SECTOR OVERVIEW

A. Economic and Sector Overview

1. **Mongolian economy.**[1] The Mongolian economy has recovered from the 2009 recession that was triggered by the global economic crisis as well as the severe shock to the financial sector, when nonperforming loans (NPLs) approached 20% of the total assets of commercial banks. While growth recovered following the recession, it has slowed as a result of a downturn of growth in the People's Republic of China (PRC) that markedly curbed demand for coal, Mongolia's largest export, and led to falling commodity prices.

2. The Mongolian economy grew by 11.7% in 2013, down from 12.4% in 2012. Growth was boosted by highly expansionary fiscal and monetary policies to compensate for the marked slowdown in coal exports and mine development financed through foreign direct investment (FDI), which have been the drivers of growth in recent years. Industrial production increased by 20.1% in 2013, driven by construction, which expanded by 66%, and was boosted by the monetary and fiscal stimulus. Mining output expanded by 20.7%, owing to the start of copper production at the Oyu Tolgoi copper and gold mine in June 2013. Services expanded by 10.0%, contributing 4.3% to economic growth, and agriculture expanded by 13.5% thanks to favorable weather. Economic growth is forecast at 9.5% in 2014, driven in particular by copper production.

3. Fiscal policy became more expansionary in 2013 as the consolidated, on- and off-budget fiscal deficit widened to 11.1% of gross domestic product (GDP) from 10.9% in 2012 as a result of large off-budget spending through the Development Bank of Mongolia (DBM). Excluding off-budget spending, the cash deficit amounted to 1.4% of GDP, which was much lower than the 7.4% recorded in 2012, and the structural deficit reached 1.7%, within the 2.0% ceiling under the Fiscal Stability Law, 2010. Actual government revenue increased by 19.6%. Revenue shortages and implementation challenges reduced public investment expenditure by 5.1% in the same period, holding the increase in government expenditure to a mere 3.1%. The Development Bank of Mongolia (DBM) has become the main source of financing for off-budget spending, providing an amount equal to 9.6% of GDP in 2013 mainly for projects such as roads that do not generate revenue. DBM debt is guaranteed by the government, so it is a contingent liability on the budget.

4. The current account deficit narrowed in 2013 to $3.2 billion, or 27.4% of GDP, from 32.6% in 2012. The trade deficit improved to 18.1% of GDP from 22.8% in 2012 as the decline in imports outpaced that of exports, but the services and transfers balance worsened. Since mid-2013, the trade and current account deficits have both narrowed rapidly as currency depreciation strengthened export competitiveness and constrained imports. Foreign direct investment (FDI) fell by 55% in 2013 because of uncertainties arising from changes in the investment law, slower growth in the PRC, completion of the first phase of Oyu Tolgoi, and delays in the expected commencement of the mine's second phase. Foreign exchange reserves almost halved in 2013, falling by about $1.9 billion to $2.2 billion, or 4 months of imports. They increased to $2.4 billion in January after the DBM issued a $290 million samurai bond 90% guaranteed by Japan Bank for International Cooperation. The togrog depreciated by 27% against the US dollar since early 2013 as capital inflows ebbed and market sentiment weakened over prolonged debate surrounding Oyu Tolgoi issues and over uncertainty regarding the regulatory framework for foreign investment.

---

[1] Asian Development Bank (ADB). 2014. *Asian Development Outlook 2014: Fiscal Policy for Inclusive Growth*. Manila.

5. To cushion the impact of declining FDI and boost credit growth, the Bank of Mongolia (BOM) cut the policy rate three times in 2013 by a total of 275 basis points to 10.5%. It injected liquidity equal to 17.1% of GDP, including for onlending to selected sectors through price stabilization and mortgage programs at subsidized interest rates. Bank credit increased as a result by 41.0% year on year in 2013 and by 54.3% year on year to January 2014. Broad money (M2) increased by 19.3% and 36.6% year on year during the same periods. The policies are widely seen as important factors behind balance-of-payment pressures starting last year. The consumer price index rose by 10.4% in 2013. It had fallen in the first half, with the phase-out of the cash handout scheme and the temporary impact of the price stabilization program of the BOM. Inflation rose subsequently, driven by currency depreciation and expansionary fiscal and monetary policies.

6. **Financial sector.** The financial sector in Mongolia is dominated by the banking sector, accounting for 96% of financial sector assets. The first private bank was established in 1990, and the system currently consists of 13 commercial banks, of which 12 are private domestic banks and one is a state-owned bank, State Bank.[2] The banking system is highly concentrated, with the top four banks (Khan Bank, Golomt, Trade and Development Bank, and XacBank) accounting for about 80% of market share. These four banks are deemed "systemically important" by the regulator, the BOM.

7. Despite an expansion in banking assets over the past decade, the banking sector is still relatively small, with assets totaling MNT20.8 trillion and gross domestic loans at about 51.3% of total assets at the end of 2013.[3] Loan growth is supported, in part, by the government stimulus package, as previously noted. Lending growth typically trails deposits with higher costs but shorter maturities. Capitalization and liquidity in the banking system have improved, but vulnerabilities remain. Weakness in bank supervision, inadequate provisioning, high loan concentration (especially in construction), dollarization, and a high and rising ratio of credit to deposits (at 103% in February 2013) have heightened the risk of bank distress in a significant economic downturn. Corporate governance needs to be strengthened in the banking sector. Interest rates are high. According to BOM statistics, the weighted average interest rates were 12.3% for togrog deposits and 5.4% for foreign currency denominated deposits as of November 2013. Given the high cost of debt, liquidity, and high inflation, the weighted average interest rate of togrog lending was 17.3% per annum while foreign currency denominated lending was 12.3% per annum as of the end of November 2013.[4]

8. Asset quality improved with more stringent credit appraisals as a result of the crisis, but challenges remain. With economic growth and a tapering of the 2009 crisis, the NPL ratio decreased and reached 5.3% at year-end 2013 (4.2% as of the end of 2012). In the third quarter of 2013, bank loans were highly concentrated in five industries: real estate (17.6%), trade (15.8%), construction (14%), mining (11%), and manufacturing (10.2%).[5] Given the significance of the mining industry and increasing business activities in the real estate sector, shares of mining, real estate, and the construction sector as a percentage of total loans are likely to increase further (end of 2012, 38.5%; end of September 2013, 42.4%). This leads to increased exposures vulnerable to boom and bust cycles. The systemic banks' average reported capital

[2] State Bank was established as a bridge bank, taking on the good assets of two failed banks, Anod and Zoos, in 2009 following the global financial crisis. In July 2013, State Bank also took over Savings Bank following its failure due to related party lending problems.
[3] Central Bank of Mongolia. 2013. *Consolidated Balance Sheet of Banks*. http://www.mongolbank.mn/documents/statistic/balancesheet/2013/09e.pdf
[4] BOM. 2013. *Bank of Mongolia Monthly Statistical Bulletin 2012-2013*. Ulaanbaatar; and discussions with BOM.
[5] The other 50.1% is made up of various other sectors not having substantial shares.

adequacy ratio (CAR) was 15.5% at the end of December 2013, and all were above the new capital requirements.[6] Table 1 provides a peer comparison of the four largest banks in Mongolia.

Table 1: Peer Comparison (as of September 2013)
(MNT billion)

Item	Khan Bank	TDB	Xac	Golomt
Total assets	4,202	4,231	1,573	3,613
Net loans	2,510	2,243	1,010	2,005
Net profit	69	65	17	35
Customer deposits	2,497	2,141	698	2,244
Income composition				
Net interest income	139	72	48	53
Return on equity (%)	34.5	32.8	22.8	22.0
Return on asset (%)	2.8	2.5	1.6	1.8
Capital adequacy ratio	15.5	14.9	15.3	17.7

Source: Bank of Mongolia and banks' websites; Khan Bank.

9. **Small and medium-sized enterprises sector.** The small and medium-sized enterprise (SME) sector is critical for the diversification of Mongolia's economy, with a contribution to GDP of 70%.[7] SMEs are prominent in the agriculture, mining, manufacturing, construction, and service sectors. SMEs in Mongolia have difficulty obtaining finance on a sustainable basis.[8] Only 10% of about 37,000 SMEs regularly access finance through banks.[9] Female borrowers do have access to financing. About 54.2% of female-owned SMEs have a loan or a credit line in Mongolia.[10] At the end of 2012, the value of total outstanding SME loans was $424 million.[11] Following a rapid growth of SME loans in 2011, with an annual growth rate of 71%, SME loan growth slowed to 24.6% in 2012.

10. **Access to finance.** Although the banking sector has experienced rapid loan growth, domestic credit provided by the sector as a percentage of GDP in Mongolia remains low, indicating an access to finance issue. As provided in Table 2, this indicator was 36.8% in 2010 and lagged behind the developing countries in Europe and Central Asia (39.4%) and East Asia and the Pacific (40.1%). Bank finance remains predominantly short-term because of the country's level of financial sector development and penetration.

[6] The four systemically important banks were required to raise their Tier 1 ratios to 8% and CAR to 13% by December 2012, and to 9% (Tier 1 ratios) and 14% (CAR) by June 2013.

[7] Institute of Developing Economies under JETRO. 2008. *Improving Access to finance for SME: International Good Experiences and Lessons for Mongolia*. Tokyo.

[8] Mongolia's SME law defines SMEs by sector: industry, retail trade—maximum 199 employees and maximum turnover of MNT1.5 billion; trade—maximum 149 employees and maximum turnover of MNT1.5 billion; and services—maximum 49 employees and maximum annual turnover of MNT1 billion.

[9] ADB. 2012. *Improving Access to Finance in Mongolia*. Manila; ADB. 2012. *Promoting Private Sector Development in Mongolia*. Manila.

[10] World Bank. Financial Inclusion Indicators. http://datatopics.worldbank.org/g20fidata/country/mongolia

[11] Bank of Mongolia. *Bank Statistics*. http://www.mongolbank.mn/eng/default.aspx (accessed 28 April 2014)

Table 2: Financial System Development Characteristics of Selected Countries, 2010

Item	Indicator	Mongolia	Europe and Central Asia[a]	Lower Middle Income	East Asia and Pacific[b]
Depth	Private credit to GDP (%)	36.8	39.4	30.3	40.1
Access	Bank accounts per 1,000 adults	1,339.0	894.0	641.0	488.0
Efficiency	Net interest margin (%)	1.6	3.9	4.0	2.7

GDP = gross domestic product.
Note: The World Bank includes Mongolia under East Asia and Pacific.
[a] Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, Former Yugoslav Republic of Macedonia, Moldova, Montenegro, Romania, Russian Federation, Serbia, Tajikistan, Turkey, and Turkmenistan.
[b] Cambodia, the People's Republic of China, Fiji, Indonesia, Kiribati, Republic of Korea, the Lao People's Democratic Republic, Malaysia, Marshall Islands, Micronesia, Mongolia, Myanmar, Palau, Papua New Guinea, the Philippines, Samoa, Solomon Islands, Thailand, Timor-Leste, Tuvalu, Tonga, and Vanuatu.
Source: World Bank. 2013. *The Little Data Book on Financial Development 2013*. Washington, DC.

11. Low financial sector penetration has particularly impacted certain segments. Enterprise surveys and industry participants suggest that access to finance remains a top constraint for businesses, especially SMEs. The World Bank's Enterprise Survey shows that access to finance is the most important constraint among the top 10 constraints reported by firms, with more than 30% of firms in Mongolia perceiving access to finance as the largest issue for their operations. A World Bank study notes that when finance is available to SMEs, loan terms and conditions are characterized by high interest rates, shorter maturities, smaller amounts that do not meet the full financial needs of these companies and that are primarily based on immoveable collateral-based requirements.

12. **Deposit insurance.** In January 2013, a new deposit insurance law, the Law of Deposit Insurance, was introduced, which provides for deposit protection with a cap of up to MNT20 million (about $14,000) per account. Banks are now required to pay risk differentiated fees based on their risk profiles. The government established the Deposit Insurance Corporation under the new law, and it is developing relevant procedures for its operation.

13. **Central bank.** The regulatory and supervisory function relating to banks is carried out by the Bank Supervision Department of the BOM. The BOM performs at least one comprehensive examination of every bank on an annual basis. The Mongolian regulators have not fully adopted the Basel framework. However, certain reforms have been made in line with Basel I and II pertaining to operational risk and market risk. The BOM has tightened asset classification and other prudential requirements since 2010. As noted, starting from 2013, the BOM required systematically important banks to maintain a CAR above 14%. Moreover, the minimum capital requirement was doubled to MNT16 billion, effective from May 2013 to protect investors and depositors and to encourage mergers and acquisition of banks. Table 3 provides an overview of prudential requirements.

14. The BOM, as lender of last resort, lends to banks when lending is secured by government bonds, central bank bills, borrower's accounts held at the central bank, and any highly liquid assets accepted by the BOM. In addition, the BOM is expected to act if the borrower's liquidity constraint is considered temporary and a borrower is unable to pay back its loans. The government took over three nonperforming banks through the only state-owned bank. As of November 2013, the BOM's lending to commercial banks was MNT348.8 billion of which MNT84 billion was backed by central bank bills. The BOM offers banks overnight loans, pay day credit, emergency loan, and reverse repo.

Table 3: Overview of Prudential Requirements

No.	Prudential Requirements
1	**Capital adequacy** (i) Capital/Risk-weighted assets ratio (12.5%) (14% for systematically important banks) (ii) Tier 1 capital/risk-weighted assets ratio (7%) (9% for systematically important banks)
2	**Loan concentration risk figures**
A	Aggregate exposure of loan, guarantee, and letter of credit to a single borrower and their related parties shall not exceed 20% of capital
B	Loan, guarantee, letter of credit to shareholders, bank officers, and employees and their related persons: (i) The aggregate exposure shall not exceed 20% of capital (ii) Single borrower exposure shall not exceed 5% of capital
3.	**Prudential ratios for foreign assets and liabilities** For an individual currency + or – 15% of total capital For all currencies (+ or – 40%) of total capital
4.	**Fixed assets ratio** Fixed assets ratio shall not exceed 8% of the net assets.
5.	**Liquidity ratio** Liquid assets to total liabilities, net of clearing settlements, at a minimum of 25%

Source: Khan Bank