff capacity and expertise. In the future, ADB financing could look into the environmental and social dimensions of financial institutions' lending operations.

29. These are useful recommendations arising from the experience of implementing the FRGP. It supports the view that ADB should remain engaged in the financial sector of Mongolia despite the setback in implementing the FRGP. It may be an appropriate time for ADB to take stock of where its program stands in relation to the financial sector of Mongolia and what shape its future programs may take as it reviews the failings under the FRGP to avoid repetition. Nonetheless, where political will may be lacking, ADB can still pursue development projects that support financial market development.

30. The scope for reforms remains large in terms of improving market efficiency, and the breadth and depth of the market. Major constraints still point to access to finance. The WB's enterprise survey in 2009[6] showed that this is the most important constraint among the top 10 constraints reported by firms in the country, especially among small-to-medium scale enterprises and in the rural areas. Maturities remain on the short end of the spectrum with long-term finance still severely limited. Also, as pointed out by the PCR, the market will likely have a crucial role in allocating and recycling expected mining revenues in the future.

V. OTHER CONSIDERATIONS AND FOLLOW-UP

A. Monitoring and Evaluation Design, Implementation, and Utilization

31. The FRGP included easily available performance indicators to evaluate impact and outcomes, but these were too ambitious as there was no direct linkage between the proposed reforms and the intended impact and outcomes. The policy matrix was sufficiently specific for evaluation purposes but could have been more detailed with defined critical paths for monitoring purposes. Consequently, feedback on the progress of reforms and corrective actions could have been given in a more timely fashion. The motivation driving the various market players were not adequately analyzed. Accordingly, it was not sufficiently explained why the government opted to forego the second tranche of the program loan.

B. Comments on Project Completion Report Quality

32. The quality of the PCR is rated *satisfactory*. It was prepared in accordance with PCR preparation guidelines PAI 6.07. The PCR reflected a good grasp of the policy issues and suitably focused on the key shortcomings of the program—both in its formulation and implementation. The findings have also been adequately substantiated. Recommendations drawn from lessons learned would be useful for subsequent program interventions of this nature. The PCR was well written in clear prose and with a logical flow.

[6] The World Bank and International Finance Corporation. 2010. *Enterprise Surveys: Mongolia Country Profile, 2009.* Washington, DC.

C. Data Sources for Validation

33. This validation relied on the program loan's PCR, the report and recommendation of the President, past evaluation study of the financial sector in Mongolia, the program performance evaluation report for the SFSP, back-to-office reports, and various memoranda of understanding. There was no midterm review report as there was low compliance with the policy matrix, instead, a major change in the scope of an approved TA grant to support program implementation was undertaken.

D. Recommendation for Independent Evaluation Department Follow-Up

34. A project performance evaluation report may not be necessary.