



# Report and Recommendation of the President to the Board of Directors

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Project Number: 51054-001  
April 2017

## Proposed Policy-Based Loan and Technical Assistance Grant Mongolia: Banking Sector Rehabilitation and Financial Stability Strengthening Program

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 3 April 2017)

Currency unit	–	togrog (MNT)
MNT1.00	=	\$0.00040
\$1.00	=	MNT2,451.90

## ABBREVIATIONS

ADB	–	Asian Development Bank
AMC	–	asset management company
BOM	–	Bank of Mongolia
CDRC	–	corporate debt restructuring committee
DICOM	–	Deposit Insurance Corporation of Mongolia
ERP	–	Economic Recovery Program
FSC	–	Financial Stability Council
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
NPL	–	nonperforming loan
PBL	–	policy-based loan
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance
US	–	United States

## NOTE

In this report, "\$" refers to United States dollars unless otherwise stated.

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## PROGRAM AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 51054-001</b>	
<b>Project Name</b>	Banking Sector Rehabilitation and Financial Stability Strengthening Program	<b>Department /Division</b>	EARD/EAPF
<b>Country Borrower</b>	Mongolia Government of Mongolia	<b>Executing Agency</b>	Ministry of Finance
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Finance</b>	Finance sector development		100.00
		<b>Total</b>	<b>100.00</b>
<b>3. Strategic Agenda</b>	<b>Subcomponents</b>	<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
<b>4. Drivers of Change</b>	<b>Components</b>	<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Institutional systems and political economy	No gender elements (NGE)	✓
<b>5. Poverty and SDG Targeting</b>		<b>Location Impact</b>	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		
<b>6. Risk Categorization:</b>	Complex		
<b>7. Safeguard Categorization</b>	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>100.00</b>	
Sovereign Program (Regular Loan): Ordinary capital resources		100.00	
<b>Cofinancing</b>		<b>0.00</b>	
None		0.00	
<b>Counterpart</b>		<b>0.00</b>	
None		0.00	
<b>Total</b>		<b>100.00</b>	
Note: An attached technical assistance will be financed on a grant basis by the Technical Assistance Special Fund (TASF-6) in the amount of \$750,000; Financial Sector Development Partnership Special Fund in the amount of \$750,000.			



## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan (PBL) to Mongolia for the Banking Sector Rehabilitation and Financial Stability Strengthening Program. The report also describes proposed technical assistance (TA) for the Banking Sector Rehabilitation and Financial Stability Strengthening Program, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.

2. The Government of Mongolia has requested financial assistance from the Asian Development Bank (ADB) in the form of a PBL to stabilize and restructure the banking industry, strengthen financial stability, and enhance competition among banks. The program aligns with and supports the government's Economic Recovery Program (ERP) and was requested by the Minister of Finance in the development policy letter in Appendix 3.<sup>1</sup>

## II. THE PROGRAM

### A. Rationale

3. **Development challenges.** The government faces two interrelated challenges: restoring economic growth and reviving the banking industry. Mongolia's economy has deteriorated as it is highly dependent on its mining industry and is vulnerable to shocks. Mineral exports have declined due to falling commodity prices and moderating growth in the People's Republic of China, Mongolia's largest trading partner. The growth rate of its gross domestic product (GDP) fell from 17.5% in 2011 to 1.0% in 2016, and the fiscal deficit rose from 5.0% of GDP in 2015 to 15.4% of GDP in 2016, amounting to MNT3,667.8 billion. As a result, the ratio of public debt to GDP, excluding central bank liabilities and state-owned enterprise debt, rose from 31.0% in 2010 to 83.1% in 2016. Consequently, Moody's Investors Service Singapore Pte Ltd. downgraded Mongolia's credit rating to Caa1 in November 2016.<sup>2</sup>

4. The government responded quickly by passing the ERP in 2016. The ERP aims to (i) reduce balance-of-payment pressures; (ii) increase foreign exchange reserves; (iii) intensify the implementation of infrastructure projects; and (iv) implement strategies to increase foreign direct investment, job growth, and economic diversification. However, weaknesses in the banking system have constrained government efforts to restore macroeconomic stability and growth. High levels of nonperforming loans (NPLs) impede financial intermediation and reduce the banking industry's capacity to increase private sector credit and support job creation. Unless addressed quickly, elevated NPL levels will continue to depress financial intermediation and credit growth, jeopardize the ERP's implementation, continue the gridlock in markets like property, detract from finance sector development, and further heighten bank vulnerabilities.

5. Slowing economic growth, combined with increases in the central bank's policy rate, has reduced loan growth.<sup>3</sup> Moreover, declining GDP is depressing business conditions, leading to a rise in bank NPLs and threatening the solvency of banks. The banking industry's aggregate NPL

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<sup>1</sup> Government of Mongolia. 2016. *Economic Recovery Program, 2016–2020*. Ulaanbaatar. The government passed the ERP on 24 November 2016.

<sup>2</sup> Moody's downgraded the government's long-term issuer and senior unsecured ratings from B3 to Caa1 on 18 November 2016. Caa1 refers to a country's long-term foreign currency credit rating, and is considered non-investment grade and speculative.

<sup>3</sup> The volume of loans declined by 1% during 2014–2016.

ratio increased from 3.8% in June 2013 to 8.5% in December 2016<sup>4</sup> (15.0% when past due loans are incorporated).<sup>5</sup> Compounding this problem, the currency declined 25.3 percentage points against the United States (US) dollar in 2016, exposing additional financial vulnerabilities. The Mongolian National Chamber of Commerce and Industry has reported a rising number of small and medium-sized enterprise (SME) bankruptcies due to increased debt service requirements from loans made in US dollars. In 2016, about 19% of banking system loans were denominated in a foreign currency as banks often preferred to lend to SMEs in US dollars to maximize interest margins and help balance foreign currency open positions.

6. Overall, weak oversight encouraged regulatory forbearance and the underreporting of risks, primarily of NPLs, because of lenient restructuring policies and noncompliance with international capital standards. This has resulted in the overstatement of the reported banking industry consolidated total capital adequacy ratio that stood at 18.5% as of the end of 2016. The loan loss provision covers only 44.8% of NPLs and past due loans, relative to the international best practice of 100.0%, and return on assets was only 0.7% for 2016, which is insufficient to cover additional provisioning and capital augmentation.<sup>6</sup>

7. Empirical evidence shows strong links between finance sector development, economic growth, and poverty alleviation.<sup>7</sup> Lessons from the 1997–1998 Asian financial crisis show that rapid NPL resolution is essential to strengthen credit flows and hasten economic recovery. Higher levels of NPLs reduce credit-to-GDP ratios, lower growth, and increase unemployment.<sup>8</sup> Financial inclusion impediments may stem from concerns regarding access to credit, the depth of the credit market, and inefficient credit intermediation. When blockages arise in these areas, financing for individuals, SMEs, and entrepreneurs is impaired most due to their perceived higher credit risk. The resulting inequality and inefficiency in credit allocation will negatively impact economic growth and thus hamper inclusive growth. The ultimate result is reduced credit relative to GDP. The credit-to-GDP gap, which is the difference between the credit-to-GDP ratio and its long-term trend, is a useful early warning indicator for banking crises.<sup>9</sup> The deterioration in credit intermediation in Mongolia is outlined in Table 1, which shows the credit-to-GDP gap for Mongolia and indicates the downward trend in credit supply during the period when NPLs increased from 5.3% in 2013 to 8.5% in 2016, reflecting the banking industry crisis.

**Table 1: Ratio of Credit to Gross Domestic Product**  
(%)

	2013	2014	2015
Credit-to-GDP ratio (actual)	61.6	59.7	50.3
Credit-to-GDP trend (estimate)	64.0	61.0	52.1
Credit-to-GDP ratio gap	(2.4)	(1.4)	(1.8)

( ) = negative, GDP = gross domestic product.

Source: Asian Development Bank estimates; Bank for International Settlements. Credit-to-GDP Gaps. [http://www.bis.org/statistics/c\\_gaps.htm](http://www.bis.org/statistics/c_gaps.htm).

<sup>4</sup> Bank of Mongolia. Key Indicators of Banking System Consolidated Banking Sheet. December 2016. <https://www.mongolbank.mn/documents/statistic/balancesheet/2016/12e.pdf>.

<sup>5</sup> Reported NPLs amount to about \$427 million, and NPLs plus past due loans amount to about \$794 million.

<sup>6</sup> About \$456 million of NPLs and past due loans are not provisioned for.

<sup>7</sup> J. Zhuang et al. 2009. Financial Sector Development, Economic Growth, and Poverty Reduction: A Literature Review. *ADB Economics Working Paper Series*. No. 173. Manila: ADB.

<sup>8</sup> N. Klein. 2013. Non-Performing loans in CESEE: Determinants and Impact on Macroeconomic Performance. *IMF Working Paper*. No. 13/72. Washington, DC: International Monetary Fund.

<sup>9</sup> C. Borio and P. Lowe. 2002. Assessing the Risk of Banking Crises. In Bank for International Settlements. *BIS Quarterly Review, December 2002: International Banking and Financial Market Developments*. Basel.

8. **Binding constraints.** Mongolia's finance sector is facing three major challenges. First, the government does not have a framework for resolving the high level of NPLs in banks that jeopardize their solvency and has not developed a bank rehabilitation framework to facilitate bank recapitalization. The lack of an out-of-court corporate debt-restructuring arrangement further constrains stabilization efforts. Second, the financial stability framework is not robust enough to prevent possible crises. The relevant law and supporting regulations of the Financial Stability Council (FSC) do not fully address its mandate, membership, authority, tools, and powers needed.<sup>10</sup> Further, widespread nonconformance with international capital adequacy and banking supervision standards impair banks' capacity to sustain shocks. Weak supervisory oversight and regulatory forbearance practices by the Bank of Mongolia (BOM) have resulted in banks rescheduling past due loans and NPLs too leniently, while the deposit insurance fund lacks backup funding to support possible claims. Third, banking competition and development are impaired. Weak governance and risk management practices and a lack of strategic direction impede the creation of a competitive environment that meets the private sector's needs and will attract human and financial capital. Government ownership of the State Bank LLC also creates governance and development issues that impede competition and the development of expanded products and services, as government interests unduly influence the bank's operations.<sup>11</sup> Regulations do not clearly support the licensing and operation of foreign bank subsidiaries, impairing competition, access to credit, and the transfer of best practices in risk management.

9. **Government plans and alignment with ADB strategy.** Following the June 2016 elections, the government passed the ERP to promote foreign direct investment, job growth, and economic diversification. With regard to finance, the ERP (i) aims to strengthen sector governance, (ii) includes legal and institutional reforms to ensure the BOM's independence, (iii) provides for the revision of the foreign exchange law and FSC functions and authority, and (iv) calls for the preparation of a finance development plan through 2025.

10. The government has not formally defined a distinct national finance policy; however, the national development strategy, 2008–2021 calls for strengthening the banking and financial system consistent with practices found in highly developed countries.<sup>12</sup> Key activities include (i) strengthening the nonbanking financial system and operations, (ii) developing the securities and capital market, and (iii) strengthening risk management in banking and financial institutions. Mongolia's Sustainable Development Vision 2030 also aims to establish sound development finance and a financial market that would promote stable economic growth, increase the role of nonbank financial institutions, and stabilize the soundness of financial institutions.<sup>13</sup> The program aligns closely with the first pillar of ADB's proposed country partnership strategy for Mongolia, which promotes economic growth and social stability.<sup>14</sup> It is consistent with the ADB Strategy

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<sup>10</sup> The FSC was established in January 2010 by an amendment to the Law on the Bank of Mongolia and a regulation issued in April 2010. The council members are the minister of finance, governor of the BOM and the Ministry of Finance (MOF), the BOM, and the chair of the Financial Regulatory Commission. The FSC identifies and monitors systemic risks, and proposes actions to mitigate these risks to protect and enhance the resilience of Mongolia's financial system.

<sup>11</sup> The State Bank was established by the government from the assets of two failed banks in 2009, and it assumed the assets of the failed Savings Bank in 2013; it is the fifth-largest of 14 banks in Mongolia with a 10% deposit share. The assets of the top five banks comprise 83% of total banking industry assets.

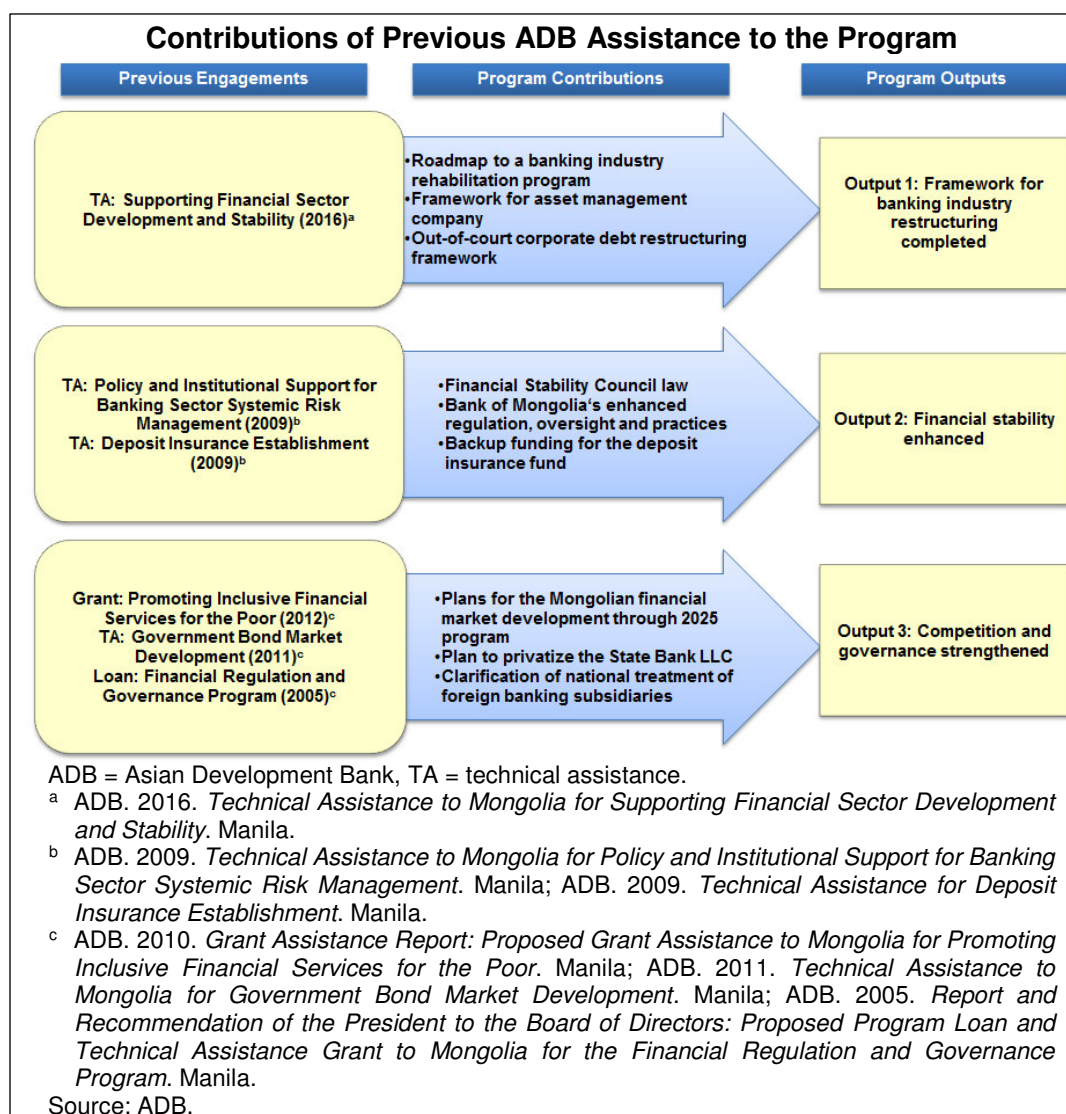
<sup>12</sup> Government of Mongolia. 2007. *Millennium Development Goals-Based Comprehensive National Development Strategy of Mongolia*. Ulaanbaatar.

<sup>13</sup> Government of Mongolia. 2016. *Mongolia's Sustainable Development Vision 2030*. Ulaanbaatar.

<sup>14</sup> ADB. Forthcoming. *Country Partnership Strategy: Mongolia, 2017–2020*. Manila.

2020's emphasis on inclusive economic growth, with finance sector development as a core area of operations.<sup>15</sup>

11. **Development partner coordination.** ADB has extensively coordinated the objectives of this program with the International Monetary Fund (IMF) and the World Bank. On 19 February 2017, the IMF reached staff-level agreement with the government on a 3-year extended fund facility. The program is consistent with the IMF's recommendations and will support the recapitalization and restructuring of the banking industry, enhance regulation and supervision, and improve governance. The program is also consistent with the World Bank's plans to support financial stability and the finance sector by developing the capacity of the Deposit Insurance Corporation of Mongolia (DICOM).



12. **Value added by ADB and the program.** ADB's strength lies in its experience in deep policy engagement, lending operations, and extensive capacity development in finance. In particular, ADB assistance has focused on supporting a stable finance sector and providing the

<sup>15</sup> ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila.

basis for expanding inclusive financial services for the poor. ADB has also contributed to economic diversity and mitigated the risk exposures affecting SMEs and the poor. Prior ADB assistance for finance sector reform set a foundation for the outputs of this program (Figure).<sup>16</sup> ADB provided the basic outline for the establishment of an NPL resolution mechanism, promoted a framework for financial consumer protection, enhanced the stability of savings and credit cooperatives, and expanded the capacity of the FSC secretariat function located within the BOM. ADB supported efforts to restructure banks; establish a bank deposit insurance system; and strengthen banking legislation and regulations, including expanding the BOM's capacity, banking industry governance, and risk management. ADB has also promoted capital market development and the expansion of inclusive financial services for the poor. Finally, ADB has extensively supported private sector development through onlending programs to Khan Bank, Xac Bank, and TenGer Financial Group LLC, which helped finance micro, small, and medium-sized enterprises.

13. **Lessons learned.** The program builds on lessons learned from prior ADB engagement in Mongolia's finance sector and from the experience of dealing with past finance sector crises in developing markets across Asia. A key lesson is to support processes through a sequenced approach over time, whereby current outputs result from prior policy and capacity development work with counterparts. Prior engagement has helped guide the government's efforts, leading to the financial infrastructure and policy reforms that this program supports. A second lesson is the need for a realistic policy framework with manageable policy actions to achieve the intended results and successfully implement the reforms.

## B. Impact and Outcome

14. The program aligns with the ERP and will support the government's plans for a well-developed finance sector and stable financial system that helps the poor and vulnerable. The outcome will be a strengthened and stable banking industry. Stabilizing the industry by dealing rapidly with the large NPL overhang is the first step towards rehabilitation. As the program is a single tranche, ADB and the government have agreed on a medium-term reform framework, 2017–2020 to provide a basis for continuing reforms and structure for future assistance. There are 12 policy actions with seven linked to disbursement. All policy actions are complied with or are expected to be completed by June 2017.

## C. Outputs

15. **Output 1: Framework for bank restructuring completed.** Output 1 will support an effective restructuring of the banking industry and a reduction in NPLs. To accomplish this, the government will develop a transparent road map for a banking industry rehabilitation program, and will create and initially capitalize an asset management company (AMC). Effective private market solutions are lacking because the high level of unresolved NPLs exceeds the absorptive capacity of the domestic illiquid capital market. Banks often lack the capacity to handle large

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<sup>16</sup> ADB. 2016. *Technical Assistance to Mongolia for Supporting Financial Sector Development and Stability*. Manila; ADB. 2010. *Grant Assistance Report: Proposed Grant Assistance to Mongolia for Promoting Inclusive Financial Services for the Poor*. Manila; ADB. 2011. *Technical Assistance to Mongolia for Government Bond Market Development*. Manila; ADB. 2009. *Technical Assistance to Mongolia for Transformational Mobile Banking Services*. Manila; ADB. 2009. *Technical Assistance to Mongolia for Policy and Institutional Support for Banking Sector Systemic Risk Management*. Manila; ADB. 2009. *Technical Assistance for Deposit Insurance Establishment*. Manila; ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to Mongolia for Supporting the Credit Guarantee System for Economic Diversification and Employment Project*. Manila; ADB. 2005. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan and Technical Assistance Grant to Mongolia for the Financial Regulation and Governance Program*. Manila.

volumes of distressed assets that can substantially drain their resources, detracting from their main objective of credit intermediation. Centralized AMC's achieve economies of scale and allow for the more effective management and sale of distressed assets. Moreover, the legal and capital market's framework in Mongolia is challenging and impedes banks' ability to resolve NPLs rapidly. In this context, a government-supported AMC has advantages based on the following special powers, which will be granted to it by law: (i) legislation will ensure that AMC operations are efficient, transparent, and market-based to maximize NPL recovery values; (ii) AMC management and staff will be given immunity and legal protection in the operation of their duties; and (iii) mechanisms to enable the clear transfer of distressed assets will be included.

16. The AMC will acquire eligible NPLs from commercial banks at values determined by a rigorous and transparent methodology<sup>17</sup> (these will be lower than the book values to reflect the NPLs' deteriorated condition). The AMC will manage this portfolio of assets, take steps to maximize their recovery values, and sell them over time. The government will also support the creation of a corporate debt restructuring committee (CDRC) to deal with the large debt burden through an inter-creditor agreement. A CDRC provides a platform for corporations and their lenders to work out feasible debt resolutions without resorting to legal proceedings or bankruptcy. The out-of-court arrangement found in an inter-creditor agreement enables eligible distressed corporations to resolve their nonperforming obligations uniformly across multiple lenders. The process facilitates the timely and orderly restructuring of debt to support firms that have a viable business model but are experiencing a temporary downturn.

17. **Output 2: Financial stability enhanced.** Output 2 will enhance financial stability and oversight to prevent problems from recurring. The government will amend the law governing FSC operations to clarify its mandate, authority, and tools; and will expand the FSC's membership to include the DICOM. The output will also support stronger oversight of the banking industry to discourage regulatory forbearance. The BOM will restructure its supervision department and amend regulations to bring banking practices into compliance with international standards. Finally, the government will expand the DICOM's capacity to deal with possible bank insolvencies by providing financing for the potential payout of deposit claims.

18. **Output 3: Competition and governance strengthened.** Output 3 will strengthen governance, risk management, and banking industry competition to protect the finance sector's development and attract foreign capital and expertise. The government will improve the sector's capacity and governance to meet its functional needs better, as well as those of individuals and corporations by formulating a financial market development program. It will also expand competition and the banking industry's potential to adopt best practices in risk management by clarifying the regulations supporting (i) the licensing and regulation of foreign bank subsidiaries, and (ii) the privatization of the State Bank.

#### **D. Development Financing Needs**

19. The government has requested a regular loan of \$100 million from ADB's ordinary capital resources to help finance the program (Table 2). The loan will have a 15-year term, including a grace period of 3 years; an annual interest rate determined in accordance with ADB's London interbank offered rate-based lending facility; a commitment charge of 0.15% per year; and such other terms and conditions set forth in the draft loan agreement. Based on the straight-line method, the average maturity is 9.25 years and there is no maturity premium payable to ADB.

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<sup>17</sup> Eligible NPLs exclude those that will be resolved in a CDRC process and those that are not commercially viable to be managed by the AMC due to their small size or unique characteristics not allowing for economies of scale.

20. The loan proceeds will finance the full foreign exchange cost (excluding local taxes and duties) of the items procured, excluding ineligible items and imports on the negative list attached to the loan agreement. The loan size was determined based on the importance of supporting the ERP, the extent of the fiscal gap, the level of NPLs and past due loans needing resolution, and Mongolia's overall development financing needs. Given the country's challenging fiscal condition, the use of budget support is justified. Specifically, the loan proceeds will support the AMC's funding and capitalization needs and help it purchase a share of eligible NPLs and past due loans. Bonds issued by the AMC and exchanged with banks for the transferred assets will cover the remaining funding needs.

**Table 2: Investment and Financing Plan**

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank		
Ordinary capital resources (loan)	100.0	100.0
<b>Total</b>	<b>100.0</b>	<b>100.0</b>

Source: Asian Development Bank estimates.

21. **Proposed financing modality.** ADB proposed a single-tranche, stand-alone PBL, as the scope and timing for potential future assistance will be identified only after the result of this program and the impact of the IMF's program are known. The PBL will help the government create an AMC that will help banks deal with the large NPL overhang. ADB will not assume risk from the purchased NPLs, which will be managed independently under market practices through the creation of an AMC and CDRC. Mongolia's payment obligations under the ADB loan are independent of the NPL collection or the AMC's performance. Should banks ultimately require recapitalization, private commercial banks are expected to be fully supported by their shareholders. The program combines dialogue with TA in recognition of ADB's long-term engagement in developing Mongolia's finance sector. The program is urgently needed to manage rising banking risks and prevent a systemic crisis that could threaten the economy, further reduce GDP growth prospects, and harm the poor and vulnerable even more. ADB and the government have agreed on a medium-term reform framework, 2017–2020 to provide the basis for continuing reforms and the structure for future assistance.

## **E. Implementation Arrangements**

22. The Ministry of Finance (MOF) will be the executing agency and will oversee and coordinate the timely implementation of the policy actions. The BOM will be the implementing agency and will implement certain policy actions under the PBL. MOF will withdraw the loan proceeds in line with ADB's *Loan Disbursement Handbook* (2015, as amended from time to time) once ADB is satisfied that the agreed policy actions have been completed. The program will support a policy framework with corresponding outputs and policy actions (Appendix 4). Of the program's 12 policy actions, seven are linked to disbursement and the rest are complementary actions that reflect the progressive steps taken to achieve the overall policy action objectives. They aim to reflect more holistically the government's commitments to reform. The government will maintain or advance the policy actions at least through December 2019. ADB may consider a follow-on program based on the progress of the reforms and the development financing needs. The program period is 1 July 2015–30 June 2017.

### III. TECHNICAL ASSISTANCE

23. The program will be supported by TA grants in the amount of \$1,600,000, of which \$750,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-6) and \$750,000 will be financed on a grant basis by the Financial Sector Development Partnership Special Fund.<sup>18</sup> ADB will engage TA consultants through a firm. Selection will follow ADB's Guidelines on the Use of Consultants (2013, as amended from time to time) using the quality- and cost-based method, with a quality–cost ratio of 90:10, following a full technical proposal. ADB will disburse TA resources following its *Technical Assistance Disbursement Handbook* (2010, as amended from time to time). The government will provide counterpart support in the form of staff, access to data and documents, facilities for key meetings, and other in-kind contributions. The MOF will be the executing agency and the BOM will be the implementing agency. The TA is estimated to begin in July 2017 and will be implemented over 24 months.<sup>19</sup> The TA will provide 48 international and 31 national person-months of consulting services. The TA will help establish and operationalize the AMC, and will create a transparent and effective oversight and governance process that supports the AMC's independent operations, free from external political influences and vested interests. The TA will also establish and guide the operations of an out-of-court corporate debt-restructuring framework to address the corporate debt burden through the Mongolian Bankers Association, with the BOM's support. Finally, the TA will guide and support the government in privatizing the State Bank.

### IV. DUE DILIGENCE

#### A. Economic and Financial

24. **Economic.** Through support for NPL resolution mechanisms including the creation of an AMC, the program will improve prospects for GDP growth, employment and credit extension. Program support will help the banking industry reduce the volume of NPLs, which will then allow banks to reduce risks and raise capital adequacy levels, enabling them to extend new credit more freely. Expanding credit availability will positively impact employment and income. The benefits will accrue to all Mongolians. Applicable research by the IMF shows that, other things being equal, a one percentage point increase in NPLs results in a cumulative decline of 1.5 percentage points in the credit-to-GDP ratio, and a cumulative increase of nearly 0.5 percentage points in unemployment (over a 3-year horizon). Also, a one percentage point rise in NPLs leads to a cumulative contraction of 1.3 percentage points in real GDP over 2 years.<sup>20</sup>

25. **Financial management.** Procyclical fiscal management and the misalignment of public expenditure and strategic priorities are two major public financial management challenges in Mongolia. The government has put certain actions in place to provide strategic guidance for the annual budget process and reduce vulnerability to the boom–bust economic cycle; however, these have been ineffective due to poor windfall revenue management and frequent amendments affecting budget expenditure. The comprehensiveness of information included in the budget, its public disclosure, and citizen participation have improved, but recent increases in off-budget expenditures and limited oversight of fiscal risks in state-owned enterprises undermine progress. The IMF-led program will help improve public financial management by preventing the government from engaging in quasi-fiscal activity, creating a fiscal council to provide independent budget forecasts and costings of new policy proposals, allowing the government sole authority to

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<sup>18</sup> Established by ADB, with the Government of Luxembourg as a financing partner.

<sup>19</sup> Attached Technical Assistance (accessible from the list of linked documents in Appendix 2).

<sup>20</sup> Ibid 8.

determine the total amount of spending in the budget, and granting MOF the authority to approve proposals to the cabinet that have a budgetary cost. Due diligence relied on the 2015 public financial management assessment completed by the World Bank.<sup>21</sup> ADB confirmed that the results of the assessment remain valid for this program and that no specific mitigating measures are needed. The MOF has sufficient financial management capabilities and is familiar with ADB's disbursement requirements, social and environmental safeguards, and negative list. Financial management assessments in 2015 for ADB-funded projects have also deemed the MOF capable of acting as an executing agency.<sup>22</sup>

## **B. Governance**

26. **Governance.** Mongolia has taken steps to improve accountability and transparency in the public sector. The Independent Authority Against Corruption has implemented public education campaigns. Reporting coverage of the Extractive Industries Transparency Initiative in Mongolia is also expanding. Despite these efforts, corruption continues to threaten the development of the Mongolian economy.<sup>23</sup> Major corruption risks include weak institutions and enforcement, lack of capacity of integrity institutions, political interference, lack of transparency and accountability, and the prevalence of conflicts of interest. The policy actions under the IMF-led program and monitoring indicators would ensure strict compliance with the program objectives and thereby minimize risks. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government.

## **C. Poverty and Social**

27. The economic slowdown in Mongolia has reduced employment opportunities, lowered income, delayed loan repayment, weakened loan access, depreciated the currency, decreased bank loan growth, and increased lending rates. It has also constrained access to credit, which is a key factor affecting the creation of new jobs and employment. Mongolian poverty data shows that the percentage of the population living in poverty declined from 27.4% in 2012 to 21.6% in 2014; however, the data also show a significant clustering of households near the poverty line, indicating that many people are vulnerable to falling back into poverty because of shocks or prolonged economic stress.<sup>24</sup> Poor households cope by (i) reducing food consumption and quality, (ii) limiting health expenditure, and (iii) increasing debt (38% of the poor have debt). Access to credit is an important coping strategy, and 82% of the lowest income quintile took out loans almost solely to support household consumption (including food, health and education, and other daily life needs) compared with 49% of the highest quintile. The program will have a positive impact on access to credit, and will improve economic growth and employment prospects. Successful program implementation and a strengthened banking industry will benefit all Mongolians, and the unemployed, poor, and vulnerable in particular. In the long term, the government's plans will involve systems for implementing an efficient finance policy that will ultimately benefit the poor and vulnerable by developing a favorable business environment, increasing job opportunities, reducing loan interest rates, and expanding the acceptability of loan collateral.

<sup>21</sup> World Bank. 2015. *Mongolia Public Financial Management Performance Report*. Washington, DC.

<sup>22</sup> ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loans for Additional Financing and Administration of Technical Assistance Grant to Mongolia for the Agriculture and Rural Development Project*. Manila; ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to Mongolia for Supporting the Credit Guarantee System for Economic Diversification and Employment Project*. Manila.

<sup>23</sup> Risk Assessment and Risk Management Plan (Summary) government assessment prepared as part of the country partnership strategy for Mongolia, 2017–2021.

<sup>24</sup> National Statistics Office of Mongolia. Census and Survey Catalogue. Household Socio-Economic Survey 2014. <http://web.nso.mn/nada/index.php/catalog/106/study-description>.

## D. Safeguards

28. The program's activities are confined to policy reforms, the loan funds will not support direct infrastructure financing, and the program will benefit all Mongolians. None of the policy actions will result in or lead to involuntary resettlement or adversely affect indigenous peoples. No adverse environmental impacts have been identified. The program is classified as *category C* for the environment, involuntary resettlement, and indigenous peoples.

## E. Risks and Mitigating Measures

29. Major risks and mitigating measures are summarized in Table 3 and described in detail in the risk assessment and risk management plan.<sup>25</sup>

**Table 3: Summary of Risks and Mitigating Measures**

<b>Risks</b>	<b>Mitigating Measures</b>
Political instability impairs finance sector reform plans.	The BOM will implement the program actions in 2017, before loan disbursement and the presidential elections.
Continuing economic weakness prevents the Government of Mongolia from rationalizing the banking industry.	The government's agreement with the IMF on an extended fund facility and an associated multilateral external financing package is expected to stabilize the economy and lay the basis for sustainable, inclusive, and long-term growth.

BOM = Bank of Mongolia, IMF = International Monetary Fund.

Source: Asian Development Bank.

## V. ASSURANCES AND CONDITIONS

30. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents. The government has agreed with ADB on certain covenants for the program, which are set forth in the draft loan agreement.

## VI. RECOMMENDATION

31. I am satisfied that the proposed PBL would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$100,000,000 to Mongolia for the Banking Sector Rehabilitation and Financial Stability Strengthening Program from ADB's ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB's London interbank offered rate-based lending facility, for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao  
President

17 April 2017

<sup>25</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).



Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
3. Competition and governance strengthened	<p>Banking Supervision on capital adequacy accords issued by the BOM and MOF (baseline: no regulation)</p> <p>2c. The BOM's banking supervision department restructured (baseline: no restructuring)</p> <p>2d. An MOU signed between the DICOM and MOF to support the DICOM's financing needs in case of potential payout of deposit claims (baseline: no MOU)</p> <p>3a. An ERP that will outline steps to improve the finance sector's capacity and governance to meet the functional needs of individuals, corporations, and the government more effectively approved by Parliament (2016 baseline: no program)</p> <p>3b. Regulation requiring banks to prepare IFRS-compliant financial statements effective from 1 January 2016 issued by the BOM and MOF (baseline: no regulation)</p> <p>3c. An MOU entered between MOF, BOM and DICOM on preparing the plan to privatize the State Bank LLC by the end of 2019 (baseline: no MOU)</p> <p>3d. Draft amended regulations to clarify the national treatment for foreign banking subsidiaries— which will cover (i) the licensing of banks and foreign subsidiaries, (ii) the scope of authorized banking activities, and (iii) the definition of paid-in capital and shareholdings— finalized by the BOM (baseline: no amendments)</p>	<p>effective on 20 December 2016</p> <p>2c. Decree by the BOM governor on 27 December 2016</p> <p>2d. Signed MOU between the DICOM and MOF</p> <p>3a. Resolution of the State Great Khural on the ERP's approval, dated 24 November 2016</p> <p>3b. Joint decree by the BOM and MOF on 20 July 2015</p> <p>3c. Parliament Resolution No. 70 to approve the 2015–2016 guideline on the privatization and restructuring of the State Bank, dated 3 July 2015; MOU signed between the BOM, MOF, and DICOM to prepare a plan to privatize the State Bank by the end of 2019</p> <p>3d. Draft amended regulations that cover (i) the licensing of banks and foreign subsidiaries, (ii) the scope of authorized banking activities, and (iii) the definition of paid-in capital and shareholdings</p>	
<p><b>Key Activities with Milestones</b> Not Applicable</p>			

**Inputs**

Asian Development Bank

Ordinary capital resources: \$100 million (policy-based loan)

TASF-6: \$750,000 (grant)

Financial Sector Development Partnership Special Fund: \$750,000 (grant)

**Assumptions for Partner Financing**

Not Applicable

AMC = asset management company, BOM = Bank of Mongolia, DICOM = Deposit Insurance Corporation of Mongolia, ERP = Economic Recovery Program, FSC = Financial Stability Council, IFRS = International Financial Reporting Standards, MOF = Ministry of Finance, MOU = memorandum of understanding, NPL = nonperforming loan, TASF = Technical Assistance Special Fund.

<sup>a</sup> Government of Mongolia. 2016. *Economic Recovery Program, 2016–2020*. Ulaanbaatar.

<sup>b</sup> The relevant law refers to the Law on the Bank of Mongolia

Source: Asian Development Bank.

**LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/RRPs/?id=51054-001-3>

1. Loan Agreement
2. Sector Assessment (Summary): Finance (Finance Sector Development)
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Attached Technical Assistance
6. Country Economic Indicators
7. International Monetary Fund Assessment Letter
8. Summary Poverty Reduction and Social Strategy
9. Risk Assessment and Risk Management Plan
10. List of Ineligible Items

**Supplementary Document**

11. Potential Safeguard Impacts of Policy Reforms

## DEVELOPMENT POLICY LETTER



### MINISTER OF FINANCE OF MONGOLIA

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Mr. Takehiko Nakao  
President  
Asian Development Bank

Date 23.03.2017

Ref. 10-1/1533

Dear President Nakao,

### **Mongolia: Banking Sector Rehabilitation and Financial Stability Strengthening Program Development Policy Letter**

We would like to thank the Asian Development Bank for its continuous support for the development of the financial sector in meeting our national goals and objectives. The financial sector plays a vital role in intermediating financial resources to foster economic diversification and employment generation.

The Mongolian economy is highly dependent on its mining sector and has been subject to external shocks. Economic growth has slowed down due to falling commodity prices and the moderating growth of its largest trading partner. Mineral exports and fiscal revenues have been negatively affected. An economic slowdown that began in 2015 continued in 2016. In addition, economic growth has also been impacted by domestic economic imbalances. This is affecting the non-mining sector, an important driver of growth and employment, leading to job losses and deteriorated living standards, in particular to the poor and vulnerable.

The rapid expansion of bank credit in 2013 and 2014, compounded by the weakness in the economy has adversely impacted the Mongolian banking system. Hence, the sector suffers from a rapid increase in non-performing loans (NPLs). The NPL ratio stands at 6.9% as of January 2017 and increases to 14.6% when adding past-due loans. The return on assets for the sector was only 0.7% for 2016. The overhang of NPLs has adversely impacted banks' capacity to provide lending for economic recovery and job creation.

Following the parliamentary election in June 2016, the Government took immediate actions to stabilize the economy and support the banking sector rehabilitation. The Parliament has ratified an Economic Recovery Program (ERP), prepared by the Government, in November 2016. The ERP aims to reduce balance of payment pressures, increase foreign exchange reserves, accelerate implementation of infrastructure projects, attract foreign direct investment and promote job growth and economic diversification. The ERP further plans to address financial sector governance, legal and institutional reforms that include strengthening the independence of the Bank of Mongolia. In addition, it will also bring the central bank's operations in line with international standards, revise the foreign exchange law, introduce measures to improve the governance, transparency and accountability of the Development Bank of Mongolia, and enhance the governance of the Financial Stability Council,

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In order to support the banking sector, we plan a series of policy measures that focus on three core areas, namely the completion of the framework for bank restructuring, the enhancement of the financial stability, and the introduction of strengthened competition and governance in the banking sector. To achieve these, we are preparing a roadmap to a banking sector rehabilitation program and supporting the Mongolian Banker's Association to establish a working group to create a corporate debt restructuring committee that will (i) prepare and approve an out-of-court corporate debt restructuring framework; and (ii) adopt an inter-creditor agreement to address corporate debt burden. In order to fully address the issue of NPL overhang impacting the banking sector, we have established an inter-agency working group to support creation of the legal and institutional framework of an Asset Management Company (AMC). We are also preparing a draft law for the establishment of the AMC.

In order to enhance the financial stability framework, the Financial Stability Council will endorse proposed amendments to the relevant law that will strengthen its mandate, composition, authority, tools and powers. We issued a revised asset classification regulation and restructured the banking supervision department of the Bank of Mongolia in December 2016 to enhance regulation and supervisory oversight of banks. With a view to maintain financial stability, we will also enter into a memorandum of understanding with the Deposit Insurance Corporation of Mongolia (DICOM) to support a certain level of financing needs of DICOM in cases of potential payout of deposit claims.

To strengthen competition and governance in the banking sector, we have taken some important policy measures. Among these, the Parliament approved the ERP that outlines steps to improve the capacity and governance of the financial sector to better meet the functional needs of individuals, corporations and the government. Additionally, we have required banks to prepare International Financial Reporting Standards compliant financial statements effective from 1 January 2016. With regard to State Bank, the Government will take steps to prepare the privatization plan of State Bank by year end 2019. This is to implement an earlier resolution by the Parliament, which required shares of State Bank LLC to be privatized. Finally, in order to clearly support the national treatment for foreign banking subsidiaries, we will finalize the amendment of regulations on licensing of banks and foreign subsidiaries, the scope of authorized banking activities, and defining paid in capital and shareholdings.

The Government has successfully engaged in continued dialogue with international financial organizations, including the International Monetary Fund. There has been a staff-level agreement on 19 February 2017 on an Extended Fund Facility program that is essential to mitigate the impact of the necessary macroeconomic, banking sector rehabilitation and fiscal policy adjustments in Mongolia. In this context, we request the assistance of the Asian Development Bank in the form of a policy-based loan in the amount of \$100 million to support banking sector rehabilitation and financial stability strengthening.

The Government is firmly committed to rehabilitation and strengthening of the banking and financial sectors. Mr. President, I would like to thank the Asian Development Bank for working closely with the Government of Mongolia in developing this Program. I wish to reiterate our full commitment and support to it.

Sincerely,



B. Chojjilsuren

## POLICY MATRIX

Outputs/Objective	Policy Actions for 1 July 2015 to 30 June 2017 <sup>1</sup>	Implementation Status and Required Documentation	Medium Term Reform Framework 2017 to 2020
<b>Output 1: Framework for bank restructuring completed</b>			
Bank capital adequacy levels support the volume of risks assumed.	<b>1. The Bank of Mongolia issued a decree that outlines the steps to rehabilitate the banking sector.</b>	<b>1. Decree of Bank of Mongolia</b>	BOM implements and enforces Basel II and III capital standards, and rules for early intervention and bank resolution in line with international best practices.
Mechanism in place to facilitate banks to resolve the high level of non-performing loans.	2. The government established an inter-agency working group to support creation of the legal and institutional framework of an Asset Management Company (AMC).	2. Joint Decree of Bank of Mongolia, Ministry of Finance and Financial Regulatory Commission, dated 3 February 2017	Transparent NPL resolution process drastically cuts sector risks through proper governance and utilizing market-based principles without improper government interference.
	<b>3. The government prepared a draft law for the establishment of an Asset Management Company that ensures: (i) proper governance, transparency and operational independence and oversight; (ii) use of market-based principles and effective allocation of risks and recovery with banks; (iii) broad special authority to manage NPLs for the timely and enforceable transfer of asset ownership rights and the unfettered rights to dispose of assets; (iv) legal protection of management and employees performing their duties; (v) profit maximizing goal and performance-based approach; (vi) commercial orientation and flexibility for private sector participation; (vii) the inclusion of a sunset clause; and (viii) resolution of NPLs of only commercial banks.</b>	<b>3 A draft law on establishment of an AMC prepared by the Bank of Mongolia and Ministry of Finance.</b>	
Out-of-court corporate restructuring framework	<b>4. The Mongolian Banker's Association, with the support of the Bank of Mongolia, established a working group to create a corporate debt restructuring committee that will (i) prepare and</b>	<b>4.a. Resolution of the Mongolian Banker's Association on establishment of a working group tasked to form the committee.</b>	Government implements structural changes considering legislation, judicial system, taxation,

Outputs/Objective	Policy Actions for 1 July 2015 to 30 June 2017 <sup>1</sup>	Implementation Status and Required Documentation	Medium Term Reform Framework 2017 to 2020
initiated.	<b>approve an out-of-court corporate debt restructuring framework; and (ii) adopt an inter-creditor agreement to address corporate debt burden.</b>	<b>4.b. Letter from BOM to the Mongolian Bankers' Association to express (i) support in the creation of the committee; and (ii) willingness to participate in the committee</b>	bankruptcy, commercial and collateral rules to support NPL resolution efforts and corporate restructuring.
<b>Output 2: Financial Stability Enhanced</b>			
Framework for the financial stability mechanism expanded.	<b>5. The Financial Stability Council endorsed proposed amendments to the relevant law that will strengthen its mandate, composition, authority, tools and powers.</b>	<b>5. Minutes of meeting of the Financial Stability Council that endorsed proposed amendments to the relevant law.</b>	Government develops Crisis Management Protocols and continues strengthening policy effectiveness.
Regulation and supervisory oversight of governance and risk management practices enhanced.	6. The government and the Bank of Mongolia jointly issued revised asset classification regulation that integrates practices from Basel Committee for Banking Supervision capital adequacy accords.	6. Joint Decree by Bank of Mongolia and Ministry of Finance dated 9 December 2016 with the effective date of 20 December 2016.	BOM enhances its technical capacity building stronger management and meets compliance with core principles for effective banking supervision including strengthening rules on related party exposures, beneficial ownership, and fit and proper requirements.
	7. The Bank of Mongolia restructured the banking supervision department to align it with best practices that include combining on-site and offsite functions into one that will allow for continuous supervisory process and support for implementing risk based supervision.	7. Decree of Bank of Mongolia dated 27 December 2016.	
Deposit insurance fund has sufficient back-up funding to support possible claims during crisis.	<b>8. MOF entered into an MOU with DICOM to support the financing needs of the DICOM in cases of potential payout of deposit claims.</b>	<b>8. MOU signed between DICOM and MOF agreeing to prepare a back-up financing facility.</b>	Capacity of DICOM to manage potential payouts increases.

Outputs/Objective	Policy Actions for 1 July 2015 to 30 June 2017 <sup>1</sup>	Implementation Status and Required Documentation	Medium Term Reform Framework 2017 to 2020
<b>Output 3: Competition and strengthened governance introduced</b>			
Banking Sector Governance and Capacity Enhanced.	<b>9. The Parliament approved the Economic Recovery Program (ERP) that will outline steps to improve the financial sector's capacity and governance to better meet the functional needs of individuals, corporations and the government.</b>	<b>9. Resolution of the State Great Khural on approval of the Economic Recovery Program, dated 24 November 2016.</b>	Government adopts the Mongolian financial market development - 2025 program that strengthens investor confidence and interest in the financial sector.
	10. The government and the Bank of Mongolia issued regulation to require banks to prepare IFRS compliant financial statements effective from 1 January 2016.	10. Joint Decree of Bank of Mongolia and Ministry of Finance dated 20 July 2015.	
Government divests its ownership in State Bank that creates governance issues.	<b>11. The government entered into an MOU with the Bank of Mongolia and DICOM on the preparation of the privatization plan of State Bank by year end 2019.</b>	<b>11. a. Parliament Resolution No. 70 to approve the 2015-2016 Guideline on privatization and restructuring - State owned shares of State Bank LLC shall be privatized, dated 3 July 2015</b>  <b>11.b. MOU signed between MOF, Bank of Mongolia and DICOM to prepare a plan to privatize State Bank by year-end 2019.</b>	State Bank's privatization encourages adoption of best practices in governance and contribution to the sector's sound development.
Regulations do support licensing of foreign bank subsidiaries.	12. The Bank of Mongolia finalized draft amended regulations to clarify national treatment for foreign banking subsidiaries. The draft amended regulations will cover (i) licensing of banks and foreign subsidiaries; (ii) the scope of authorized banking activities, and (iii) defining paid in capital and shareholdings.	12. Draft amended regulations that cover (i) licensing of banks and foreign subsidiaries; (ii) the scope of authorized banking activities, and (iii) defining paid in capital and shareholdings.	Government provides an enabling environment to support entry of foreign bank subsidiaries and transfer of best practices in governance, product development and risk management.

<sup>1</sup> Policy Actions in bold are linked to disbursement.