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# Mongolia: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision and Monetary Policy Transparency

This Financial System Stability Assessment on Mongolia was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on May 13, 2008. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Mongolia or the Executive Board of the IMF.

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MONGOLIA

**Financial System Stability Assessment**

Prepared by the Monetary and Capital Markets and Asia and Pacific Departments

Approved by Jaime Caruana and Daniel Citrin

May 13, 2008

This Financial System Stability Assessment (FSSA) is based on the work of the joint IMF/World Bank Financial Sector Assessment Program (FSAP) missions that visited Ulaanbaatar May 24-June 4, 2007 and September 27-October 10, 2007.

The FSAP team comprised Mark O'Brien (team leader, IMF), Sameer Goyal (deputy team leader, World Bank), Seung Ho Lee, Elena Loukoianova, Vassili Prokopenko, Shaina Pereira (all IMF), William Britt Gwinner, Xiaofeng Hua, Florencia Moizeszowicz, Bikki Randhawa (all World Bank), Richard Britton (formerly with U.K. Financial Services Authority), Stefan Spamer (Deutsche Bundesbank), and Walter Zunic (formerly with U.S. Federal Reserve). The mission received excellent cooperation and support from the authorities. The main findings of the assessment are:

- The Mongolian financial system is developing and performing well, in line with the economy as a whole, but faces a number of challenges. There are signs the economy is overheating and the country's dependence on a relatively narrow range of commodity exports and the rapid credit growth are also sources of risk. Further, the systemic liquidity management framework and the financial safety net are still undeveloped, limiting the system's ability to act as a buffer by absorbing shocks; the onus would thus be fully on the authorities to address any problems that might develop.

- While the bank supervision framework is reasonably well developed, implementation needs to be strengthened. Supervision of non-bank financial institutions and the capital markets is still at an early stage of development and so has gaps, providing a further source of risk, albeit more reputational than systemic due to the still small size of the non-bank financial sector.

- Several important initiatives to support financial system development are underway or planned, but they need to be carefully designed and sequenced in order to ensure success and avoid adverse side effects. Supporting improvements to legislation and other infrastructure are also needed.

The main authors of this report are Mark O'Brien and Vassili Prokopenko.

*FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud*

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## GLOSSARY

| | |
|---|---|
| ADB | Asian Development Bank |
| AML | Anti-money laundering |
| APG | The Asia/Pacific Group on Money Laundering |
| BCPs | Basel Core Principles for Effective Banking Supervision |
| BOM | Bank of Mongolia |
| CAR | Capital adequacy ratio |
| CBBs | Central bank bills |
| CFT | Combating the Financing of Terrorism |
| CGB | Corporate Governance Principles for Banks |
| CIB | Credit Information Bureau |
| FRC | Financial Regulatory Commission |
| FSAP | Financial Sector Assessment Program |
| FSSA | Financial System Stability Assessment |
| FSIs | Financial soundness indicators |
| IAS | International Accounting Standards |
| IFRS | International Financial Reporting Standards |
| LGD | Loss given default |
| LTV | Loan to value |
| MDF | Microfinance development fund |
| MFP | Code of Good Practices on Transparency in Monetary and Financial Polices: Monetary Policy |
| MOF | Ministry of Finance |
| MSE | Mongolian Stock Exchange |
| NBFIs | Non-bank financial institution |
| NPL | Non-performing loan |
| PFIs | Participating financial institutions |
| ROSCs | Reports on Standards and Codes |
| RTGS | Real time gross settlement |
| SCCs | Savings and credit cooperatives |
| SMEs | Small- and medium-size enterprises |
| UTC | Unfair Trade Commission |
| VAR | Value at risk |

## EXECUTIVE SUMMARY

**A major challenge for the authorities is to ensure that Mongolia's rapid financial sector growth takes place in a stable manner, given the risks of economic volatility and the need to continue to upgrade the regulatory and supervisory framework as the financial system evolves.** The Mongolian financial system is still quite small and undeveloped, in part because the banking system took some time to recover from several crises in the late 1990s. But developing and strengthening the financial system is at the heart of the Mongolian authorities' strategy to ensure strong, sustained economic growth. And indeed, the system—while still relatively unsophisticated—has recently been growing strongly, in line with the economy as a whole and supported by a range of financial sector reforms.

**The outlook for financial system stability in Mongolia is positive on balance, but the sector is exposed to a range of potentially significant risks**. Financial soundness indicators (FSIs) for the banking sector currently present a robust overall picture, in line with the country's strong economic growth. However, inflation has increased sharply over the past year, fuelled in part by very rapid credit growth, which poses risks to macroeconomic stability. Further the economy's dependence on a narrow range of commodity exports, and the potential for volatility in output levels or prices, poses important risks for banks' credit quality and profitability. Stress tests indicate that while the banking system as a whole would remain solvent, significant recapitalization could be needed in the event of a very severe shock.

**The systemic liquidity management framework and the financial system safety net are undeveloped, limiting the system's ability to absorb shocks and leaving the onus fully on the authorities to address any systemic problems.** The money and foreign exchange markets are still at an early stage of evolution, which also limits the effectiveness of the transmission mechanism from monetary policy operations to the structure of interest rates. Until these shortcomings can be addressed, the burden of dealing with any shocks that might occur in the near term will fall primarily on the authorities. Notably, the authorities have been willing to deal firmly with financial sector problems in the past, even if sometimes in a somewhat ad hoc fashion. There are plans to introduce a deposit insurance scheme.

**Looking ahead, various initiatives to promote financial system development are underway or planned, but they need to be well designed as well as prioritized and sequenced in order to ensure success**. Several of the areas that need strengthening (e.g., legal framework, payment system and other financial infrastructure) are fundamental and should be addressed quickly. In addition, any government programs intended to promote financial sector development (for example, the proposed creation of a development bank and efforts to further stimulate the development of housing finance) should be structured to avoid creating unfair competition or other distortions in the financial sector.

**Sustainable development of the financial system will also depend on improvements to the supervisory framework.** The Bank of Mongolia (BOM) has a reasonably well developed risk-based approach to bank supervision, given the current stage of banking development. However, there is room for improvement in the implementation of bank supervision, especially the supervision of banks' liquidity and operational risks, which will become important as banks become more sophisticated. The legal and regulatory framework should also be improved, especially as regards conducting supervision on a consolidated basis and strengthening the requirements for prior experience and background of banks' senior management and boards. The Financial Regulatory Commission (FRC)'s supervision of non-bank financial institutions and the capital markets is much less developed than bank supervision, reflecting the Commission's short existence. To strengthen its performance, the FRC needs a substantial increase in resources, more training and better industry statistics. Strengthened legal protections are also needed for both supervisory staff of both the BOM and the FRC.

**A range of important financial infrastructure initiatives are underway, but in several cases further improvements could be incorporated.** The project on real time gross settlement should be put in place as quickly as possible. In the interim, the backup system for the existing inter-bank payment needs to be improved. Closer coordination between the BOM's plan to upgrade the credit information bureau and the industry's plans for a new bureau would also be useful.

**Further progress also needs to be made on strengthening governance in financial institutions, in the BOM, and in the corporate sector**. Governance requirements for financial institutions are in the process of being strengthened, with the recent issuance by the BOM of a directive on bank boards' roles and responsibilities for oversight of significant risks. The BOM's supervisory board should be tasked with a similar oversight of the risks facing the central bank. Further, improved governance and implementation of international accounting and auditing standards in the corporate sector are essential preconditions for the successful development of the domestic capital market.

**Access to financial services in Mongolia has been improving.** The government should continue to encourage development of new products and services which can support the development of micro-, small- and medium-sized enterprises. Though the penetration of banks in rural areas has improved, many non-banks and savings and credit cooperatives continue to focus their operations close to urban areas. The government and donor programs to improve access to financial services in rural areas and for enterprises need to be designed to ensure that these services are sustainable on market principles after the completion of the programs.

**The main recommendations from the Mongolia FSAP team are provided in Box 1.**

## Box 1. Mongolia: Main FSAP Recommendations

| Objective | Recommended Actions |
| --- | --- |
| ***Short term (high priorities)*** | |
| Bank and non-bank supervision | • Strengthen supervision of banks' liquidity and operational risks (see BCP ROSC in Annex)<br>• Continue to closely monitor banks' credit quality (¶6-7)<br>• Increase FRC resources and staff skills (¶27)<br>• Introduce legal protections for both bank and non-bank supervisors (BCP ROSC) |
| Systemic liquidity and safety net | • Improve systemic liquidity forecasting and management (¶18-19)<br>• Strengthen contingency planning in case of financial sector problems (¶29)<br>• Introduce a well designed deposit insurance scheme (¶29) |
| Improve legal framework | • Pass a range of necessary laws relating to financial sector development and supervision (¶23-25), housing finance (¶38) and capital market infrastructure (¶41) |
| Payment system | • Provide backup arrangements to existing system (¶20)<br>• Develop procedures to better manage settlement risk under the planned RTGS system (¶20) |
| Credit information system | • Strengthen existing credit information bureau and coordinate with the industry regarding their proposed private credit information bureau (¶21-22) |
| Housing finance | • Proceed with improvements to the infrastructure for mortgage lending, including improving the property registry system (¶38) |
| Micro and SME lending | • Reduce banks' reliance on donor programs and funding at below-market interest rates for micro and SME lending (¶45) |
| ***Medium term*** | |
| Banking supervision | • Introduce consolidated supervision on a formal basis (BCP ROSC) |
| Strengthening the Unfair Trade Commission (UTC) | • Strengthen the powers and resources of the UTC (¶14) |
| Strengthening the FRC | • Review whether the FRC's funding model is adequate (¶27) |
| Accounting and auditing | • Upgrade accounting and auditing to international standards (¶33-34) |
| Capital market development | • Improve corporate governance (¶35) |
| Housing finance | • Establish consumer disclosure rules for lenders, standards for methodology and professional conduct by appraisers and real estate agents (¶39) |

# I. FINANCIAL SYSTEM STRUCTURE AND POTENTIAL SOURCES OF RISK [1]

## A. Structure

1. **The Mongolian financial system is relatively small and simple but growing rapidly.** As with most developing economies, the financial system is dominated by commercial banks; as at end-2007, the 16 registered commercial banks in Mongolia accounted for over 95 percent of the total financial system assets (Table 1). Total assets of the banking system grew from 52 percent of GDP in 2003 to about 87 percent of GDP in 2007, or by 4.3 times in nominal terms. The banking sector is significantly foreign-owned but, unlike the situation in a number of other transition country financial systems, the foreign owners are typically institutional investors, wealthy individuals, or relatively small regional banks.

2. **The non-bank financial institutions (NBFIs), including the savings and credit cooperatives (SCCs), are generally small and underdeveloped.** The non-life insurance industry has been developing from a very low base after the passage of a new Insurance Law in early 2004. Although the stock market capitalization has grown, a few stocks account for nearly all of the market capitalization and active trading. That said, a few of the larger securities companies and SCCs play a significant role in their respective sectors, which contributed to social pressures for government support when several of the SCCs recently failed.

## B. Risks Inherent in the Macroeconomic Environment

3. **The Mongolian economy has performed well in recent years, but there are signs of overheating**. Real GDP growth has averaged around 7 percent since 2002, aided by sharp increases in world prices of major commodities produced by Mongolia, particularly copper but also gold, and a recovery of livestock herds after several devastating winters. Inflation also steadily declined, to around 6 percent by mid-2007, but since then has picked up strongly, posing a risk to financial sector stability as it could well be associated with a deterioration in banks' credit quality.[2] Monetary policy instruments are still evolving which,

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[1] Banking sector data are of sufficient availability and quality to undertake a thorough stability assessment. However, there is a lack of information in some areas, e.g., on the household and corporate sectors' aggregate balance sheets, which limits more detailed analysis. The data on non-bank financial institutions are also limited, in large part because supervision of non-banks has been strengthened only recently, reflecting the small role these institutions have played in the financial system until now.

[2] See Box 1 in the accompanying Staff Report for an analysis of the various sources of the increase in inflation.

together with the thinness of the money and foreign exchange markets, complicates the task of tightening monetary policy.[3]

4. **Mongolia's dependence on a narrow range of commodity exports with potentially volatile output and/or prices is also a source of risk to financial stability**:[4]

- ***There is a reasonable probability of a significant fall in copper prices***. World copper prices have increased sharply since 2003, largely reflecting strong growth in China, which is a major source of world copper demand. Futures prices for copper indicate a market expectation that the copper price will gradually decline in the next few years. If the projected decline takes place, especially if more quickly than is implicit in futures prices, it could create a drag on economic growth, and thus the quality of banks' loan portfolios.[5]

- ***Mongolia is subject to periodic adverse climatic shocks***. An average winter season is relatively long with harsh weather conditions, but some winters are particularly austere. Extremely cold weather during the winters in 2000 and 2001, following severe droughts in the summers of 1999 and 2000, led to the considerable losses of animal husbandry (of around one quarter of livestock), which is the main component of the agriculture sector. A recurrence of such an event would thus be expected to have an adverse impact on the performance of agricultural sector loans.

5. **The dependence on commodity exports also increases the likelihood of exchange rate volatility.** While the exchange rate against the U.S. dollar has recently been quite stable, as foreign reserves levels have increased in line with the strong export performance, an abrupt fall in copper prices or agricultural exports would be expected to result in downward pressure on the togrog. On the other hand, reflecting its endowment in mineral resources, Mongolia is currently attracting significant foreign investor interest. Should foreign investor inflows continue and the large mining projects which are being considered start to come on-stream, pressure for togrog appreciation at some stage is also a real possibility.

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[3] Since the FSAP missions concluded, two IMF/MCM technical assistance missions provided advice on strengthening monetary policy instruments and deepening the money and foreign exchange markets. A further mission is scheduled for later in 2008.

[4] Copper-producing companies contribute around one fifth of Mongolian GDP, more than half of Mongolia' s merchandise exports, and around one fourth of government revenues. Agricultural output accounts for another fifth of Mongolian GDP.

[5] As government revenues are highly dependent on copper exports, a much lower copper price would be correspondingly lower government expenditures and thus the real economy, although this might take some time to eventuate as some revenue buffers have been built up.

## Table 1. Mongolia: Financial System Structure

| | Dec-03 | | | Dec-04 | | | Dec-05 | | | Dec-06 | | | Dec-07 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Number | Assets (bn Tg) | Percent of total assets | Number | Assets (bn Tg) | Percent of total assets | Number | Assets (bn Tg) | Percent of total assets | Number | Assets (bn Tg) | Percent of total assets | Number | Assets (bn Tg) | Percent of total assets |
| Banks | 17 | 767 | 97.6 | 17 | 892 | 92.2 | 17 | 1,371 | 97.3 | 16 | 1,899 | 94.7 | 16 | 3,279 | 95.7 |
| Private | 16 | na | na | 16 | na | na | 16 | na | na | 16 | 1,899 | 94.7 | 16 | 3,279 | 95.7 |
| Domestic | na | na | na | na | na | na | na | na | na | na | na | na | 6 | 967 | 28.2 |
| Foreign | na | na | na | na | na | na | na | na | na | na | na | na | 10 | 2,312 | 67.5 |
| State-owned | 1 | na | na | 1 | na | na | 1 | na | na | 0 | 0 | 0.0 | 0 | 0 | 0.0 |
| | | | 0.0 | | | 0.0 | | | 0.0 | | | 0.0 | | | |
| Nonbank financial institutions | 88 | 19 | 2.4 | 514 | 76 | 7.8 | 522 | 38 | 2.7 | 1,096 | 107 | 5.3 | 379 | 147 | 4.3 |
| Insurance companies | na | na | na | na | na | na | na | na | na | 19 | 22 | 1.1 | 15 | 28 | 0.8 |
| Life | na | na | na | na | na | na | na | na | na | 0 | 0 | 0.0 | 0 | 0 | 0.0 |
| Nonlife | 0 | 0 | 0.0 | 0 | 0 | 0.0 | 0 | 0 | 0.0 | 19 | 22 | 1.1 | 15 | 28 | 0.8 |
| Savings and Credit Cooperatives | 0 | 0 | 0.0 | 400 | 47 | 4.9 | 400 | na | na | 955 | 16 | 0.8 | 192 | 36 | 1.0 |
| Finance Companies / NBFIs | 88 | 19 | 2.4 | 114 | 29 | 3.0 | 122 | 38 | 2.7 | 122 | 69 | 3.4 | 137 | 66 | 1.9 |
| Securities firms / Broker firms | 0 | 0 | 0.0 | | | 0.0 | | | 0.0 | | | 0.0 | 35 | 16 | 0.5 |
| Total financial system | 105 | 786 | 100.0 | 531 | 968 | 100.0 | 539 | 1,410 | 100.0 | 1,112 | 2,006 | 100.0 | 395 | 3,425 | 100.0 |

Sources: Bank of Mongolia, Financial Regulatory Commission; and staff calculations.

### C. Major Counterparties

6. **The recent development of the mortgage market, combined with the need to upgrade Mongolia's housing stock, is leading to a significant increase in lending to households.** This represents a welcome diversification in bank lending but exposes the banks to real estate price risk. Due both to the increased lending for mortgages as well as the improvements that are taking place in Mongolia's infrastructure, lending to the construction sector has also increased significantly. Since real estate lending is in its early days in Mongolia, with the outstanding stock of mortgages equivalent to only 3.5 percent of GDP, the BOM should pay special attention to oversight of mortgage underwriting and loan servicing operations

7. **The share of lending in foreign currencies to unhedged borrowers—primarily corporates but also to households to some degree—is still reasonably high but has been falling**. Foreign currency loans declined from 44 percent of total loans in December 2006, to 33 percent by October 2007, with foreign currency deposits declining from 38 percent of total deposits to 34 percent over the same period. Foreign currency loans are predominantly to enterprises. More than half of the loans to enterprises are denominated in foreign currencies, and some of these enterprises are believed to have limited or no foreign currency earnings. At end June 2007, households' loans in foreign currency were only 12.9 percent of total household loans, equivalent of 2.1 percent of GDP. That said, as long as domestic interest rates remain significantly higher than foreign interest rates in nominal terms, demand for unhedged foreign currency borrowing would be expected to increase.

## II. Strengths and Vulnerabilities of the Banking Sector

### A. Performance

8. **The aggregate FSIs for the banking system present a robust picture (Tables 2 and 3)**. While the average capital adequacy ratio (CAR) has declined significantly, from 20 percent in 2002 to about 14 percent in December 2007, this reflects to a large extent more efficient use of capital as lending volumes have increased substantially.[6] Similarly, non-performing loan (NPL) levels have fallen to relatively low levels. The system's average return on equity (after tax) declined from 21 percent in 2002 to 14 percent in 2006, but then increased substantially to 21 percent in 2007. While the ongoing high profitability generally reflects rapid growth in lending, the sharp increase in 2007 resulted in part from some diversification by several large commercial banks towards cheaper offshore funding.

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[6] While CARs have fallen in relative terms, the banks have been substantially increasing their total capital in level terms as the banking system has grown, so as to ensure that they continuously meet their required CARs.

## Table 2. Mongolia: Core Financial Soundness Indicators for the Banking Sector

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|
| *Capital Adequacy* | | | | | | |
| Regulatory capital to risk-weighted assets | 20.0 | 20.4 | 20.0 | 18.2 | 18.1 | 14.2 |
| Regulatory Tier I capital to risk-weighted assets | 17.7 | 18.5 | 17.4 | 15.8 | 15.6 | 11.9 |
| *Asset Composition and Quality* | | | | | | |
| NPLs to gross loans | 5.0 | 4.7 | 6.0 | 5.6 | 4.7 | 3.2 |
| NPLs net of provisions to capital | -1.0 | 0.0 | 0.7 | 0.2 | 2.5 | 2.4 |
| Sectoral distribution of loans (in % of total loans, stock) | | | | | | |
| Agriculture, hunting, forestry and fishing | 4.1 | 5.7 | 4.7 | 6.7 | 8.2 | 7.6 |
| Electricity, steam and water supply | 1.5 | 1.9 | 2.5 | 2.2 | 1.1 | 1.5 |
| Construction | 6.2 | 7.5 | 8.6 | 8.9 | 9.1 | 15.6 |
| Mining and quarrying | 15.4 | 8.4 | 8.6 | 9.0 | 7.8 | 6.3 |
| Manufacturing | 24.2 | 20.1 | 18.7 | 16.2 | 12.9 | 13.0 |
| Wholesale and retail trade, repair of household goods | 30.8 | 34.0 | 34.6 | 33.2 | 31.0 | 29.2 |
| Traveling and hotels, restaurants | 1.7 | 1.8 | 2.0 | 2.1 | 1.6 | 1.3 |
| Transport, storage and communication | 2.9 | 3.0 | 2.8 | 4.3 | 4.2 | 1.7 |
| Activities of immovable asset renting business | 1.1 | 2.2 | 2.6 | 2.4 | 2.5 | 2.5 |
| Health and education | 0.6 | 0.5 | 1.0 | 0.7 | 0.9 | 0.7 |
| Financial intermediaries | 0.5 | 1.0 | 0.9 | 1.0 | 1.2 | 0.7 |
| Others | 11.0 | 13.8 | 13.1 | 13.2 | 19.2 | 19.8 |
| *Earnings and Profitability* | | | | | | |
| ROA (after tax) | 4.3 | 3.1 | 2.5 | 2.2 | 2.7 | 2.5 |
| ROE (after tax) | 20.8 | 14.7 | 12.3 | 12.1 | 14.3 | 20.8 |
| Interest margin to gross income | 39.8 | 35.9 | 31.5 | 30.9 | 27.8 | 28.3 |
| Noninterest expenses to gross income | 50.3 | 49.1 | 58.8 | 54.3 | 55.4 | 46.5 |
| *Liquidity* | | | | | | |
| Liquid assets to total assets | 39.9 | 35.3 | 31.6 | 36.0 | 37.9 | 28.1 |
| Liquid assets to short term liabilities | ... | 83.5 | 28.8 | 37.7 | 38.2 | 37.0 |
| Loans to deposits ratio | 67.3 | 78.5 | 91.9 | 89.7 | 95.6 | 101.3 |
| *Sensitivity to Market Risk* | | | | | | |
| Net open positions in FX to capital | 8.9 | 36.5 | 33.6 | 27.4 | 30.8 | 30.1 |

Source: Bank of Mongolia

9. **Many FSIs are, however, backward looking indicators.** In particular, it is not unusual for rapid credit growth, such as been occurring in Mongolia, to mask a build up in NPLs. Further, the still relatively short maturities of most loans in Mongolia, and the ability to roll them over in an environment of rapidly expanding bank balance sheets, means that any decline in credit quality may not be quickly apparent. Accordingly, the BOM has intensified its supervision, including through specially targeted on-site inspections, and is confident that credit quality has continued to improve.

10. **The rapid credit growth thus seems to reflect to a large extent financial sector deepening**. That said, the strong fiscal stimulus to the economy has recently also been a factor, and the increasing signs of general overheating suggest there can be no complacency about credit quality going forward. The deepening in the financial system is in any case strengthening macro-financial linkages, in turn exposing the banking sector to new types of risk.

11. **Although Mongolian banks' dependence on foreign funding is still relatively low, the increasing trend will eventually create a further potential vulnerability**. The aggregate loan to deposit ratio for the banking system is presently close to unity (Table 2), which reflects banks' continued reliance on domestic deposits as the primary source of funding. However, this ratio has been increasing in the last two years. As can be seen in a number of Central and Eastern European banking systems, a heavy reliance on foreign funding exposes banks to liquidity risk in the event of a reassessment of a country's riskiness by foreign investors, whether due to due to events within the country or in others, which results in a severe limitation on access to foreign funding.

12. **While the banking system as a whole is performing well, individual bank performance varies widely, with some smaller banks performing much less well than the average**. The four largest commercial banks are currently very profitable. However, several of the smaller ones are less so, and several have even incurred some losses at times despite the strong economy. The share of NPLs in total loans also varies across commercial banks, with the four largest banks having NPL to total loan ratios that are significantly smaller than those for the five smallest banks. In conjunction with its intensified supervision of banks' credit quality, the BOM is closely monitoring bank performance more generally. Due to the small size of the less strongly performing banks, the risks are less of a systemic nature and more to the BOM's reputation as a supervisor.

13. **Despite high domestic interest rates and the profitability of the largest Mongolian banks, in general there seems to be adequate competition in the banking sector**. Deposit interest rates in Mongolia are still very high. However, intense competition for the best customers has meant that lending rates and spreads between deposit and lending rates have been declining, with spreads having now converged to levels pertaining in a range of peer countries. The continued high deposit rates may be due to high inflation expectations, and an only gradual transition to more normal levels following the banking crises of the late 1990s. The Unfair Trade Commission (UTC) also considers that there are no clear signs of collusive behavior among banks and the mobility of depositors is sufficiently high.[7]

[7] Established in January 2005, the Unfair Trade Commission is in charge of measuring the competition in all economic sectors, including banking, with an objective of ensuring efficient provision of goods and services.

14. **That said, there is scope to foster more competition among Mongolian financial institutions in some specific aspects**. Some banks are apparently using their dominant position in specific rural areas to charge relatively high fees, and analysis of average intermediation spreads suggests that interest margins in rural areas are higher than those in the cities. A further step to enhance the competitive environment could be to strengthen the powers and resources of the UTC, as these are currently extremely limited. Looking ahead bank profits are likely to come under increasing pressure as competition continues to increase, and some consolidation in the sector may be expected.

### B. Stress tests

15. **A range of stress tests were designed and performed by the FSAP team in close cooperation with the BOM staff** (Appendix 1). The tests included both sensitivity and scenario analyses. The size of shocks was chosen based on historical and hypothetical changes in key variables (credit, interest rate, and exchange rate risks). One scenario envisaged a negative shock originating in the external sector and another scenario considered a surge in capital inflows. Liquidity risks (either domestic or cross-border) were not tested as liquidity risks are still low in the Mongolian banking system; the short duration of bank's assets means that the duration mismatch between assets and liabilities is small and banks also have a low degree of reliance on external funding sources.

16. **The stress tests undertaken by the FSAP team indicate that the banking sector as a whole would remain solvent in the face of the various shocks and scenarios, but in the event of the most severe shocks some banks could require significant recapitalization to restore capital adequacy**. The resilience of the system as a whole reflects a combination of factors, including the strong capital position of the majority of banks to start with, good and improving asset quality, a relatively low share of foreign currency lending to unhedged borrowers, and a relatively short maturity of the bank loan portfolio. The most significant risk for the entire system would result from a substantial shock to the quality of loan portfolios. For example, in the case of a decline in the world copper price and an associated slowdown in economic activity, the aggregate CAR for the banking system would fall from around 15 percent to just over the regulatory minimum of 10 percent (Appendix 1, Table 4). Similarly, in terms of single factor tests, the hypothesized substantial increase in the NPL ratio by 10 percentage points would take the aggregate CAR to 9.8 percent.

17. **There are, however, significant differences in the balance sheet structures of individual banks, so the results of stress tests vary significantly across the system.** In particular, for several of the shocks some systemically important banks are projected to be significantly more affected than the system average. For example, the simulation of the adverse shock to the agriculture sector due to poor weather conditions results in a reduction in the aggregate CAR for the group of largest banks to around 8.5 percent, while the increase in the NPL ratio by 10 percentage points would result in the average CAR for this group of

banks to fall to just below 7 percent. The shock associated with the hypothesized decline in the world copper price would have a similar aggregate impact on this group of largest banks. By contrast, the group of small banks, many of which primarily provide investment banking-type services, would remain relatively immune to the direct effects of the shocks used in the stress tests.

## C. Systemic Liquidity

18. **Systemic liquidity management is constrained by the thinness of the money, foreign exchange and securities markets, and volatility in autonomous flows (especially transfers between the Ministry of Finance's (MOF's) treasury account and the banking system)**. One-week central bank bills (CBBs), although having been issued since the early 2000s, became the BOM's key instrument for managing banking system liquidity from July 2007, as part of a move to a new monetary policy implementation framework. Since the change, there have been only a few CBB auctions, and market participants are still adjusting to the new policy approach. Further, the BOM's ability to forecast liquidity flows has been hampered by volatility in some flows, such as MOF expenditures and revenues, which they are finding hard to predict. As a result of these limitations, the authorities' ability to manage liquidity and the financial system's capacity to absorb shocks are both constrained.

19. **Improving the effectiveness of liquidity management will require time as the markets need to mature, however there are steps which can be taken in the interim.** The BOM is considering deepening the securities markets by introducing CBBs of longer maturities, as well as increasing the frequency of auctioning 12-week CBBs. Other improvements which should be considered include reducing the number of the BOM's standing facilities, requiring full collateralization by CBBs for any drawings from the facilities, and improving the BOM's liquidity forecasts including by having the MOF provide better and more timely information regarding forthcoming treasury transactions.

## D. Financial System Infrastructure

### Interbank payment system

20. **There are plans to modernize the payment system, which will help to strengthen the financial system infrastructure**. Transaction volumes and values settled by the interbank payment system are growing strongly. The use of non-cash payment instruments, while still relatively small, has also been growing. A real time gross settlement (RTGS) for high value transactions, which will reduce payment system risks, is therefore planned to replace the end-of-day net settlement in 2008. A card processing system that could replace the individual banks' proprietary systems is also scheduled for launch. Other needed reforms to support a more robust payment system include:

- To better manage any settlement risk, the BOM should develop procedures for intra-day liquidity support in agreement with banks. While the present end-of-day netting system works well, banks may encounter funding shortage during the day under the RTGS.

- The system architecture for the payments system needs to be upgraded and a business continuity strategy is needed. In particular, the current system architecture fails to provide the interbank payment system members direct access to the backup center should there be a prolonged shutdown of the main system. As a result, the interbank payments for the whole banking system would come to a stop in such an eventuality.

- The BOM should consider upgrading the accounting software for the settlement of interbank payment transactions, and for financial accounting and reporting of central bank operations. The BOM's current home-grown accounting software may not be able to deal with the increasing transaction turnover in the future.

**Credit information system**

21. **The Credit Information Bureau (CIB) of the BOM should be strengthened in several areas to better respond to the current needs of the industry**.[8] The data quality and coverage should be improved, including through consolidating all credit information by borrower. In consultation with the industry and the other BOM departments, the type of data collected should be expanded and reporting modules should be upgraded.

22. **The limited ability of the CIB to cater to the fast growing and diversifying industry needs, has lead to efforts by some banks to set up a project to establish an independent private credit information system**. Good coordination between the existing CIB and the industry's plans for a new bureau will be important to ensure development of an information system which can effectively serve supervisory and industry needs.

**Legal Framework**

23. **While substantial progress has been made with upgrading the legal framework, especially following the banking sector problems of the late 1990s, it still suffers from a number of weaknesses that should be addressed in order to support stable financial sector development**. Many of the necessary new laws have been drafted, and the government should move quickly to pass them. These laws include: (i) a revised banking law; (ii) a revised securities market law; (iii) a draft law on mortgage collateral; and (iv) a draft mortgage securitization law.

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[8] The CIB is a public credit registrar established in 1997. All banks submit information to the CIB on loans above one million togrog on a regular basis. Its purpose is to serve as a tool for banks and some large NBFIs to check a borrower's credit record and status when reviewing credit applications.

24. **In addition, some other existing laws should be amended**. The company law is one example. The obligations of companies towards minority shareholders are not properly set out and sanctions for non-compliance of the obligations that are codified are not sufficiently serious to encourage compliance. Both gaps serve to undermine the development of the capital markets in Mongolia. The company law also does not require there to be any independent directors on a company's board. The bankruptcy law was passed in 1996 but there have been only a handful of cases and the process is slow and cumbersome.

## III. The Financial Stability Policy Framework

### A. Supervisory and Regulatory Framework

#### Commercial banks

25. **The assessment of Basel Core Principles for Effective Banking Supervision (BCPs) found that banking supervision is relatively well developed in comparison to other countries at Mongolia's stage of transition.** The BOM has built the necessary expertise and put in place a supervisory framework for risk-based supervision of banks so that it largely complies with the BCPs. Gaps in the legal and regulatory framework that need to be filled include that legislation does not allow for conducting supervision on a consolidated basis; while this is not a major issue yet, it will become so over time. A legal definition of "connected parties" is also needed in order to better monitor large exposures, the legal requirements relating to prior experience and background of banks' management and board members should be strengthened, and legal protections should be provided for BOM supervisors carrying out their duties in good faith (see Annex 1 for details).

26. **Banks' managements are required by the BOM to identify and manage risks and contain them to prudent levels.** Market- and credit-risk related computations and suitable reporting requirements are also in force. However, the BOM had not yet issued a liquidity risk guidelines at the time of the BCP assessment. Further, the schedule of maximum fines had been eroded by inflation, so that these fines were not effective as a deterrent.

#### Non-banks and capital markets

27. **Supervision of non-banks and capital markets needs to improve significantly**. In particular, the FRC needs improvements in staffing, expertise, and funding.[9] With the responsibility of overseeing nearly 400 institutions, the FRC—which was established only in 2006—is struggling to better understand the non-bank sector, build appropriate relationships

[9] The FRC intends to open a training center to provide much needed training for its staff and industry participants. Consideration could be given to sharing costs or training facilities with the BOM or the Bankers' Association.

with stakeholders, and strengthen its institutional capacity (see Appendix 2 on the supervision of savings and credit cooperatives). Staffing and skills need to be better aligned with industry needs and international best practices for similar regulatory bodies. Training, particularly with experienced regulators overseas should be a priority. Consideration should be given to increasing the FRC's financing from government. Although there are advantages in securing the independence of a regulatory body in making it significantly or wholly funded by a levy on the firms it regulates, at this stage of financial sector development in Mongolia, the non-bank sector may not be able to bear such an additional tax on its business.

28. **In addition, the NBFI Law should be amended to make more of an enabling than a prescriptive law**. Better understanding of NBFIs operations, financial position and performance, and their strengths and weaknesses, would help the FRC in developing such a revised law.

### B. Financial System Safety Net

29. **There is scope for strengthening financial safety net arrangements**. The BOM lender-of-last-resort facilities appear adequate—because the banking system has until recently been very liquid these facilities have been used only infrequently—however they could be rationalized. Further, although Mongolia has not been affected by the turbulence on the global financial markets since mid-2007, reflecting the limited exposure to the global financial system, additional contingency planning to deal with possible future problems should be a priority. Perhaps most importantly, with competition in the banking system projected to increase and profits to reduce accordingly, the BOM should strengthen plans for dealing with any banks that might encounter liquidity or solvency problems. As the financial system becomes more complex, the recently established Financial Stability Board could potentially become a crucial element in coordinating contingency plans.[10] The authorities should also move ahead with their plans to introduce a deposit insurance scheme for banks.[11]

### C. Monetary Policy Transparency and Central Bank Governance

30. **The transparency of monetary policy is generally good, but the governance of the BOM, particularly the formal accountability arrangements for the Governor, should be strengthened**. In line with international best practices for central bank monetary

[10] The Financial Stability Board was established in June 2007 by the BOM, the Ministry of Finance, and the FRC. Its declared purpose is to promote financial system stability and to ensure a better coordination in areas where all three bodies are involved, including systemic crises.

[11] A deposit insurance scheme law is presently under discussion in the parliament. Features of the proposed scheme include that it will be *ex ante* funded and compulsory for all commercial banks. Premiums are envisaged at a flat quarterly rate of 0.08 percent of the total bank's deposits with coverage of household deposits up to Tg 1.5 million (US$1,268, or around 80 percent of 2007 per capita GDP). In addition, emergency financing from the Government, especially in crisis situations, is provided for.

policy transparency and governance, the BOM Law should be amended to give more authority to the Supervisory Board to oversee the BOM and the Governor's decisions, especially as regards aspects of BOM operations that give rise to financial or other risks. Even before a BOM Law amendment is able to be implemented, however, the Supervisory Board could play a more active role in enhancing the BOM's transparency through publicizing oversight of BOM activities. For example, the Supervisory Board's reports to parliament could be included, in detail or in summary form, in the BOM's Annual Report. In order to fulfill their responsibilities effectively, the Supervisory Board would need to be strengthened to include more individuals with background and experience in financial sector policies and practices.

31. **In addition, the BOM management could also improve transparency by publicly disseminating more information about the policies and procedures which are in place to identify and manage it's balance sheet and policy risks**. For example, the BOM could publicize the internal rules that are in place to limit the risks arising from foreign reserves investment transactions, as these have increased in line with the increased volume of international reserves.[12]

## D. AML/CFT Framework

32. **The recent assessment of Mongolia's AML/CFT framework by the Asia Pacific Group on Money Laundering (APG) found that while significant steps have been taken to improve compliance with relevant prudential norms in banks, less progress had been made as regards non-banks**.[13] This differential rate of progress is primarily because the FRC was only recently created. The assessment noted that while the Financial Intelligence Unit had only been recently created in the BOM, and would benefit from additional staffing and AML training, there is good cooperation between the BOM, the FRC and the police Prosecutor's Office. Gaps in the AML framework that were identified included legal deficiencies as regards suspicious transaction reporting requirements by banks, capacity constraints in law enforcement, and the need for the State Registration Division and the FRC to be given more powers and resources to require the disclosure of beneficial ownership when processing company registrations. The assessment also noted that Mongolia's large informal sector and channels for remittances have the potential to be used for money laundering.

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[12] Other recommendations aimed at enhancing monetary policy transparency can be found in Annex 1.

[13] The mutual evaluation report assessing the framework can be found on the APG's website (http://www.apgml.org).

### E. Accounting and Auditing Standards

33. **Although the Accounting Law of Mongolia requires accounts to be prepared in accordance with International Accounting Standards, the implementation outside the banking sector appears to be weak**. According to the FRC, many accountants do not adhere to the requirements of the law.[14] Nor is it clear which version of IAS/IFRS the accountants should be following. The original IAS were translated into Mongolian by the government but subsequent updates (i.e., IFRS) have not been officially translated. The local professional accounting body, the Mongolian Institute of Certified Public Accountants, issues guidance but is not viewed as very effective in promoting high and consistent standards among its members.

34. **Auditing standards are regarded as also weak, and the quality of auditors is extremely variable**. Independence appears to be an issue particularly for the smaller auditing firms and working practices and record keeping are often poor. The Mongolian government has invited the World Bank to carry out a ROSC on Accounting and Auditing, in order to assist in undertaking a sequenced approach towards improving accounting and audit standards in Mongolia.

### F. Corporate Governance

35. **There is recognition by both the public and private sectors that corporate governance in Mongolia is well below international standards and needs to be improved in order to increase investor confidence and encourage greater participation in the capital market**. This unanimity is demonstrated by the joint work of the FRC and the Chamber of Commerce to develop a Corporate Governance Code, based on the OECD Principles for Corporate Governance. While intended as a voluntary code initially the authorities should also consider amendments to the 1999 Company Law on a range of matters such as setting a minimum number of independent members of a company's board of directors. The low level of sanctions for non-compliance needs to be raised.

## IV. Financial System Development Priorities

36. **There are ambitious plans to develop the financial system, and the capital markets in particular, in order for it to support sustained strong economic growth**. However, these plans need to be carefully prioritized and sequenced in order to ensure success. In particular, specific government initiatives (for example, efforts to stimulate the development of housing and SME finance, and the proposed creation of a development bank)

[14] Banks are subject to substantial disclosure requirements and are required by the BOM to follow international accounting standards rather than Mongolian standards and are audited accordingly.

should be carefully structured to avoid creating unfair competition in the financial sector or other distortions, such as incentives for imprudent behavior.

## A. Housing Finance

37. **The Mongolian mortgage market is emerging rapidly**. Mortgage lending began in 2002, with sub-market rate funding provided by the Asian Development Bank (ADB). As of August 2007, the total mortgage portfolio stood at around 4.5 percent of total bank assets, or 3.5 percent of GDP. Mortgage interest rates are high and maturities are short, restricting lending to upper income households.[15] Loans can be as long as 10 years, but in practice are much shorter. Reported loan-to-value ratios (LTV) at origination are between 70 and 80 percent, permitted debt-to-income ratios are 30 percent. Mortgage defaults are very low and foreclosure experience quite limited, in part because the mortgage market is new and real estate prices have been rising.

38. **The planned improvements to the mortgage market's legal framework should be promulgated as soon as possible to assist market development**. The current uncertainty about the incomplete legal framework for mortgage lending—in particular, uncertainty about the ability of banks to foreclose on a primary residence given the constitutional right to shelter—adds to mortgage loan interest rates and so reduces housing affordability. The draft mortgage collateral law, when enacted, will establish the preeminence of the mortgage contract, and the necessity of the borrower to either repay the mortgage or give up the house. It is similarly important to clarify the legal framework by enacting the mortgage securitization and mortgage bond laws. At the same time, it will be important for the development of the mortgage market that mortgage securitization be developed on a fully market-price basis, without any initiatives aimed at transferring risk away from purchasers of securities.

39. **The government should also continue its efforts to improve the State Property Registry and develop consumer disclosure rules for mortgage lenders, education programs in financial literacy, standards for real property appraisals, and real estate brokerage services.** The ADB is helping to update the necessary property registry systems. The Millennium Challenge Corporation also plans to help the State Registry to update its automated systems and to improve its business processes. Problems with mortgage defaults can be reduced by educating consumers and by requiring lenders to identify clearly the terms and risks of the loans that they offer. Standards for real estate appraisers would establish their independence as well as minimal requirements for the methodology of appraisals. Professional standards for real estate brokers should be set, and requirements introduced for public disclosure of fees.

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[15] Interest rates in togrog are as high as 34 percent, and 18 percent in US dollars.

## B. Capital Market Development

40. **Given the still small size of the majority of domestic firms, and the availability of external finance for most of the large foreign investors, the extent to which Mongolian capital markets will develop in the near term is not clear.** The development of capital markets will be shaped by potential changes on both the demand- and supply-sides. These include: (i) likely increased investment in Mongolian stocks by overseas emerging markets funds; (ii) the creation of mortgage backed and other asset backed securities; (iii) the creation of Mongolian depository receipts; (iv) the creation of a life insurance industry which should generate demand for securities; (v) the creation of private equity funds; (vi) changes to the Banking Law to enable banks to take a greater role in the capital market as intermediaries and investors; and (vii) listings by Mongolian companies on overseas stock exchanges. While all of these changes will benefit one or more sectors of the Mongolian economy not all of them will be advantageous to the goal of developing a vibrant domestic capital market, nor can they be prevented as Mongolia becomes increasingly a participant in the global capital market.

41. **Many of the companies originally listed as part of the privatization program of the early 1990s were by 2007 little more than shells**. The majority owners of some others were not regularly publishing audited financial statements. To aid development of a robust capital market, and to support the reputation of the MSE, 200 of the 380 listed companies were delisted in November 2007. Other measures which should be taken to support capital market development include: (i) upgrading the legal foundations of the capital market to meet international standards; (ii) developing a medium to long term yield curve of either government or similar high quality bonds as the basis for pricing—the planned introduction of a market in mortgage backed securities might provide a suitable benchmark; and (iii) expanding the processing capacity of the Securities Clearing House and Central Depository to provide a cushion against a sudden increase in traded volume.

## C. Development Banking

42. **The Mongolian authorities are considering setting up a development bank; any such initiative should focus on supporting underserved sectors of the economy (e.g., infrastructure development)**. Instances of successful developmental banks worldwide are outnumbered by the failures. The experience from other countries has shown that the government's role in supporting an enabling environment that stimulates the development of financially viable institutions is preferable to a role as a direct provider of financial services. Moreover, care should be taken to ensure that development banking activities do not undermine financial sector development, through the provision of concessional interest rates to clients which are already well served by the private financial sector.

## D. Access to Financial Services

### SME financing

43. **Most Mongolian banks provide services in microfinance and small- and medium-size enterprise (SME) finance, but access to finance remains a major impediment to SME growth.** Most registered business entities in Mongolia fall in the SME category by the definitions provided in the new SME Law. However, compared to larger companies, SMEs often find it difficult to finance their capital investment and daily operational needs. The main impediments include relatively high lending rates, limited market information, and weak capacity for market research and business planning.

44. **Many banks have started to target SME borrowers but a large portion of their programs appear to rely on donor funding**. The Microfinance Development Fund (MDF) is a key source of funds for the top three banks engaged in microfinance as well as other banks which are keen on expanding to rural areas.[16] The continued reliance of some these institutions on the preferential interest rates provided by MDF and other donors is an outstanding issue. In the longer run, institutions will need to diversify their funding sources for SME lending to ensure that there is not a perennial reliance on donor programs and that they can sustain their operations mainly from funds obtained at market rates. The future organizational structure of the MDF should also be reviewed, especially as its location at the BOM could potentially create a conflict with the BOM's role as a supervisor.

45. **The proposal, incorporated in the recently passed SME Law, to reform the SME Development Fund into a permanent apex institution which would provide funding to financial institutions at below market rates should be reviewed**. The new law does address a number of existing impediments to the development of SME finance. However, international experience has shown that government programs that use market mechanisms to support SME development tend to have a higher rate of success. Direct interventions, such as provision of funds at below market rates to SMEs, often lead to weaker financial discipline by SMEs and distorted credit risk assessments by their creditors.

### Technological innovations

46. **Financial institutions are looking to technological innovations to reach out to new customers and maintain market share, but the legal and regulatory environment needs significant strengthening to support these innovations.** Banks are offering new products and services through e-banking and issuance of bank cards. However, the increased use of technologies by banks is taking place in some cases without sufficient laws and

[16] The MDF, which is a lending facility at the BOM created under a World Bank project, currently has 18 participating financial institutions (PFIs), of which 10 are banks and 8 NBFIs.

regulations, such as those regarding authenticity and finality of e-transactions, verification of e-signatures, customer privacy protection, and banking information confidentiality. Two laws and an amendment to the Civil Code regarding these subjects have been drafted by the Information Communication Technology Authority and are expected to be submitted to the Parliament in 2008.

47. **Card business is expected to grow rapidly, but may be constrained by the lack of common platform for card processing and electronic billing systems.** Most credit/debit card transactions are processed by the two largest banks, with another having recently started to develop its own card processing system. The lack of interoperability of these systems (which may reflect attempts to protect market share) is becoming increasingly inconvenient for consumers and vendors. The BOM’s Switch and Clearing Center has the capability to provide a shared card processing platform and is in compliance with the current international technical standards for card processing. Before the Switch Clearing Center’s card processing function becomes operational, the BOM should however revisit the legal status of the Clearing Center, as card processing is a commercial activity.

## Appendix 1. Mongolia: Stress Testing Methodology and Assumptions

48. **The stress tests were designed and performed by the FSAP team in close cooperation with the staff of the BOM**. The tests were performed individually for all sixteen commercial banks operating in Mongolia, as well as for the system as a whole, using detailed bank balance sheet data for end-June 2007. The stress tests were also conducted separately for three peer groups of banks: Group 1 included five largest Mongolian banks, accounting for almost three quarters of the total market share in terms of assets; Group 2 included six small banks, with a combined market share of 7.3 percent, which all perform more investment banking-type of activities, with very narrow deposit base and high capitalization ratios (average capital adequacy ratio of banks of this group is 40.4 percent); and Group 3 included the remaining five small- and medium-sized banks (Table 3).

### Table 3. Mongolia: Selected Indicators of Bank Performance

(based on the data of June 30, 2007)

| | Group 1 | Group 2 | Group 3 | Total |
|---|---|---|---|---|
| Number of banks | 5 | 6 | 5 | 16 |
| Market share (in percent of total assets) | 72.4 | 7.3 | 20.3 | 100.0 |
| Market share (in percent of total deposits) | 78.9 | 3.3 | 17.7 | 100.0 |
| Capital adequacy ratio (in percent of risk-weighted assets) | 12.3 | 40.4 | 13.1 | 15.2 |
| Capital to assets ratio (in percent of total assets) | 9.2 | 40.8 | 10.9 | 11.9 |
| Loans in percent of assets | 61.7 | 81.4 | 68.6 | 64.5 |
| Loans in percent of deposits | 81.9 | 258.5 | 113.8 | 93.4 |
| Sectoral distribution of loans (in percent of total loans) | | | | |
| Agriculture | 9.7 | 1.7 | 4.1 | 7.9 |
| Construction | 15.7 | 3.8 | 12.3 | 14.1 |
| Mining | 8.7 | 8.8 | 10.2 | 9.1 |
| Manufacturing | 11.5 | 38.6 | 10.0 | 13.2 |
| Trade | 29.2 | 31.4 | 27.2 | 28.9 |
| Transport & Communication | 2.3 | 1.3 | 1.7 | 2.1 |
| Other sectors | 22.9 | 14.4 | 34.4 | 24.8 |
| Type of borrowers (in percent of total loans) | | | | |
| Enterprises | 54.9 | 42.8 | 53.9 | 53.6 |
| Households | 37.3 | 16.1 | 37.1 | 35.3 |
| FX loans in percent of total loans | 40.8 | 41.7 | 34.6 | 39.6 |
| FX household loans in percent of total household loans | 11.2 | 22.5 | 16.5 | 12.9 |
| NPLs/Loans | 3.3 | 6.7 | 3.2 | 3.6 |
| Provisions/NPLs | 91.0 | 82.0 | 80.6 | 87.5 |
| NPLs net of provision /Capital | 2.0 | 2.4 | 3.8 | 2.4 |
| Return on assets | 3.0 | 1.2 | 0.7 | 2.4 |
| Return on equity | 46.4 | 2.5 | 6.2 | 22.1 |
| Liquid assets/Total assets | 33.7 | 15.3 | 22.1 | 30.0 |
| Liquid assets/Short-term liabilities | 35.7 | 25.9 | 23.4 | 32.7 |

Source: BOM, and staff calculations.

**Methodology**

49. **The stress tests included both sensitivity and scenario analyses**. Sensitivity stress tests consisted of testing the banking sector exposure to separate interest rate, exchange rate, and credit risks. Scenario stress tests consisted of evaluation of effects on banks from three different macroeconomic shocks. The purpose of the tests was to examine the potential effects on banks' financial condition of a set of specified changes in risk factors, corresponding to exceptional but plausible events.

50. **The methodology used in all stress tests consisted of estimating the present value of net losses or gains incurred as a result of certain shocks, and expressing these losses or gains as a one-time and immediate charge to capital**. In tests for credit quality shocks, the losses consisted of increases in provisions and a corresponding decrease in the amount of regulatory capital; in tests for foreign exchange shocks, they consisted of a revaluation gain or loss expressed as a percent of regulatory capital; and in tests for interest rate shocks, they consisted of net gains or losses in the discounted value of interest-bearing assets and liabilities, considered per maturity and re-pricing brackets, also calculated as a percent of regulatory capital.

**Assumptions**

51. **The size of the various shocks used in the stress testing exercise was chosen based on both historical and hypothetical changes in the key variables**. Single-factor scenarios assessed the exposure of banks to interest rate, exchange rate, and credit risks:

- ***Exchange rate risk***. Two tests were performed to evaluate the effects on Mongolian banks of a change in the value of the togrog: (i) a simultaneous depreciation against all currencies by 15 percent; and (ii) a simultaneous appreciation against all currencies by 20 percent. The magnitude of considered depreciation was broadly equivalent to the largest depreciation of the togrog against the US dollar recorded within one quarter from January 1999 to April 2007 (a depreciation by 15.4 percent in March 1999), while the magnitude of considered appreciation was hypothetical. An additional test considered the effects on bank balance sheets from a hypothetical appreciation of the Chinese yuan against all currencies by 10 percent, which is a plausible assumption in the current circumstances.

- ***Interest rate risk***. The tests considered: (i) a parallel upward shift in all interest rates by 10 percentage points; (ii) a steepening in the togrog yield curve (increase in the long-term interest rates by 5 percentage points, and a decrease in the short-term interest rates by 2 percentage points); and (iii) a flattening in the togrog yield curve (increase in the short-term interest rates by 5 percentage points, and a decrease in the long-term interest rates by 2 percentage points). The assumption of an upward shift in all interest rates by 10 percentage points was roughly corresponding to the actual largest quarterly increase in interest rates on central bank bills recorded in the period January 1999-April 2007 (11.4 percentage points, June 2003). The assumptions of steepening/flattening in the yield curve were purely hypothetical.

- ***Credit risk***. Three tests were used to estimate the effects of different credit shocks: (i) a weather-related shock, affecting performance of the agriculture sector; (ii) a wide-ranging increase in the non-performing loans; and (iii) a downward migration of loans by one classification category.

    - The first test was based on an assumption of a climatic shock. Mongolia is subject to periodic adverse climatic shocks, so the probability of such a shock is quite high. An average winter season is relatively long with harsh weather conditions, but some winters are particularly severe. Extremely cold weather during the winters in 2000 and 2001, following severe droughts in the summers of 1999 and 2000, led to the considerable losses of animal husbandry (of around one quarter of livestock), which is the main component of the agriculture sector, accounting for one fifth of Mongolian GDP. The test considered that half of all bank loans distributed to the agriculture sector become non-performing, and the recovery rate on these loans is zero.

    - The second test assumed an increase in the ratio of non-performing loans to total loans by 10 percentage points. Such a magnitude of the shock was similar to the largest historical quarterly increase in the NPL ratio for the system as a whole during the period April 1997-April 2007 (December 1997, 9.9 percent). The loss given default (LGD) was assumed to be a simple average of the required provisioning ratios for loans classified as substandard, doubtful, and loss (approximately 72 percent).

    - The third test assumed that 10 percent of standard loans become past due, while all other classified loans migrate by one notch down (i.e., all past due loans become substandard, all substandard loans become doubtful, and all doubtful loans become loss), with a corresponding increase in the amount of required provisions.

52. **In addition to sensitivity stress tests, two macroeconomic scenarios were considered**. Scenario 1 assumed a shock to the terms of trade, and Scenario 2 assumed a "Dutch disease"-type of shock, with a surge in trade and capital inflows.

- ***Scenario 1: negative external shock***. Scenario 1 was based on an assumption of a terms of trade shock: a fall in the world price of copper (a major Mongolian export) combined with a stable level of prices of oil and other fuel (Mongolia is a net importer of oil). Copper-producing companies play a very important role in the economy of Mongolia, contributing around one fifth of Mongolian GDP, more than half of Mongolia's merchandise exports, and around one fourth of government revenues. There is a reasonable probability of a fall in international copper prices. Following a long period of relative stability, world copper prices have increased sharply since 2003, largely reflecting a strong growth in China, which is a major source of world copper demand. However, future contracts suggest that the price of copper is expected to decline from the current high levels in the next few years, while oil prices will remain at about current levels. It was assumed that a very large fall in copper prices would lead to a fairly rapid deterioration in the quality of loans issued to the mining sector (50 percent of all loans to the mining sector are assumed to become losses), a depreciation of the togrog by 10 percent, an increase in the interest rates, and a general slowdown in economic activity.

- ***Scenario 2: surge in capital inflows***. Under this scenario, it was assumed that substantial trade and capital inflows result in an appreciation of the togrog by 20 percent, and intensified inflationary pressures, leading to a moderate slowdown in the performance of all tradable and non-tradable sectors. Interest rates were assumed to remain at the current levels.

**Table 4. Mongolia: Summary Results of the Stress Tests** [1/]

(based on the data of June 30, 2007)

| Test | Regulatory Capital (in percent of risk weighted assets) | | | |
|---|---|---|---|---|
| | Group 1 | Group 2 | Group 3 | Total |
| Baseline capital adequacy ratio | 12.3 | 40.4 | 13.1 | 15.2 |
| **A. Sensitivity analisys** | | | | |
| *Exchange Rate Risk* | | | | |
| Depreciation by 15 percent | 13.0 | 42.1 | 13.1 | 15.8 |
| Appreciation by 20 percent | 11.4 | 38.2 | 13.0 | 14.3 |
| Appreciation of CNY by 10 percent | 12.3 | 40.4 | 13.0 | 15.2 |
| *Interest Rate Risk* | | | | |
| Increase in interest rates by 10 percentage points | 10.1 | 38.2 | 11.1 | 13.0 |
| Steepening in the yield curve | 11.6 | 39.7 | 12.5 | 14.5 |
| Flattening in the yield curve | 12.3 | 40.5 | 13.0 | 15.2 |
| *Credit Risk* | | | | |
| Shock to the agriculture sector | 8.6 | 40.0 | 11.6 | 12.3 |
| Increase in the NPL ratio by 10 percentage points | 6.7 | 36.8 | 7.7 | 9.8 |
| Downgrading of classified loans by one category | 11.1 | 38.4 | 11.8 | 13.8 |
| **B. Scenario Analysis** | | | | |
| *Scenario 1* | 7.1 | 37.8 | 7.0 | 10.1 |
| *Scenario 2* | 9.5 | 36.9 | 11.2 | 12.5 |

1/ Group 1 includes five largest banks, accounting for almost three quarters of the total market share in terms of assets; Group 2 includes six small banks, with a combined market share of 7.3 percent, which all perform more investment banking-type of activities; and Group 3 includes the remaining five small- and medium-sized banks.

Appendix 2. Mongolia: Supervision of Savings and Credit Cooperatives

53. **The SCC sector has grown rapidly, without a clear formal regulatory and supervisory framework that would ensure financial discipline and protect member savings**. Prior to the creation of the FRC in early 2006, SCCs were not under the purview of a government entity and were governed by the law on cooperatives which does not adequately distinguish between the financial intermediation role of SCCs and those cooperatives which offer non-financial services to their member base. A consequence was the proliferation of financially weak SCCs. The imposition of the oversight of SCCs led to the failure of 32 SCCs accounting for more than half the assets of the sector in 2006.[17] The reputation of the SCCs sector has suffered as a result and it has yet to recover. A law specific to SCCs was drafted in 2006 but has not been passed yet. The FRC has gained some initial experience since 2006 in supervising SCCs, and portions of the draft law may need to be revisited to ensure proper implementation. It is also critical that prior to the passage of this law, the SCC industry's views are sought.

54. **In the absence of appropriate legislation for SCCs and in light of a large number of member complaints, the FRC issued in 2006 a temporary regulation on licensing SCC activities**. Out of 955 registered SCCs in 2006, around 500 applied for a license before October 1, 2007 (the deadline for applying for licensing), and many have been subsequently licensed. These newly licensed SCCs are located mainly in the capital city and competing directly with the banking sector by offering higher deposit rates.

55. **The FRC's capacity to supervise SCCs is constrained by limited skilled and experienced staff as well an appropriate complement of number of staff to conduct the inspections**. Since June 2006, the FRC has conducted 50 on-site supervisions of SCCs and its mandate is to conduct these regardless of the size of the SCC. As the licensing process could result in over 200 SCCs, it is critical that FRC collect data on the key characteristics of the newly licensed ones and categorize them as large, medium and small (based on asset size, number of members, etc.) and consider using a tiered model to supervise them on-site. Prudentially regulating all SCCs may not be either necessary or feasible in light of FRC's limited staff capacity. As the draft law is still being discussed, it would be useful for FRC to examine the experience of some other countries using the tiered approach and revise the supervisory aspects in the law accordingly

[17] Around half of the total loss of the failed SCCs (TOG 33 billion) is supposed to be paid out by the state budget. As of April 2008, TOG 19 billion has already been paid.

## Annex I. OBSERVANCE OF SELECTED FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

This annex contains summary assessments of observance of the Basel Core Principles for Effective Banking Supervision (BCP) and the Code of Good Practices on Transparency in Monetary and Financial Polices: Monetary Policy (MFP).

The detailed assessment of observance of the BCP was undertaken by Stefan Spamer (bank supervision expert, Deutsche Bundesbank) and Walter Zunic (bank supervision expert, formerly U.S. Federal Reserve).

The primary assessor of monetary policy transparency was Elena Loukoianova (Monetary and Capital Markets Department, IMF), with the help and assistance of SeungHo Lee (Asia Pacific Department, IMF).

Both assessments were based on a range of sources including:

- Self-assessments done by the Mongolian authorities;
- Reviews of relevant legislation, decrees, regulations, policy statements and other documentation;
- Detailed interviews with the supervisory authorities;
- Meetings with other relevant authorities and independent bodies; and
- Meetings with banks and other financial sector firms and associations.

### Observance of the Basel Core Principles for Effective Banking Supervision

#### Information and methodology used for assessment

56. The assessment was carried out on the basis of the legal framework governing the supervision of banks, principally, the Law of Mongolia on the Central Bank (BOM Law), the Banking Law of Mongolia, as well as regulations and guidelines issued by the BOM, and informed by responses to a questionnaire sent to the BOM before the mission and a self-assessment prepared by the BOM in advance of the mission. The assessors are grateful for the generous assistance of all those whom they met in the course of undertaking the assessment.

57. The assessment of observance of each of the Core Principles follows a qualitative approach and is based on the revised Core Principles Document of October 2006. The assessment method consisted of examining the degree of observance of each of the Core Principles Methodology's essential criteria and, where the assessors judged necessary, of the additional criteria, as well.

#### Institutional and macroeconomic setting and market structure—overview

58. The macroeconomic setting in which banks operate can be characterized as one of a less developed, but rapidly growing, economy driven by record prices for commodity exports

and the recovery of the agricultural sector from several unusually severe winters. The economic growth rate has contributed to large increases in household incomes, particularly for public sector workers, and very high growth rates in bank lending. At the time of the BCP assessment, bank lending and deposit interest rates were still high in both nominal and real terms, but were gradually converging to levels similar to those in other countries at a similar stage of transition.[18] The margins between bank deposit and lending rates were already in line with these countries, indicating that there is a reasonable degree of competition in the banking sector.

59. The banking system comprises 16 registered commercial banks in Mongolia, which account for over 95 percent of total financial system assets. Total assets of the banking system grew from 52 percent of GDP in 2003 to about 87 percent of GDP in 2007, or by 4.3 times in nominal terms. There are a large number of savings and credit cooperatives (SCCs) which can also take deposits. While these are generally small, several of the larger SCCs do play an important role. The BOM is the sole authority for carrying out licensing and supervision of banking institutions in Mongolia. The SCCs, as with all non-bank financial institutions and the capital markets, are supervised by the Financial Regulatory Commission.

**Preconditions for effective banking supervision**

60. The Basel Committee has made clear that it is difficult to establish and maintain an effective system of banking supervision unless certain pre-conditions, often beyond the control of a supervisory agency, are met. The main requirements are as follows:

- **Soundness and sustainability of macroeconomic policy**. Mongolia's economic performance has been very strong in recent years. Annual GDP growth has averaged over 7 percent since 2002; inflation has been reduced to mid-single digit levels by mid-2007, and the budget and current account recorded surpluses in 2006-07. However, booming economic conditions and some relaxation in fiscal policy meant that inflation started to pick up later in 2007.

- **Legal infrastructure.** While a suitable legal framework for banking supervision exists and substantial progress has been made with upgrading the legal framework in general, there are still a number of weaknesses. Needed new or amended laws include: (i) a revised banking law; (ii) a revised securities market law; (iii) a law on mortgage collateral; and (iv) a mortgage securitization law. In addition, some other legal procedures need to be upgraded; for example, the bankruptcy law was passed in 1996 but there have been only a handful of cases and the process is slow and cumbersome.

[18] A spike in inflation in late-2007 and early-2008 may slow the rate of decline in nominal interest rates.

- **Effective market discipline**. Banks are subject to substantial disclosure requirements and are required to follow international accounting standards. Examination of the accuracy of accounting procedures is an integral part of on-site inspections. The Banking Law specifies that banks shall disclose to the public, through the media, a financial statement each month, and an audited financial report of the previous financial year in the first quarter of the following year. The Banking Law also gives power to the BOM to hold a bank's management and board responsible for ensuring that financial record keeping system are reliable and that the annual statements issued to the public receive proper external verification and contain an external's auditor opinion.

- **Mechanisms for providing an appropriate level of systemic protection (or public safety net)**. There is no compulsory deposit insurance scheme although one is under consideration. Bank resolution procedures were put to the test following several banking sector problems in the late 1990s which required changes to the laws in order to enable them to be resolved by the authorities. As a result of the reforms that took place, the banking sector was privatized.

**Main findings**

61. The main findings of the assessment can be briefly summarized under the following headings:

- **Objectives, independence, powers, transparency, and cooperation (CP1**). The supervisory objectives and legal powers of the BOM are well laid out and its formal independence, both in decision-making and resources, is satisfactory. However, the reasons for possible removal of the Governor, with regard to unsatisfactory performance and conflicts of interest, are very general and Governors have several times in the past been replaced following a change of government. There is also no formal legal protection for BOM against lawsuits for actions taken while discharging their functions in good faith.

- **Licensing and structure (CPs 2–5)**. The laws and regulations covering licensing are comprehensive, however some gaps exist. In particular, the background and experience required for senior staff management and boards should be set out in more detail. Further, if a license was granted based on false information, the license can only be revoked within a year of registration. The Banking Law also does not require notification or approval for an investment or majority share holding in banks, other than as described above, and banks are not required to fully consolidate all subsidiaries, and there are no laws, regulations and guidelines concerning the mitigation of risks arising out of non-banking activities of subsidiaries/associates.

- **Prudential regulations and requirements, (CPs 6–18)**. Senior managements of banks are required to establish acceptable limits for different types of risks, including credit, market, operational, legal and reputational risks. These requirements were enhanced in 2006, to require that assignment of responsibilities and decision making authorities by management should be appropriate for a bank's risk profile and supported by adequate internal controls. Market-risk-related computations, capital charges, and reporting requirements are in force in Mongolia and the BOM monitors the effectiveness of risk assessments and mathematical models. While the BOM has instituted suitable policies and procedures for monitoring and control of interest risk, it had not issued a liquidity risk guideline at the time of the BCP assessment. In addition, some smaller banks do not yet have the sophistication to calculate and control various risks. While risk-weighted capital adequacy requirements are applied on a "solo" basis only, consolidated calculations are made on an informal basis to some extent; a draft regulation on consolidated supervision is in preparation. There is currently no clear definition in law or regulation of a "group of connected counterparties" to support monitoring of large exposures. Although this is expected to be rectified shortly, a threshold for identifying large exposures also needs to be defined.

- **Methods of ongoing supervision, (CPs 19–21)**. Regulations and guidelines for appropriate onsite and offsite supervision are in place, and the BOM is continuously introducing improvements to bring its inspection and monitoring processes further in line with internationally accepted principles. The supervisors are doing a competent job in providing an objective evaluation of the quality of an institution, and identifying areas where corrective action is required to strengthen the bank. The evaluation of the various components used to analyze the financial institutions is a mix of quantitative and qualitative judgment. The legislation does not codify the possibility for conducting supervision on a consolidated basis, so that the BOM's supervisors do not have the authority to request and obtain information on the makeup of a banking group or bank holding company, or to analyze the activities of the legal entities constituting them when such entities are non financial companies.

- **Accounting and disclosure (CP 22)**. Banks are required to follow international accounting standards, however the BOM's supervisors could rely more on banks' external auditors through direct meetings.

- **Remedial measures (CP 23)**. The BOM Law gives the BOM wide powers for supervisory intervention and corrective actions in the interests of banking policy, in the public interest, or where the affairs of a bank are being conducted in a manner detrimental to the interest of depositors. These powers are actively employed, including the liquidation of insolvent banks. However, the schedule of maximum fines has been eroded by inflation and needs to be updated to be effective as a deterrent.

- **Consolidated and cross-border banking supervision (CPs 24–25)**. While consolidated supervision is not exercised by the BOM, the BOM seeks to get an overall picture in an informal way. Consolidated capital adequacy ratios are reported by the banks, but prudential requirements are not applied on a consolidated basis although supervisors do have access to information on banks' subsidiaries. Amendments to the Banking Law are in preparation which should empower the BOM to obtain all the information it needs both on banking groups and wider groups of which a bank forms a part, and that it can take all necessary action to protect the bank in such groups. Also, a "Regulation on Information Sharing" between the BOM and the Financial Regulatory Commission, which will inter alia specify how lead supervisors of financial groups are to be decided, is in preparation. Currently, there are no branches of foreign banks in Mongolia, with the exception of foreign investors/investment companies owning up to 100% of 6 Mongolian banks, and the only overseas presence of Mongolian banks comprises representative offices.

62. **The Bank of Mongolia implemented a number of enhancements to the bank supervision and regulatory framework after the BCP assessment was carried out in May 2007**. Because these changes were implemented after the BCP assessors' visit, they have not been taken into account in this assessment but could, in a future assessment, result in improved compliance with the BCPs.

### Table 5. Summary of Observance of the Basel Core Principles

| Core Principle | Comments |
|---|---|
| 1. Objectives, independence, powers, transparency, and cooperation | Some deficiencies on the independence of the BOM exist and the exchange of information. |
| 1.1 Responsibilities and objectives | Responsibilities and objectives are clear. |
| 1.2 Independence, accountability and transparency | Independence of the BOM is satisfactory, however the reasons for removal of the BOM Governor from his post are overly general. |
| 1.3 Legal framework | A suitable legal framework exists. |
| 1.4 Legal powers | Suitable legal powers exist. |
| 1.5 Legal protection | No legal protections for supervisors are provided in law. |
| 1.6 Cooperation | Arrangements for cooperation exist but could be augmented by stricter confidentiality requirements on information that is exchanged. |
| 2. Permissible activities | The use of the term "bank" and banks' permissible activities are well defined in law. |
| 3. Licensing criteria | Requirements for prior banking experience by bank management and boards and license revocation powers by the BOM could both be strengthened. |
| 4. Transfer of significant ownership | Definitions of significant ownership and controlling interest could be more formalized. |

| Core Principle | Comments |
|---|---|
| 5. Major acquisitions | There are some gaps in the regulations covering notification and approval of major investments, and monitoring of risks arising from non-banking activities. |
| 6. Capital adequacy | Formal reporting is on a solo basis only, although the BOM makes informal consolidated calculations. |
| 7. Risk-management process | Supervision is adequate but is in the process of being significantly enhanced. |
| 8. Credit risk | Supervision of credit risk is sufficient. |
| 9. Problem assets, provisions, and reserves | Provisioning arrangements and supervisory review processes are satisfactory. |
| 10. Large exposure limits | No legal definition of a group of connected parties exists, and a quantitative threshold for defining a large exposure is needed. |
| 11. Exposure to related parties | Norms are generally adequate, although Banking Law should be strengthened as regards procedures covering loans to board members |
| 12. Country and transfer risks | Inspection procedures are adequate however banks reporting requirements should be strengthened. |
| 13. Market risks | Suitable supervisory policies and procedures exist, but focused primarily on the larger, more sophisticated banks and separate limits for currencies and commodities do not exist. |
| 14. Liquidity risk | A comprehensive liquidity risk guideline is needed. |
| 15. Operational risk | Operational risk rules and requirements exist. Compliance by small banks can be improved. |
| 16. Interest rate risk in the banking book | Risk management systems are adequately supervised, however compliance with supervisory requirements by some smaller banks should be improved. |
| 17. Internal control and audit | The BOM is requiring internal audit functions at banks to become more risk focused. |
| 18. Abuse of financial services | The FIU at the BOM is new and so understaffed and requiring of training. |
| 19. Supervisory approach | Supervisors have a thorough understanding of banks. |
| 20. Supervisory techniques | Adequate regulations and guidelines are in place, and supervision is competent. |
| 21. Supervisory reporting | Banks are required to report quarterly, however only on a solo basis. |
| 22. Accounting and disclosure | Generally compliant however there could be greater input sought from banks' external auditors. |
| 23. Corrective and remedial powers of supervisors | Adequate powers exist and are utilized, however the schedule of fines is far too low, due to inflation. |
| 24. Consolidated supervision | Consolidated supervision is not exercised, but necessary amendments to the BOM Law are being drafted. |
| 25. Home-host relationships | Activities by foreign banks in Mongolia are limited and by Mongolian banks offshore relate only to representative offices. |

## Recommended action plan and authorities' response

### *Recommended action plan*

### Table 6. Recommended Action Plan to Improve Observance of the Basel Core Principles

| Reference Principle | Recommended Action |
|---|---|
| CP 1.2 Independence, accountability and transparency | Specify more concretely reasons for removal of BOM Governor. |
| CP 1.5 Legal protection | Amend BOM Law to provide protection for both the BOM and its staff. |
| CP 3. Licensing criteria | Issue laws, regulations or guidelines to provide for:<br>more intensive supervision of newly authorized banks; more detail experience requirements for bank management and board members; and elimination of the one year limitation on the revocation of a license if it was based on false information should be eliminated. |
| CP 4. Transfer of significant ownership | Provide a definition of significant ownership and controlling interest comparable to international standards in the Banking Law. |
| CP 5. Major acquisitions | The Banking Law or respective regulation or guidelines should provide a definition of a single qualifying holding in any other company, and should require the notification or approval for an investment or majority share holding in banks. |
| CP 6. Capital adequacy | Introduce calculation and reporting on a consolidated basis. |
| CP 7. Risk management process | Complete as soon as possible targeted onsite reviews at all banks to determine their extent of compliance with the new Corporate Governance Regulation, and their improvement of risk management policies. |
| CP 10. Large exposure limits | Provide a clear definition in the Banking Law on a "group of connected counterparties", as the basis to monitor large exposures.<br>Introduce a definition and a threshold for identifying large exposures. |
| CP 11. Exposure to related parties | The Banking Law, together with any relevant regulations or guidelines, should indicate that any loans or transactions with a director or member of the board and related parties have to be discussed in their absence. |
| CP 13. Market risks | Set up separate position limits for currencies and for commodities. |
| CP 14. Liquidity risk | Issue a comprehensive liquidity risk guideline. |
| CP 15. Operational risk | Encourage the smaller banking institutions to implement operational risk control measures commensurate to their activities. |

| Reference Principle | Recommended Action |
| --- | --- |
| CP 16. Interest rate risk in the banking book | Require all banks to implement the interest risk methodology commensurate to their activities. |
| CP 17. Internal control and audit | Ensure that the implementation process of the Corporate Governance Principles for Banks (CGB) issued in 2006, is completed by the first quarter of 2008. |
| CP 18. Abuse of financial services | Allocate additional human resources to the FIU and train supervisors more fully in this area. |
| CP 21. Supervisory reporting | Issue guidelines covering implementation of consolidated supervision. |
| CP 22. Accounting and disclosure | Increase the frequency of contacts with the outside auditors. |
| CP 23. Corrective and remedial powers of supervisors | The schedule of fines should be reviewed and increased. |
| CP 24. Consolidated supervision | Introduce amendment to the Banking Law on consolidated supervision. |
| CP 25. Home-host relationships | Prepare, in the Banking Law, regulations and guidelines, for the eventuality that Mongolian banks seek to operate internationally and vice versa. |

***Authorities' response to the assessment***

63. The Mongolian authorities were in broad agreement with the findings of the BCP assessment. They noted that since the BCP assessment was conducted in May 2007, significant steps have been taken to enhance the supervisory and regulatory framework which in their view will result in improved observance of the BCPs. These steps include:

- strengthened regulations relating to AML/CFT issues, especially as regards reporting suspicious transactions, and know-your-customer rules; a new regulation requiring banks to report all large exposures (as against the previous requirement to report only the largest 20 exposures);

- strengthening consolidated supervision by requiring prior BOM approval for any changes made by a holding company or other affiliate which affects the ownership, management or structure of a bank, and by strengthening the BOM's rights to obtain information relevant to consolidated supervision; and

- requiring those banks using Value-at-Risk (VAR) frameworks to implement more comprehensive analysis, to introduce stress testing and scenario analysis, and to validate their internal models including through back testing.

## Code of Good Practices on Transparency in Monetary and Financial Policies: Monetary Policy

### General

64. **This assessment examines the observance by the BOM of the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies* (hereafter the MFP Transparency Code) as it relates to monetary policy**. The assessment was based on the *MFP Transparency Code* and has taken into account the implementation issues mentioned in the *Supporting Document* to the *MFP Transparency Code*.

### Institutional Structure—Overview

65. **The relevant agency for the monetary policy assessment is the Bank of Mongolia (BOM)**. The BOM was formed through reorganization of key departments in the former State Bank and establishment of a two-tier banking system in May 1991 based on new banking laws. In addition to being responsible for formulating and implementing monetary policy in Mongolia, the BOM is responsible for: issuing currency into circulation; acting as the Government's fiscal intermediary; supervising banking activities; arranging interbank payments and settlements; and holding and coordinating the State's international reserves.

66. **The main objective of monetary policy, as specified in the legislation, is to promote the stability of the national currency**. Within its main objective the BOM also promotes balanced and sustained development of the national economy, through maintaining the stability of the money and financial markets, and the banking system.

67. **The institutional framework provides for two bodies concerned with monetary policy, the BOM and the parliament (the "State Ikh Khural")**. The Constitution of Mongolia (January 13, 1992) provides that "[t]he parliament ...shall keep within its executive power the following issues and decide thereon: ... (7) to define the State's financial...and monetary policies." The BOM is statutorily independent from the government and parliament is prohibited from intervening in the conduct of monetary policy. The BOM annually proposes monetary policy for the next year, in the form of "monetary policy guidelines" for review and approval by parliament. Before submitting a draft of the monetary policy guidelines to parliament, the BOM posts the draft on its website for public discussion. Once finalized and approved, the guidelines are made public through the media.

68. **The Governor of the BOM has sole decision making power**. There is a 14-seat Board, or Council, which is chaired by the governor and includes senior management and two outside non-voting members, which makes recommendations and gives advice to the Governor. In addition, there is a Supervisory Board which has responsibility for monitoring the activities of the BOM and reporting its views to the parliament. Parliament appoints the Governor, the First Deputy Governor, and the Deputy Governor for terms of six years.

**Main findings**

69. **There is a reasonably high degree of monetary policy transparency in general, with significant improvement having been made over the couple of years reflecting the BOM's awareness of the benefits of greater increased policy transparency**. However, there is room to further enhance the transparency of monetary policy decisions. Moreover, the governance of the BOM, and in particular the accountability of the Governor, could be strengthened.

70. **While the objective of monetary policy is defined in the legislation, it is done so in quite broad terms, and so is potentially open to varying interpretation**. Nor are there regulations that define the ultimate objective with clarity. To address this, the BOM publicizes on its website and in other public statements the narrower "price stability" as the ultimate objective of monetary policy. Also, the parliamentary resolutions approving the state monetary policy guidelines are available through the media. These processes go some way to clarifying the policy objectives.

71. **The main recommended actions to improve monetary policy transparency are to:** (i) achieve greater clarification in law of monetary policy role, responsibilities, and objectives of the BOM; (ii) achieve greater public disclosure of framework, instruments, targets, and decisions of monetary policy; (iii) improve the BOM's internal governance procedures, including the accountability of the governor of the BOM; (iv) and provide legal protection for officials and staff of the BOM when carrying out their duties in good faith. A summary of the full set of recommendations is provided in Table 8.

72. **There is an intention to amend the BOM Law**. The proposed amendments would, if enacted, help to address several of the institutional gaps in monetary policy transparency. In the meantime, the BOM is in the process of issuing several guidelines and internal regulations to address issues in internal governance and monetary policy transparency.

**Table 7. Summary Observance of the Transparency Code: Monetary Policy**

| Principle | Findings |
|---|---|
| 1.1 The ultimate objective(s) and institutional framework of monetary policy should be clearly defined in relevant legislation or regulation | The ultimate objective and institutional framework of monetary policy are defined in the BOM Law. The objectives of the BOM should be redefined with price stability as the primary objective and the stability of the exchange rate and the stability of the financial system as secondary objectives. |
| 1.2 The institutional relationship between monetary and fiscal operations should be clearly defined | The institutional relationship between the BOM and the government is reasonably clearly defined in the BOM Law, however there are some deficiencies with respect to the regulation covering central bank lending to government, the BOM's involvement with the rest of the economy and the definition of the BOM's net income.. |

| Principle | Findings |
|---|---|
| 1.3 Agency roles performed by the central bank on behalf of the government should be clearly defined | The agency roles performed by the BOM on behalf of the government are defined in the BOM Law. |
| 2.1 The framework, instruments, and any targets that are used to pursue the objectives of monetary policy should be publicly disclosed and explained | At a broad level, the framework, instruments, and targets for monetary policy are described, explained, and publicly disclosed, on the BOM website and various publications. Explanations about implementation of monetary policy instruments are publicly disclosed in the BOM Annual Reports and quarterly bulletins. An annual inflation objective is set in the state monetary policy guidelines and publicly disclosed through the BOM website. Also, in 2007, the BOM introduced a practice of posting a draft of the monetary policy guidelines on its website for public discussion before submitting it to parliament. |
| 2.2 Where a permanent monetary policy making body meets to assess underlying economic developments, monitor progress toward achieving its monetary policy objective(s), and formulate policy for the period ahead, information on the composition, structure, and functions of that body should be publicly disclosed | It may be worth considering establishing a Monetary Policy Committee, which would have authority for monetary policy decisions. Until such time as this is done, the Governor could be made more accountable for policy decisions by strengthening the BOM Supervisory Board's reporting to parliament. |
| 2.3 Changes in the setting of monetary policy instruments (other than fine-tuning measures) should be publicly announced and explained in a timely manner | The BOM Law requires the BOM to publicize information on changes in monetary policy instruments and settings. Each time the BOM decides to change monetary policy instruments or settings, it has a practice of announcing the main considerations for the decisions to market participants. However, while the practice is for the announcements to be immediate, there is no pre-announced maximum delay for these disclosures. |
| 2.4 The central bank should issue periodic public statements on progress toward achieving its monetary policy objective(s) as well as prospects for achieving them | The BOM publishes developments and progress in conducting monetary policy and explains affecting factors in its quarterly bulletins. |
| 2.5 For proposed substantive technical changes to the structure of monetary regulations, there should be a presumption in favor of public consultations, within an appropriate period | For proposed substantive technical changes to the structure of monetary regulations, there is a presumption in favor of consultation with relevant parties in the industry. |
| 2.6 The regulations on data reporting by financial institutions to the central bank for monetary policy purposes should be publicly disclosed | Although the BOM Law allows the BOM to request information, reports and data from banks, individuals, and legal entities, there is no specific single regulation on data reporting by financial institutions to the BOM for monetary policy purposes. |

| Principle | Findings |
|---|---|
| 3.1 Presentations and releases of central bank data should meet the standards related to coverage, periodicity, timeliness of data and access by the public that are consistent with the International Monetary Fund's data dissemination standards | Mongolia has been a participant in the GDDS since August 2000. Data are disseminated shortly after the end of each reporting period. |
| 3.2 The central bank should publicly disclose its balance sheet on a preannounced schedule and, after a predetermined interval, publicly disclose selected information on its aggregate market transactions | The BOM publicly discloses its balance sheet in a timely manner on a monthly basis in its monthly bulletin on the BOM website. In addition, its audited financial statements are published in its Annual Report each year. Although the BOM has an internal regulation on deadlines of publications, it is in the process of addressing the issues regarding pre-announcing the schedule of publications to the public. Also, there is no regulation regarding the deadline for annual report publication. The disclosure of aggregate market transactions is also not broken down by type of operation. |
| 3.3 The central bank should establish and maintain public information services. | The BOM has a public information office and maintains an informative website, including an English version. |
| 3.4 Texts of regulations issued by the central bank should be readily available to the public | Text of regulations are readily available to the public. |
| 4.1 Officials of the central bank should be available to appear before a designated public authority to report on the conduct of monetary policy, explain the policy objective(s) of their institution, describe their performance in achieving their objective(s), and, as appropriate, exchange views on the state of the economy and the financial system | By October 1 each year, the BOM is required to submit to parliament the proposed draft state monetary policy guidelines for the following year. At that time, the Governor and other policy making department heads present to parliament the activities undertaken by the BOM, monetary and financial developments, policy targets, and prospects for achieving those targets. Also, the BOM senior officials are always available to appear before the parliamentary standing committees, joint assembly, and cabinet meetings to report on the conduct of monetary policy and exchange views on the state of the economy and the financial system. |
| 4.2 The central bank should publicly disclose audited financial statements of its operations on a preannounced schedule | The Annual Report of the BOM includes an audited balance sheet and an income statement. The BOM's Supervisory Board could, however, play a greater role in ensuring good governance in the BOM including in relation to foreign reserves investment policies and performance. |
| 4.3 Information on the expenses and revenues in operating the central bank should be publicly disclosed annually | Information on the expenses and revenues is disclosed in the BOM's Annual Report's financial statements. |

| Principle | Findings |
|---|---|
| 4.4 Standards for the conduct of personal financial affairs of officials and staff of the central bank and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed | There is no formal protection for BOM staff in either the Central Banking Law or the Banking Law against lawsuits for actions taken while discharging their functions in good faith. |

**Recommended action plan and authorities' response**

## Table 8. Recommended Action Plan to Improve Monetary Transparency

| Principle | Recommended Action |
|---|---|
| 1.1, 1.1.1 The ultimate objectives of monetary policy should be specified in legislation and publicly disclosed and explained. | The objectives of the BOM should be redefined with price stability as the primary objective and the stability of the exchange rate and the stability of the financial system as secondary objectives. |
| 1.1.6 The conditions under which the government has the authority to override central bank policy decisions may be invoked, and the manner in which it is publicly disclosed, should be specified in legislation. | When defining the annual state monetary policy guidelines the parliament should avoid any conflicts between the BOM's legal responsibilities spelt out in the BOM Law and the more broad guidance sometimes given in the guidelines on financial sector development priorities. |
| 1.2.3 The procedures for direct central bank participation in the primary market for government securities should be publicly disclosed. | New regulations on central bank lending to the government should be issued, covering the detailed procedures for any BOM purchasing of government debt instruments in the primary market. |
| 1.2.4 Central bank involvement in the rest of the economy should be conducted in an open and public manner on the basis of clear practices and procedures. | Either an amendment to the BOM Law should be made or the BOM should issue an internal regulation that would require it to disclose its involvement in the rest of the economy. |
| 1.2.5 The manner is which central bank profits are allocated and how capital is maintained should be publicly disclosed. | The definition of the BOM's net income in the BOM Law should be brought into line with the BOM's actual practice, by including investment earnings from foreign reserves management. |

| Principle | Recommended Action |
| --- | --- |
| 2.2 Where a permanent monetary policy making body meets to assess underlying economic developments, monitor progress toward achieving its monetary policy objective(s), and formulate policy for the period ahead, information on the composition, structure, and functions of that body should be publicly disclosed. | It may be worth considering establishing a Monetary Policy Committee, which would have authority for monetary policy decisions. Until such time as this is done, the Governor could be made more accountable for policy decisions by strengthening the BOM Supervisory Board's reporting to parliament. |
| 2.3.1 The central bank should publicly disclose, with a preannounced maximum delay, the main considerations underlying its monetary policy decisions. | Consideration could be given to introducing a pre-announced maximum delay for this disclosures of the main considerations underlying monetary policy decisions. |
| 3.2.2 Information on the central bank's monetary operations, including aggregate amounts and terms of refinance or other facilities (subject to the maintenance of commercial confidentiality) should be publicly disclosed on a preannounced schedule. | The BOM should disclose a breakdown by type of operation, shortly after those operations have taken place. |
| 4.2.2 Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed. | Following best practice, the BOM Law should be amended to give more authority to the Supervisory Board of the BOM to scrutinize the BOM's risk management rules and procedures as regards foreign reserves management. Until such time as the BOM Law can be amended, the BOM could in any case increase its disclosure of these rules and procedures. |
| 4.4.1 Information about legal protections for officials and staff of the central bank in the conduct of their official duties should be publicly disclosed. | The BOM Law should be amended to provide legal protections BOM staff and officials when carrying out their duties in good faith. |

**Authorities' response to the assessment**

73. The BOM welcomes the FSAP team's evaluation of its generally high degree of policy transparency and intends to ensure and enhance effectiveness and transparency of monetary policy in the future. As recognized by the assessors, the BOM has made important strides in recent years in increasing and strengthening the communication of its monetary policy framework, operations, and stance to ensure that the public has sufficient information to clearly understand and appreciate any change in the monetary policy stance and operations. In particular, annual parliamentary resolutions on the state monetary policy guidelines set out inflation objectives for the following year. The BOM Annual Reports provides detailed assessments of recent economic developments and the outlook that underlie

the monetary policy implementation. The BOM also publishes the details of its monetary market operations.

74. The BOM acknowledges that the current system where the Governor holds the ultimate authority to make decisions may not be ideal and that there is some ambiguity with regard to the objective of monetary policy in the legislation. The BOM is planning to request that the BOM Law be amended by parliament to address these issues.