

ASIAN DEVELOPMENT BANK

TAR: MON 33287

TECHNICAL ASSISTANCE

TO

MONGOLIA

FOR

STRENGTHENING RESTRUCTURING OF THE BANKING SYSTEM

June 1999

CURRENCY EQUIVALENTS

(as of 31 May 1999)

Currency Unit	–	Tugrik (Tug)
Tug1.00	=	\$0.0010
\$1.00	=	Tug1,003.28

ABBREVIATIONS

AB	–	Agriculture Bank
BITI	–	Bank for Investment and Technological Innovation
BOM	–	Bank of Mongolia
ESAF	–	Enhanced Structural Adjustment Facility
FSPL	–	Financial Sector Program Loan
HLSC	–	High Level Steering Committee
IMF	–	International Monetary Fund
RB	–	Reconstruction Bank
RWG	–	Restructuring Working Group
TA	–	Technical Assistance
USAID	–	United States Agency for International Development

NOTE

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

I. INTRODUCTION

1. The Government of Mongolia has been pursuing finance sector reforms since 1991. The reforms seek to develop a sound banking system to strengthen economic recovery. The Bank has supported the reforms through its Financial Sector Program Loan (FSPL).¹

2. Banking system reforms, and specifically the fundamental restructuring of the banks, are critical components of the FSPL. The bank restructuring action plan for 1999-2000, which has recently been agreed among the Government, the Bank, and the International Monetary Fund (IMF), is an integral component of the IMF's enhanced structural adjustment facility (ESAF). In this context, the Bank of Mongolia (BOM)² requested Bank technical assistance (TA)³ to support bank restructuring under the action plan and to develop banking system reforms for the next phase of the FSPL. The TA framework is presented in Appendix 1.

II. BACKGROUND AND RATIONALE

3. To support reforms under the FSPL, the Bank approved a TA grant and a TA loan in December 1996.⁴ The TA grant helped strengthen the capacity of BOM to regulate, supervise, and restructure the commercial banking system. Areas covered included the (i) development of a core group of qualified banking supervisors through classroom and on-the-job training; (ii) development of bank examination methodologies and procedures; (iii) preparation of regulations pertaining to banking supervision, bank licensing, and conservatorship;⁵ (iv) enhancement of bank accounting standards and regulations in line with international practices; (v) operational and financial restructuring of selected banks; and (vi) liquidation of banks. The TA was effectively utilized to support these activities and was completed in May 1999.

4. The goal of the still ongoing TA loan is to improve the capacity of commercial banks to operate in a market-oriented economic system. International consultants were hired under the TA loan to design a training program to launch the operations of the newly created Training Center. Training activities under the program include a combination of domestic and international training in basic and advanced banking skills together with the development of a trainers' program. The training activities were successfully implemented, however, further assistance is required to help (i) higher education institutions play a more active role in the training of staff of commercial banks, and (ii) train staff in the use of integrated banking software. The TA loan has supported training programs both for BOM and commercial banks. The remaining TA loan funds are expected to be used for purchase of the banking software (the tendering process is already under way), as well as for additional training activities.

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

² In February 1999, the Governor of BOM, requested the assistance of a bank restructuring coordinator/adviser to support implementation of BOM's restructuring action plan.

³ The TA first appeared in *ADB Business Opportunities* (Internet edition) in May 1999.

⁴ TA 2720-MON: *Strengthening the Supervisory and Restructuring Capacity of Bank of Mongolia*, for \$1 million, approved on 19 December 1996; and TA Loan 1510-MON: *Upgrading Skills and Systems of Commercial Banks*, for \$3 million, approved on 19 December 1996.

⁵ According to the Banking Law, BOM can appoint a conservator when a bank becomes insolvent or is likely to become insolvent, in order to undertake restructuring measures with the objective of restoring the bank.

5. While the technical support provided under the TAs has built capacities at BOM and commercial banks, progress in implementing FSPL has been adversely affected by delays in the bank restructuring process. Besides political resistance, the Government has faced problems in recapitalization of the three problem banks, namely, Agriculture Bank (AB), Bank for Investment and Technological Innovation (BITI), and Reconstruction Bank (RB). One of the issues has been budgetary constraints stemming from a fall in taxes because of the slow growth in export earnings and contraction in the overall tax revenue base. Delays in capitalization and restructuring of banks have further weakened asset quality and the financial positions of these banks. The three banks, accounting for over 23 percent of total assets of the banking system and over 70 percent of its nonperforming portfolio, are technically insolvent.

6. In December 1998, after a six-month hiatus under a caretaker Government when major policy reform initiatives were put on hold, Parliament appointed a new Government. The new Government is committed to the reforms and has signaled this by agreeing to the ESAF, which centers on fiscal and banking system reforms.⁶

7. More recently, BOM has stepped up its efforts to restructure AB, BITI, and RB. Under BOM's guidance and monitoring, the three banks have ceased net lending to halt further financial deterioration. In addition, conservators were appointed to manage the three banks and an aggressive program of downsizing has started including staff retrenchment, branch closures, and selling of assets.

8. BOM has also (i) amended the banking law, (ii) strengthened banking regulations, (iii) approved new regulations for non-bank financial institutions, and (iv) submitted a bank privatization strategy to Parliament. These measures will facilitate FSPL's effective implementation.

9. Under the ESAF, a time-bound action plan was prepared in collaboration with the Bank, with the objective of creating a stronger market-based and commercially viable banking system. The restoration of the three banks is the critical component of this reform process. Key elements under the plan include (i) establishing a high level steering committee to foster broad political support and ensure effective implementation of banking system reforms; (ii) establishing a restructuring working group to ensure aid coordination during implementation of the bank restructuring process; (iii) appointing conservators and advisers to the conservators in the three banks; (iv) preparing restructuring plans and commencing implementation; (v) seeking Parliamentary approval of the Bank Privatization Strategy; (vi) appointing external auditors and introducing due diligence at the three banks; (vii) amending the Banking Law; (viii) privatizing the Trade and Development Bank;⁷ (ix) convening shareholders meetings and inviting existing shareholders to increase capital in the three banks; (x) putting the three banks up for sale if no agreement is reached to recapitalize; and (xi) if the sale is unsuccessful, appointing receivers and liquidating the enterprises.

10. These actions will build on policy discussions held under FSPL and carry forward the policy agenda for 1999-2000. To ensure successful program implementation, including release of FSPL's second tranche, the United States Agency for International Development (USAID), the Bank, and IMF will be required to provide additional technical support. USAID has already appointed a bank restructuring consultant at each of the three insolvent banks. The consultants will assist the BOM conservators and will work in coordination with a bank restructuring adviser

⁶ The ESAF will be submitted for consideration by the IMF Board on 16 June 1999.

⁷ Trade and Development Bank is the largest commercial bank in Mongolia with Tug69 billion in total assets.

at BOM to be funded by the proposed TA. The adviser will also provide support in banking supervision development and training, as well as in the design of a finance sector development strategy over the medium term. IMF is providing TA support to BOM to strengthen internal auditing, accounting, and budget control systems. Additional TA support is to be provided by IMF in money market development and in phasing out bank restructuring bonds.

11. In addition, The World Bank is supporting the strengthening of the Trade and Development Bank and has a credit line for \$10 million through Banking and Enterprise Sector Adjustment Credit. USAID is also supporting privatization of the Trade and Development Bank. The German Agency for Technical Cooperation is providing TA support to AB and an equity investment is also being considered.

12. The bank restructuring action plan, to be supported through the TA, will be implemented through to March 2000 with the objective of effective resolution of the three problem banks, AB, BITI, and RB. This will constitute a major achievement toward developing a commercially viable banking system that is independent of Government support, conforms to prudential regulations, and better responds to market discipline.

III. THE TECHNICAL ASSISTANCE

A. Objectives

13. To maintain the momentum of finance sector reforms, the key objective of the TA is to help develop a restructured and viable banking system that will lay the foundation for improved and stable economic growth in Mongolia.

B. Scope

14. The TA will provide advisory support to develop, coordinate, and facilitate banking system reforms, and in particular bank restructuring activities. This will include support for (i) diagnosing/halting financial deterioration, and developing a restructuring strategy for AB, BITI, and RB; (ii) streamlining operations under the restructuring strategy; and (iii) facilitating the sale, merger, and/or liquidation of the banks.

15. The TA will provide additional support for banking supervision development and training, including on-site and off-site activities with a special focus on monitoring the three banks.⁸

16. Finally, guidelines will be prepared for the strategic development of the finance sector in Mongolia. They will chart the direction of sector reforms over the short to medium term, and as such, support the groundwork for FSPL follow-up activities. Advisory support will be provided to the Governor of BOM on major policy issues to strengthen the reform process and guide decision-making. The TA will also provide effective liaison with the Bank for monitoring conditions of the FSPL.

⁸ While this component was supported under TA 2720, it is important to note that additional strengthening is required. Banking supervision represents the critical element to ensuring that prudential norms are complied with and the health of the banking system preserved. Bank conservators have primarily been selected from the Banking Supervision Department at BOM placing further pressure on remaining staff. Accordingly, new staff will have to be hired and trained.

C. Cost Estimates and Financing Plan

17. The total cost of the TA is estimated to be \$240,000 equivalent, including foreign exchange costs of \$220,000 and local currency costs of \$20,000 equivalent. The Bank will finance the entire foreign exchange cost of \$220,000 on a grant basis from the Bank-funded TA program. The Government will provide \$20,000 equivalent through in-kind contributions of counterpart staff, office facilities, and logistical support. The cost estimates and financing plan are in Appendix 2.

D. Implementation Arrangements

18. The Executing Agency for the TA will be BOM. The services of a banking system reform specialist, who will concurrently serve as an adviser to the Governor of BOM, will be required for 8 person-months beginning in July 1999. BOM will provide office space, equipment, and local support for the consultant. The terms of reference of the services to be provided by the consultant, who will be engaged on an individual basis in accordance with the Bank's *Guidelines on the Use of Consultants*, are given in Appendix 3.⁹ The proposed TA will commence by July 1999 and be completed by March 2000.

IV. THE PRESIDENT'S DECISION

19. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance, on a grant basis, to the Government of Mongolia in an amount not exceeding the equivalent of \$220,000 for the purpose of Strengthening Restructuring of the Banking System, and hereby reports such action to the Board.

⁹ The terms of reference were reviewed and cleared by BOM.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Targets	Monitoring Mechanisms ¹	Risks/Assumptions
I. Sector Goal <ul style="list-style-type: none"> To develop a sound, market-oriented financial system to improve banking, restore credit growth, and strengthen economic recovery 	<ul style="list-style-type: none"> Credit growth Deposit growth Asset quality growth Bank profitability indicators Reduction in nonperforming loans Increased capital in the banking system Improved prudential regulatory requirements, including capital adequacy, liquidity ratio, loan/deposit ratio, single borrower limits, sectoral exposures, foreign currency position² Merging/liquidation of bank(s) 	<ul style="list-style-type: none"> Policy dialogue Review missions Inception/interim reports Final reports 	<ul style="list-style-type: none"> Macroeconomic stability Political resolve to deepen the reforms Containing power of vested interests
II. Objective <ul style="list-style-type: none"> To develop a restructured and viable banking system 	<ul style="list-style-type: none"> Bank restructuring plans Full compliance with Financial Sector Program Loan (FSPL) end of the program conditions 	<ul style="list-style-type: none"> Policy dialogue Review missions Inception/interim reports Final reports 	<ul style="list-style-type: none"> Independence of high-level steering committee Aid coordination Training activities
III. Components <ol style="list-style-type: none"> Bank Restructuring <ol style="list-style-type: none"> Design time-bound bank restructuring plans for three problem banks. Prepare an implementation plan to support sale, merger, or liquidation of problem banks. Banking Supervision Development and Training Finance Sector Development Strategy (Short to Medium Term) Policy Advisory Support to Governor, BOM 	<ul style="list-style-type: none"> Bank restructuring plans for Agriculture Bank, Bank for Investment and Technological Innovation, and Reconstruction Bank Recapitalize bank(s) Sell bank(s) Liquidate bank(s) Workshops Seminars Institutional restructuring of BOM Supervision Department Reports covering both banking and nonbank financial institutions Memos Briefing notes 	<ul style="list-style-type: none"> Review missions Reports Review missions Reports Resolutions of working group steering committee Review missions Reports Review missions 	<ul style="list-style-type: none"> Coordination between Bank of Mongolia (BOM) and Ministry of Finance (MOF) Coordination between BOM, MOF, and State Property Committee Approval of amendments to the Banking Law Supervision manual is translated, printed, and distributed Coordination with World Bank sector study Coordination with International Monetary Fund (IMF) and United States Agency for International Development (USAID)
IV. Inputs <ol style="list-style-type: none"> Consulting Services Training Activities 	<ul style="list-style-type: none"> Terms of reference 	<ul style="list-style-type: none"> Inception/interim reports Final reports 	

¹ Risks associated to inaccurate reporting have been mitigated to the extent that: (i) financial and portfolio audits are being prepared by Arthur Andersen for the three problem banks; (ii) individual restructuring advisers are reviewing the banks' financial statements and loan reports; (iii) improvements in on-site supervision through previous TA in the area.

² For assessment of sector goal targets, improvement is to be measured by contrasting balance sheets of problem banks before and after regulations are improved.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency (or in kind)	Total Cost
A. Bank Financing			
1. Consultants			
a. Remuneration and Per Diem			
i. International	185.00	0.00	185.00
b. International and Domestic Travel	7.00	0.00	7.00
2. Communications and Reports	5.00	0.00	5.00
3. Training	3.00	0.00	3.00
4. Contingency	20.00	0.00	20.00
Subtotal (A)	220.00	0.00	220.00
B. Government Financing			
1. Counterpart Staff	0.00	8.00	8.00
2. Office Facilities and Logistical Support	0.00	8.00	8.00
3. Contingency	0.00	4.00	4.00
Subtotal (B)	0.00	20.00	20.00
Total	220.00	20.00	240.00

TERMS OF REFERENCE

A. Background

1. As part of the Financial Sector Program Loan (FSPL), the Bank is supporting the Bank of Mongolia (BOM) in ongoing efforts to create a more efficient banking system. Under the second tranche of the FSPL, a critical condition requires BOM to restructure three large commercial banks that are technically insolvent. The simultaneous restructuring of three of the country's largest banks will pose economic and political challenges.

2. A time-bound action plan has been jointly prepared by BOM, the Bank, and the International Monetary Fund (IMF) that will carry through reforms identified under the FSPL and will lead to a resolution of the problem banks. The action plan will require technical assistance (TA) to help BOM, through the newly appointed bank conservators, to design restructuring plans, as well as support implementation of these plans. Three United States Agency for International Development (USAID) restructuring advisers have been recruited for an eight-month period to assist in restructuring activities at the individual banks. In addition, a Government high-level steering committee (HLSC) on bank restructuring and privatization is being established to foster political consensus toward a problem-free resolution of the banks' difficulties. The HLSC will be supported through the technical work undertaken by the Bank Restructuring Working Group (RWG), which has also been recently established. The consultant will be expected to be a major contributor to the discussions, reports, and activities undertaken by the RWG.

3. The consultant will have to liaise regularly with Bank Headquarters to support monitoring of the FSPL in general, as well as actively participate in discussions with major funding agencies involved in the finance sector. IMF has included under its proposed enhanced structural adjustment facility (ESAF) program with the Government of Mongolia, conditionalities relating to the restructuring of these three problem banks. USAID, in addition to providing individual restructuring consultants, will support the privatization of the Trade and Development Bank (TDB). The World Bank is expected to carry out work in support of a finance sector study for Mongolia and is supporting TDB and Golomt Bank with a credit line. Finally, the German Agency for Technical Cooperation (GTZ) has been providing technical support to the Agriculture Bank through the services of an adviser. An equity component is also being considered. Close consultation will be maintained with representatives of the four organizations in reviewing findings and considering restructuring options.

B. Activities

4. The banking system reform specialist who will also act as adviser to the BOM Governor will be engaged for 8 person-months beginning in July 1999. The responsibilities will include the following activities.

1. Bank Restructuring Activities

5. The consultant will provide technical support to the ongoing bank restructuring activities as supported by BOM conservators and the individual bank restructuring experts. While each of the three consultants will have responsibility for one bank, it is expected that there will be substantial benefits if the four consultants work as a team and consult frequently with each other and BOM staff. The consultant will regularly review the work of the individual bank restructuring consultants, and provide the necessary support to maintain consistency of actions and quality of

work across the individual banks. The consultant will have full access to all information gathered by the restructuring consultants, and will have the right to request consultants' work at all times. In addition, frequent consultations with the Economic Policy Support Program Chief of Party, and representatives of IMF and the World Bank will be arranged throughout the assignment.

a. Phase 1: Diagnosis/Halting Financial Deterioration/Strategy Formulation, 4-6 weeks.

6. The consultants will have the following responsibilities:

- (i) Initiate immediate actions to cease lending activity and restrict liability growth.
- (ii) Review the major weaknesses of the banks, including management capacity, loan portfolio, credit policies, lending to connected entities, credit management systems, liquidity management, risk management, loan loss provisions, Other Real Estate-Owned (OREO) foreclosure, capital adequacy, funding strategies, treasury operations, internal controls, business strategy, and organizational structure.
- (iii) Prepare recommendations to overcome major weaknesses identified in (ii).
- (iv) Based on (iii), design a time-bound restructuring plan emphasizing required downsizing/rationalization measures over the short term (6-8 months) to bring the banks to the point of sale.
- (v) Make recommendations on the enforcement of loan recovery (including legal impediment to loan recovery, loan rescheduling, self-liquidation of OREO), and repayment, and actions to address any liquidity shortfall.

b. Phase 2: Streamline Strategy Operations, 5-6 months.

7. The consultants will

- (i) develop an action plan for monitoring of implementation of benchmarks identified above on a monthly basis in cooperation with the Supervision Department of BOM to ensure that loan quality is being maintained and that the major restructuring measures are being met; and
- (ii) provide direct assistance to BOM and its conservators in preparing and implementing specific actions as requested by the Governor of BOM.

c. Phase 3: Facilitating Sale, Merger, and/or Liquidation of Problem Banks, 2-3 months.

8. The consultants have the following responsibilities:

- (i) Based on the findings of external audits, prepare a plan to sell the banks. The plan should include a detailed step-wise approach to include convening of a shareholder's meeting, presenting true financial condition of bank, advising on the nature of the sale, preparing tender documents, developing resulting shareholder structure (if recapitalized), and estimating loss to be borne by

existing shareholders. If the sale materializes, prepare the prerequisites to facilitate completion of the sale. Special consideration will be given to consolidating loss making countryside and Ulanbaatar branches of problem banks and reviewing the provision of banking services in soums. The strategy should envisage

- (a) recapitalization through use of public funds (to raise paid-up capital to zero) conditional on privatization;
 - (b) writing down of existing shareholder's capital appropriately;
 - (c) private capital infusion of up to 6 percent risk weighted capital adequacy ratio (initially); and
 - (d) signed agreement to increase capital adequacy to 10 percent over one year.
- (ii) If the sale fails, review the scope for possible merger with solvent banks and prepare a plan to support a merger (if any). The merger plan would have to provide an assessment of the feasibility of such a merger ensuring that the resulting institution will be a viable entity. If the merger materializes, oversee and make recommendations on the implementation of the merger.
 - (iii) If sale and merger fail, prepare and implement liquidation plans, ensuring that the hierarchy of secured creditors is properly followed and the burden on the national budget is minimized.

2. Banking Supervision

9. Building on the work undertaken by the former banking supervision specialist, the consultant will assist the on-site and off-site supervision teams by

- (i) advising BOM on how to strengthen its on-site inspection function (organization, methodologies, procedures, including documentation procedures);
- (ii) training BOM supervision staff in the use of the on-site inspection manual;
- (iii) training BOM supervision staff in the qualitative analysis of loans; the use of the Capital, Asset Quality, Management, Earnings, and Liquidity (CAMEL)¹ approach in assessing banks; and the review and evaluation of credit, risk management, and internal control systems and procedures of commercial banks;
- (iv) helping BOM with on-site inspection of banks;
- (v) advising on the organization, information requirements, and procedures for adequate off-site inspection of commercial banks;

¹ The CAMEL system provides a method to evaluate Bank viability by assessing five factors and assigning weighted score for each: capital adequacy, asset quality, management, earnings, and liquidity.

- (vi) training BOM staff in off-site inspection, in particular, procedures and computer-based balance sheet and income statement analysis;
- (vii) advising BOM on an examination system for banking supervisors;
- (viii) training selected BOM staff on how to act as conservators/receivers for banks;
- (ix) helping BOM staff with the closure and liquidation of banks;
- (x) helping the Legal Division, BOM, with the preparation or amendment of regulations on bank supervision, licensing, conservatorship and receivership, and draft-related procedures (including comments on the amendments to the Banking Law);
- (xi) improving the compilation and presentation of financial information on commercial banks to facilitate the decision-making process of BOM management; and
- (xii) advising BOM on how to assess banking license applications by domestic and foreign applicants;

3. Strategic Development

10. In collaboration with World Bank activities in this area, the adviser will prepare a financial sector development study.

a. Banking

11. This portion of the study will

- (i) assess the viability of banking based on the current state of the banking system;
- (ii) assess the capability of expanding of banking activities based on medium-term supply and demand projections and business plans of major banks;
- (iii) undertake an in-depth review of bank prudential regulations and supervisory framework in order to foster its effectiveness;
- (iv) assess major obstacles hindering development of a sound banking sector including policy, institutional, and human resources; and recommend ways to improve banking services;
- (v) assess current financing arrangements of banking, and specifically BOM support through restructuring bonds, and recommend phasing out of restructuring bonds in an orderly manner;
- (vi) assess viability of existing banks and recommend consolidation (if any) to ensure a viable banking system;
- (vii) assess bank privatization strategy prepared by Government and provide supporting inputs to strengthen plan;

- (viii) recommend actions to resolve problems facing savings banks and prospects for eventual removal of lending restrictions; and
- (ix) prepare a five-year banking development study based on items (i)-(viii).

b. Nonbank Financial Institutions

12. The study will

- (i) assess prospects for the development of nonbank financial institutions (NBFIs) including savings institutions (i.e., credit cooperatives), insurance companies, pensions systems, financial leasing, factoring companies, and development finance institutions;
- (ii) recommend pre-requisites including creation of required infrastructure, improvements in the legal/regulatory framework, and policies to facilitate an enabling environment to foster the strategic development of NBFIs; and
- (iii) prepare a five-year NBF development study based on (i) and (ii).

4. Advisory Assistance

13. The consultant will draw from experience to provide continuous advisory service to the Governor of BOM on central banking activities, including designing a program to phase out bank restructuring bonds, supporting the development of interbank markets, improving the conduct of money market operations, and any other aspect related to banking sector development.

C. Structure and Oversight of the Consulting Services

14. The consultant will report directly to the Governor of BOM. In support of the bank restructuring activities, the consultant will work closely with BOM staff, conservators, and the bank restructuring consultants at the three problem banks. Accordingly, the consultant will have the right to request the bank restructuring consultants to undertake actions or studies to meet the needs of the Bank in monitoring progress. Coordination of this reporting and oversight will be handled through the RWG.

15. The BOM will ensure that the consultant is provided with an office and necessary equipment in BOM, and with translation and more general assistance services as needed. Transportation to rural branches will be provided, whenever necessary.

16. The consultant will regularly liaise with the Bank and will provide regular monthly reports based on activities undertaken. One month before the end of the assignment, a draft final report will be submitted to the Bank. By the end of the assignment, a final report will be submitted (10 copies).