Unofficial translation
of Prudential regulation
approved by Governor's Decree 138
of 2019

DRAFT REGULATION ON SETTING AND MONITORING PRUDENTIAL RATIOS TO BANKING OPERATION

ONE. General Provision

1.1. The purpose of this regulation is to set minimum requirements by Bank of Mongolia *(hereafter "BOM")* on risk bearing capacity of banks, defined Articles 16 of the Banking Law, and to ensure regulated banks follow and comply with the set requirements.

1.2. Banks shall comply with the following prudential requirements in their operations.

1.2.1. Capital adequacy ratios and Capital conservation buffer;
1.2.2. Liquidity ratio;
1.2.3. Net open position limit;
1.2.4. Concentration risk limit;

1.3. Banks shall calculate the requirements stated in the Article 1.2 of this regulation as well as assess and review the underlying factors and reasons that influenced their changes and take necessary steps to prevent it from breaching the minimum requirements stated in this regulation.

1.4. The BOM shall impose or adopt additional supplementary measures, ratios or limits for a particular bank if deemed necessary by the BOM.

TWO. Capital adequacy ratios

2.1. Risk bearing capacity of a bank shall be assessed under the provision 3.1.9 of Article 3 of Banking Law. The Capital adequacy of the bank shall be determined based on following ratios:

2.1.1. Tier-1 capital to risk-weighted assets ratio;
2.1.2. Capital to risk-weighted assets ratio;
2.1.3. Leverage ratio.

2.2. The Tier-1 capital to risk weighted assets ratio *(hereafter "Tier-1 ratio")* is calculated as the Tier-1 capital defined in the Article 2.7 with adjustment as stipulated in the Article 2.12 of this regulation divided by the risk-weighted assets defined in the Article 2.14 of this regulation.

2.3. The capital to risk weighted assets ratio *(hereafter "CAR ratio")* is calculated as the capital defined in the Article 2.6 with adjustment as stipulated in the Article 2.12 of this regulation divided by the risk-weighted assets defined in the Article 2.14 of this regulation.

2.4. The leverage ratio is calculated as Tier-1 capital defined in the Article 2.7 with adjustment as stipulated in the Article 2.12 of this regulation divided by the sum of the total asset adjusted with the net receivable of financial derivatives and 50 percent of net contingent liability.

2.5. The minimum requirement for the Tier-1 ratio is set at 9 percent, the minimum requirement for the CAR ratio is set at 12 percent, and the minimum requirement for the leverage ratio is set at 5 percent.

2.6. The bank capital may comprise Tier-1 capital and Tier-2 capital.

2.7. The Tier-1 capital shall have the following components:

2.7.1. Common stock;
2.7.2. Common stock surplus (share premium);
2.7.3. Retained earnings/losses;
2.7.4. General reserve.

2.8. The Tier-2 capital shall have the following components:

2.8.1. Preferred stock;
2.8.2. Preferred stock surplus (share premium);
2.8.3. Convertible;
2.8.4. Subordinated debt.

2.9. Preferred stock to be included in the Tier-2 capital shall satisfy the following conditions:

2.9.1. No maturity and to exercise a call option a bank must receive prior the BOM approval;
2.9.2. Bank must have full discretion at all times to cancel distribution and payments;
2.9.3. Bank must always have right to exercise the option stated in the Article 2.28.2 and 2.29.4 of this regulation;
2.9.4. No other incentives other than dividend;
2.9.5. Fund must be legally and after-tax income,
2.9.6. The instrument's decision and contract explicitly envisage the conditions indicated in the Article 2.9.1 and 2.9.5 of this regulation,

2.10. Convertible to be included in the Tier-2 capital shall satisfy the following conditions:

2.10.1. With minimum original maturity of over five years,
2.10.2. No principle payments in the duration of maturity,
2.10.3. Must be automatically convertible to common stocks if the Tier-1 ratio of a bank falls below 7.2 percent,
2.10.4. Bank must always have right to exercise the option stated in the Article 2.28.4 and 2.29.4 of this regulation,
2.10.5. No step-ups in interest rate and other incentives,
2.10.6. Is neither secured nor covered by a guarantee of the issuer or related party,
2.10.7. Not possible to payback before its maturity unless the bank is not in breach of its capital buffer requirement and obtains a permission from the BOM in advance,
2.10.8. Not possible to transfer to a third party without the prior BOM approval,
2.10.9. An investor must be fit and proper and its fund must meet suitability conditions set forth by the relevant law and regulations,
2.10.10. The instrument's decision and contract explicitly envisage the conditions indicated in the Article 2.10.1–2.10.9 of this regulation.

2.11. Subordinated debt to be included in the Tier-2 capital shall satisfy the following conditions:

2.11.1. With minimum original maturity of over five years, upon its maturity to be converted to common stocks following an investor's decision,
2.11.2. No principle payments in the duration of maturity,
2.11.3. Must be automatically convertible to common stocks if the Tier-1 ratio of bank falls below 5.4 percent,

2.11.4. Bank must always have right to exercise the option stated in the Article 2.28.4 and 2.29.4 of this regulation,
2.11.5. No step-ups in interest rate and other incentives,
2.11.6. Is neither secured nor covered by a guarantee of the issuer or related party,
2.11.7. Not possible to payback before its maturity unless the bank is not in breach of its capital buffer requirement and obtains a permission from the BOM in advance,
2.11.8. Not possible to transfer to a third party without the prior BOM approval,
2.11.9 An investor must be fit and proper and its fund must meet suitability conditions set forth by the relevant law and regulations,
2.11.10. The instrument's decision and contract explicitly envisage the conditions indicated in the Article 2.11.1–2.11.9 of this regulation,

2.12. The capital shall be sequentially adjusted as follows to reflect the true risk bearing capacity of a bank:

2.12.1. Treasury common stock shall be deducted from Tier-1 capital. Treasury preferred stock shall be deducted from the total preferred stock;
2.12.2. Goodwill shall be deducted from the Tier-1 capital,
2.12.3. If sum of deferred tax asset and software is greater than 10% of TIER I capital, surplus shall be deducted from the Tier-1 capital.
2.12.4. Amount that exceeds the limits set forth by the Provision 17.1-17.5 of the Banking law shall be deducted in portion 75 percent from Tier-1 capital, and 25 percent from the Tier-2 capital. If Tier-2 capital is insufficient, remaining balance shall be deducted from Tier-1,
2.12.5. The Tier-2 capital shall be capped at 50 percent of the Tier-1 capital.

2.13. Other adjustments deemed necessary by the BOM shall be made.

2.14. Risk-weighted assets of a bank shall comprise the following:

2.14.1. Credit risk-weighted asset;
2.14.2. Exchange rate risk-weighted asset;
2.14.3. Operational risk-weighted asset.

2.15. The credit risk-weighted assets shall be calculated as the weighted sum of on-balance assets and off-balance contingent liabilities and contractual obligations with the risk-weights specified in the Annex 1 of this regulation, with the following guidelines:

2.15.1. If an asset satisfies definitions of two or more categories listed in the Annex 1 of this regulation, it must be in a category with the highest risk-weight,
2.15.2. The risk weights for claims on foreign banks and the exposures backed by the foreign bank guarantees shall be determined based on the table below where the corresponding risk-weights are mapped to the ratings assigned by Standard and Poor's, Moody's, and Fitch.

Standard & Poors	AAA/AA-	A+/A-	BBB+/BBB-	BB+/B-	B-lower	Not rated
Fitch						
Moody's	Aaa/Aa3	A1/A3	Baa1/Baa3	Ba1/B3	B-lower	
With maturity of more than 3 months	20%	50%	50%	100%	150%	100%
With maturity of less than 3 months	20%	20%	20%	50%	150%	100%

2.15.3. If foreign banks rated by at least two rating agencies listed above, the lowest rating shall be used to map to risk-weight.

2.16. The following credit risk-mitigations shall be given credit to reflect the true riskiness of assets:

2.16.1. Assets guaranteed by and secured under a risk sharing arrangement with financial institution with credit rating of “A” or higher level set forth by Standard and Poor’s, Moody’s, and Fitch shall be netted out subject to 80% ceiling,
2.16.2. Assets guaranteed by or secured under a risk sharing arrangement with the World bank, the International Financial Cooperation, the European Bank for Reconstruction and Development, the Asian Development Bank shall be netted out,
2.16.3. Unfinanced as well as financed syndicated loans with domestic bank be netted out. This provision shall not apply for syndicated loans between related banks,
2.16.4. On-balance assets and off-balance contingent liabilities and contractual obligations shall be netted out of specific provision,
2.16.5. Assets and off-balance contingent liabilities and contractual obligations with legally enforceable netting arrangements shall be netted out.

2.17. The total credit risk weighted asset shall be netted out of general provision and projected provision.

2.18. The exchange rate risk-weighted asset shall be the total open position mentioned in the Article 4.3 of this regulation.

2.19. The operational risk-weighted asset shall be calculated as 1 percent of the last three years’ average cross income multiplied by inverse of the minimum requirement for the capital to risk-weighted assets ratio.

2.20. Any information or reports deemed necessary by the BOM shall be submitted on demand.

2.21. The capital conservation buffer, intended to safeguard banks risk bearing capacities, shall be imposed on all banks.

2.22. The capital conservation buffer shall comprise the general buffer and the systemic buffer. The general buffer on set on top of the minimum requirements for the Tier-1 ratio. The systemic buffer shall set on top of the general buffer.

2.23. The general buffer shall be 2 percentage points and applicable to all the bank whereas the systemic buffer shall be applicable to the systematically important banks.

2.24. Systemically important banks shall be determined by the decree of the Governor of the BOM accordance with relevant law and regulations.

2.25. The systemic buffer shall comprise a constant component and a variable component. The constant component shall be 1 percentage point. The variable component shall be determined by the sum of three elements, based on the table below:

№	Indicators	REF	Buffer (percentage point)	
1	Asset/ total asset of the system	At the end of the previous year	0% if less than 15%	0.5% if over 15%
2	Number of interbank transaction/ total number of interbank transaction	During the the previous year	0% if less than 10%	0.25% if over 10%
3	Max of individual-loan share or entity-loan share	At the end of the previous year	0% if less than 10%	0.25% if over 10%

2.26. The variable component shall be renewed no more than once year by the BOM.

2.27. The breach of capital conservation buffer shall occur if a bank's Tier-1 ratio falls below the minimum requirement for Tier-1 ratio plus the capital conservation buffer.

2.28. A bank which has breached its buffer is not allowed to make discretionary distributions of earnings. If the capital conservation buffer has been breached up to 50 percent, the following remedial actions shall be taken.

2.28.1. It is prohibited to buy back its own shares (share repurchase);
2.28.2. It is prohibited to distribute any dividends on common and preferred stock;
2.28.3. It is prohibited to distribute over 50 percent of any due bonuses and other performance-based payments to members of board of directors and management team;
2.28.4. It is prohibited to distribute over 50 percent of any due coupon payments on convertibles and subordinated debts that meet requirements stated in Article 2.10-2.11 of this regulation.

2.29. If the capital conservation buffer is depleted by more than 50 percent, the following remedial actions shall be taken.

2.29.1. Actions stated in the Article 2.28.1-2.28.2 of this regulation.
2.29.2. It is prohibited to increase salaries and bonuses for members of board of directors and management team;
2.29.3. It is prohibited to pay any bonuses and other performance-based payments to members of board of directors and management team.
2.29.4. It is prohibited to make any payments on preferred stocks, convertibles and subordinated debts that meet requirements stated in Article 2.9-2.11 of this regulation;

2.30. If the Tier I ratio breaches the minimum requirement, the following remedial actions shall be taken.

2.30.1. Actions stated in the Article 2.29 of this regulation;
2.30.2. It is prohibited to pay any salary, bonuses and payments to members of board of directors and management team;
2.30.3. The bank shall immediately prepare for conversion of convertibles and subordinated-debts to common stocks in accordance with the Company law, Bank charter and other relevant documents.

2.31 The conversions shall be carried out in the following order:

2.31.1. Convertibles (subordinated-debts) belonging to shareholders and related parties shall be converted in full,
2.31.2. If the Tier I ratio continues to breach the minimum requirement, convertibles (subordinated-debts) belonging to other investors shall be converted partially or in full,

Three. Liquidity ratio

3.1. The liquidity ratio shall be set to ensure ability of bank to grant claims of customers and depositors at their first demand as well as to encourage banks better assess of liquidity risk.

3.2. The minimum requirement for the liquidity ratio shall be 25 percent.

3.3. The liquidity ratio shall be calculated as liquid assets defined in the Article 3.4 of this regulation divided by total liabilities defined in the Article 3.6 of this regulation. Report on compliance shall be submitted to the BOM as per Annex 2 of this regulation on a weekly as well as monthly bases.

3.4. Liquid assets equal to the sum of cash, claims on the BOM, net claims on the interbank market, claims on foreign banks and financial institutions with credit rating of at least "BBB" of Standard & Poor's, Moody's, and

Fitch, spot value of gold and silver bars, and the BOM bills, the treasure bonds, and government-guaranteed bonds. Liquid assets shall be adjusted as follows:

3.4.1. Transfer delays in clearing account must be deducted;
3.4.2. Liquid assets pledged against financial obligation must be deducted;
3.4.3. Liquid assets with owner rights were not transferred yet must be deducted;
3.4.4. Claims on a bank with revoked license, or under receivership or conservatorship must be deducted;
3.4.5. Cash in transit must be deducted.

3.5. Other adjustments deemed necessary by the BOM shall be made.

3.6. Total liabilities shall be calculated as sum of current accounts, time and demand deposits, net liabilities to the interbank market, liabilities of other financial institutions, other liabilities, net liabilities for financial derivatives, accrued interests, and payables for contingent liabilities. The total liabilities shall be adjusted as follows:

3.6.1. Transfer delays in clearing account are deductible,
3.6.2. Financial obligation with liquid assets pledged are deductible,
3.6.3. Subordinated Debt and Convertible, that meets requirements stated in Article 2.10-2.11 of this regulation, are deductible.

3.7. A bank shall conduct the comparative analysis of liquidity positions and internally adopt generally accepted risk management framework for liquidity.

3.8. Cash flow report shall be submitted to the BOM as per Annex 5 of this regulation on weekly basis.

3.9. Report on interbank exposures shall be submitted to the BOM as per Annex 6 of this regulation on weekly basis.

3.10. Report on remaining maturities of receivables and payables shall be submitted to the BOM as per Annex 7 of this regulation on weekly basis and as per Annex 8 of this regulation on monthly basis.

3.11. Report on projection for cash flow shall be submitted to the BOM as per Annex 9 of this regulation on monthly basis.

3.12. Other reports deemed necessary by the BOM shall be submitted on demand.

Four. Net open position risk limits

4.1. The limits shall be set for open position in single and aggregate foreign currencies to limit losses associated with the exchange rate fluctuations to risk bearing capacity of banks.

4.2. The amount of open position in a single foreign currency shall not exceed 15 percent of bank's capital defined in the Article 2.6 of this regulation with stipulated adjustments defined in the Article 2.12 of this regulation.

4.3. The total open position equals to higher of the sum of long positions or the absolute sum of short positions in individual foreign currencies plus the spot value of open gold and silver positions, if any. The total open position shall not exceed 30 percent of bank's capital defined in the Article 2.6 of this regulation with stipulated adjustments defined in the Article 2.12 of this regulation.

4.4. The level defined in the Article 4.2 and 4.3 shall be reduced for a particular bank if the BOM finds that the activities of bank adversely affect the stability of the foreign exchange market.

4.5. The open position in a single foreign currency shall be calculated as follows: Report on compliance shall be submitted to the BOM as per Annex 3 of this regulation on a weekly as well as monthly bases.

4.5.1. Net spot position - that is the difference between on-balance foreign currency assets and liabilities in *(of which, the accrued interests are included and the spot value of gold and silver,* foreign currency *non-performing assets with other currency provision shall be deducted);*
4.5.2. Difference between payables and receivables of financial derivatives excluding transactions with BOM in foreign currencies which are to be exercised within the next 12 months of the reporting period (*as for the swap deal, the part associated with the spot deal shall be deducted and their future inflows and outflows shall be evaluated at the spot rate);*.
4.5.3. Negative sum of any guarantee, warranty and other off-balance contingent liabilities which are to be exercised within the next 6 months of the reporting period with the following adjustments:
4.5.3.1. Included contingent liabilities with corresponding the same currency liabilities can be excluded from position,
4.5.3.2. Included contingent liabilities without corresponding the same currency liabilities but with the same currency credit line can be excluded from position.
4.5.4. Negative sum of other contingent liabilities,
4.5.5. Difference between payables and receivables of other deals and transactions,
4.5.5. The delta value of foreign currency option as per Annex 11 of this regulation.

4.6. The BOM and bank shall exclude any receivables which deemed to be not exercised, from the computation of the open position.

4.7. Bank shall have right to include or exclude payables and receivables of any transactions with the BOM.

4.8. Any reports deemed necessary by the BOM shall be submitted on demand.

Five. Concentration risk limits

5.1. The sum of all the large loans defined in the Article 1.11.16 of “Regulation on computing, ensuring, reporting, and monitoring limits” shall not exceed 300 percent of the equity defined in the “Bank accounting guideline” adopted by the BOM.

5.2. The fixed assets calculated as sum of property and equipment, investment properties and assets held for sale shall not exceed 8 percent of the total assets of the bank.

5.3. The sum of 10 largest depositor’s current account and deposits’ balances shall not exceed 25 percent of bank’s total asset.

5.4. The limit for the total loans to the total assets ratio might be set by the decree of the Governor of the BOM to prevent a bank from taking excessive risk.

5.5. The limit for loans extended to a sector to the total loans ratio might be set by the decree of the Governor of the BOM to prevent a bank from taking excessive concentration risk.

5.6. The BOM shall reserve right to impose additional supplementary prudential ratios or limits for a particular bank if general risk level of the bank exceeds the systemic average.

5.7. Report on compliance shall be submitted to the BOM as per Annex 4 of this regulation on monthly bases.

SIX. Miscellaneous

6.1. The bank shall comply with the prudential ratios set forth in this regulation on a daily basis. In case of any breaches, a bank shall immediately inform the BOM in writing and email.

6.2 The bank shall submit the compliance report and other relevant reports to the BOM in both hardcopy and electronic format by the 5th day of the following month.

6.3. The BOM shall monitor compliance, and take necessary actions to ensure regulated banks follow and comply with the set requirements.

6.4. If the infringements to this regulation do not constitute a criminal offense, penalties shall be imposed to the perpetrator in accordance with the Banking law and the Law on infringement.