FINANCIAL SECTOR ASSESSMENT

Sector Road Map

A. Sector Performance, Problems, and Opportunities

1. Since Mongolia underwent transition from a centrally planned economy to a market based one, financial intermediation has deepened with broad money (M2) to GDP rising from 15.7% at its lowest level in 1995 to 59.2% in 2011 (See Table 1). The transition has not been smooth with the Mongolian financial system being beset by a number of financial crises, in 1994,1996, 1999. These have been attributed to the Government's practice of intervening in the lending process of banks. Although directed credits ceased in 1994, the consequence of redirecting credits to poorly performing enterprises and the moral hazard it created precipitated the crises in future years.[1] The most recent in 2008 was driven by the world financial crisis and a drop in copper prices. The latter prompted the Government into entering into a standby arrangement with the International Monetary Fund (IMF). The standby arrangement (SBA) ended in October 2010. The SBA plus support provided by development partners have been successful in stabilizing the economy and the economy has since rebounded on the strength of rising commodity prices for copper and coal and timely policy adjustments.

1. Structure

2. The financial system of Mongolia presently comprises 14 commercial banks, with 1 state-owned bank and the rest, privately owned banks. The banks predominate controlling over 96% of system assets. The nonbank financial institutions account for about 3.5% of assets that include 192 microfinance companies, 170 savings and credit cooperatives (SCCs), 17 insurance companies, and 88 securities/brokerage firms. Leasing is still at a low level of development.

Table 1: Financial Indicators

Year (end of 2012)	Banks	Nonbank Financial Institutions	Savings and Credit Cooperatives
Loans (MNT billion)	6,941	158[2]	48
No. of customers (000)	2,500[3]	483[4]	26[5]

Source: BOM and Financial Regulatory Committee statistics.

3. The system is highly concentrated with the top 5 banks accounting for 87% of total banking assets. Bank loans are the primary source of revenues of banks covering over 50% of total assets. The bulk of loans are in Ulaanbaatar, about 80%, and in terms of sectors, about 65% in trade, construction, real estate, mining, and manufacturing.

4. Microfinance companies constitute about 2 percent of total financial sector lending, while SCCs constitute less than 1 percent of total financial sector lending. Microfinance companies serve about 137,000 customers nationwide, about 30% borrowers. On the other hand, there are 170 SCCs that serve about 27,000 customers, mostly low-income and rural households.

[1] Mongolian Banking Sector, Tsolmon Erdene, Bank of Mongolia, ERINA Discussion Paper 1004e, December 2010, Niigata Japan.
[2] 70% to 80% of loans by non-bank financial institutions are to micro entrepreneurs and small enterprises.
[3] Duplicated figure for 2011.
[4] Estimated at 30% of total customers of 137,000.
[5] Loans basically to low income and rural households.

5. Mongolia has a nascent insurance industry. The total capital of the 17 reported insurance firms in operation is about $41.7 million in 2011. Data from the Financial Regulatory Commission show total premiums reached $23.4 million equivalent as of 2010. Over 80% of premiums written are for property insurance. There is only one life insurance company established in 2008 while the rest are engaged in general insurance. In 2005, the World Bank introduced index-linked insurance to protect herders that make up about 30% of the population that are most exposed to climatic change and livestock mortality.

6. The Mongolian Stock Exchange (MSE) was established in 1991 to serve as a vehicle for the privatization of large scale enterprises in the country. In November 2000, Government bonds started to be auctioned on the Exchange. As of March 2012, there were 332 listed companies at the MSE with a total market capitalization of US2.3 billion equivalent. Issuers are mainly from the mining sector. While investors comprise about 800,000 accounts of which 99% are individuals and 1% institutions. The latter being mainly investment funds. There are now 24 firms with underwriting licenses.

2. Performance

7. The banking system has basically recovered from the crisis. Currently, domestic credit and deposits are on the uptrend as are the total assets of the banking system. Assets rose from around $2.4 billion in 2007 to $7 billion by the close of 2011. Loans have also more than doubled over the same period. Bank returns have turned positive and nonperforming loans have decreased.

8. Although microfinance has experienced rapid growth in Mongolia in the last decade, microfinance companies constitute a small portion of microlending remaining basically small and underdeveloped. Khan Bank and Xac Bank continue to dominate the microlending market. There is no specific legal and regulatory framework for microfinance, as well as no specific national policy for the development of the microfinance sector.

9. In the insurance market, according to the Mongolian Insurers Association, there are early signs of growth reflected in the most recent figures, with total premium income rising by 48% year-on-year to US$7.7million equivalent by the second quarter of 2011 and total assets increasing to US$52.8 million equivalent, a 60% year-on-year rise. While auto and home insurance penetration is currently less than 5% of the population, the Mongolian government has already approved a law that made auto insurance mandatory by October 1.[6]

10. The MSE has seen rapid growth in the past five years. As recently as 2006, it was the world's smallest stock exchange by market capitalization, approximately US$83 million. By 2008 that rose to US$406 million and then quadrupled to US$2.0 billion by 2011. As of March 2012, it has 332 listed companies with a combined market capitalization of US$2.3 billion. To improve its performance and operation, the MSE reached an agreement on a partnership with the London Stock Exchange (LSE). The LSE will help the MSE upgrade its trading platform and build up capacity. The LSE will also advise the MSE on changes to listing and trading rules. A Securities Market Law is expected to be passed by December 2012. The Government remains committed to privatizing the stock exchange over the medium term.

[6] Mongolia: Overcoming insurance challenges, The UB Post. 16 September 2012.

3. Problems and Constraints

11. Level of Intermediation Costs and Interest Rates. Spreads between deposit and lending rates remain wide, based on year-end rates, ranges anywhere from 5% to almost 8% for domestic currency loans from 2007 to 2011. Although it is trending down. Moreover, interest rates have remained sticky, even with lower inflation, deposit rates have remained high even in comparison with comparator countries based on an IMF report.[7] This may indicate high risk taking behavior by banks, competing for deposits by quoting high rates while pushing for more loans that given high loan rates may be attracting only risky borrowers.

12. Access to Finance. A poverty assessment by the ADB points to limited access as one of the contributing factors to poverty incidence. The World Bank Enterprise Survey shows that access to finance is the most important constraint reported by business firms, specially micro, small and medium sized firms. In Mongolia, 38.6% of firms surveyed reported access to finance as a major constraint compared with 19.2% for East Asia and the Pacific and 31.7% for the World. [8]

13. Banking system remains vulnerable. Despite improvements, Mongolia has some of the lowest Tier 1 capital buffers in the East Asia region and also some of the highest NPL ratios that date back to the banking sector crisis from 2008-09 when 2 large banks failed.[9] Enforcement remains weak as the BOM still practices regulatory forbearance as some banks still do not meet minimum capital requirements and supervision is still compliance-based and authorities have yet to move to risk-based supervision. Banks are also exposed to currency risk as they engage in foreign currency lending that may not be hedged. Thirty percent of deposits are in foreign currency. Dollarization poses risks to the ability of the BOM to conduct monetary policy or act as a lender of last resort. Gaps and omissions still plague existing laws. Under Anti-Money Laundering/Countering Financing of Terrorism (AML/CFT), foreign pawnbrokers, casinos, professionals and politically exposed persons are yet to be covered. While Mongolia has adopted International Financial Reporting Standards (IFRS), due to limited capacity, related costs and difficulties in implementation, there is limited compliance with the IFRS. Likewise, although lending is collateral-based, there are no standards for property valuation and, pursuing claims through the judicial system can be a lengthy process. It is time to replace the blanket guarantee on deposits issued as a result of the 2008 crisis.[10] The credit information system is just being developed. A private credit bureau has been set up but not yet operational.

14. Other segments of the financial system remains underdeveloped. The capital market despite growth in market capitalization owing to the rise in prices, remains relatively underdeveloped. Of the 332 companies, only 40 to 50 issues are actively traded. Only 48 companies are considered compliant with MSE rules. Many issues are inactive. The amount of market float is estimated to be only 5% of market capitalization. Thus, market is largely illiquid. It is expected, however, that with the upsurge in mining, initial public offerings (IPOs) will increase from the sector. The insurance sector is still small but growing so is the microfinance sector.

---

[7] See Mongolia FSAP - Note - A Puzzle of High Interest Rates in Mongolia.DOC 18 July 2011.

[8] See Mongolia: Access to Finance Technical Note, Financial Sector Assessment Program Development Module, the World Bank, June 2012.

[9] Mongolia Quarterly Update. The World Bank. June 2012.

[10] Mongolia: Financial System Stability Assessment, IMF Country Report No.11/107, May 2011.

B. Government's Sector Strategy

15. Under Priority Outcome 2 of Section on Priority Outcomes of Money and Loan Policy of the National Development Strategy (NDS) of the Government, based on the Millennium Development Goals, the implementation strategy calls for, among others, strengthening the banking and financial system consistent with the common practice established in highly developed countries; strengthening non-banking financial system and operations; developing securities and capital market; strengthening risk management system of the banking and financial institutions; and making Ulaanbaatar city as a larger banking and financial center of the Eastern and Northern Asia and Central Asia regions, among others. Thus, developing the country's financial sector is one of the important priorities of the Government spanning the period 2007–2021.

C. ADB's Sector Strategy

16. To ensure increased access to finance, ADB will continue to provide technical assistance to support the development of inclusive financial markets, aside from the current project on modernizing the country's payments system. Ongoing technical assistance projects are focusing on providing greater access to financial services for poor and vulnerable households and developing microinsurance. ADB is also working with the BOM and the Ministry of Finance to develop an efficient deposit insurance scheme that will serve the banking sector better and reduce government exposure.

17. Since 2010, ADB has been working with partner Mongolian banks under the Trade Finance Program (TFP) which provides guarantees and loans in support of international trade. As of March 2012, TFP has supported 42 transactions in Mongolia valued at close to $53 million. TFP helps mobilize private sector resources to developing member countries and a significant percentage of the trade transactions supported by TFP in Mongolia has been co-financed by the private sector. ADB's TFP has narrowed the trade finance gap in Mongolia and has helped support economic growth and job creation.

18. To help improve market infrastructure, ADB will help the government to strengthen corporate governance systems and associated regulatory capacity. ADB will also provide assistance to strengthen key institutions to ensure contract enforcement through improving dispute resolution, either through using court or arbitration mechanisms. ADB is supporting the development of a government bond market by helping to establish an auction mechanism and platform for secondary market trading, which will enable the establishment of a benchmark yield curve and support broader financial sector development.