PROPOSED LOANS
FINANCIAL SECTOR PROGRAM
(MONGOLIA)

ATTACHMENTS

Financial Information on Commercial Banks
Table 1: Restated Balance Sheets of Commercial Banks

FINANCIAL INFORMATION ON COMMERCIAL BANKS

1. *Ardyn Bank:* Although reporting income after tax of Tug366 million for the year ending 31 December 1995, Ardyn Bank actually operated at a loss. The bank's accounting policies considerably overstate net income, assets and capital. According to a Bank-financed portfolio audit undertaken in August 1996, about 57 percent of the loans made by Ardyn Bank management without Government directives were nonperforming at that date. If the financial statements of Ardyn Bank were restated in accordance with international accounting standards by making adequate loan loss provisions and recognizing interest income properly, it is estimated that the bank would have a negative capital of at least Tug10 billion ($17 million). It had operating losses (i.e. before loan loss provisioning) of at least Tug1 billion from January to June 1996. Ardyn Bank's liquidity position has been inadequate as collections on non-performing loans have been minimal and the Bank continued to make new loans. Ardyn Bank has frequently relied on liquidity support from BOM to stay afloat. It has failed to comply with reserve requirements, credit ceilings and the prudential guidelines of BOM on a regular basis. At best, Ardyn Bank's financial position is precarious and substituting the directed and inherited loan portfolio with interest-bearing Government securities will not resolve the financial condition of the bank. In September 1996, Ardyn Bank was put into conservatorship as (i) it could not meet withdrawal requests by depositors without additional liquidity support from BOM, (ii) existing management did not have the skills to manage a commercially oriented bank, and (iii) it was considered unlikely that Ardyn Bank could restructure itself to generate sufficient earnings over the next three years to achieve minimum capital adequacy standards required under the Program without substantial additional capital injections from the Government. The conservatorship was not extended beyond 30 days due to heavy public criticism of BOM by Ardyn Bank shareholders and former management. In light of this experience, the Government has decided to put the Ardyn Bank into receivership in accordance with the new banking law.

2. *Trade and Development Bank (T&D Bank):* T&D Bank reported after tax profits of Tug 599 million for the year ending 31 December 1995 after adequate provisioning for loan losses. T&D Bank has the best financial position of any of the five major banks mainly due to its low-cost funding base of current accounts, foreign borrowings and share capital, a relatively sound loan portfolio, and a high share of profitable foreign exchange transactions. Of the five major banks, T&D Bank is the only one to comply with BOM's liquidity ratio requirement and be sufficiently capitalized. T&D Bank consistently complies with the prudential norms established by BOM. The resolution of the inherited and directed loan portfolio would further improve the capitalization of T&D Bank and would help to ensure its long-term financial viability.

3. *BITI:* BITI reported after tax income of Tug1,003 million for the year ending 31 December 1995. BITI has made a provision for loan losses of only 2 percent of its total loan portfolio. About 18 percent of BITI's own loans are non-performing. Should the balance sheet be adjusted to reflect a more realistic loan loss provision, the capital of the bank would be reduced, and the bank might have negative net-worth. Refinancing of the directed and inherited debt will improve BITI's financial position, but by itself would not enable it to meet the capital adequacy standards stipulated under the Program. BITI currently has liquidity problems as a major depositor withdrew its deposits on short notice in April 1996. The liquidity ratio is only half that required by BOM and the bank consistently fails to comply with BOM's reserve requirement. BITI needs to improve its liquidity management by better matching the maturities of its assets and liabilities.

4. *Agricultural Bank:* Agricultural Bank reported after tax losses of Tug1,537 million for the year ending 31 December 1995, and a negative capital position as at 30 June 1996. Agricultural Bank has Tug3,571 million of directed and inherited debt which accounts for 30 percent of its total assets. About 36 percent of its own loans are non-performing. If the balance sheet is restated to reflect international accounting standards, the Agricultural Bank has negative capital of about Tug2.8 billion. Refinancing of directed and inherited loans will improve the overall financial position of Agricultural Bank, but will not achieve positive capitalization and guarantee the bank's long-term financial viability. Agricultural Bank continues to operate non-profitable branches as part of its mandate to act as the Government's payment agent. The bank is compensated through large interest-free Government deposits, although the extent to which the provision of these funds fully compensates for costs incurred is unclear and other banks also benefit from Government deposits but are not obliged to provide services Significant financial and organizational restructuring will be necessary to improve the bank's long-term prospects.

5. *Insurance Bank:* Insurance Bank reported after *tax* losses of Tug239 million for the year ending 31 December 1995. Insurance Bank provides reserves for loan losses of less than 4 percent of its "own-made" loan portfolio. Analysis of the overall portfolio indicates that over half of the portfolio could be uncollectible. If the balance sheet of Insurance Bank is restated in accordance with international accounting standards, the bank has a negative net worth in excess of Tug5 billion. Insurance Bank is illiquid and has been kept afloat through liquidity injections of BOM credit. Other ad hoc measures to prevent the collapse of Insurance Bank, have included the transfer of interest-free Government deposits, and forced capital injections by SOEs. The Insurance Bank is not complying with BOM's reserve requirement. Despite this, Insurance Bank has continued to make working capital loans with 15-40 days maturity to its best client. Any loan repayments are used to make new loans instead of preserving liquidity. Resolving the directed and inherited loan problem would have little effect on the overall financial position of Insurance Bank. There does not appear to be any prospect of rehabilitating this bank, and there is general agreement that it should be liquidated under the provisions of the new banking laws.

Table1: Restated Balance Sheets of Commercial Banks (million tug)
(as of 30 June 1996)

Item	Agriculture Bank	Ardyn Bank	Insurance Bank	ITI Bank	T&D Bank	Small Banks	All Banks
Cash	948.9	2,244.5	184.8	604.4	298.9	154.2	4,435.7
Demand deposits with BOM	1.0	290.8	(463.5)	131.0	194.7	290.8	444.8
Liquid foreign assets	351.1	1,938.7	104.1	1,406.7	5,244.1	743.3	9,788.0
Total Liquid Assets	**1,301.0**	**4,474.0**	**(174.6)**	**2,142.1**	**5,737.7**	**1,188.3**	**14,668.5**
Central Bank bills	0.0	0.0	0.0	0.0	1,020.0	1,155.0	2,175.0
Time deposits	0.0	0.4	0.0	530.9	6,373.8	441.9	7,347.0
Claims on Government	46.2	341.5	17.2	216.2	624.7	217.6	1,463.4
Loans (Short-term)	5,782.0	21,732.2	4,575.0	16,396.5	11,647.4	7,559.9	67,693.0
in Domestic Currency	5,584.0	21,193.4	3,899.7	12,514.2	2,377.1	6,241.2	51,809.6
in Foreign Currency	198.0	538.8	675.3	3,882.3	9,270.3	1,318.7	15,883.4
(Loan Loss Provisions)	(1,391.1)	(8,797.6)	(2,171.6)	(1,432.1)	(3,511.7)	(1,778.4)	(19,082.4)
Interest accrued	799.0	1,808.0	573.6	96.9	264.8	386.8	3,929.1
Net Loans	5,190.0	14,742.6	2,977.0	15,061.3	8,400.5	6,168.3	52,539.7
Interbank loans	0.9	1,309.3	844.1	266.0	153.6	357.7	2,931.6
in Domestic Currency	0.0	1,103.5	0.0	0.0	153.6	125.0	1,382.1
in Foreign Currency	0.9	205.8	844.1	266.0	0.0	232.7	1,549.5
Securities	0.0	0.0	0.0	12.6	0.0	305.8	318.4
Total Current Assets	**6,538.1**	**20,867.8**	**3,663.7**	**18,229.1**	**22,310.3**	**9,834.6**	**81,443.6**
Fixed Assets (net)	1,652.5	3,725.2	1,009.1	2,146.8	2,225.6	771.3	11,530.5
Other Assets	716.8	307.8	98.4	2,467.1	223.3	678.9	4,492.3
Settlement Float	(533.9)	2,548.9	308.1	1,724.4	(87.1)	434.1	4,394.5
Directed Loans	2,132.7	3,299.7	932.2	2,138.4	906.9	0.0	9,409.9
Inherited Loans	1,438.3	804.6	324.1	330.8	1,045.1	0.0	3,942.9
Other Government Obligations	0.0	2,952.4	0.0	0.0	756.0	0.0	3,708.4
Total Assets	**11,944.5**	**34,506.4**	**6,335.6**	**27,036.6**	**27,380.1**	**11,718.9**	**118,922.1**
Current Accounts	1,767.1	7,883.0	2,257.6	8,484.8	9,054.9	2,373.8	31,821.2
in Domestic Currency	1,559.5	7,073.4	1,306.1	5,818.7	2,018.5	1,455.4	19,231.6
in Foreign Currency	207.6	809.6	951.5	2,666.1	7,036.4	918.4	12,589.6
Demand Deposits	1,875.8	8,292.2	197.6	599.2	809.5	1,810.2	13,584.5
in Domestic Currency	1,875.8	7,765.8	197.6	590.2	42.8	1,591.7	12,063.9
in Foreign Currency	0.0	526.4	0.0	9.0	766.7	218.5	1,520.6
Government Deposits	2,783.1	5,512.1	3,053.8	3,317.0	1,525.4	114.8	16,306.2
current	2,783.1	5,512.0	3,009.2	3,317.0	1,525.4	114.8	16,261.5
demand	0.0	0.1	44.6	0.0	0.0	0.0	44.7
Interbank credit	0.0	0.0	477.3	200.0	0.0	317.0	994.3
BOM credit	3,170.6	3,221.9	1,543.1	6,427.9	126.9	960.7	15,451.1
Foreign Liabilities	24.0	32.5	746.7	2,777.6	5,005.1	15.4	8,601.3
Total Current Liabilities	**9,620.6**	**24,941.7**	**8,276.1**	**21,806.5**	**16,521.8**	**5,591.9**	**86,758.6**
Time and Savings Deposits	3,192.0	18,758.6	2,829.4	2,952.9	790.9	2,567.9	31,091.7
Other liabilities	1,907.0	810.6	359.9	835.5	7,463.0	1,134.5	12,510.5
Total Liabilities	**14,719.6**	**44,510.9**	**11,465.4**	**25,594.9**	**24,775.7**	**9,294.3**	**130,360.8**
Paid-up Capital	414.3	1,585.2	1,063.5	1,630.6	461.9	3,538.7	8,694.2
Retained Earnings and Reserves	(3,189.5)	(11,589.7)	(6,193.3)	(188.9)	2,142.5	(1,114.1)	(20,132.9)
Total Capital	**(2,775.2)**	**(10,004.5)**	**(5,129.8)**	**1,441.7**	**2,604.4**	**2,424.6**	**(11,438.7)**
Total Capital and Liabilities	**11,944.4**	**34,506.4**	**6,335.6**	**27,036.6**	**27,380.1**	**11,718.9**	**118,922.1**

Item	Agriculture Bank	Ardyn Bank	Insurance Bank	ITI Bank	T&D Bank	Small Banks	All Banks
Ratios							
Current Ratio	0.68	0.84	0.44	0.84	1.35	1.76	0.94
Liquid Assets/Total Assets	0.11	0.13	(0.03)	0.08	0.21	0.10	0.12
Liquid Assets/Total Deposits	0.20	0.21	(0.03)	0.17	0.50	0.28	0.24
Total Capital/Total Assets	(0.23)	(0.29)	(0.81)	0.05	0.10	0.21	(0.10)
Total Liabilities/Equity	(5.30)	(4.45)	(2.24)	17.75	9.51	3.83	(11.40)
Equity/Risk Assets	(0.26)	(0.33)	(0.79)	0.06	0.12	0.23	(0.11)
Total Loans/Total Deposits (w/ Gov. dep.)	0.60	0.54	0.55	1.07	0.96	1.10	0.73
Total Loans/Total Deposits (w/o Gov. dep.)	0.85	0.62	0.87	1.36	1.09	1.12	0.88
Reserve Requirement	0.15	0.12	(0.06)	0.08	0.14	0.14	0.10
Liquidity Ratio	0.10	0.11	0.06	0.10	0.39	0.32	0.16
Capital Adequacy (BIS tier-1)	-37.62%	-36.35%	-96.05%	6.10%	11.18%	24.49%	-11.79%
Tier-1 Capital	(2,775.2)	(10,004.5)	(5,129.8)	1,441.7	2,604.4	2,424.6	(11,438.7)
Adjusted Assets	7,377.4	27,525.3	5,340.8	23,615.8	23,289.8	9,901.3	97,050.4
Loan Portfolio Quality							
Gross Loans	5,782.0	21,732.2	4,575.0	16,396.5	11,647.4	7,559.9	67,693.0
Rated Pass	2,915.0	6,443.6	1,678.7	12,128.7	4,669.9	4,879.9	32,715.8
Overdue	890.0	2,843.0	212.0	1,267.3	696.1	490.5	6,398.9
Substandard	532.0	1,987.5	328.6	1,639.7	42.6	319.2	4,849.5
Doubtful	450.0	4,500.5	570.3	945.3	5,582.8	450.9	12,499.8
Loss	995.0	5,957.6	1,785.4	415.6	656.0	1,419.4	11,229.0
Required Loan Loss Provision	1,391.1	8,797.6	2,171.6	1,432.1	3,511.7	1,778.4	19,082.4
Existing Loan Loss Provision	233.0	1,347.4	204.5	335.4	2,391.4	97.5	4,609.2
% problem loans/bank loans	49.6%	70.3%	63.3%	26.0%	22.1%	35.5%	51.7%
% non-performing loans/bank loans	34.2%	57.3%	58.7%	18.3%	10.5%	29.0%	42.2%
% doubtful+loss loans/bank loans	25.0%	48.1%	51.5%	8.3%	9.8%	24.7%	35.1%
Recapitalization Requirements							
Tier-1 capital = 2% of BIS-adjusted assets	147.5	550.5	106.8	472.3	465.8	198.0	1,941.0
Current tier-1 capital	(2,775.2)	(10,004.5)	(5,129.8)	1,441.7	2,604.4	2,424.6	(11,438.7)
Recapitalization needs after substitution of directed and inherited loans	2,922.7	10,555.0	5,236.6	(969.4)	(2,138.6)	(2,226.6)	13,379.7
Government directed and inherited loans	3,571.0	7,056.7	1,256.3	2,469.2	2,708.0	0.0	17,061.2
Total recapitalization needs (2% BIS)	6,493.7	17,611.7	6,492.9	1,499.8	569.4	(2,226.6)	30,440.9
* (2% BIS)	6,493.7	17,611.7	6,492.9	2,469.2	2,708.0	0.0	35,775.5
Total recapitalization needs (4% BIS)	6,641.2	18,162.2	6,599.7	1,972.1	1,035.2	(2,028.6)	32,381.9
* (4% BIS)	6,641.2	18,162.2	6,599.7	2,469.2	2,708.0	0.0	36,580.4

* Total recapitalization cost, if the Government fully substitutes directed and inherited loans for all banks.

Source: BOM call reports, Bank-financed portfolio audits and Bank estimates.

BOARD OF DIRECTORS

ASIAN DEVELOPMENT BANK

FOR OFFICIAL USE ONLY
(For consideration by the Board
on or about 19 December 1996)

R291-96
28 November 1996

PROPOSED LOANS AND TECHNICAL ASSISTANCE GRANT FINANCIAL SECTOR PROGRAM (MONGOLIA)

1. The Report and Recommendation of the President (RRP:MON 28200) on proposed loans and technical assistance grant to Mongolia for the Financial Sector Program is circulated herewith, together with the following attachments:

   (a) (Draft) Loan Agreement

   (b) (Draft) Technical Assistance Loan Agreement

2. This Report and Recommendation should be read with the review of economic developments in Mongolia (CER:MON 96023), which was circulated to the Board on 5 November 1996 (DOC.IN.232-96).

For Enquiries: Mr. R. Boumphrey, Infrastructure, Energy and Financial Sectors Department (East) (Ext. 6451)
Mr. R. Kumar, Programs Department (East) (Ext. 6261)
Mr. R. Clendon, Office of the General Counsel (Ext. 4911)

The attached document has a restricted distribution until it has been approved by the Board of Directors. Following such approval, the document will be available to the public upon request.

RRP:MON 28200

ASIAN DEVELOPMENT BANK

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON

PROPOSED LOANS

AND

TECHNICAL ASSISTANCE GRANT

TO

MONGOLIA

FOR THE

FINANCIAL SECTOR PROGRAM

November 1996

CURRENCY EQUIVALENTS

(as of 15 November 1996)

Currency Unit	-	Tugrik (Tug)
Tug1.00	=	$0.0015
$1.00	=	Tug651

The tugrik was floated on 28 May 1993. For the purpose of calculations in this Report, an exchange rate of Tug560 to $1.00 has been used.

ABBREVIATIONS

BIS	-	Bank for International Settlements
BITI	-	Bank for Investment and Technological Innovation
BOM	-	Bank of Mongolia
CMEA	-	Council for Mutual Economic Assistance
ESAF	-	Enhanced Structural Adjustment Facility
GAAP	-	Generally Accepted Accounting Principles
GDP	-	Gross Domestic Product
GTZ	-	Gesellschaft fuer Technische Zusammenarbeit
ICB	-	International Competitive Bidding
IDA	-	International Development Agency
IMF	-	International Monetary Fund
KfW	-	Kreditanstalt fuer Wiederaufbau
MOF	-	Ministry of Finance
MOJ	-	Ministry of Justice
MSE	-	Mongolian Stock Exchange
NBFI	-	Non-Bank Financial Institution
ODA	-	Official Development Assistance
SDR	-	Special Drawing Right
SOE	-	State-Owned Enterprise
SPC	-	State Property Committee
T&D	-	Trade and Development Bank
TACIS	-	Technical Assistance to the Commonwealth of Independent States
USAID	-	United States Agency for International Development

NOTES

(i) The fiscal year (FY) of the Government ends on 31 December.

(ii) In this Report, "$" refers to US dollars.

CONTENTS

LOAN AND PROGRAM SUMMARY

Borrower : Mongolia

I. THE PROGRAM

Rationale : The Program will (i) complement the Government's macroeconomic stabilization and adjustment reforms, which are supported by the International Monetary Fund; (ii) reform the legal, regulatory and policy environment for the financial sector; and (iii) strengthen banks by improving the commercial orientation, efficiency and prudence of their operations. These measures will instill greater financial discipline and public confidence in the financial sector. Improved operations of the banking system will lead to greater mobilization of financial resources and a more efficient allocation of resources, thus enhancing economic growth and development of the Mongolian economy.

Objective : The Program is aimed at promoting the establishment of a sound, market-based financial system that can mobilize and allocate resources efficiently.

Scope : The Program seeks to (i) strengthen the legal and regulatory framework for banking operations by improving banking supervision and the regulation of non-bank financial institutions, improving the financial information on banks, improving the legal basis for debt recovery, and facilitating the enforcement of financial sector related laws; (ii) strengthen financial intermediaries by facilitating the operational and financial restructuring of banks; and (iii) improve the efficiency of the financial intermediation process by reducing Government involvement in bank operations, and establishing market-determined interest rates.

Classification : Economic Growth

Risks and Safeguards : The major risk for the successful implementation of the Program is that the current liquidity problems of the banking system and the anticipated closure of major banks will result in a run on viable banks. The Program seeks to prevent a loss of public confidence in the banking system by promoting the restructuring of insolvent, but potentially viable, banks and placing nonviable insolvent banks in receivership in an orderly manner to minimize the impact of bank failures on depositors.

Another risk for the Program is that the Bank of Mongolia (BOM) and the commercial banks lack the ability to implement financial and operational restructuring programs. To mitigate this risk, comprehensive technical assistance will be provided under the Program to commercial banks and BOM to assist with restructuring and to improve human skills in the banking sector.

Success in restructuring commercial banks is expected to result in the closure of less efficient business enterprises. This could potentially have adverse, short-term consequences for employment and pose a political risk for the Program. In addition, there will be costs to enterprises, who will lose up to 10 percent of their deposits. The Bank loans will provide the Government with additional resources to assist in meeting costs associated with bank restructuring. This will limit the impact on other areas of the economy. Also, the World Bank-financed enterprise adjustment credit will help to mitigate the short-term social impact of the Program measures.

In a parliamentary system there is a risk that the passage of proposed legislation may be delayed or amended prior to final enactment. To eliminate this potential risk, parliamentary approval of changes in banking legislation was a precondition for Board consideration. New banking legislation was enacted in September 1996.

II. BANK ASSISTANCE

A. Program Loan

Loan Amount and Terms : A Program loan of SDR24.201 million ($35 million equivalent) will be provided from the Bank's Special Funds resources to support a program of reforms in the banking sector. The loan will have a maturity of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.

Procurement : In the case of goods commonly traded on international commodity markets, procurement undertaken in accordance with normal commercial procedures appropriate to the trade will be regarded as acceptable to the Bank. Procurement of other goods for which contracts are less than $5 million will be based on normal commercial practices for procurement by the private sector or Government procurement procedures acceptable to the Bank for procurement by the public sector. Each supply contract for eligible imports estimated to cost $5 million or more will be awarded through international competitive bidding procedures in accordance with the Bank's *Guidelines for Procurement*.

Disbursement : The proceeds of the loan are expected to be disbursed against a broad range of imports, subject to a negative list of items. The proceeds may be disbursed to finance eligible expenditures incurred within 180 days prior to loan effectiveness.

Counterpart Funds : The Borrower shall ensure that sufficient funds are available to meet the costs (principal and interest) associated with the Borrower's financial sector restructuring program. Any counterpart funds not required for the financial sector restructuring program shall be used to finance expenditures for general development purposes of the Borrower.

Tranching : The loan will be released in two equal tranches. The first tranche will be made available upon loan effectiveness. The second tranche is expected to be released by December 1998, dependent upon satisfactory implementation of the Government's financial sector reform program.

B. TA Grant

: The Government requested technical assistance (TA) to assist with implementation of the Program. It is proposed that the Bank provide a $1,000,000 TA grant to strengthen the bank supervisory capabilities of BOM. The consultants required to undertake the TA will be engaged by the Bank in accordance with the Bank's *Guidelines on the Use of Consultants.*

C. TA Loan

Loan Amount and Terms : A TA loan of SDR2.074 million ($3 million equivalent) will be provided from the Bank's Special Funds resources to upgrade skills and systems of commercial banks in line with Program requirements. The loan will have a maturity of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.

Consulting Services : Part of the TA loan will finance the provision of international consulting services rendered in connection with the operational restructuring of commercial banks and of advisory and training services required to upgrade commercial banking skills of banks. The consultants required to undertake the TA will be engaged by BOM in accordance with the Bank's *Guidelines on the Use of Consultants.*

Procurement : The balance of the TA loan will finance the procurement of integrated banking software packages for commercial banks. As the contract with each participating bank is expected to be below $500,000, procurement will be done on the basis of international shopping in line with the Bank's *Guidelines for Procurement.*

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on (i) a proposed loan to Mongolia for the Financial Sector Program; (ii) a proposed loan to Mongolia for Upgrading Skills and Systems of Commercial Banks; and (iii) proposed technical assistance for Strengthening the Supervisory and Restructuring Capacity of the Bank of Mongolia.

II. INTRODUCTION

2. The Bank's operations in Mongolia have supported the country's transition to a market-based economy. Because of the importance of the financial system for mobilizing and efficiently allocating resources, the Bank has provided technical assistance (TA) totaling $2.295 million for the financial sector.[1] The Bank has played a leading role in the external aid community in assisting the Government to identify policy, institutional, and regulatory constraints on the financial sector operations and in formulating and implementing reform measures. The Bank's medium-term country strategy includes provision of assistance for the restructuring and development of the banking sector (see Appendix 1), and accordingly the proposed financial sector program loan was included in the Bank's 1996 Country Program.

3. Mongolia's transition to a market economy has been generally successful, particularly compared with other countries that were also members of the former Council for Mutual Economic Assistance (CMEA). The Government, with support from the Bank, the International Monetary Fund (IMF), and the World Bank, has undertaken a program of reforms aimed at macroeconomic stabilization and liberalization. As a result of these measures, the annual inflation rate has declined, and since 1994 the economy has been growing.

4. A Bank Reconnaissance Mission for the proposed Financial Sector Program Loan was undertaken in August/September 1995, a Fact-finding Mission in April 1996, and an Appraisal Mission in August/September 1996.[2] This Report is based on the findings of the Bank missions; various Bank-financed studies pertaining to banking sector reforms and restructuring; discussions with staff of the Bank of Mongolia (BOM), Ministry of Finance (MOF), State Property Committee (SPC), Ministry of Justice (MOJ), and commercial banks; and consultations with the IMF, World Bank, and other external assistance agencies active in the sector.

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1 TA No. 1855-MON: *Institutional Strengthening of the Financial Sector* for $595,000, approved on 17 March 1993; TA No. 2105-MON: *Institutional Strengthening of Agricultural Banking Services* for $300,000, approved on 20 June 1994; TA No. 2219-MON: *Strengthening of the Commercial Banking System* for $600,000, approved on 5 December 1994; TA 2353-MON: *Strengthening of Financial Intermediaries* for $600,000, approved on 30 June 1995; TA No. 2543-MON: *Development of Procedures for the Reconstruction and Liquidation of Insolvent Banks* for $100,000, approved on 19 March 1996; and TA No. 2605-MON: *Development of Bank Restructuring Strategies* for $100,000, approved on 2 July 1996.

2 The Appraisal Mission comprised R. Boumphrey (Senior Economist, Mission Leader), R. Clendon (Senior Counsel), R. Vokes (Senior Economist), H. Feig (Investment Officer), R. Kumar (Programs Economist), and L. Kulp (Staff Consultant).

III. BACKGROUND

A. Development Objectives, Strategy and Plans

5. Following the breakup of CMEA, Mongolia experienced a severe and sudden reduction in aid from the former Soviet Union and major changes in trading and payments relationships. This contributed to reduced output, high rates of inflation, fiscal difficulties, reduced trade and foreign reserve levels, and falling standards of living. Gross domestic product (GDP) declined by 24 percent between 1990 and 1993; inflation reached 320 percent in 1992; net international reserves declined from $49 million in 1990 to $4.6 million in 1992; and the value of the currency (tugrik) depreciated sharply. Mongolia has undertaken key reforms: fiscal and monetary policies were tightened; domestic and international trade was liberalized; some public assets were privatized; and incentives for savings and investment were improved. In addition, there was a redefinition of the role of Government, and initial steps were taken to create a legal and regulatory framework compatible with a market economy.[1]

1. Fiscal Policy

6. Mongolia has undertaken fiscal stabilization under the auspices of IMF's Enhanced Structural Adjustment Facility (ESAF). This has helped reduce the overall budget deficit, from 22.8 percent of GDP in 1994 to 11.4 percent in 1995, and contributed to a budgetary surplus. Preliminary estimates for the first half of 1996 suggest that, despite the 30 June 1996 election, the fiscal situation has remained under control. Reduced revenues due to declines in international prices of copper and cashmere, and shortfalls in revenues from privatization and tourism will require the Government to curb expenditure if fiscal targets are to be met.[2]

7. Key fiscal reforms have included: (i) introduction of a tax system more appropriate to a market economy, covering both direct and indirect taxes and improvements in tax administration and enforcement;[3] (ii) rationalization of social outlays; (iii) reduction of subsidies to State-owned enterprises (SOEs); and (iv) reduction in the number of ministries from 16 to 9. As a consequence of tax reforms, Government revenue increased from 28 percent of GDP in 1994 to 34 percent in 1995. Rationalization of social sector spending involved the introduction of a new health insurance system based on employer and employee contributions in January 1994. Major revisions were made during 1994 and 1995 to the social security system, including delinking of the system from state enterprises, introducing employee contributions to the pension scheme, and standardization of minimum retirement ages.[4] The rationalization of education and health

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1 For further details see CER:MON 96023 "*Country Economic Review for Mongolia*", October 1996.

2 Tourist arrivals declined in 1996 because of steppe fires and an outbreak of cholera.

3 Supported under TA No. 2606-MON: *Strengthening the Taxation System*, for $343,000, approved on 9 July 1996.

4 Supported under TA No. 2252-MON: *Strengthening Social Insurance*; for $84,000, approved on 20 December 1994; TA No. 2279-MON: *Strengthening Health Insurance*, for $500,000. approved on 29 December 1994; and TA No. 2371-MON: *Administrative Reform of Social Insurance*, for $900,000, approved on 28 July 1995.

expenditures is also being pursued.[1] To mitigate the possible negative effects of a more contractionary fiscal policy on lower income groups, the Government has formulated a national poverty alleviation program.

2. Monetary Policy

8. Monetary policy has aimed at containing credit expansion to a level consistent with the Government's inflation and external objectives. Tight monetary policy resulted in a sharp decline in the growth of broad money, from 79 percent during 1994 to 33 percent in 1995. The money supply grew at 19 percent during the first six months of 1996. Efforts are being made to gradually abolish direct monetary control and increase reliance on open market operations. However, in the absence of a developed institutional framework for indirect monetary control, Mongolia has relied on direct instruments – including reserve requirements and quantitative limits on bank lending to nonbanks – to regulate monetary and credit expansion.

9. The system of reserve requirements was streamlined during 1993 and 1994. In 1993, reserve requirements on tugrik deposits were unified and consolidated across all commercial bank branches and regulations on the calculation and management of reserve requirements were issued. Reserve requirements are now equivalent to 17 percent of deposits in commercial banks during the previous month. Foreign currency deposits are not included. However, many commercial banks have regularly failed to meet minimum reserve requirements and six of the 12 commercial banks, including four of the five largest banks, violated the minimum reserve requirement in the first quarter of 1996. By July 1996, the liquidity position had deteriorated further.

10. The introduction of central bank bills in November 1993 marked the start of BOM's efforts to develop indirect instruments for monetary management and to develop the money market over the medium term. Initially, Tug1 billion in bills, with a maturity of three months and carrying a monthly interest rate of 11 percent, was issued. As inflation fell, monthly interest rates declined to 5.2 percent in December 1995, and 4.75 percent in the first quarter of 1996. A Dutch auction system was introduced for the bills in November 1994: auctions are now held every two weeks and the maturity of the bills is two weeks. Although these bills have helped reduce liquidity, their usefulness for monetary and liquidity management has been hampered by a less-than-transparent allocation process and the absence of a well developed legal framework for Government debt instruments. To address this problem, a Law on Bills was passed in November 1995 and this will help efforts to develop the market for Government debt.

11. BOM continues to impose credit ceilings on each commercial bank to ensure compliance with the broad money program under the ESAF. In January 1996, monthly credit ceilings were fixed for each bank for 1996, and a system of rewards and penalties was

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[1] The Bank is playing a leading role in rationalizing and improving efficiency in the health and education sectors and has provided support through TA No. 1801-MON: *Human Resources Development and Education Reform*, for $535,000, approved on 11 December 1992; TA No. 2228-MON: *Education Development*, for $400,000 approved on 9 December 1994; TA No. 2414-MON: *Health Sector Development*, for $600,000, approved on 3 October 1995; and TA No. 2659-MON: *Restructuring and Staff Rationalization*, for $70,000, approved on 7 October 1996.

introduced.[1] Some commercial banks have breached these credit ceilings, but data for the first half of 1996 indicate that overall there has been an improvement.

12. The portfolios of most commercial banks include a low level of liquid assets and a preponderance of loans to large State enterprises, many of which are nonperforming. To overcome liquidity problems, BOM has provided (i) resource deficiency loans to support special economic activities; (ii) settlement clearing loans to meet banks' short-term liquidity needs associated with payments clearing; and (iii) general liquidity support on a case-by-case basis. BOM no longer gives resource deficiency loans but banks still have relatively easy access to liquidity through clearing loans, which are provided through BOM's clearing and settlement window. The amount of these loans is limited to 20 percent of a bank's paid-up capital, the interest rate is currently 9 percent per month and the loan maturity is five days.

13. Given the negative implications of clearing loans for liquidity management and for the development of the interbank market, the Government has taken steps to (i) develop a reserve money program (in which the permissible increase in liquidity is determined); (ii) abolish the open-ended use of the BOM clearing window and avoid directed credits; and (iii) develop a new BOM refinance facility through which predetermined amounts of liquidity can be injected and central bank bills can be used for fine tuning the level of liquidity. A regular refinance facility was introduced on 1 March 1995. Under this facility, a predetermined amount of BOM credit with a maturity of seven days is auctioned every week. To limit problems associated with moral hazard and adverse selection, each bank has its own credit ceiling and there is a minimum (average) monthly interest rate of about 7 percent. The refinance facility and the reserve money program have helped strengthen the framework for indirect monetary management by BOM.

14. Interest rates in Mongolia have been generally liberalized over the last five years, although until recently there was a minimum interest rate on deposits. Commercial banks were paying annual interest rates of about 48 percent on domestic currency deposits with a maturity of less than one year and between 12 and 42 percent on foreign currency deposits with the same maturity. In October 1996, the minimum rate was removed and interest rates have fallen to about 36 percent per annum for most banks. Lending rates charged by commercial banks range from 60 percent to 180 percent annually. Some interest rate subsidies still exist, and until recently nonbank financial institutions, continued to lend at preferential interest rates.

3. External Policies

15. The reduction of controls and barriers on foreign trade and adoption of a market-determined exchange rate regime have opened the economy to the rest of the world. Mongolia's adoption in 1995 of Article VIII status under the IMF, which binds member countries to current

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[1] The agreements state that banks will be penalized by 1 percent of the exceeded amount if they violate the credit ceiling. Those banks that remain within the credit ceiling will be rewarded by 1 percent provided minimum reserve requirements are not violated. If a bank observes the credit ceiling and minimum reserve requirement during the first half of 1996, its credit ceiling will be removed. The ceiling will, however, be reimposed if minimum reserve requirements are violated for one or more months during the second half of the year.

account convertibility, marked a major step in the country's efforts towards external account liberalization.

16. Efforts have also been made to develop a legal framework more appropriate to the efficient functioning of a market-oriented economy. This has involved attempts to legalize private property ownership by individuals and firms and to support other changes in the economic structure.[1] The first phase of voucher based privatization of SOEs has been completed and cash privatization initiated.[2]

17. The new Government is committed to faster reform and has demonstrated its commitment by implementing several important reform measures during its first few months in office. These include raising power and heating tariffs by 60 percent, raising petroleum prices, and enacting two new banking laws.

18. Further reforms are expected to include: restructuring the civil service and reducing staff levels, accelerated privatization, and reform of the banking sector, which accounts for the bulk of financial sector assets in Mongolia. These issues will be covered in a stand-by arrangement, which is expected to be considered by IMF's Board in early 1997. The Government has placed priority on financial sector and enterprise reform and IMF has made it clear that developing a sound plan for restructuring the banking system in conjunction with further enterprise reforms is a precondition for concluding a stand-by arrangement. The Government and IMF are looking to the Bank and the World Bank, respectively, to provide assistance in these areas.

4. The Importance of Financial Sector Reforms

19. Financial sector reforms will contribute to macroeconomic stability, and are a crucial component of the ongoing structural adjustment in Mongolia. A well developed and efficient financial sector performs the key economic functions of mobilizing savings, protecting savings and allocating resources to their most productive use. The Mongolian financial system is at present unable to perform these functions adequately. Commercial bank deposits in Mongolia represent only 25 percent of GDP compared with about 40 percent in the Philippines and 76 percent in Malaysia. Total banking sector assets are about 25 percent of GDP in Mongolia compared with levels of 279 percent in the United States, 126 percent in Thailand, 86 percent in the Philippines and 74 percent in India. These ratios reveal significant levels of financial disintermediation, with the banking sector providing limited support for the development of other sectors.

20. Like other centrally planned economies, Mongolia inherited a Soviet-style monobanking system in which all banking business was conducted by the State Bank of Mongolia. The monobank acted as a cashier to the Government and allocated financial resources to (inefficient) industries according to Government directions within the framework of a credit plan (the financial counterpart of the physical plan specifying output targets) and not on the basis of

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1 The Bank has assisted the process of legal reforms through TA No. 1930-MON:*Developing Mongolia's Legal Framework*, for $500,000, approved on 17 August 1993.

2 The Bank has supported privatization efforts through TA No.1989-MON:*State Privatization Commission*, for $490,000, approved on 22 November 1993.

commercial considerations. The financial system was not designed to respond to price signals and interest rates were administered.

21. Mongolia's financial sector reforms, which are a crucial part of the overall reform process, aim at creating a more decentralized, diversified and competitive financial sector, which is capable of mobilizing and allocating financial resources in an efficient and effective manner to serve the needs of a market economy. The shift from the monobank system to a two-tiered banking system and the divestiture of commercial banking operations from the former State Bank of Mongolia, the monobank, in 1991 was a first step in this process. The banks that resulted from the breakup of the monobank inherited large numbers of nonperforming loans and subsequently provided loans to enterprises at the direction of the Government. In addition, these banks have large numbers of nonperforming "own-made" loans. This has adversely affected the solvency and stability of the Mongolian banking system and banks are unable to meet acceptable financial and prudential norms.

22. Extensive operational and financial restructuring reforms of commercial banks are required. These will cover banking practices and skills, and the policy, legal, regulatory and supervisory framework governing the banking sector for the Mongolian banking sector to reach internationally acceptable financial and prudential norms. New institutions and policy instruments must be created, and new skills developed for Mongolia to develop a commercially oriented, competitive and efficient financial sector. The reforms will take time and involve high learning and other costs.

B. Recent Economic Performance

23. The Mongolian economy has emerged from the serious economic crisis that followed the collapse of the CMEA. In 1994, the economy grew by 2.3 percent (see Appendix 2, table 1) and in 1995 by 6.3 percent. Growth in 1995 was based on 14.5 percent growth in the industrial sector, 4.2 percent in agriculture and 0.2 percent in the services sector. However, service sector growth is believed to be an underestimate due to inadequate coverage of the emerging and dynamic private services sector.[1] During the first half of 1996, GDP grew by 0.8 percent and is expected to grow by 3 percent on an annual basis in 1996. The industrial growth rate fell to 0.8 percent in the first half of 1996 because of: (i) a 30 percent decline in international copper prices; (ii) a decline of between 10 and 15 percent in cashmere prices; (iii) disruptions in power supplies; (iv) a decline in earnings from tourism due to steppe fires and a cholera outbreak; and (v) severe liquidity problems in the banking sector. Although still high, the 57 percent inflation rate during 1995, was lower than in previous years, and in the first seven months of 1996 inflation fell to 28 percent. Inflation is expected to rise in the second half of 1996 as a result of: (i) increased energy prices; (ii) further depreciation of the tugrik; and (iii) increased borrowings from BOM by the Government to cover revenue shortfalls. Inflation for the whole of 1996 is forecast to be about 53 percent.

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[1] The Bank is helping the State Statistical Office to strengthen the statistical system and convert the national accounts to the UN system under TA No. 1811-MON: *Improving and Strengthening the Statistical System* for $500,000, approved on 22 December 1992.

24. Total tax revenues increased by 48 percent in 1995 with revenues from direct taxes, which were first introduced in 1991, increasing by 53 percent. This enabled the Government to generate a current budget surplus of 4.2 percent of GDP in 1995, compared with 1.3 percent in 1994.[1] The budget position in the first half of 1996 has been constrained by the decline in copper earnings and delays in the cash privatization program. The fiscal situation in 1996 is expected to deteriorate with the overall fiscal deficit reaching about 12 percent.

25. Exports increased by 31 percent in 1995 reaching $482 million, and imports grew by 35 percent – the first increase since the onset of reforms. Although the current account deficit increased from 5.8 percent of GDP in 1994 to 6.8 percent in 1995, this was more than offset by external capital flows, most of which were on concessional terms. The current account deficit is expected to deteriorate further in 1996 because of declines in earnings from exports and tourism.

26. Net international reserves with BOM increased from a low of $4.6 million in 1992 to $70 million at the end of 1995. However, by the end of June 1996 net reserves had fallen to $53 million. Despite the adoption of Article VIII status (see para. 15) and minimal central bank intervention in the exchange rate markets, the tugrik depreciated by only 8.7 percent against the dollar during 1995. At the end of 1995, the exchange rate was $1 to Tug 448. The exchange rate has depreciated further during 1996 and by November it was $1 to Tug 620. The situation in the banking sector has put pressure on the exchange rate.

27. To the extent that economic recovery and positive growth are sustained, the poor are likely to benefit through increased employment opportunities, higher productivity, and rising incomes. Over the short term, however, there have been some costs in terms of human development. According to official data, there was no poverty in Mongolia before 1990, basic needs were met, and access to a full range of social services was guaranteed. By 1994, about 26 percent of the population was living below the poverty line.[2] Registered unemployment grew from 55,407 in January 1992 to 72,542 in 1994 but in 1995 it declined to 66,000. Cuts in social spending, as a result of fiscal constraints, resulted in a deterioration of health and education services, as reflected in the following indicators: the number of students (in all types of educational institutions) declined from 266 per thousand persons in 1989 to 175 in 1994; the number of physicians fell from 29 per ten thousand persons in 1990 to 27 in 1994; the number of medical personnel of medium rank declined from 92 per thousand persons in 1990 to 75 in 1994; and the maternal mortality rate increased from 12 per thousand live births in 1990 to 21.2 in 1994.

C. Coordination with IMF and World Bank

28. Despite initial difficulties, the second annual arrangement for 1995 under the ongoing ESAF was successfully completed. The IMF board approved the review of the second annual arrangement in February 1996 and cleared the implementation of the third annual arrangement. However, an IMF mission in March 1996 could not reach an agreement with the Government on structural conditions. Informal quarterly quantitative performance targets were therefore established, all of which were achieved during the first half of 1996. A new IMF

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1 Mongolia is the only transition economy to have achieved public savings of this magnitude.

2 The poverty line in late 1993 was Tug3,200 ($8) per person per month for urban areas and Tug2,900 ($7.20) per person per month for rural areas.

arrangement is expected to be finalized by December 1996 and to be submitted to the IMF board in January 1997.

29. IMF, as part of its overall strategy to achieve monetary and fiscal stabilization and bring down the inflation level, has provided technical assistance and guidance to the Government for banking sector reforms since 1990. IMF's efforts have focused on strengthening BOM's capability to supervise commercial banks, lay down and enforce prudential norms, increase efficiency of the inter bank clearing system and restrain growth of the money supply. In 1996, IMF provided advice on how to handle the emerging lending crisis in the short term. By participating in IMF missions and exchanging documents, the Bank has maintained close coordination with IMF's stabilization program in Mongolia, particularly with IMF's activities relative to the central bank, and has liaised closely with IMF concerning the proposed reforms in the banking sector. The proposed technical assistance to BOM for the strengthening of its supervision department was designed in consultation with IMF to ensure complementarity of efforts in this area.

30. Bank technical assistance activities in the commercial banking sector have been coordinated with IMF and the World Bank, which has also provided some technical assistance to commercial banks and supported institutional capacity building for legal reforms and SOE restructuring. This has involved sharing of reports and related documents and ensuring overlapping of missions and thereby allow for coordination in the field. Policy measures included in the Government's program for banking sector and SOE reforms have emerged as a result of policy dialogue between the Bank, the World Bank, IMF and the Government. Successful financial sector reforms will require parallel efforts to reform enterprises to ensure that problems in enterprises do not result in the nonrepayment of bank loans in the future. To ensure donor coordination, the Government has agreed that the Bank will play the lead role in the financial sector and the World Bank will play the lead role in enterprise reform.

31. The World Bank is undertaking a program that focuses on areas related to SOE restructuring and the completion of legal reforms required to facilitate the restructuring of enterprises and commercial banks. The World Bank plans to make available $15 million of International Development Agency (IDA) funds in the first quarter of 1997 to support this program of legal and state enterprise reforms. This will complement the Bank's assistance to promote financial sector reform.

D. Medium-term Prospects

32. Uncertainties associated with the wide ranging policy and structural reforms that characterize the process of transition from central planning to a market economy make it difficult to forecast the medium term prospects in transition economies. The necessary assumption for any forecast of future economic performance is that macroeconomic stability will be maintained and the structural reform program will be pursued with as much commitment as has been evident in Mongolia during the past two years. The successful completion of financial sector and State enterprise reforms is essential for building public confidence in the market based system and for increasing the levels of private sector investment, both domestic and foreign. Given that macroeconomic stability and commitment to structural reform are maintained, the economy is expected to grow at an annual rate of between 3 and 4 percent between 1996 and 1998. Annual inflation is forecast to be about 40 percent in 1996 and decline during the next two years to

between 10 and 15 percent. With the acceleration of cash privatization and a further broadening of the tax base, current revenues are projected to increase to 32 percent of GDP in 1998. This will help increase the current budget surplus to 5.9 percent of GDP in 1997 and 6.5 percent in 1998. The overall budget deficit is anticipated to fall to 10 percent of GDP in 1998. With greater liberalization of the current account and sustained growth of GDP, the current account deficit is forecast to widen to 10 percent of GDP in 1998. Continued external assistance will be required to meet Mongolia's investment needs. Mongolia needs to build up net international reserves to a level of eight weeks of imports implying net international reserves of nearly $90 million by 1998. With continued good economic management and external support, Mongolia should be able to achieve this level with the growth of its exports and external capital inflows. Given the concessional nature of Mongolia's external debt liabilities, debt servicing levels are expected to remain within acceptable levels and to be less than 11 percent of exports at the end of 1998.

IV. THE FINANCIAL SECTOR AND THE PROGRAM

A. Structure of the Financial Sector

33. The financial sector in Mongolia is dominated by the banking sector. At the apex is the central bank (BOM) which is responsible for maintaining monetary stability and supervising the operations of commercial banks. There are now 12 commercial banks – five large banks and seven smaller banks.

34. Efforts to develop a decentralized and diversified banking sector were initiated in late 1990, when BOM and the five large commercial banks (Ardyn Bank, Bank for Investment and Technological Innovation (BITI), Trade and Development Bank (T&D Bank), Agricultural Bank and Insurance Bank) were established as spin-offs from the monobank. Specific assets and liabilities of the monobank were allocated to each of the banks. Together, these banks control 90 percent of the Tug119 billion total banking sector assets, 93 percent of the Tug93 billion total banking sector deposits, and 89 percent of the Tug68 billion total loans of the banking system. Although each of the five large commercial banks had a specific orientation at its establishment and continue to perform specific functions, there is no legal restriction to diversification.

35. Ardyn Bank is Mongolia's largest bank in terms of total assets and accounts for about 29 percent of the total assets of the banking sector. It has 127 branches and offices, 1,500 staff and 325,000 customers. It also accounts for the largest share of total – both Government and non-Government – deposits of any commercial bank. Ardyn Bank acts as the Government's agent for pension fund payments and other budgetary funds. It inherited the monobank's household savings deposits, which gave it access to low-cost funds for expanding its lending operations. It is a retail bank and is active in all economic sectors.

36. The T&D Bank, which accounts for about 23 percent of total banking sector assets, concentrates on international business activities, in particular trade finance. About 40 percent of its assets consist of demand and time deposits in foreign banks. The T&D Bank finances about 60 percent of the banking system's foreign currency loans, which are funded through foreign exchange demand deposits and foreign borrowings. T&D Bank has three branches and 79 employees.

37. BITI also accounts for 23 percent of banking sector assets and is a major lender to larger industries. Its main clients include mining and energy industries and it provides most of the finance for the country's gold mining operations. Its clients account for about 80 percent of the country's exports and it handles about 60 percent of Mongolia's foreign exchange transactions. It has 40 branches, including one in each *aimag* center, and 725 employees.

38. With a countrywide network of 22 branches and 319 sub-branches, the Agricultural Bank's activities include distributing pensions, paying salaries and administrative expenses on behalf of the Government, and providing farm loans and credit and deposit services to clients in cities, *aimags* and *sums*. Agricultural Bank's assets account for about 10 percent of total banking sector assets. Its main customers are rural enterprises and rural households.

39. Insurance Bank, the smallest of the five major banks, accounts for about 5.3 percent of total banking sector assets. It has 30 branches and 252 employees and primarily provides loans to enterprises in the service sector.

40. Much of the banking sector has been nominally privatized and of the five large banks, only T&D Bank is fully owned by the State. However, much of the capital of Ardyn Bank, BITI and Insurance Bank is still held either directly by the Government or by partially privatized SOEs. About 44 percent of the shares of the Ardyn Bank are State-owned either directly by Government or indirectly by State dominated enterprises. Three of BITI's principal shareholders are SOEs (Erdenet, Neft Import Company and Central Energy System) which together control about 69 percent of the paid-up capital. About 69 percent of the total outstanding shares of Insurance Bank are held by the Government, either directly or indirectly (with the Insurance Company holding about 30 percent). By contrast, only 3 percent of the shares of the Agricultural Bank are owned by the Government. The remaining ownership is widely dispersed among 200 shareholders.

41. The small private banks have grown quickly and their share in total banking sector assets increased from less than 5 percent in September 1994 to about 10 percent in June 1996. Their share in total deposits stands at about 7 percent, and their share in loans at 12 percent. Most of the private banks increased their capital in 1995 to meet BOM's new minimum capital requirements. A high percentage of their assets is financed by shareholders' equity contributions. Most of the small banks have high loans to deposits ratios of over 176 percent. The other major source of funds is household time and savings deposits.

42. The five large banks fund themselves mainly through deposits (about 80 percent), with the balance consisting of BOM borrowings, foreign borrowings and equity. About 46 percent of bank deposits are held by individuals in the form of savings and time deposits.[1] Government deposits account for about 18 percent of deposits and enterprises account for 36 percent.

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[1] Time and savings deposits of below Tug100,000 account for about 20 percent of total deposit base, deposits from Tug 100,000 to Tug500,000 for about 20 percent, deposits from Tug500,000 to Tug1,000,000 for about 13 percent, deposits from Tug1 to 3 million for about 19 percent and deposits in excess of Tug3 million for about 28 percent. About 85 percent of the 440,000 household deposits accounts are below Tug100,000 and about 12 percent are between Tug100,000 and Tug500,000.

43. Another element of the financial sector is the securities market, which is in its initial stages of development following mass privatization through a voucher-based system. The Mongolian Stock Exchange (MSE) was opened in February 1992.[1] Secondary trading began on 28 August 1995, following the passage of the Securities Law in September 1994. Currently, 422 companies are listed on the MSE and trading is arranged through 28 licensed brokerage firms, all of which have been privatized. About 30 stocks are actively traded. Total market capitalization was Tug13.7 billion ($24 million) on 31 August 1996 and the average daily trading volume was Tug27.2 million ($49,000) during August 1996.

44. In addition, the Government has initiated efforts to develop non-bank financial institutions (NBFIs). In 1995 and 1996, licenses were granted to four domestic investment funds, including a construction fund. The total assets of these funds are currently about Tug1 billion ($2 million). While mutual funds were established in 1991, they currently exist as divisions of brokerage firms and hold unused vouchers from the privatization program.[2] The vouchers held by the mutual funds will be used to buy shares in enterprises. During 1996, these funds will be separated from the brokerage companies and the 28 mutual funds will act as independent entities. In the longer term, it is expected that they will operate as full-fledged mutual funds, thus assisting in savings mobilization. There are no regulations prohibiting the operations of foreign banks in Mongolia and a Malaysian finance company was given an investment banking license in July 1996.

B. Performance of the Banking Sector

45. The financial position of most commercial banks in Mongolia is unsatisfactory. With the breakup of the former State Bank, the commercial banks inherited a portfolio of loans that had been made to State enterprises based on the requirements of the former centrally planned economy. Such loans were not based on commercial considerations. Subsequently, the banks were directed, by the Government, to provide loans to enterprises, usually because these enterprises were subject to price and output controls. These "inherited" and "directed" loans, which account for 20 percent of total loans, are now largely uncollectible.

46. More than half of the banking system's "own-made" loans are problem loans. This reflects (i) continued external interference with banks' lending decisions, (ii) lack of accountability of bank management, (iii) lack of proper credit skills and systems, (iv) lack of reliable financial information on bank borrowers, and (v) inadequate accounting standards that recognize accrued interest on nonperforming loans as income. Portfolio problems are compounded because nonperforming loans are routinely rescheduled by the banks. Viable borrowers do not repay their loans because they do not expect to be given new loans. Banks increase lending rates in an attempt to achieve profitability thereby crowding out other potentially viable borrowers. Legal and regulatory impediments to debt recovery have hindered recovery efforts of banks. The debt-

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1 The Bank assisted the operationalization of the Mongolian Stock exchange by providing: TA No. 1536-MON: *Adviser to Mongolian Stock Exchange* for $100,000, approved on 17 July 1991; and TA No. 1542-MON: *Training for the Mongolian Stock Exchange* for $95,000, approved on 24 July 1991.

2 Under the mass privatization program, vouchers were distributed to the population free of charge. These vouchers were then used to bid for shares in state enterprises.

service capacity of borrowers has been impaired due to adverse economic and monetary conditions.

47. The existence of high interest rate margins enabled banks to cover some of their loan losses. At the end of 1995, commercial bank lending rates averaged about 8.5 percent per month. The average cost of funds was about 3.5 percent per month, but varied among banks depending on the composition of their funding base. Some banks have also benefited from having access to cheap enterprise (1-2 percent interest per month) and Government (on which no interest was paid) demand deposits.

48. The liquidity level of most banks is precarious. In June 1996, only seven out of 12 banks met the liquidity ratio of 20 percent set by BOM. Of the five largest banks, only the T&D Bank has sufficient liquid assets in relation to its deposit base. Although loan to deposit ratios for banks have come down from 80 percent on average in July 1995 to 73 percent in June 1996, this is still too high considering the unsatisfactory level of asset quality. Banks have increasingly relied on BOM for liquidity support.[1]

49. Available financial data do not provide a clear indication of the financial position of the banks. The Bank, through technical assistance, has played a leading role in clarifying the financial position of the five major banks. A summary of the financial position of the commercial banks, based upon information reported to BOM as of 30 June 1996, Bank-financed portfolio audits and best estimates by Bank staff regarding asset quality, is given in the following paragraphs.

50. *Ardyn Bank's* capital and liquidity positions have been inadequate and it has consistently failed to comply with reserve requirements, credit ceilings and the prudential guidelines of BOM. Substituting the directed and inherited loan portfolio with interest-bearing Government securities will not resolve the financial condition of the bank. In September 1996, Ardyn Bank was put into conservatorship as (i) it could not meet withdrawal requests by depositors without additional liquidity support from BOM, (ii) existing management did not have the skills to manage a commercially oriented bank, and (iii) it was considered unlikely that Ardyn Bank could restructure itself to generate sufficient earnings over the next three years to achieve minimum capital adequacy standards required under the Program without substantial additional capital injections from the Government. The conservatorship was terminated after 30 days due to public criticism.

51. *Trade and Development Bank (T&D Bank)* reported after tax profits of Tug599 million for the year ending 31 December 1995 after adequate provisioning for loan losses. T&D Bank has the strongest financial position of any of the five major banks mainly due to its low-cost funding base of current accounts, foreign borrowings and share capital, a relatively sound loan portfolio, and a high share of profitable foreign exchange transactions. Of the five major banks, T&D Bank is the only one to comply with BOM's liquidity ratio requirement and be sufficiently capitalized. T&D Bank consistently complies with the prudential norms established by BOM. The

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[1] As of 30 June 1996, BOM loans accounted for about 12 percent of total liabilities of commercial banks.

resolution of the inherited and directed loan portfolio would further improve the capitalization of T&D Bank and would help to ensure its long-term financial viability.

52. *BITI* reported after tax profits of Tug1,003 million for the year ending 31 December 1995. Refinancing of the directed and inherited debt will improve its capital position, but by itself would not enable it to meet the capital adequacy standards stipulated under the Program. BITI currently has liquidity problems. The liquidity ratio is only half that required by BOM and the bank consistently fails to comply with BOM's reserve requirement. BITI needs to improve its liquidity management by better matching the maturities of its assets and liabilities.

53. *Agricultural Bank* reported after tax losses of Tug1,537 million for the year ending 31 December 1995, and a negative capital position as at 30 June 1996. Agricultural Bank has Tug3,571 million of directed and inherited debt which accounts for 30 percent of its total assets. Refinancing of directed and inherited loans will improve the overall financial position of Agricultural Bank, but to guarantee the bank's long-term financial viability further steps will be necessary. Agricultural Bank continues to operate non-profitable branches as part of its mandate to act as the Government's payment agent. It is compensated through large interest-free Government deposits, although the extent to which the provision of these funds fully compensates for costs incurred is unclear and other banks also benefit from Government deposits but are not obliged to provide services. Significant financial and organizational restructuring will be necessary to improve the bank's long-term prospects.

54. *Insurance Bank* reported after tax losses of Tug239 million for the year ending 31 December 1995. This compounded already severe solvency problems. It is not complying with BOM's reserve requirement, credit ceilings or prudential guidelines. It has, however, continued to make working capital loans using loan repayments to make new loans. Resolving the directed and inherited loan problem would have little effect on the overall financial position of Insurance Bank.

55. The poor performance of most of the large banks and recurring liquidity problems means that the public is losing confidence in the banking system. Commercial banks are frequently unable or unwilling to honor depositors' requests to immediately withdraw funds. This is reflected in decreases in the deposit base of commercial banks in real terms despite increases in deposit rates. From January to June 1996, bank deposits declined by about 40 percent in real terms and lending fell by 47 percent in real terms.

56. In Mongolia there have been no recognized procedures for handling bank liquidation. In 1994, two insolvent banks were merged under BOM directives with larger banks. This adversely affected the profitability of the recipient banks. In July 1996, BOM closed the Central Asian Bank, a private bank with assets of $3 million. The uncertain legal environment existing at the time of the closure prevented BOM from taking the necessary actions to close down and liquidate the bank in an orderly manner. As no contingency plans for compensating depositors were in place, there were public demonstrations of depositors. The closure further damaged public confidence in commercial banks.

C. Constraints

57. Mongolian commercial banks are experiencing severe financial problems. This is contributing to a loss of public confidence in the banks and is having an adverse impact on their ability to provide credit. The banking sector has substantial negative net worth. This is because of (i) deficiencies in the legal and regulatory framework governing the banking sector's operations, (ii) impediments in the financial intermediation process, and (iii) the lack of skills and systems within the commercial banks and BOM. Reforms in the following areas will be required if the sector is to play the appropriate role in allocating resources.

1. Legal and Regulatory Impediments

58. The legal and regulatory framework governing the operation of commercial banks has been weak. When Mongolia embarked on its transition to a market economy, there were no banking laws or comprehensive legal property rights, and accounting, auditing and other information systems were not consistent with the needs of a market economy. Competition did not exist and the concept of bankruptcy was unknown. Consequently, the entire body of commercial and property law needed to be written. In April 1991, Parliament passed the first Banking Law, which established BOM as the central bank and defined its role; it contained only one sentence on bank supervision. Commercial bankers resisted the efforts of BOM to obtain information, to regulate lending behavior and generally to supervise their operations.

59. The Banking Law was subsequently amended three times in October 1992, November 1993 and January 1995. The amended law (i) recognized that interest rates should be determined in the market, (ii) contained a more substantial section on banking supervision, (iii) recognized that commercial banks have responsibilities to depositors, and (iv) recognized the importance of prudent banking practices. BOM was also given greater regulatory powers in laying down prudential norms. The law provided for a minimum capital requirement of Tug400 million ($0.7 million) for opening a bank.

60. Notwithstanding these efforts, the legislative framework remained inadequate for BOM to perform its regulatory and supervisory functions. BOM was not able to enforce prudential norms, monthly credit ceilings or minimum reserve requirements under existing laws and this contributed to the poor financial condition of the banks. A major part of the Bank's policy dialogue focused on the need to improve the legal framework for the financial sector. The Bank provided assistance to help draft new legislation[1] and comments were provided by Bank staff on successive drafts.

61. On 3 September 1996, Parliament enacted two new banking laws: a central banking law and a commercial banking law. This new legal framework provides BOM with adequate regulatory and enforcement powers for the supervision of banks. In particular, the new legislation sets adequate exposure limits and other prudential norms, and confers on BOM the right to determine capital adequacy standards. The legislation also enhances BOM's enforcement powers and provides for fines and warnings for simple violations, and measures such as the

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[1] TA No. 2543-MON: *Development of Procedures for the Reconstruction and Liquidation of Insolvent Banks* for $100,000, approved on 19 March 1996.

removal of management and the issuance of cease and desist orders for more serious violations. The new legislation also addresses major gaps in the previous Banking Law concerning the closure and liquidation of banks by (i) providing a legal basis for establishing conservatorship and receivership for insolvent banks, (ii) giving BOM the authority to appoint a receiver to liquidate an insolvent bank, and (iii) classifying the prioritization of claims in the liquidation process.

62. Property rights of individuals and corporations and the provisions under which these can be transferred, subordinated or used as collateral to raise financial resources need to be defined in Mongolia. Systems for registering property (movables and immovables) need to be put in place. Without such a legal and institutional basis, it is difficult for commercial banks to establish adequate collateral security and this inhibits their ability to provide secured loans. Debt recovery is also constrained by the new Civil Code, which took effect on 1 January 1995. Provisions of the new Civil Code have been interpreted as placing severe limits on the amounts of default interest that can be collected when the principal sum is not paid when due. The Gesellschaft fuer Technische Zusammenarbeit (GTZ) and the World Bank are expected to assist in the preparation of the necessary legislation to deal with these legislative problems and provide advice on property and collateral registration.

63. Other legal weaknesses relate to institutional aspects. Mongolian courts do not have experience in bank related issues. The interpretation and enforcement of new laws relating to banking operations is difficult and significant human resource development efforts are needed to upgrade the capacity of the Mongolian judicial system in the area of commercial and banking law. The Bank and GTZ have provided technical assistance for this purpose[1] and, in the case of the Bank, future assistance for a training program for legal professionals is under discussion. An ineffective bailiff system considerably constrains the enforcement of court judgments in debt recovery cases. World Bank technical assistance plans to identify measures to improve the execution of judgments.

64. A closely related issue is the shortage of expertise within BOM to monitor bank performance, supervise operations and enforce regulations already in place. IMF has provided technical assistance in the establishment of the banking supervision function within BOM. Although progress has been made, substantial training for the Supervision Department of BOM is still required so that BOM is recognized by the banks as having the expertise and authority to supervise commercial banks.

65. Financial reporting by the commercial banks to BOM must be strengthened to facilitate the supervision of commercial bank operations. Current reporting practices fail to produce meaningful information on bank asset quality. Reporting requirements should include information on banks' loan collection and rescheduling practices. The November 1995 Law on Deposits, Settlements and Credit formalizes BOM loan classification and provisioning standards for commercial banks based on international practices. However, as banks are not able to claim tax deductibility for loan loss provisions, they have been reluctant to classify all of their nonperforming assets. In November 1995, to further improve the accuracy and transparency of

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1 RETA No. 5516: *Legal Training in Development Law* for $600,000, approved on 16 December 1992; and RETA No. 5640: *Institutionalizing Legal Training in Cambodia, Mongolia, People's Republic of China and Viet Nam* for $450,000, approved on 23 August 1995.

information on the financial position of banks, BOM approved new accounting standards (based on international standards) and guidelines for commercial banks for full compliance by December 1997.

2. Impaired Financial Intermediation Process

66. The relatively good performance of T&D Bank suggests that bank governance and good management are more important at this stage in Mongolia than the issue of ownership. After nominal privatization, the commercial banks continued to act as channels for credit extended under Government directives in support of priority sectors and projects. BOM provided commercial banks with loans at preferential interest rates under its resource deficiency lending window to finance some of this lending.

67. Even with the ending of formal directed credit in 1994, bank managers have come under pressure to make loans to connected enterprises in the agricultural and industrial sectors. Further, the decentralized nature of the large banks has given substantial discretion to branch managers and made credit decisions susceptible to political pressures from local governments. As a result of these pressures, commercial banks have not assumed full responsibility for their financial position.

68. There are other noncommercial factors that influence bank lending decisions. In many banks, shareholders treat the bank and its paid-up capital as a ready source of liquidity and commercial banks regularly lend large amounts to their shareholders. In most countries such lending is considered a conflict of interest and is strictly controlled.

69. Although commercial banks' lending rates are now largely deregulated and market determined, distortions remain with regard to their access to, and cost of, funds. These distortions include (i) provision of substantial interest-free deposits of the Government to selected banks with the aim of improving their liquidity and profitability, and (ii) BOM's stipulation of minimum deposit rates on time and savings deposits.

70. BOM has taken several steps to rationalize its interest rate structure in line with monetary and market conditions. To give demand and supply factors a greater role in the determination of interest rates, regular auctions of central bank bills were started in 1995. The market in central bank bills remains thin, partly because no discount facility exists. The central bank bill rate has served as a benchmark for the interbank market. The development of the interbank market has been hindered due to the existence of a BOM clearing window, which guaranteed banks unlimited access to liquidity and amounted to an implicit BOM guarantee on interbank lending. BOM discontinued open-ended use of the clearing window by restricting borrowing to 20 percent of banks' paid-up capital. In March 1995, BOM started to provide liquidity support to the banking system through an auction based refinance facility. To prevent banks from relying on the refinance facility for funding rather than the interbank market, BOM has stipulated credit ceilings for each bank and a minimum interest rate, and limited maturity to seven days. This facility is intended to replace the BOM clearing window after the interbank payments system becomes more efficient.

71. Non-bank financial institutions such as the Privatization Fund and State enterprises have provided loans at interest rates that are substantially below the rates charged by banks. There are plans to develop channels for subsidized and preferential credit outside the banking system in the form of regional development and sector funds. Some bilateral donors are also encouraging the Government to use such mechanisms for subsidized, directed credit. Such NBFIs can potentially undermine the banking system. Regulations governing NBFIs need to be developed. The Bank's policy dialogue has stressed that all financial institutions involved in lending activities should be regulated by BOM to ensure a coherent and balanced development of the financial sector. The new central banking law provides BOM with regulatory and supervisory powers over NBFIs engaged in banking-type activities such as lending and financial leasing.

3. Institutional Weaknesses

72. For commercial banks in Mongolia, a competitive and commercial management culture has not yet been established. Commercial banking practices are radically different from those of a monobank system. It takes time to change behavior and develop the necessary skills and systems that are taken as given in a market economy. BITI and T&D Bank are more commercial in their approach and have been able to attract qualified managers by adopting competitive remuneration policies. There is, however, a shortage of qualified managers in the banking system and the limited number of well-qualified professionals is thinly spread.

73. Banks have only recently begun to develop business plans. Credit policies and credit appraisal techniques are inadequate. Once loans are made, monitoring and portfolio management are weak. Most banks do not have separate loan review departments and workout units have only recently been established. Internal control and management information systems are rudimentary, and accounting systems have not been fully converted to international standards. These problems have been compounded by the weaknesses in the regulatory and policy environment. The entry of a reputable international bank and making bank management accountable for performance, strictly enforcing the prudential norms and requiring shareholders to bear the financial costs of bad loans would help to bring about the desired changes.

74. Development of bank systems and upgrading of skill levels in commercial banks have been supported by the Bank[1], the World Bank, United States Agency for International Development (USAID) and Kreditanstalt fuer Wiederaufbau (KfW). Further assistance is required to strengthen operational practices in the following areas: (i) credit appraisal and loan structuring, (ii) portfolio management and loan review, (iii) problem loan management and workout, (iv) asset/liability management, (v) corporate planning, (vi) conversion to international accounting standards, (vii) development of internal control systems, and (viii) design and implementation of management information systems. Such assistance would require significant resources and

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[1] TA No. 1855-MON provided initial training in credit administration for selected banks; TA No. 2105-MON provided assistance in the establishment of a bank training program at the Economics College and trained trainers from Ardyn Bank and Agricultural Bank; TA No. 2219-MON, provided assistance in the formulation of credit policies and in the conversion of accounting standards to BITI and Ardyn Bank; TA No. 2353-MON provided training in credit appraisal methodologies, loan review and workout, and initial training in asset/liability management for BITI and assessed the internal control systems for BITI and Ardyn Bank.

expertise from multilateral and bilateral sources over a period of several years. This will be a major area for technical assistance funded by the Bank under the proposed TA loan.

D. The Program

1. Objectives and Strategy

75. The Program is aimed at promoting the establishment of a sound, market-based financial system that can mobilize and allocate resources efficiently for economic growth. It supports the Government's efforts to introduce a policy, legal, and regulatory framework that encourages the development of a market-oriented banking system. This entails a shift in the role of Government from that of allocating credit to being responsible for the regulation of financial institutions that allocate credit according to commercial considerations. BOM will set and enforce prudential norms that encourage the prudent management of deposit-taking institutions and limit the specific types of risks of exposures. Ultimately, however, the viability of banks will be determined according to market forces.

76. In view of the serious financial situation of some of the major banks, the Government's short-term objective is to restore public confidence in banks. Restructuring the existing large banks is an essential element in this strategy because (i) the problems of these banks are so urgent and serious that they could collapse before the newly established smaller banks, which currently have a limited capital base, have time to build up market share; (ii) the only sound bank, T&D Bank, concentrates on trade finance and has little experience in general commercial banking operations; and (iii) the entry of reputable foreign banks that are interested in engaging in activities other than trade finance services appears unlikely at this stage.

77. Restructuring of the banking sector will entail the financial and operational restructuring of potentially viable banks and closure of nonviable banks. Most of the restructuring costs will be borne by the banks' shareholders and the Government. To the extent possible, such costs should be shouldered by the banks' existing shareholders, as most of the banks' financial problems are due to large volumes of non-performing loans made by these banks of their own volition without Government directive. To facilitate restructuring the Government has, in line with advice given by the Bank and the World Bank, decided to assume financial responsibility for directed and inherited bank loans. To preserve fiscal resources, the Government does not intend to bail out banks that do not have long-term viability. Such banks will be liquidated. Banks that are still insolvent after the substitution of directed and inherited loans, but have the potential for profitable operations, will be given time to downsize and earn their way out of their financial crisis in accordance with performance targets approved by BOM. Banks that fail to meet these targets and improve their financial performance and capital position to acceptable levels within a reasonable period will also be liquidated.

78. The Government, BOM and the commercial banks recognize that upgrading systems and skills is crucial for the successful implementation of financial sector reform. Substantial external technical assistance has been requested to build capacity and human resources in the banking system.

2. Policy Framework and Actions

79. The Program is also aimed at supporting the Government's medium-term strategy for financial sector development and reforms in the following areas: (i) improving the legal and regulatory framework for banking operations, (ii) strengthening BOM's capacity to supervise and enforce prudential norms, (iii) strengthening financial intermediaries through financial and operational restructuring, (iv) improving the operations and skills of the banks, and (v) establishing a financial intermediation process based on market conditions. The Program as a whole is set out in the form of a Development Policy Letter and a Policy Matrix in Appendix 3.

a. Legal and Regulatory Reforms

80. A major component of the Program is support for the establishment of a clear and well-defined legal and regulatory framework for the banking sector based on internationally accepted norms. The Program seeks to strengthen the powers and responsibilities of BOM in the supervision of commercial banks. In particular, it supports the creation of a legal framework that gives BOM the necessary powers to set prudential norms for commercial banks, take corrective action if banks do not comply with these norms, and terminate the operations of commercial banks on the basis of insolvency. Passage of new banking legislation that addresses these areas of concern was made a precondition for submission of the proposed loan to the Board. Not all existing banks will be viable and an important part of the Program is, therefore, to establish a framework for the liquidation of commercial banks. The Bank provided assistance in drafting the necessary provisions in the new banking law and BOM regulations.

81. The Program supports progressive introduction and enforcement of BOM prudential regulations based on international standards. It tightens exposure limits to one borrower, limits lending to shareholders, limits the holding of securities by banks and prohibits banks from engaging in stock market activities on their own account. In addition, the Program aims to establish a rate of 4 percent tier-one capital on the basis of Bank for International Settlements (BIS) standards by the end of the Program period and prepare the banks for ultimately achieving an overall capital ratio of 8 percent relative to risk weighted assets in line with the banks' and their shareholders' ability to generate additional capital. Although the Government is committed to meeting internationally acceptable capital adequacy standards, the current financial position of banks would necessitate massive capital infusion from the Government and shareholders if full BIS compliance (i.e. total capital of at least 8 percent of risk-weighted assets) were required during the Program period.

82. While well-conceived prudential regulations are important, they do not ensure a sound banking system. Realization of that objective requires adequate supervision of banks by the central bank to monitor compliance and to enforce applicable laws and regulations. Effective supervision hinges upon the development of staff and the provision of accurate and meaningful information to regulatory authorities. Although prudential standards in Mongolia have been developing towards international standards, the capacity to enforce these regulations has developed at a slower pace. More effective enforcement will require the sustained development of supervisory staff skills in BOM, the recruitment of additional staff, improved financial reporting requirements and the introduction of adequate bank accounting standards. These measures will be supported under the Program and under an associated TA (see para. 130).

83. To improve BOM's capacity to regulate commercial banks, the Program supports improved reporting requirements for commercial banks. The Law on Deposits, Settlements and Credit formalized loan classification and provisioning standards on the basis of numbers of days that loan principal repayments have become due. With Bank assistance, BOM prepared new accounting standards based on international standards and related accounting guidelines for banks (see para. 65).[1] The Program supports the conversion of commercial banks' accounting systems to the new standards to achieve full compliance of all banks by 31 December 1997. The capacity of the commercial banks to comply with the new standards will depend on whether tax authorities allow banks to use loan loss provisions as a tax deductible expense. The Program therefore supports the full tax-deductibility of loan loss provisions. The legal basis for this was established as a prerequisite for Board consideration of the proposed loan.

84. The Program not only strengthens the supervision of banks by BOM, but also improves corporate governance of banks by clarifying the responsibilities of directors and shareholders. The Program, therefore, provides that shareholders will not be allowed to withdraw their paid-up capital in banks other than through sale of shares. In addition, to increase transparency and enable depositors and shareholders to assess the financial position of banks more accurately, the Program promotes the publication of annual financial statements.

85. In view of the substantial portfolio problems of banks, the Program supports the improvement of the legal and institutional framework for security and debt recovery. Program measures include the removal of legal limits on debt recovery, the establishment of a legal framework governing secured transactions, an action plan for setting up a property registry, as well as changes in the Bankruptcy Law to recognize secured lenders.

86. While the Program focuses on banking sector reforms, it is important that NBFIs, commercial banks and other entities that engage in commercial lending are subject to a consistent legal and regulatory framework. The Program therefore supports the extension of BOM's regulatory authority to cover NBFIs engaging in commercial lending activities.

b. Banking Sector Restructuring

87. A central part of the Program will be to support the development of viable banks. This will entail financial and operational restructuring by commercial banks and the liquidation of insolvent banks. To deal with the immediate liquidity problems of the banking system, the Program supports the issuance of cease and desist orders for insolvent banks, specifying an interim program of remedial actions to be undertaken by 31 December 1996. Such orders were issued to Ardyn Bank, Insurance Bank and BITI in November 1996. Required actions include: (i) preparation of cashflow projections; (ii) stopping all lending except to viable customers with a sound repayment record, who have current deposit accounts with the bank and who are considered to have the capacity to repay the loans: (iii) establishing an adequately staffed loan workout department; (iv) establishing and implementing a loan collection strategy with monthly performance targets and targeting the largest borrowers; (v) preparing plans for the divestment of assets; and (vi) limiting lending authority to the Headquarters' credit committee and canceling all

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[1] Under TA No. 2219-MON, two bank accounting advisors were provided to advise BOM on the formulation of international standards and to train bank accounting staff in the implementation of the new standards.

other lending authorities. In addition, BOM reviews liquidity reserves of insolvent banks on a regular basis and the management are required to have weekly meetings with the management of BOM to report on progress.

88. The Program supports the improvement of bank credit and risk management policies and systems. In line with practices in most market economies, commercial banks will be required to adopt credit policies that are consistent with sound banking principles. It will be an important part of BOM's supervision role to monitor the implementation of such policies. In view of the substantial portfolio problems of banks, the Program endorses BOM's decision to prohibit banks from making new loans to borrowers in default. Any rescheduling of loans to such borrowers will only be allowed if feasible repayment schedules have been negotiated. Rescheduling agreements for loans above Tug10 million will be provided to BOM. In the context of its on-site supervision, BOM will assess the adequacy of bank risk management and internal control systems and make recommendations for changes as necessary. The Program will support the establishment of adequate financial risk management and control systems through technical assistance.

89. An important part of any financial rehabilitation of the major commercial banks will be the resolution of the problems associated with directed and inherited bank loans, which are classified as unrecoverable. The Government has assumed financial responsibility for these loans and support for this decision is a major rationale for the proposed loan. Specific loans which fall into this category were identified with assistance from the Bank and the World Bank. In addition, the Government has assumed responsibility for an Ardyn Bank loan of Tug2.95 billion to the Chinggis Khan Hotel.[1] The Government will substitute these nonperforming assets with interest bearing Government securities in January 1997. To preserve fiscal resources, and to avoid moral hazard problems and the recurrence of solvency and liquidity problems, any substitution of directed and inherited loans with interest bearing Government instruments will be conditional on the banks meeting BOM prudential norms and a tier-one capital ratio[2] of at least 2 percent relative to risk-weighted assets on the basis of international accounting standards. For banks that do not meet these conditions by 1 January 1997, the issuance of Government securities will be subject to them committing to undertake operational and financial restructuring measures that are designed to achieve adequate capitalization and compliance with prudential norms by 1 June 1998.

90. Restructuring will entail one or more of the following measures: (i) the banks downsizing themselves through a reduction of their lending operations and the divestment of nonproductive assets and/or closure of unprofitable branches; (ii) the banks developing and implementing loan recovery strategies; (iii) additional capital contributions from existing bank shareholders; (iv) the conversion of large deposits into shareholdings; and (v) the adoption of improved credit, risk management and control policies and procedures. Monitoring of the restructuring strategies will be the responsibility of the Bank Restructuring Unit that has been established within the Banking Supervision Department. The Bank has provided technical

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1 When the property was privatized the outstanding obligations to banks and other creditors were not transferred to the new owner.

2 Tier-one capital according to BIS norms includes stockholder equity and perpetual preferred stock and related surplus, but excludes other forms of perpetual stock and allowances for loan losses.

assistance in developing a restructuring strategy for Agricultural Bank.[1] This was formalized in a Memorandum of Understanding signed by BOM, the Ministry of Finance and the management of Agricultural Bank. A similar restructuring strategy has been developed by BOM for BITI.

91. The enforcement of receivership provisions for insolvent banks that make insufficient efforts towards meeting agreed performance and restructuring targets and/or that cannot be restructured into viable banks is included in the Program as a second tranche condition. To preserve fiscal resources, banks with little potential for long-term viability will be liquidated as soon as possible. Before resorting to full liquidation, other alternatives, that are less disruptive to the functioning of the economy and the banking system will be considered. Such alternatives include: (i) purchase and assumption transactions that involve another bank purchasing and taking over the failed bank's assets and liabilities, (ii) the establishment of a bridge bank, with the Government as temporary owner and administrator, that preserves the bank as a going concern, (iii) the transfer of deposits to other banks.

92. Two of the large banks that are insolvent, Ardyn Bank and Insurance Bank, have little long-term viability unless recapitalized and put under new management. The requisite recapitalization of these two banks would require substantial capital injections by the Government. The Government is not willing to recapitalize these banks, as it does not see any chance of finding qualified management teams who could turn these banks around in a manner that would ensure their future profitability. BOM has, therefore, decided to put Ardyn Bank and Insurance Bank into receivership in accordance with the new banking law. Three successor institutions will emerge from the receivership process to minimize the negative impact of bank closures on the financial system and the economy. A savings bank will be established to assume most of the household deposit-taking functions of Ardyn Bank and Insurance Bank. It will take over both bank's household deposits together with some of their liquid assets. An enterprise bank will receive the performing enterprise loans of the two insolvent banks, as well as their enterprise deposit base. An asset recovery agency will be established by the Government to collect on the non-performing loans of Ardyn Bank and Insurance Bank. Initially the receiver will sell all assets of the two failed banks to the recovery agency, in return for Government restructuring bonds. The receiver then transfers deposits and an equal amount of bonds to the savings bank and the enterprise bank. The recovery agency will sell liquid and fixed assets and performing loans to these successor banks and other banks against cash and bonds.

c. Improvements in the Financial Intermediation Process

93. The Program seeks to ensure that the financial intermediation process is primarily based on market signals and is not distorted by noncommercially motivated interference with lending decisions. It, therefore, aims at reducing the Government's direct involvement in the decisions of commercial banks. The Program supports the development of a strategy for the reduction of state shareholdings in commercial banks by implementing measures that improve the autonomy of banks and increase the accountability of bank shareholders and managers. The Program also supports the discontinuation of Government credit directives to BOM and other financial institutions. BOM will stop new lending to public enterprises and local governments. In

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[1] TA No. 2605-MON:*Development of Bank Restructuring Strategies*, for $100,000, approved on 9 July 1996.

addition, the Program seeks to prevent shareholders' exerting undue influence on credit decisions by restricting lending to shareholders to prudent levels.

94. To facilitate the establishment of market-based interest rates, the Program supports: (i) creation of risk-free interest rate benchmarks through the establishment of a BOM discount facility; (ii) use of credit auctions for BOM refinancing of commercial banks; and (iii) use of market-based interest rates on all deposits, including Government deposits. By increasing autonomy of commercial banks and reducing the role of the Government, the provision of preferential interest rates for State enterprises and priority sectors will stop. In addition, the Program will eliminate lending to enterprises by non-bank financial institutions such as the Privatization Fund, which has been providing loans to enterprises at noncommercial terms. The Program seeks to ensure that banks are adequately compensated for all services they provide in connection with the transfer and distribution of social security and budget funds. The Government has also agreed not to seek bilateral support for credit that would be provided to commercial enterprises at subsidized rates outside the banking system.

3. Capacity Building

95. Weak commercial banking skills and inadequate systems are a major impediment to the development of the financial sector and one of the main causes of the current financial problems of Mongolian banks. This is compounded by the weak supervisory capacity of BOM. Accordingly, institutional strengthening of the commercial banks, including the new savings and enterprise banks, and BOM is a key component of the Program and will be supported by extensive technical assistance.[1]

96. The Program will support the improvement of banks' credit and risk management policies and systems through policy dialogue and technical assistance. In particular, the Program will support the implementation of appropriate credit policies and procedures, the establishment of portfolio management, loan review, loan workout and asset liability management functions and the introduction of adequate financial information and management systems. The Program will support the provision of the services of long-term advisors for commercial banks. These advisors will provide on-the-job training in commercial banking operations, participate in the banks' credit and asset/liability management committees, and advise senior management on implementing institutional changes and capacity building measures. Funding for these advisors will be provided under the proposed TA loan but the commercial banks will be expected to bear 50 percent of the cost.

97. The development of off-site surveillance of both the banking system as a whole and individual banks is necessary to monitor the implementation of regulations and progressively build up an early warning system. The Program requires an upgrading of the prudential, accounting, and credit reports routinely submitted to BOM by the banks and seeks to improve the ability of BOM staff to analyze these reports. These measures will be supported by the proposed technical assistance. Improving BOM's capacity for meaningful on-site examination is an important task facing BOM's Banking Supervision Department. The Program will support (i) the

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[1] The World Bank will provide capacity building for the new asset recovery agency.

development of a core group of qualified banking supervisors for comprehensive examinations of banks; and (ii) the introduction of examination methodologies and procedures that enable supervision staff to assess and monitor liquidity management more effectively, credit policies, loan classification and internal controls of banks.

98. Experience in Mongolia with Bank-financed institutional strengthening TAs in the financial sector indicates that training in international banking practices is most effective if there are corresponding regulatory changes that promote the implementation of international standards. The Program, therefore, supports institutional capacity building in the context of policy reforms that provide incentives for institutional change.

4. Bank Restructuring Program and its Financing

99. There are substantial costs associated with the Program and restructuring of the banking system. The medium-term financial sector adjustment costs are estimated to be between $75 million and $95 million, which includes bank recapitalization and anticipated liquidation costs of between $70 million and $85 million, and operational restructuring costs of between $5 million and $10 million. These costs will be financed by the banks, their shareholders, non-household depositors and the Government.

100. If all banks were to be recapitalized in line with a minimum risk-adjusted tier-one capital ratio of 4 percent required under the Program, additional capital requirements of at least Tug32 billion ($57 million) would have to be met out of retained earnings and additional capital infusions by shareholders and the Government. As at least two of the major banks will be put under receivership, the realization of assets may be reduced. The restructuring costs may, therefore, be higher than estimates prepared on the basis of existing values.

101. The Government is committed to substitute the directed and inherited loans of banks with Government securities. Outstanding principal and accrued interest on inherited and directed loans, amount to about Tug14.1 billion ($25 million). In addition, the Government will assume the financial responsibility for Ardyn Bank's loan of Tug3 billion to the Chinggis Khan Hotel Project and compensate the bank for losses of Tug1.7 billion incurred in conjunction with the forced merger of Ardyn Bank with a smaller insolvent bank. Under the strategy for Ardyn Bank, the Government will have to issue at least another Tug9 billion of restructuring bonds to facilitate the purchase of all assets by the recovery agency.

102. The new banking law places household deposits in a higher creditor category than other depositors in the case of liquidation. The bonds issued for the liquidation of Ardyn and Insurance banks will be adequate to provide full recovery for all household deposits and about 79 percent of other deposits. To maintain public confidence in the banking system, the Government has made a budget provision to provide an average payment to enterprise depositors which do not have bad loans of, on average, 90 percent of the value of their deposits. Smaller (less than 50 employees) enterprises, which are mostly privately owned, will receive greater deposit protection than the larger enterprises.

103. As a result of the Bank's policy dialogue, the Government has allocated Tug18 billion ($32 million) in its 1997 budget to cover the interest costs on restructuring bonds and

on bonds substituting directed and inherited loans, to compensate enterprise depositors, to recapitalize BOM to cover its loan losses incurred as a result of bank liquidation, to capitalize the new savings bank and enterprise bank and to reimburse banks for transfer payment services on behalf of the Government.

104. No further recapitalization assistance is anticipated to be provided by the Government to viable commercial banks under the Program. The remainder of banks' capital requirements are expected to be met through additional capital contributions by shareholders and/or through retained earnings. Bank earnings will only improve if the banks implement operational restructuring measures and maintain high interest rate margins. A substantial portion of bank restructuring costs will be shouldered by their borrowers who will continue to pay relatively high interest rates (in real terms) on their loans.

5. Expected Impacts

a. Economic Impact

105. The Program is expected to result in an increase in investment in the medium-term because Program measures will help to control inflation, reduce effective lending rates, and promote the mobilization of resources for economic growth. Banking sector and enterprise reforms are inextricably linked. Without reform of the banking system, the emerging private sector will continue to have difficulty in obtaining adequate financial resources and the restructuring of existing enterprises is likely to take longer than is desirable. The Program is expected to improve resource mobilization by developing confidence in the banking system. This should ensure that loans are made to business and activities with the best prospects of financial viability rather than supporting the continued operation of enterprises that are not financially viable. The Program will, therefore, complement enterprise reform efforts and policy reform measures in the agricultural and industrial sectors,[1] and support the adjustment process and the emerging private sector in Mongolia.

106. The Program will reduce the pressures on inflation in several ways. First, there will be a decrease in the growth of BOM net domestic assets through reductions in BOM lending to the Government, nonbanks and commercial banks. Second, BOM will stop lending to State enterprises and local governments. Third, the Program restricts commercial banks' access to liquidity support from BOM by abolishing the clearing window and by limiting banks' access to the refinance facility. Fourth, the Program supports the liquidation or downsizing of some of the large commercial banks. This is expected to provide some restraint to credit expansion but should not result in any significant reduction in the level of economic activity.

b. Social Impact

107. The Program is expected to facilitate resource mobilization and increase the efficiency of resource allocation thereby benefiting overall economic activity. The Program is a

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1 The Bank supported agriculture sector policy reforms under Loan No. 1409-MON: *Agriculture Sector Program*, for $35 million, approved on 5 December 1995, and industrial sector policy reforms under Loan No. 1244-MON: *Industrial Sector Program*, for $30 million, approved on 17 August 1993.

corrective measure to restructure a collapsing banking system. Without the Program over 4,000 jobs in the banking sector, the savings of more than 300,000 individual depositors, and the payment of pensions and social benefits to vulnerable groups would be at risk. By protecting household deposits and the majority of enterprise deposits, the Program will contribute to increased public confidence in Mongolia's banking system. In addition it will facilitate access to, and reduce costs of, credit for businesses and entrepreneurs. This should lead to increased employment opportunities, particularly in the emerging private sector. Although the Program is expected to yield substantial benefits, there will also be some short-term social adjustment costs. Ending bank subsidies and preferential access to credit for selected enterprises is expected to result in the closure of some inefficient businesses. However, over the longer term, the removal of such subsidies should have a beneficial impact. The resources saved will be available to other activities that are better suited to Mongolia's economic condition or to reduce social hardship. A Poverty Impact Assessment is provided in Appendix 4.

c. Environmental Impact

108. The environmental impacts of the Program are indirect and long term. The greater financial discipline that a market-based banking system will instill on enterprises is expected to provide incentives for more efficient production processes. In the long run, improvements in the financial intermediation process will most likely result in resources being diverted from financing existing energy-intensive, inefficient, industrial enterprises to financing service sector activities. Although indirect, related environmental impacts should be marginally positive.

E. Lessons Learned

109. Bank operations in Mongolia commenced in 1991 and this is the first loan to the financial sector. Only one project, the Special Assistance,[1] has been postevaluated but the findings of the Project Completion Report and the Project Performance Audit Report for the Special Assistance are of limited relevance to the current Program except that they emphasize the lack of experience in Mongolia relevant to project processing.

110. The Bank has had experience with program loans for the financial sector in other developing member countries and program completion reports (PCRs) have been prepared for financial sector program loans in Indonesia,[2] the Lao People's Democratic Republic[3] and Sri Lanka.[4] However, the different circumstances prevailing in Indonesia and Sri Lanka indicate that the experience of those countries is of limited relevance to Mongolia. Nonetheless, one of the lessons to be derived from these earlier loans is the importance of undertaking extensive preparatory work to gain a sound understanding of the sector and the complex macroeconomic and structural conditions. The extensive technical assistance undertaken by the Bank in Mongolia is in cognizance of this lesson.

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[1] Loan No. 1109-MON(SF), *Special Assistance*, for $30 million, approved on 29 October 1991.
[2] PCR:INO 24270:*Second Financial Sector Program Loan*, September 1996.
[3] PCR:LAO 23335:*Financial Sector Program Loan*, December 1994.
[4] PCR:SRI 23270:*Financial Sector Program Loan*, July 1994.

111. The experience of the Lao PDR is of more relevance to Mongolia. The PCR for that program emphasizes that the success of reforms is dependent on the policy decisiveness of the Government and on coordination among relevant Government agencies. In Mongolia, it is clear that the Government has recognized the importance of banking sector reform and this has the highest priority. In addition, the PCR for the financial sector program loan to the Lao PDR indicated the importance of the legal framework and the introduction of market rules. In recognition of such concerns, the Program places a heavy emphasis on the development of an appropriate legal framework and the upgrading of BOM's regulatory and supervisory capabilities.

V. THE PROPOSED ASSISTANCE

A. Objectives and Scope

112. The objectives of the proposed loan coincide with that of the Government's financial sector program, namely promoting the establishment of a sound, market-based financial system by creating a banking system that can mobilize and allocate resources efficiently. This objective will be achieved by (i) strengthening financial intermediaries by facilitating the operational and financial restructuring of banks; (ii) upgrading the skills of the commercial banks; (iii) strengthening the legal and regulatory framework, improving supervision and the regulation of banks and NBFIs, improving the financial information on banks, improving debt recovery, and facilitating enforcement; (iv) improving the regulatory capabilities of BOM; and (v) improving the efficiency of financial intermediation by reducing the Government's involvement in commercial bank operations and establishing market-determined interest rates. The Program as a whole is set out in the form of a Policy Matrix in Appendix 3.

113. Bank assistance consists of the following components:

(i) a Program loan for SDR24.201 million ($35 million equivalent) to support policy reform in the financial sector;

(ii) a technical assistance loan for SDR2.074 million ($3 million equivalent) to finance capacity building in commercial banks; and

(iii) a technical assistance grant for $1 million to strengthen the capacity of BOM to regulate, supervise, and restructure the commercial banking system.

B. Bank Assistance

1. Program Loan

a. Amount, Source of Funds, Term, Utilization Period and Tranching

114. It is proposed that the Bank provide a loan of SDR24.201 million ($35 million equivalent) from its Special Funds resources to support the Program of ongoing policy reform in the financial sector. The Borrower will be Mongolia and the loan will carry an annual service charge of 1 percent. It will have a term of 40 years, including a grace period of ten years.

115. The loan is expected to be used over a period of 24 months from the date of loan effectiveness. The proceeds of the loan may be used to finance eligible imports incurred within 180 days prior to the date of loan effectiveness.

116. The loan will be released in two tranches of equal amounts. The first tranche will be made available upon loan effectiveness. The second tranche is expected to be released by December 1998 but this will be dependent upon satisfactory implementation of the Government's financial sector reform program, in particular fulfillment of conditions for release of the second tranche, as specified in the Policy Matrix, and substantial compliance of the Government with IMF conditions.

b. Tranche Conditions

117. There are 66 conditionalities in the Policy Matrix of which 41 have already been complied with. Twelve actions have been specified as conditions for the release of the second tranche of the loan. These conditions are:

(i) Government to prepare an action plan for setting up a registry for immovable property (I.A.4.);[1]

(ii) Government to submit draft Law on Secured Transactions (for movables) to Parliament (I.A.5.);

(iii) Government to strengthen bankruptcy legislation to facilitate debt recovery, in particular, giving preferred status to secured creditors (I.A.8.);

(iv) BOM to set minimum capital to risk-weighted assets standards for all banks in line with BIS standards - 2 percent (tier-one capital) (I.B.8.);

(v) BOM to approve a regulatory framework, acceptable to the Bank, for NBFIs (I.C.2.);

(vi) BOM to enforce full compliance with new accounting standards and regulations based on international generally accepted accounting principles (GAAP) for all commercial banks (I.E.1);

(vii) Government to substitute inherited and directed loans with interest-bearing Government securities for all banks that qualify (II.B.3);

(viii) BOM to enforce compliance of BITI and Agricultural Bank with restructuring strategies (II.C.5.);

(ix) BOM to fully enforce receivership provisions under the Banking Law with regard to insolvent banks (II.D.4.);

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[1] References in parenthesis are to relevant items in the Policy Matrix.

(x) Government to prepare a strategy, acceptable to the Bank, for the divestment of direct and indirect state holdings in banks (III.A.5.);

(xi) BOM to discontinue clearing loan facility (III.C.7); and

(xii) BOM to restrict the provision of credit or liquidity to commercial banks outside its refinancing or discount facility to emergency support for illiquid banks in accordance with the provisions of the Central Banking Law (III.C.8).

c. Implementation Arrangements

118. BOM will be the Executing Agency for the Program loan and will be responsible for the effective administration and disbursement of the loan proceeds and the proper maintenance of records. On a six-monthly basis, BOM will provide reports on the progress of the loan. These will indicate, among other things, progress made, problems encountered and remedial action taken during the previous six months and proposed Program activity and expected progress during the following six months.

119. A steering committee will be established to oversee the implementation of the Program. The committee will be chaired by a Deputy Governor of BOM and comprise representatives of MOF and MOJ. This committee will meet at least once every three months to ensure that the proposed reforms are undertaken in line with the agreed timetable.

d. Eligible Items

120. Loan proceeds will be available to finance the foreign exchange cost (excluding duties and taxes) of imports by both the private and public sectors provided that the items are procured from the Bank's member countries and are not included in the negative list (see Appendix 5).

e. Procurement and Disbursement

121. In the case of goods commonly traded on international commodity markets, procurement undertaken in accordance with normal commercial procedures appropriate to the trade will be regarded as acceptable to the Bank. Procurement of goods for which contracts are less than \$5 million will be based on normal commercial practices for procurement by the private sector or Government procurement procedures acceptable to the Bank for procurement by the public sector. Each supply contract for eligible imports estimated to cost \$5 million or more will be awarded through international competitive bidding (ICB) procedures in accordance with the Bank's *Guidelines for Procurement*. Contracts valued at less than \$5 million will be subject to an ex-post review by the Bank. In the event that appropriate procedures have not been followed, the Bank reserves the right to withhold the disbursement of funds, or to seek reimbursement. Proceeds of the loan will be withdrawn in accordance with the Bank's standard disbursement procedures. Expenditures for eligible items imported within 180 days prior to the date of loan effectiveness will qualify for reimbursement provided that such items have been provided in accordance with the standard procedures.

f. Counterpart Funds

122. The Borrower shall ensure that sufficient funds are made available to meet the costs (principal and interest) associated with the Borrower's financial sector restructuring program. Any counterpart funds not required for the financial sector restructuring program shall be used for general budget support.

g. Monitoring

123. The Bank will, in cooperation with BOM, carry out periodic reviews of progress in the implementation of the Program, and will assess the impact of the Program on the banking and other sectors of the economy. The Government will keep the Bank informed of the outcome of the policy discussions with other multilateral and bilateral aid agencies that have implications for implementation of the Program, and will provide the Bank with an opportunity to comment on the resulting policy proposals.

124. In addition to the six monthly progress reports, BOM will submit a Program Completion Report to the Bank within six months of the release of the second tranche. This report will evaluate the implementation of the policy reform measures under the Program, their impact on the economy and the banking sector, lessons learned during the Program period and further reforms and assistance needed for the development of the sector.

h. Imprest Account

125. An Imprest Account will be established at BOM, and will be operated and maintained in accordance with the Bank's *Guidelines on Imprest Fund and Statement of Expenditures Procedures.*

2. Technical Assistance Loan

126. In addition to the Program loan and in support of the Program, it is proposed that the Bank provide a technical assistance loan of SDR2.074 million ($3 million equivalent) from its Special Funds resources for Upgrading the Skills and Systems of Commercial Banks. This TA loan is expected to cover part of the capacity building required for commercial banks to support the implementation of financial sector reforms. The TA loan will finance expenses related to (i) consulting services rendered in connection with the operational restructuring of commercial banks, (ii) advisory and training services required to upgrade skills in banks, and (iii) procurement of integrated banking software and equipment for commercial banks. Details of the proposed TA loan are given in Appendix 6.

127. The Borrower will be Mongolia and the TA loan will carry an annual service charge of 1 percent. It will have a term of 40 years, including a grace period of ten years. The TA loan is expected to be used over a period of 30 months from the date of loan effectiveness.

128. BOM will be the Executing Agency for the TA loan and will be responsible for supervising the recruitment of consultants, and the procurement of banking software. All consultants recruitment and procurement will be undertaken in consultation with and with the agreement of the Bank. Consultants will be recruited in accordance with the Bank's *Guidelines on*

the Use of Consultants, and software procurement will be done on the basis of international shopping, in line with the Bank's *Guidelines for Procurement*.

129. Commercial banks participating in the TA program will share one half of total costs of consulting services and banking software. The balance of expenses will be covered by the TA loan. BOM will provide 5-year loans to participating banks at the Bank's OCR rate to help them finance their share of TA expenses. The commercial banks will assume the foreign exchange risk.

3. Technical Assistance Grant

130. In addition to the two loans, it is proposed that the Bank provide the Government with a technical assistance grant to assist BOM in Banking Supervision and Bank Restructuring. The Banking Supervision Department of BOM will play a crucial role in the restructuring of the banking system by ensuring that commercial banks are meeting relevant BOM regulatory requirements and that banks committed to restructuring agreements are fulfilling the targets agreed with BOM. The TA will be provided to upgrade the capacity of the Banking Supervision Department in line with Program requirements. The TA will assist BOM in (i) developing a core group of qualified banking supervisors through classroom and on-the-job training; (ii) developing bank examination methodologies and procedures; (iii) preparing regulations pertaining to banking supervision, bank licensing, and conservatorship; (iv) enhancing bank accounting standards and regulations in line with international practices; (v) overseeing the operational and financial restructuring of selected banks; and (vi) liquidating banks, as required.

131. Four international consultants (a bank restructuring specialist, a banking supervision specialist, a bank accounting specialist, and a legal advisor), will be recruited in accordance with the Bank's *Guidelines on the Use of Consultants* to provide a total of 36 person-months of services.

132. The Executing Agency for the TA will be BOM. The total cost of the TA is $1,015,000, of which $983,000 is the foreign exchange cost. It is proposed that the Bank provide $1,000,000 to finance the entire foreign exchange component and $17,000 equivalent of the local currency costs on a grant basis. The Government will finance the remaining local currency costs for counterpart staff, office facilities and support services. The terms of reference and cost estimates are in Appendix 7.

VI. PROGRAM BENEFITS AND RISKS

A. Benefits

133. The Program will support the reform and strengthening of the legal, regulatory and policy environment for financial sector operations, and promote the institutional development of banks. It is designed to help improve the efficiency and prudence of bank operations and thereby instill greater financial discipline in the banking system. Improved operations of the banking system will lead to a more efficient mobilization of financial resources and appropriate allocation of resources within the overall economy. This will enhance structural adjustment and contribute to efficient economic growth. A Logical Program Framework for the proposed Program is given in Appendix 8.

B. Risks

1. Public Confidence in the Banking System

134. The major risk to the successful implementation of the Program is that the current liquidity problems of the banking system and the anticipated closure of major banks will result in a run on viable banks. The Program seeks to prevent a loss of public confidence in the banking system by promoting the restructuring of insolvent, but potentially viable, banks and by winding down nonviable insolvent banks in an orderly manner to minimize the impact of bank failures on depositors.

2. Restructuring of Banks

135. Another risk for the Program is that BOM and the commercial banks lack the ability to implement financial and operational restructuring programs. To mitigate this risk, a comprehensive package of technical assistance will be provided under the Program to commercial banks and BOM to help manage the restructuring process.

3. Approval of Legislation by Parliament

136. Parliament sometimes makes alterations to submitted draft legislation or there are delays in passing legislation. To avoid such risks, changes in banking legislation required under the Program were made a condition for Board consideration. The legislation was approved by Parliament on 3 September 1996 and became effective on 1 October 1996. Changes in the existing bankruptcy legislation have been made a condition for release of the second tranche. The Government is committed to have a new Bankruptcy Law approved within 1997 and the passage of this Law is a condition for effectiveness of the World Bank's Enterprise Adjustment Credit. The MOJ is receiving technical assistance for the preparation of a Bankruptcy Law from GTZ and the World Bank. A Working Group, comprising members of Parliament, MOJ, MOF and BOM, will be established to revise the existing Bankruptcy Law.

4. Social Impact of Enterprise Restructuring

137. Success in restructuring of commercial banks is expected to bring about structural adjustment, with larger, less efficient business enterprises being obliged to close. This could potentially have adverse, short-term consequences for employment which could pose political risk for the Program. Additional budget resources available under the loan will assist the Government in meeting costs associated with bank restructuring and thereby limit the impact on other areas of the economy. The World Bank-financed Enterprise Adjustment Credit will also help to mitigate any short-term social impact of the Program on enterprises.

5. Progress on Reforms

138. The full commitment of the Government and BOM is essential for the successful implementation of the Program. The Program faces the potential risk that vested interests may seek to undermine the content and timing of the reforms if they see themselves as being adversely affected. Groups that will lose control over, or preferential access to, financial resources as a result of the Program include local governments, beneficiaries of preferred credit in the

industrial and agricultural sector and managers of insolvent commercial banks. However, it is considered that the Government will be able to control the demands of such groups and implement the financial sector reforms as envisaged.

VII. ASSURANCES

139. Other than the tranching conditions stated earlier, the Government has assured the Bank (i) that the policies adopted and actions taken prior to the date of the Program Loan Agreement, as described in the Development Policy Letter (Appendix 3), will continue in effect for the duration of the Program period, and (ii) that the Government will promptly adopt the other policies and take the other actions included in the Program as specified in the Development Policy Letter and/or Program Loan Agreement and ensure that such policies and actions continue in effect for the duration of the Program period.

VIII. RECOMMENDATION

140. I am satisfied that the proposed loans and technical assistance for the Financial Sector Program (the Program) would comply with the Articles of Agreement of the Bank and recommend that the Board approve:

(i) the loan in various currencies equivalent to Special Drawing Rights 24.201 million to Mongolia for the policy component of the Program, with a service charge at the rate of 1 percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Program Loan Agreement presented to the Board;

(ii) the loan in various currencies equivalent to Special Drawing Rights 2.074 million to Mongolia for the technical assistance component of the Program, with a service charge at the rate of 1 percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Technical Assistance Loan Agreement presented to the Board; and

(iii) the provision of technical assistance, on a grant basis, to the Government of Mongolia in an amount not exceeding the equivalent of $1,000,000 for the purpose of Strengthening the Supervisory and Restructuring Capacity of the Bank of Mongolia.

MITSUO SATO
President

25 November 1996

APPENDIXES

BANK OPERATIONS AND STRATEGY

1. The thrust of the Bank's medium-term operational strategy for Mongolia is to facilitate the transition to a market-based economy. This requires the emergence of a vigorous and competitive private sector that will encourage an efficient allocation and utilization of resources and provide the basis for achieving sustained economic growth. In this context, the three priority concerns to be addressed in the Bank's strategy are: (i) creation of an environment conducive to a competitive, efficient market economy; (ii) development of the human resources and requisite skills; and (iii) establishment of adequate physical infrastructure needed for a market economy.

2. The strategy recognizes the important role of the financial sector in facilitating and supporting growth in other sectors of the economy. Although initial policy measures and legislative steps were taken to establish a modern two-tier banking sector, the financial sector requires substantial additional reforms to service the needs of a market economy and facilitate the growth of the private sector. Strengthening of the banking sector is therefore an important component of the strategy.

3. Macroeconomic stability is essential to the strategy and to the development of the banking sector. The strategy recognizes that technical assistance aimed at improving skills and operational practices in commercial banks will be effective only if the regulatory framework has been put in place and the supervision capability of the Bank of Mongolia has been strengthened. The strategy also recognizes the importance of establishing internationally acceptable accounting standards and practices in commercial banks. Improved credit delivery to the industrial and agricultural sectors will be ensured with the establishment of an efficient commercial banking system within a well-supervised regulatory framework.

ECONOMIC AND SECTOR INDICATORS

Table1: Key Economic Indicators

Item/Indicator	1991	1992	1993	1994	1995	Jun-96 [a]
A. Income and Growth						
1. GDP per Capita ($, current)	339.7	540.7	265.2	303.3	376.0	443.8
2. GDP Growth (%, in constant prices)	-9.2	-9.5	-3.0	2.3	6.3	0.8
Agriculture	-4.4	-2.1	-2.7	2.7	4.2	n.a.
Industry	-12.8	-12.9	-6.9	2.1	14.6	0.5
Services	-9.8	-13.2	1.0	2.0	0.2	n.a.
B. Savings and Investment (current market prices)			(percent of GDP)			
1. Gross Domestic Saving	1.4	3.6	20.4	16.2	15.6	n.a.
2. Gross Domestic Investment	21.3	11.3	27.2	22.0	22.4	n.a.
C. Money and Inflation			(annual percent change)			
1. Consumer Prices [b]	-	202.9	268.4	87.6	56.8	33.7
Consumer Prices [c]	205.4	325.5	183.0	66.3	57.0	46.6
2. Broad Money (M2)	53.5	31.7	227.6	79.5	32.9	18.7
D. Government Finance			(percent of GDP)			
1. Revenue	47.4	27.3	33.3	28.3	33.6	33.3
2. Expenditure	57.1	38.9	49.4	51.1	44.9	40.3
3. Current Balance	-4.3	-1.0	2.0	1.3	4.2	5.1
4. Overall Surplus/Deficit (-)	-9.7	-11.6	-16.1	-22.8	-11.4	-7.1
E. Balance of Payments			(percent of GDP)			
1. Merchandise Trade Balance	-19.2	-5.3	-1.5	-0.5	-2.1	-0.5
2. Current Account Balance [d]	-20.0	-7.7	-6.8	-5.8	-6.8	-1.2
			(annual percent change)			
3. Export ($) growth (%)	-22.1	2.7	2.8	0.3	31.5	-13.0
4. Import ($) growth (%)	-52.5	-14.0	-10.5	-1.1	35.1	21.0
F. External Payments Indicators						
1. International Reserves (Mn $) [e]	20.5	4.6	27.2	37.2	70.0	53.4
- months of imports	0.5	0.2	1.0	1.3	1.4	1.6
2. External Debt Service (% of current receipts) [f]	4.2	10.5	10.6	16.3	14.1	n.a.
3. External Debt (% of GDP)	25.0	27.6	62.4	68.6	56.7	n.a.
Memorandum Items:						
1. GDP (current prices, Mn Tugriks)	18,910	47,298	166,219	283,263	391,103	200,440
2. GDP (current prices, Mn $)	730	1,182	587	692	872	402
3. Exchange Rate (Tugrik per $, annual average)	25.9	40.0	283.0	409.6	448.7	498.2

[a] Preliminary estimates
[b] Annual average
[c] End of period.
[d] Excludes official transfers.
[e] Refer to net official reserves.
[f] Excludes servicing of medium- and long-term obligations in transferable rubles to Russia and other former CMEA countries.

ECONOMIC AND SECTOR INDICATORS

Table 2: Monetary Survey

(in million tugrik)

Assets	12/31/91	12/31/92	12/31/93	12/31/94	06/30/95	03/30/95	12/31/95	01/31/96	03/31/96	04/30/96	05/31/96	06/30/96	07/31/96
Foreign Assets	495.4	-27.0	23,395.7	29,699.3	26,082.9	42,796.8	51,709.7	45,148.4	40,142.0	40,752.8	34,971.5	36,698.9	37,152.1
Domestic Credit	10,971.2	16,078.2	24,460.3	49,190.3	58,592.0	49,646.7	45,494.7	49,947.1	60,031.5	58,439.0	62,937.7	66,207.1	68,682.8
Claims on Central Government	-1,883.7	-3,051.7	-7,143.4	-3,773.1	-3,475.5	-14,688.9	-17,227.8	-17,374.4	262.3	-122.9	479.9	2,523.4	4,275.9
Claims on Public Enterprise	9,779.6	12,204.2	21,744.4	12,193.3	10,129.1	8,892.2	10,883.3	15,801.6	12,531.8	11,242.5	13,875.4	13,578.5	12,948.8
Claims on Private Sector	3,075.3	6,925.7	9,859.3	40,638.0	51,784.1	55,297.8	51,653.5	51,395.6	47,113.1	47,201.1	48,464.1	49,987.2	51,340.1
Claims on Non-Banks Fin. Institutions				7.8	21.5	21.3	61.4	0.0	0.0	0.0	0.0	0.0	0.0
Share and Promissory Note				124.3	132.8	124.3	124.3	124.3	124.3	118.3	118.3	118.0	118.0
Total Assets	**11,466.6**	**16,051.2**	**47,856.0**	**78,889.6**	**84,674.9**	**92,443.5**	**97,204.4**	**95,095.5**	**100,173.5**	**99,191.8**	**97,909.2**	**102,906.0**	**105,834.9**

Liabilities	12/31/91	12/31/92	12/31/93	12/31/94	06/30/95	03/30/95	12/31/95	01/31/96	03/31/96	04/30/96	05/31/96	06/30/96	07/31/96
Money	7,313.7	7,640.2	18,548.4	32,871.2	39,640.1	41,893.7	42,636.5	44,361.9	43,785.5	44,537.4	47,826.3	49,765.6	56,719.7
Quasi-Money	2,601.2	5,412.1	24,215.8	43,905.8	50,265.1	62,986.3	59,408.2	61,626.4	58,237.2	57,344.7	55,635.5	56,980.0	58,852.4
Long-term Foreign Liabilities	1,981.7	3,809.5	9,094.4	7,452.1	6,752.8	14,779.9	14,176.2	15,283.5	15,622.4	8,694.8	9,027.3	9,027.3	8,803.7
Other Items (net)	-430.0	-810.6	-4,002.6	-5,339.5	-11,983.1	-27,216.4	-19,016.5	-26,176.3	-17,471.6	-11,385.1	-14,579.9	-12,866.9	-18,540.9
Total Liabilities	**11,466.6**	**16,051.2**	**47,856.0**	**78,889.6**	**84,674.9**	**92,443.5**	**97,204.4**	**95,095.5**	**100,173.5**	**99,191.8**	**97,909.2**	**102,906.0**	**105,834.9**

Source: Bank of Mongolia

DEVELOPMENT POLICY LETTER FROM THE GOVERNMENT

GOVERNMENT OF MONGOLIA

Fax # (976 1) 310011 Tel# (976 1 322408)

Date № Ulaanbaatar-12
State House

13 November, 1996

Mr. Mitsuo Sato
President
Asian Development Bank
Manila, Philippines

Dear Mr. Sato,

The new Government of Mongolia inherited an economy faced with major challenges in making the transition from a centrally planned to a market economy. The previous Government initiated reforms in key areas and, after several years of high inflation and negative growth, there have been signs of improvement since 1994. The recovery, however, remains fragile and recent developments in the banking sector threaten to disrupt the progress that has been made.

The Government is committed to speeding up the pace of reforms to address the urgent economic problems facing the economy and provide a more sustainable basis for growth. The Government's commitment to reform is demonstrated by measures taken during its first few months in office. These include removal of the ban on export of raw cashmere, raising power and heating tariffs by 60 percent, raising petroleum prices to market related levels, and enacting two new banking laws.

The Government recognizes the importance of macroeconomic stabilization in addressing the immediate problems, sustaining economic growth, and implementing reforms necessary for the successful completion of the transition to a market economy. To this end, the Government has entered into negotiations with the International Monetary Fund (IMF) for a new three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF). The Government is committed to implementing the program agreed with the IMF.

The Government also recognizes the central role that commercial banks have to play in a market economy and that an efficient and effective banking sector is crucial for macroeconomic stability and economic growth. The Government has inherited a banking system that faces major difficulties. There is little understanding of the role that commercial banks should play and inadequate knowledge of the operations of commercial banks in a market economy. The requisite skills are lacking and past attitudes to banking continue to prevail among management of many of our commercial banks. The problem has been compounded by weaknesses in the legislative framework and by the Bank of Mongolia's lack of experience in supervising and regulating commercial banks. One of the results has been poor credit decisions and many of the commercial banks are faced with loan portfolios that contain a high proportion of unrecoverable loans.

The situation appears to be particularly serious in some of the larger commercial banks. Inadequacies in the available data make it difficult to determine the full extent of the problem but inevitably the situation has had an adverse impact on public confidence in commercial banks. The closure of the Central Asia Bank in July 1996 has further eroded confidence. In September 1996, it was considered necessary for the Bank of Mongolia, with the support of the Government, to intervene in Ardyn Bank, the largest of the commercial banks in Mongolia. The situation is serious and there appears to be little hope that Ardyn Bank can recover from its current problems. The situation at Insurance Bank is even worse, with liabilities exceeding assets by more than 80 percent. Together, the Ardyn Bank and the Insurance Bank account for nearly 60 percent of the assets in Mongolia's banking system.

The situation has its origins in the past. Under the centrally planned economy, the State Bank of Mongolia financed the losses and working capital requirements of State-owned enterprises. This resulted in an accumulation of non-performing loans which were inherited by the newly established commercial banks following the break up of the State Bank in 1991. Subsequently, the new commercial banks were directed to provide loans to State owned enterprises. Many of these loans are now also non-performing. As a result of these pressures, banks have not assumed full responsibility for their financial position. In addition, the banks have also accumulated non-performing loans made at their own discretion. As a result, a large part of the loan portfolio of the five largest banks is non-performing. Approximately Tugrik28 billion ($62 million) would be required to recapitalize the five largest commercial banks in line with Bank of Mongolia's capital adequacy requirements. The Government has assumed responsibility for the directed and inherited loans.

The Government recognizes that reform of State-owned enterprises is critical to addressing the problems of the financial and banking sector and in sustaining the economic recovery, maintaining stability and attracting foreign direct investment into the country. The Government is addressing enterprise reform, with particular emphasis on the six largest defaulters to the banking system, with the support of the World Bank under its proposed Banking and Enterprise Sector Adjustment Credit.

After five years of initiating financial sector reforms, a basic institutional framework has been established. However, major weaknesses in supervision, regulation, lending practices and in accounting practices remain. Significant gaps in legal and institutional structures emerged as the sector evolved. The need for greater training and skills development has also become clear. The accumulated bad debts of the banks, including inherited and directed non-performing loans, are much larger than originally envisaged and there is an urgent need for restructuring of the sector. These issues will be addressed in the reform program for which the Government is requesting financial support. Adequate funds will be provided in the 1997 budget to finance the cost of the restructuring of the banking sector. The proposed program covers reform of the financial sector and in particular of the commercial banking system. The main objective of the program is to promote the establishment of a competitive, market-based and sound financial system that can efficiently mobilize and allocate resources for economic growth. This objective will be achieved through a financial sector reform program designed to strengthen financial intermediaries; strengthen the legal and regulatory framework for the financial sector; and establish a market based financial intermediation process. The program as a whole is set out in the form of a Policy Matrix in the Attachment.

A major component of the program will be to support the establishment of a clear and well-defined operating framework for the banking sector based on internationally accepted norms. The powers and responsibilities of the Bank of Mongolia in the supervision of commercial banks and non-bank financial companies will need to be strengthened and more clearly defined. The program addresses such matters as the enforcement of prudential regulations, including restrictions on bank lending to shareholders; licensing requirements for new banks and non-bank financial companies, including foreign and joint-venture banks; the Bank of Mongolia's powers with respect to bank closure/liquidation; responsibilities of executive and non-executive board directors of banks; and reporting requirements for banks. The Bank of Mongolia will receive assistance to upgrade its supervisory capacity.

The program will identify targets for capital adequacy standards, on the basis of Bank of International Settlements standards, and exposure requirements for the banks. It will also provide a well-defined schedule for meeting those targets. Monitoring of these targets will require that commercial banks meet internationally accepted accounting standards, as well as loan classification standards and adequate loan loss requirements that will be introduced under the program. In view of the substantial portfolio problems of banks, the program also addresses the need for improvement of the legal and institutional framework for defining property rights and facilitating debt recovery. It is considered unlikely that all existing banks will be viable. An important part of the program is therefore to establish a clear legal framework for the liquidation of commercial banks. The Parliament enacted new legislation in September 1996 covering the role and powers of the Central Bank and operations of commercial banks. The Law on the Central Bank vests greater powers in the Bank of Mongolia to regulate and supervise commercial banks, penalize them in case commercial banks are in violation of prudential norms and liquidate banks which are declared insolvent. The Government expects the Bank of Mongolia to exercise these powers to establish greater discipline among commercial banks and restore public confidence in the banking system.

Strengthening the legal and regulatory framework for the financial sector will require a greater awareness among the country's legal profession of financial and commercial sector laws. The program will institutionalize legal training within Mongolia by developing a long-term program for judges and lawyers in the implementation of laws relating to financial sector operations. To achieve the objective of establishing market-based financial intermediation, the program will eliminate Government influence on credit decisions by divesting direct and indirect State shareholdings in banks and by implementing measures that improve the autonomy of banks and increase the accountability and responsibility of bank shareholders and managers. The program supports the discontinuation of preferential interest rates for favored sectors. The program seeks to limit undue external influence on credit decisions by imposing limits on lending to shareholders. In addition, the program will limit lending to enterprises which are in default to the banks. Such enterprises should either be restructured or liquidated and lending from the banking sector will be on commercial terms and limited to enterprises with viable restructuring plans.

The program will work towards establishing a clear and well-defined regulatory structure for establishing and operating non-bank financial companies which include financing and leasing companies, trusts and investment companies and non-equity funds.

An important component of the program will be strengthening of the viable commercial banks. This will entail financial and operational restructuring. The commercial banks will be responsible for the development of business plans and under the program they will receive appropriate support for implementation, including training and consulting services, for which we are seeking $3 million in technical assistance from the Asian Development Bank. The preparation of time bound plans for restructuring of insolvent banks that indicate long-term viability, represents an important component of the program. These plans will involve, among other things, (i) additional capital contributions by existing bank shareholders; (ii) downsizing of the banks through a reduction in lending operations and the divestment and/or closure of non-productive assets and unprofitable branches; (iii) implementation of measures designed to improve financial performance; and (iv) reaching conciliation agreements with defaulters and implementation of other collection strategies. Agreement has been reached on such plans for the Agriculture Bank and the ITI Bank. However, where commercial banks are insolvent and cannot demonstrate that they have long-term viability, the Government will respond decisively to bring about an orderly liquidation.

A major part of any financial rehabilitation of the major commercial banks will be the resolution of the problems associated with unrecoverable directed and inherited bank loans. Having decided to assume the financial responsibility for these, the Government has developed a strategy for removing such assets from the balance sheets of commercial banks and the substitution of these non-performing assets with interest bearing Government securities is one of the major parts of the restructuring strategies under the program.

Even with the Government's assumption of directed and inherited debt, the Ardyn and Insurance banks will be insolvent. Therefore, following the recently approved banking laws, both banks will be placed in receivership and wound up. Assistance will be received from the Bank and IMF to help plan and implement this process in an orderly way. Three institutions will emerge from the receivership process: (i) a narrowly based household bank to provide safety for household deposits; (ii) an enterprise bank for the deposits and performing loans to businesses; and (iii) the Mongolian Asset Recovery Agency, which will be established by the Government, will be tasked with aggressively collecting non-performing loans. This radical restructuring of over half of Mongolia's banking system is designed to send strong messages to the economy. Part of the message is designed to promote public confidence in the banking system by ensuring that the deposits of those who do not have nonperforming loans are substantially protected. According to the recently enacted banking legislation, household deposits enjoy a higher creditor status than other deposits for banks that are to be liquidated. Based on the estimated value of the assets of Ardyn and Insurance banks, the deposits of households will be fully protected. The remaining asset value is estimated to be adequate to cover approximately 79 percent of the value of the non-household deposits. This is all that is required under the law. However, a special provision will be made in the 1997 budget to reimburse business depositors with either deposits and no loans or deposits and performing loans at an average of 90 percent of such deposits. However these use of such funds will first be used to protect the deposits of small businesses (i.e., those with less than 50 employees). The remaining funds will be used for the larger enterprises. Strong signals will also be sent to penalize those responsible for the poor performance of these two banks. In particular: (i) the value of the capital of shareholders will be reduced to zero; (ii) senior management will be replaced; and (iii) those with bad loans will be vigorously pursued and their deposits will be written down to the maximum percent permissible under law. To ensure that Mongol Bank can function effectively as a central bank, the 1997 budget will include a provision to reimburse Mongol Bank for losses incurred as a result of the liquidation of these two banks.

The program also supports the improvement of credit and risk management policies and systems of the commercial banks. Appropriate credit policies and procedures, as well as adequate financial information and management systems must be implemented by all banks and the Mongolian Asset Recovery Agency. Training in these areas has already been initiated with support from the Asian Development Bank, the World Bank, Germany and other aid agencies. Much more is still needed. While the Government will provide some additional funding under the program, the banks will increasingly be expected to take on responsibility and allocate resources for training of their staff and skills development.

The program will facilitate resource mobilization and increased efficiency of resource allocation thereby benefiting the population at large. It will contribute to the protection of depositors' interests and to increased confidence in the country's banking system. In addition, the program can be expected to facilitate access to credit for private entrepreneurs and this will have a positive impact on employment opportunities in the growing private sector of the economy.

Restructuring the banking sector will cause some lay-off of bank employees. Discontinuation of bank subsidies and preferential access to credit for selected enterprises may result in the closure of some businesses. Although new employment opportunities will emerge as investment picks up and the economy grows, the Government recognizes that there will be some adjustment costs and for some individuals the costs may be high. The Government will address this issue through its social security and poverty reduction programs, which are already ongoing with assistance from both bilateral and multilateral donors. However, the Government's longer term objectives, namely, the development of a sound and effective banking system, cannot be achieved unless there is public confidence in the commercial banking system. Available evidence suggests that this confidence is currently weak and the Government has and will take the necessary steps to restore the confidence of the public and in particular individual depositors. The Mongol Bank will ensure that there is sufficient liquidity to meet customers demands to withdraw deposits after the restructuring strategy is implemented.

I consider that the above represents an ambitious, but achievable, program of reforms that will establish the banking sector in Mongolia on a sound financial footing and will enable its operation according to internationally accepted norms and accounting principles. The Government of Mongolia requests the Asian Development Bank's support with a loan from its Special Funds resources, for the government's financial sector reform program.

I recognize that while assistance from the Asian Development Bank and the other multilateral institutions will help facilitate implementation of the proposed program, the ultimate responsibility and effort lies with the Government of Mongolia.

Finally, Mr. President, I should like to express the Government's appreciation for the assistance that the Asian Development Bank has extended to Mongolia so far. The technical assistance provided for strengthening Bank of Mongolia's capabilities, completing portfolio reviews of large commercial banks and training of their personnel during the last three years, and the policy dialogue with the Asian Development Bank has contributed to the preparation of this reform program. This program, when completed, will enable the financial sector to play its role of efficiently mobilizing and allocating financial resources within the context of a market-based economy.

Yours sincerely,

PRIME MINISTER

POLICY MATRIX FOR PROPOSED MONGOLIAN FINANCIAL SECTOR PROGRAM LOAN

GOAL: **The Program promotes the establishment of a sound, market-based financial system that can efficiently mobilize and allocate resources for economic growth.**

OBJECTIVE	ACTION PROGRAM	ACTIONS TO BE COMPLETED PRIOR TO BOARD CONSIDERATION	ACTIONS TO BE TAKEN FOR RELEASE OF SECOND TRANCHE[1]	OTHER ACTIONS TO BE TAKEN DURING THE PROGRAM[2]
I. Strengthening of the legal and regulatory framework for financial sector				
I.A. Facilitate debt recovery	I.A.1. BOM to establish Working Group to draft proposal to rectify current deficiencies in the Civil Code pertaining to debt recovery	November 1996		
	I.A.2. Amend Civil Code to remove deficiencies in the Civil Code pertaining to debt recovery			December 1997
	I.A.3. Establish a property registration division within Ministry of Justice to consider strategies for setting up a registration agency	August 1996		
	I.A.4. MOJ to prepare action plan acceptable to the Bank for setting up a registry for immovable property		June 1997	
	I.A.5. Government to submit draft Law on Secured Transactions (for movables) to Parliament		June 1998	
	I.A.6. Enact new banking law to permit banks to exchange credit information on borrowers	September 1996		
	I.A.7. MOJ to establish Working Group to review Bankruptcy Law	September 1996		
	I.A.8. Strengthen bankruptcy legislation to facilitate debt recovery, in particular giving preferred status to secured creditors		June 1998	
	I.A.9. MOJ to prepare recommendations on how to improve the structure and operations of the bailiff system			December 1997
I.B. Improve Banking Supervision	I.B.1. Enact new banking legislation to clarify duties and responsibilities of management of commercial banks	September 1996		
	I.B.2. Enact new banking legislation to confer on BOM the right to replace bank management	September 1996		
	I.B.3. Enact new banking legislation to prohibit banks from directly engaging in equity market activities for their own account	September 1996		
	I.B.4. Enact new banking legislation to confer on BOM powers relating to the conservatorship, receivership, and liquidation of commercial banks	September 1996		
	I.B.5. BOM to approve regulations and implementation procedures for the liquidation of banks	November 1996		
	I.B.6. Enact new banking legislation to disallow shareholders to take out their paid-up capital in banks other than through sale of shares	September 1996		
	I.B.7. Enact new banking legislation to limit lending to any one borrower or related groups of borrowers to 20 percent of paid-up capital of bank	September 1996		
	I.B.8. BOM to set minimum capital to risk-weighted assets standards for all banks in line with BIS standards:			
	2 percent (tier one capital)		June 1998	
	4 percent (tier one capital)			December 1999
	I.B.9. Enact new banking legislation to enhance BOM 's powers to enforce prudential regulations	September 1996		

OBJECTIVE		ACTION PROGRAM		ACTIONS TO BE COMPLETED PRIOR TO BOARD CONSIDERATION	ACTIONS TO BE TAKEN FOR RELEASE OF SECOND TRANCHE[1]	OTHER ACTIONS TO BE TAKEN DURING THE PROGRAM[2]
		I.B.10.	Banks to report all loan reschedulings for loans above Tug 10 million to BOM on a quarterly basis	November 1996		
		I.B.11.	Banks to provide quarterly status reports on collection efforts for all loans classified as substandard, doubtful, and loss to BOM	June 1996		
		I.B.12.	Banks to provide monthly status reports on new lending and loan repayments to BOM	November 1996		
I.C.	Establish a framework for regulating NBFIs	I.C.1.	Enact new banking legislation to provide powers to BOM to regulate non-bank financial institutions (e.g. finance and leasing companies, investment, and non-equity funds, and other entities engaging in lending or related activities)	September 1996		
		I.C.2.	BOM to approve a regulatory framework for NBFIs that is acceptable to the Bank		December 1997	
I.D.	Facilitate the enforcement of financial sector related laws	I.D.1.	Develop a long-term program within IAMD to train judges and lawyers in the implementation of laws related to financial sector operations	October 1996		
I.E.	Improve transparency about the financial position of banks	I.E.1.	BOM to enforce full compliance with new accounting standards and regulations based on GAAP for all commercial banks.		January 1998	
		I.E.2.	BOM to require full compliance by all commercial banks with provisions on recognition of interest income under new BOM accounting regulations	October 1996		
		I.E.3.	BOM and MOF to issue loan classification and loan loss provisioning requirements acceptable to the Bank	November 1996		
		I.E.4.	BOM to enforce full compliance with loan classification and loan loss provisioning requirements	November 1996		
		I.E.5.	Enact new banking legislation to permit tax deductibility for loan loss provisions	September 1996		
		I.E.6.	Enact new banking legislation to require banks to be subject to an annual external audit and to publish annual financial statements	September 1996		
II.	**Strengthening of financial intermediaries**					
II.A.	Improve banks' policies and systems	II.A.1.	BOM to require all banks to approve credit policies that reflect sound banking principles	October 1996		
		II.A.2.	BOM to prohibit banks to make new loans to borrowers in default	March 1996		
		II.A.3.	BOM to prohibit banks to automatically reschedule loans to borrowers in default without negotiated repayment schedules that ensure borrowers' debt servicing capacity	July 1996		
		II.A.4.	All banks to establish adequate loan workout departments/units	September 1996		
		II.A.5.	All banks with assets above Tug 10 billion to establish asset/liability management committees	September 1996		
		II.A.6.	Government to make TA Loan funds provided by the Bank available to BOM for onlending to commercial banks for technical assistance to support the upgrading of their skills and systems			Commencing January 1997
II.B.	Remove unrecoverable directed and inherited loans from banks' balance sheets	II.B.1.	Banks to capitalize interest in arrears on unrecoverable inherited and directed loans, and to show loans separately on banks' balance sheets	March 1996		
		II.B.2.	Government to determine strategy acceptable to the Bank for removing these assets from banks' balance sheets	October 1996		
		II.B.3.	Government to substitute inherited and directed loans with interest-bearing Government securities for all banks that qualify under the strategy determined under II.B.2.		January 1997	

OBJECTIVE		ACTION PROGRAM		ACTIONS TO BE COMPLETED PRIOR TO BOARD CONSIDERATION	ACTIONS TO BE TAKEN FOR RELEASE OF SECOND TRANCHE[1]	OTHER ACTIONS TO BE TAKEN DURING THE PROGRAM[2]
II.C.	Restructure banks that have long-term viability	II.C.1.	Enact new banking legislation to prohibit the payment of dividends and any other distribution of profits by banks that do not fully comply with BOM prudential norms and capital adequacy standards	September 1996		
		II.C.2.	BOM to issue cease and desist orders for all insolvent banks specifying an interim program of remedial actions	November 1996		
		II.C.3.	BOM to determine time-bound restructuring strategy for Agricultural Bank that is acceptable to the Bank	November 1996		
		II.C.4.	BOM to determine time-bound restructuring strategy for BITI that is acceptable to the Bank	December 1996		
		II.C.5.	BOM to enforce compliance of Agricultural Bank and BITI with restructuring strategies determined under II.C.3. and II.C.4.		commencing January 1997	
II.D.	Close banks that do not have long-term viability	II.D.1.	BOM to put Ardyn Bank and Insurance Bank into receivership and sell their assets to an asset recovery agency (ARA) in return for Government bonds			January 1997
		II.D.2.	Receiver to transfer household deposits and an adequate level of bonds to a newly established savings bank			January 1997
		II.D.3.	ARA to transfer performing loans to a newly established enterprise bank			February 1997
		II.D.4.	Government to make adequate provisions in the 1997 budget to finance the bank restructuring program agreed with the Bank	December 1996		
		II.D.5.	BOM to fully enforce receivership provisions under the Banking Law for insolvent banks		June 1998	
III.	**Financial intermediation process based on market conditions**					
III.A.	Curtail Government interference with banking activities	III.A.1.	Government to discontinue issuance of credit directives to BOM and financial institutions			Continued compliance
		III.A.2.	Enact new banking legislation to limit extension of BOM credit to the Government including public enterprises and local Governments	September 1996		
		III.A.3.	Incorporate Trade and Development Bank under the Company Law			March 1997
		III.A.4.	MOF and BOM to clarify ownership of banks and to issue definite lists of shareholders			June 1997
		III.A.5.	Government to prepare strategy, acceptable to the Bank, for the divestment of direct and indirect state holdings in banks		June 1998	
		III.A.6.	Establish BOM/MOF Working Group to review taxation of commercial bank branches	October 1996		
III.B.	Restrict shareholder access to credit	III.B.1.	Enact new banking legislation to restrict lending to one single shareholder to no more than 5 percent of paid-up capital of the relevant bank and lending to all shareholders to no more than 20 percent of total paid-up capital	September 1996		
		III.B.2.	Banks to report all lending to shareholders with shareholdings of more than 1 percent of bank shares to BOM on a monthly basis			Continued compliance
III.C.	Establish market-determined interest rates	III.C.1.	Government to discontinue lending by Government non-bank financial institutions including funds unless authorized by BOM	September 1996		
		III.C.2.	BOM to remove interest rate floor on time deposits	October 1996		
		III.C.3.	Banks to pay interest on Government deposits in line with market conditions and Government to adequately compensate banks for all services rendered in connection with the transfer and distribution of social security, pension, and budget funds			January 1997

OBJECTIVE	ACTION PROGRAM	ACTIONS TO BE COMPLETED PRIOR TO BOARD CONSIDERATION	ACTIONS TO BE TAKEN FOR RELEASE OF SECOND TRANCHE[1]	OTHER ACTIONS TO BE TAKEN DURING THE PROGRAM[2]
	III.C.4. BOM to use auction mechanism for its refinance facility	March 1996		
	III.C.5. BOM to enforce its limits on commercial banks' access to its refinance facility			Continued compliance
	III.C.6. BOM to provide facility to discount central bank bills	June 1996		
	III.C.7. BOM to discontinue clearing loan facility		June 1998	
	III.C.8. BOM to restrict the provision of credit or liquidity to commercial banks outside its refinancing or discount facility to emergency support for illiquid banks in accordance with the provisions of the Central Banking Law		June 1998	

[1] It is expected that release of the second tranche will take place within two years of loan effectivity, i.e. by 31 December 1998.
[2] Program period ends on 31 December 1999.

POVERTY IMPACT ASSESSMENT

A. Introduction

1. In the short term, the rapid economic transition in Mongolia has been achieved at some costs in human development. In 1994, about 26 percent of the population was living below the official poverty line.[1] Registered unemployment increased from 55,500 in January 1992 to 72,500 in 1994, but by 1995 it had declined to 66,000. Cuts in social spending, as a result of fiscal constraints, led to deteriorating health and education services, as reflected in the following indicators: the number of students (in all types of educational institutions) declined from 266 per thousand persons in 1989 to 175 in 1994; the number of physicians declined from 29 per ten thousand persons in 1990 to 27 in 1994; the number of medical personnel of medium rank declined from 92 per thousand persons in 1990 to 75 in 1994, and the maternal mortality rate per thousand live births increased from 12 in 1990 to 21.2 in 1994.

B. Policy Actions with Potential for a Significant Impact on the Poor under the Program

2. The specific policy actions to be taken under the Program are either slightly pro-poor or poor-neutral. The overall Program will have a major impact on society because of the significant role of the banking sector in the economy; about 30 percent of the total population have a bank account. Most household accounts are held with the Ardyn Bank or the Agricultural Bank. All Government salaries and Government transactions are distributed through the banking system. Pensions and social welfare benefits are delivered to over 300,000 individuals through the banking system. The present instability and crisis in any commercial bank affects not only business but also threatens the functioning of the social safety net. Poverty Impact Assessment (PIA) matrices for the Program are given in pages 5-9 of this Appendix, and discussed briefly in paras. 3-17 below.

1. Improve Bank Credit and Risk Management

3. In principle, the impact of improving bank credit and risk management is to free resources for productive loans which would create employment for, and reduce the number of, poor. This assumes that there are good loans to be made and that bad loans are presently crowding out good loans. In the short run, some unemployment will be created because of closures triggered by discontinuing the policy of automatically renewing loans to debtors in default. The unemployment impact of the conditionalities under Objective IA (see PIA matrices) will be limited as (i) it is anticipated that the unemployment impact will be small as financially viable enterprises will continue to receive support from banks, (ii) current experience indicates that about 80 percent of all businesses currently in default have stopped operating, and (iii) most large State-owned enterprises have already significantly downsized. Segregating the impact of the Program on employment in general macroeconomic statistics is difficult. A review of the loan portfolio of the banks after the Program is under way may provide some indication on the contribution of the banks to job creation.

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1 The official poverty line in 1994 was Tug 3,200 ($8) per person per month for urban areas and Tug 2,900 ($7.20) per person per month for rural areas.

2. Restructuring of Banks

4. Restructuring the banking sector should improve services to the approximately 700,000 customers. Providing that at least one banks continues to maintain a presence in the *somon* centers to enable payment of social security and social welfare allowances, these measures will contribute to the better delivery of services to over 300,000 individuals. The combined effect of restructuring and consolidation will be a net loss of 600 jobs over a three-year period. The cessation of payment of dividends to shareholders of banks operating at a loss is unlikely to have a major impact as such payments would likely represent a small part of shareholders' total income. In the long run, shareholders should benefit from improvements in the value of their assets.

3. Remove Unrecoverable Government Directed Loans from Banks' Balance Sheet

5. This objective is largely poor-neutral. To the extent that the issuance of bonds improves liquidity, the condition contributes to improved delivery of pension and social allowance payments.

4. Consolidate Banking System

6. This objective is pro-poor. The orderly closure of nonviable banks should reduce the risks of a run on all banks, which would disrupt access to pensions and social allowances and could precipitate the closure of good banks. Further, continued support of nonviable banks reduces resources available for productive purposes. The Government must, however, maintain depositor confidence from the onset of liquidation procedures. A consumer survey carried out for this PIA found that while depositors have confidence in Government support of the banks, there is some concern regarding depositor protection.

7. At least two banks, the Ardyn Bank and Insurance Bank, are likely to be liquidated. As a result of the consolidation and restructuring, there will be a net decrease of about 600 job to the sector over a three-year period due to the expected elimination of some activities. As both restructuring and consolidation will be carried out together, it is difficult to distinguish the impact of consolidation vis-a-vis restructuging. However, it can be anticipated that most of the job loss will occur early in the Program. Household depositors and small enterprises should not be adversely affected by the liquidation as the Government of Mongolia will cover their deposits. There will, however, be more loss to larger enterprises.

5. Facilitate Debt Recovery

8. This objective is either poor-neutral or slightly pro-poor. Facilitating debt recovery through appropriate legal measures creates incentives for repayment, facilitates the lending process, lowers transaction costs to both borrowers and lenders, and contributes to the availability of funds for lending. Depositors have greater protection. The pursuit of individuals and businesses in court claims and bankruptcy proceedings protects the lender but is unlikely to contribute significantly to unemployment. Eighty percent of loans to non-State enterprises in default are to small enterprises or individuals. Increasing the availability of funds for lending to good borrowers can contribute to employment generation for expanded or new activities.

6. Improve Banking Supervision

9. This objective is essentially poor-neutral although it does contribute to increased public confidence in the commercial banks.

7. Regulate Non-Banking Financial Institutions (NBFIs)

10. In general, regulation of NBFIs will contribute to consumer protection and sound regulation but the poor do not make significant use of NBFIs in Mongolia.

8. Facilitate Enforcement of Financial Sector Related laws

11. This objective contributes to the net effect of the other objectives and is poor-neutral.

9. Improve Transparency about the Financial Position of Banks

12. This measure is essentially poor-neutral. Establishing and enforcing compliance with internationally recognized accounting standards, external audits, and publication of annual financial statements introduces transparency into the banking system. The public have access to more accurate information and, therefore, make informed choices. This contributes to a credible banking system, to consumer confidence, and ultimately to the mobilization of savings through the banking system.

13. In the short run, publishing true bank financial statements would indicate the extent of problems in commercial banks and could contribute to a withdrawal of funds from the banks. It is important, therefore, that the Government demonstrates its commitment to resolving its problems of the sector and to restructuring and establishing a sound banking system.

10. Curtail Government Interference with Banking Activities

14. These measures are poor-neutral as they contribute to increased transparency of policy-based subsidies by coursing them through the budget rather than through commercial banks. It is not clear that Government directed loans have, in the past, contributed effectively to social welfare. Indeed, to the extent that directed loans to the agriculture sector contributed to inflation, which is essentially anti-poor, they may have had a negative impact. Targeted subsidies are more cost-effective and the Government should carry out welfare related policies through the budget.

11. Restrict Shareholder Influence on Credit Decisions

15. This objective is poor-neutral as it contributes to good banking practices, which ultimately lead to increased depositor confidence and lower potential for destabilizing runs on banks.

12. Establish Market Interest Rates

16. This objective is poor-neutral or slightly pro-poor. One of the requirements of this objective is that the Government adequately pays the banks for the cost of services provided.

This will enable banks to provide social services such as payment of pensions without imposing a burden on customers and/or shareholders.

C. Mitigation of Social Impacts

17. The Program is a corrective measure to restructure a collapsing banking system. Without the program, over 4,000 jobs in the banking sector, the savings of 700,000 individual depositors, payment of pensions and social allowances to vulnerable groups, and all Government transactions would be at stake. To ensure that the impacts of the program remain pro-poor or pro-neutral, the banking system should maintain its presence in rural *somon* centers to ensure the ability of the Government to maintain the social safety net for rural dwellers. The Government must also take steps to preserve public confidence in the commercial banks.

POVERTY IMPACT MATRICES

POVERTY IMPACT: OBJECTIVE I A FACILITATE DEBT RECOVERY					
	Type of Effect				Ongoing and Planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour		Employment generation (2) Employment loss small. Current banking experience shows that excluding the state enterprises, over 80 percent of loans are to small businesses that are no longer in operation by the time they are taken to court.	Lower cost of borrowing permits lending for more labour intensive activities (3)	Employment generation (2) for new or expanded activities Employment loss small. Current banking experience shows that excluding the state enterprises, over 80% of loans are to small businesses that are no longer in operation by the time they are taken to court	
Prices				Better access to credit (1)	
Access for Poor				Protects savings of about 700.000 depositors	
Transfers					
Crucial Assumptions	(1) Bad loans are now crowding out good loans (2) There are good loans to be made (3) Improved loan recovery contributes to overall lower cost of loans				
Total Net Effect	Poor neutral and possibly slightly pro-poor				
Narrative	The actions covered under Objective I A of the policy matrix will facilitate debt recovery, securing loans, and credit investigations, create incentives for debt repayment, lead to better lending and lower transaction costs. Depositors are afforded better protection and more funds become available for lending.				

POVERTY IMPACT: OBJECTIVE I B IMPROVE BANKING SUPERVISION					
	Type of Effect				Ongoing and planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor					
Transfers					
Crucial Assumptions					
Total Net Effect	Poor neutral				
Narrative	The actions covered under Objective I B of the policy matrix contribute to creating a credible system and depositor confidence. Survey results suggest that despite recent bank closure, many depositors feel that interest rates and availability of cash are two of the most significant factors in their decision to put money into banks.				

POVERTY IMPACT: OBJECTIVE I C ESTABLISH A FRAMEWORK FOR REGULATING NBFIS					
	Type of Effect				Ongoing and planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor					
Transfers					
Crucial Assumptions	Poor may be more likely to make use of NBFIs for savings or to obtain small scale credit (in the future)				
Total Net Effect	May be pro-poor				
Narrative	The actions covered under Objective I C of the policy matrix contribute to consumer protection and sound regulation.				

POVERTY IMPACT: OBJECTIVE I D FACILITATE ENFORCEMENT OF FINANCIAL SECTOR RELATED LAWS					
	Type of Effect				Ongoing and planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor					
Transfers					
Crucial Assumptions					
Total Net Effect	none				
Narrative	The actions covered under Objective I D of the policy matrix contribute to the net effect of the other objectives.				

POVERTY IMPACT: OBJECTIVE I E IMPROVE TRANSPARENCY ABOUT THE FINANCIAL POSITION OF BANKS					
	Type of Effect				Ongoing and Planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor					
Transfers					Government must demonstrate its commitment to restructure and establish a sound banking system. Government must demonstrate its commitment to resolving problems in the banking system by effective handling of bank closures.
Crucial Assumptions	Publication of true financial statements does not trigger loss of public confidence in the banks.				
Total Net Effect	Poor neutral				
Narrative	The actions covered under Objective I E of the policy matrix contribute to establishing and enforcing compliance with internationally recognised accounting standards and external audits, and publication of annual financial statements introduces transparency into the banking system. The public can be fully informed and thus make educated choices. This contributes to a credible banking system, to consumer confidence, and ultimately to the mobilisation of savings through the banking system.				

POVERTY IMPACT: OBJECTIVE II A IMPROVE BANK'S POLICIES AND SYSTEMS					
	Type of Effect				Ongoing and Planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour		Employment generation (3) Some loss of employment for enterprises in default cut off from new loans. Not likely to be significant as downsizing of many enterprises has already occurred (4)	Lower cost of borrowing permits lending for more labour intensive activities (3)	Employment generation (2) for new or expanded activities Some loss of employment for enterprises in default cut off from new loans. Not likely to be significant as downsizing of many enterprises has already occurred (4)	1. Bank Employment Generation Project 2. TACIS project 3. World Bank poverty alleviation programme
Prices					
Access for Poor				Better access to credit (1)	
Transfers				Protects savings of about 700,000 individuals	
Crucial Assumptions	(1) Bad loans are crowding out good loans (2) There are good loans to be made (3) Better quality loans and better loan management will contribute to reduced cost of borrowing (4) Financially viable enterprises in default will receive some support from the banks				
Total Net Effect	Slightly pro-poor				
Narrative	The actions covered under Objective II A of the policy matrix contribute to better quality loans and better loan management both of which are good for borrowers and lenders. Access to funds by good borrowers is improved. Good credit policies contribute to increased depositor confidence and therefore to the availability of funds for investment.				

POVERTY IMPACT: OBJECTIVE II B REMOVE UNRECOVERABLE GOVERNMENT DIRECTED LOANS FROM BANK'S BALANCE SHEETS					
	Type of Effect				Ongoing and Planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor					
Transfers		Fewer delays in pension and social allowance payments due to improved liquidity			
Crucial Assumptions	Bond issue provides banks with liquidity				
Total Net Effect	Poor neutral				
Narrative	The actions covered under Objective II B of the policy matrix stop banks from showing spurious positive income from interest accrual and prevent the financial position of enterprises from deteriorating further as a result of interest accumulation on unproductive inherited and directed loans. The balance sheets of banks would reflect their position more accurately. Bond issues will provide banks with needed liquidity. Apart from possibly contributing improved payment of pensions and social allowances, this objective will have little impact on the poor.				

POVERTY IMPACT: OBJECTIVE II C RESTRUCTURE BANKS THAT HAVE LONG-TERM VIABILITY					
	Type of Effect				Ongoing and planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour				Downsizing of services may lead to reduction of 600 jobs in banks	
Prices					
Access for Poor					
Transfers	Improved bank performance contributes to improved availability of cash and delivery of pensions and social allowances to over 300,000 individuals(1)			Protects savings of over 700,000 depositors	
Crucial Assumptions	(1) Banks continue to maintain units in Somon centres to enable payments of social security, social allowances, and salaries. (2) Dividends do not represent a large part of shareholders income and, in general, bank shares do not represent a major portion of shareholder assets.				
Total Net Effect	Slightly pro-poor provided that crucial assumption (1) is met				
Narrative	The actions covered under Objective II C of the policy matrix will enable better delivery of services to nearly 300,000 individuals receiving pensions and social allowances. The rationalisation of Ardyn and Agricultural Banks will lead to better provision of services to their customers and provide positive examples for other banks.				

POVERTY IMPACT: OBJECTIVE II D CLOSE BANKS THAT DO NOT HAVE LONG-TERM VIABILITY					
	Type of Effect				Ongoing and planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour		Loss of jobs due to the dislocation of business if unplanned and unmanaged bank closures takes place		Together with downsizing of services may lead to a reduction of 600 jobs in banks.	
Prices			Resources are not spent propping up insolvent banks (2)		
Access for Poor					
Transfers	Disrupted access to pensions and social allowances if a run on banks is precipitated (1)			Savings of about 400,000 depositors potentially affected.	The Government will cover household and small enterprise deposits as well as 90 percent of medium and large scale enterprises.
Crucial Assumptions	(1) Planned Government coverage of deposits can maintain consumer confidence in the banking system and prevent a run. (2) Some banks are insolvent and their continued support reduces resources otherwise available for productive purposes.				
Total Net Effect	Pro-poor providing that crucial assumption (1) is met				
Narrative	The actions covered under Objective II D of the policy matrix will result in bank closures under orderly and controlled circumstances which provides more protection for depositors than uncontrolled collapses. Good borrowers will take their business elsewhere. Bad borrowers will have more time to get their affairs in order. Bank liquidation will result in lost jobs and a short-run net reduction in employment.				

POVERTY IMPACT: OBJECTIVE III A CURTAIL GOVERNMENT INTERFERENCE WITH BANKING ACTIVITIES					
	Type of Effect				Ongoing and planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor					
Transfers		Targeted transfers can be made directly through the budget rather than indirectly through the banking system. (1)			
Crucial Assumptions	(1) Targeted transfers are more effective than indirect transfers				
Total Net Effect	Poor neutral or slightly pro-poor				
Narrative	The actions covered under Objective III A of the policy matrix contribute to increased transparency of policy based subsidies by coursing them through the budget rather than through the commercial banks. The Government can carry out employment generation policies or anti-unemployment generated policies in a more targeted fashion,. Commercial bank customers otherwise bear the cost of subsidies which creates disincentive to use the formal banking system.				

POVERTY IMPACT: OBJECTIVE III B RESTRICT SHAREHOLDER ACCESS TO CREDIT					
	Type of Effect				Ongoing and Planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor					
Transfers					
Crucial Assumptions					
Total Net Effect	Poor neutral				
Narrative	The actions covered under Objective III B of the policy matrix contribute to good banking practices which ultimately lead to increased consumer confidence and lower potential for destabilising runs on the bank.				

POVERTY IMPACT: OBJECTIVE III C ESTABLISH MARKET DETERMINED INTEREST RATES					
	Type of Effect				Ongoing and planned
Channel	Direct	Indirect	Macro	Non-poor	Mitigation Measures
Labour					
Prices					
Access for Poor		Better delivery of pensions and social allowances			
Transfers					
Crucial Assumptions	(1) Banks can provide better delivery of social services such as payment of pensions if adequately paid for the service.				
Total Net Effect	Poor neutral or slightly pro-poor				
Narrative	The actions covered under Objective III C of the policy matrix contribute to freeing resources for the budget by prohibiting lending by Government non-financial institutions, banks are no longer subsidised by interest free Government deposits while the cost of public services are borne by the public as a whole rather than by bank customers alone. Cost of services become transparent and more easily managed.				

Appendix 5

INELIGIBLE ITEMS

1. The proceeds of the proposed Program loan may be used to finance the foreign currency expenditures in respect of the reasonable cost of imported goods (excluding any duties or taxes) required during the implementation of the Program. All imported goods financed from the proposed loan must be produced in, and procured from, the Bank's member countries.

2. Notwithstanding the provisions of paragraph 1 above, no withdrawal may be made in respect of:

(i) expenditures for goods included in the following groups or subgroups of the United Nations Standard International Trade Classification, Revision 3;

Group	Subgroup	Description of Items
112	–	Alcoholic beverages
121	–	Tobacco, unmanufactured; tobacco refuse
122	–	Tobacco, manufactured (whether or not containing tobacco substitutes)
525	–	Radioactive and associated materials
667	–	Pearls; precious and semi-precious stones, unworked or worked
718	718.7	Nuclear reactors and parts thereof; fuel elements (cartridges), non-irradiated for nuclear reactors
897	897.3	Jewelry of gold, silver or platinum group metals (except watches and watch cases); goldsmiths' wares or silversmiths' wares (including set gems)
971	–	Gold, non-monetary (excluding gold ores and concentrates)

(ii) expenditures for goods intended for a military or paramilitary purpose or for luxury consumption;

(iii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a or 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification;

(iv) expenditures for goods supplied or to be supplied under any contract that a national or international financing institution or any other financial agency has financed or agreed to finance, including any contract financed or to be financed under any loan from the Bank; and

(v) expenditures incurred more than 180 days prior to the date of effectiveness of the loan.

TECHNICAL ASSISTANCE LOAN FOR UPGRADING SKILLS AND SYSTEMS OF COMMERCIAL BANKS

A. Introduction

1. The proposed Program recognizes that the development of an efficient, commercially oriented banking system in Mongolia will require that some individual banks pursue a restructuring strategy to raise their performance to an acceptable standard. To implement these strategies successfully it will be necessary to have long-term advisors in the relevant banks. These advisors will work with the banks to implement the Program, provide on-the job guidance/training to staff and identify areas in which further training is needed. The skills required by such advisors are lacking in Mongolia; it will therefore be necessary to engage suitably qualified international advisors.

2. In addition, training will play a crucial role in assisting the transition from mono-banking to a market-oriented, two-tier commercial banking system. Training has already been provided by various multilateral and bilateral agencies to the Bank of Mongolia (BOM), commercial banks, and to relevant faculties in the Mongolian National University and other Colleges specializing in banking and finance studies.

3. The training for commercial banks has mainly been to the larger commercial banks and the training has largely been in the form of short-term courses either within each bank, as in the case of Ardyn Bank and ITI Bank, or in classroom situations. On-the-job training has covered accounting principles and procedures, credit appraisal, and monitoring, loan recovery, and asset liability management.

4. The training provided so far has generally been successful and there has been considerable progress in improving skills in the commercial banks. However, there is a critical need for further training and, in particular for on-the-job training of between six and 12 months by international experts. Some banks are already allocating funds for training programs, but the cost of international experts is beyond the resources of existing banks; although most banks would be in a position to meet a part of the costs of international experts.

5. Another major deficiency in the commercial banks is the absence of adequate computer software, management information systems and associated equipment. Computerization was initiated during monobanking days but the software and information systems inherited by the commercial banks are inadequate for the needs of a market-oriented banking system. BOM has received a World Bank grant for central bank accounting software and to train the staff in its use. Agricultural Bank is receiving technical assistance from GTZ which covers integrated banking software. The software of other banks needs to be upgraded and most banks would like to install integrated banking software packages that cover general ledger functions, deposit and loan accounts and could be used for operating a management information system. The requirements of the commercial banks differ widely, and software packages will have to be individually adapted to each bank's needs. A detailed study of existing software and the specific requirements needs of the commercial banks software and associated equipment will be undertaken, taking into account the business strategies of each bank.

B. Objectives

6. The proposed TA loan is aimed at improving the capacity of the commercial banks to undertake the role required in a market-oriented economic system. This will involve providing international consultants to improve the performance of commercial banks by upgrading banking skills and the quality of human resources, by helping higher education institutions to play a more active role in the training of staff of commercial banks, and by assisting commercial banks to upgrade their computer software and associated equipment and train their staff in the use of integrated banking software.

C. Scope

7. The TA loan will be used for (i) providing long-term experts to assist in the implementation of restructuring strategies for Agricultural Bank and BITI; (ii) providing assistance for commercial banks to employ a general banking expert to advise on an appropriate strategy for making the transition to a commercially oriented bank, and identifying the training requirements of the banks; (iii) providing training in specially identified areas where the individual bank perceives some weaknesses in relation to its development plans; (iv) exposing the top management of commercial banks to working of commercial banks in developed market economies; (v) purchasing, adapting and installing integrated banking software and equipment; and (vi) training the staff of commercial banks in the use of integrated software and equipment to maintain accounts, monitor loans, operate management information systems and generate reports.

8. The TA has two main components: (i) implementing restructuring strategies, staff training and upgrading skills, primarily through long-term on-the-job training; and (ii) installing integrated software packages in commercial banks. The long-term advisors will be required to (i) advise senior management of commercial banks on the implementation of restructuring strategies, (ii) provide on-the-job-training to bank staff, (iii) provide short-term training in specific areas, (iv) identify areas where additional training is required and advice on the appropriate means of acquiring the training, and (v) help to install the software package.

9. The TA provides funds for an international expert to work in the Agricultural Bank for 12 months advising on the implementation of the restructuring strategy, and on other matters.[1] In addition, the TA provides funds to enable other banks to recruit advisors to assist in implementing their business plan and making the transition to a market-oriented system, to provide on-the-job training for bank staff in credit underwriting, loan documentation, syndication, monitoring, and recovery, and asset liability management, to identify areas where further training may be necessary, and to initiate such training to assist in identifying requirements for software and associated equipment and to provide general advice on the efficient operations of these banks. In consultation with bank management, the advisors will identify special needs of the staff and arrange for classroom training either in the facilities available in local colleges and universities

[1] GTZ currently has an advisor in Agricultural Bank to develop a viable rural credit system for three years. GTZ is implementing its assistance to Agricultural Bank within the framework of the proposed Program Loan and the advisor recruited under this TA will be expected to liaise closely with the GTZ advisor.

or by inviting international consultants. These experts may be required for periods of between three and six months, depending on the needs of the particular bank.

10. The TA provides for up to 55 person-months of international consultant services for the above components. The resident advisors will be active or recently retired bankers with general banking experience in commercial banks in market economies and preferably with experience of banking in transition economies.

11. In order to avail of the training component, commercial banks will be required to submit a training program to BOM, which, in consultation with the Bank, will make a decision whether or not to approve funding of the proposed training. Those commercial banks that do not recruit an advisor will still be able to obtain funding for training by filing similar training plans with BOM.

12. To strengthen the training facilities outside the banks in existing university facilities and colleges, funds will be available under the TA for needed equipment and teaching aids to selected institutes. In the course of previous TA projects of the Bank, four institutes – the Economics Faculty of the Mongolian National University, the Economics College, the College of Business and Commerce and the Institute of Management and Development – have been identified as having programs leading to degrees or specialized courses in banking and finance. In order to avail of funds under the TA loan, the relevant institute will submit proposals for equipment and teaching aids to BOM, which will evaluate the proposals taking into account the needs of commercial banks and in consultation with the Bank determine whether to approve funding.

13. All existing commercial banks would be eligible for participation in the program to be financed from the TA loan.

14. The software component will have two phases. In the first phase, a consultant, specializing in banking software, will undertake an assessment of the software requirements of commercial banks. The cost of the package and training will also be estimated. In the second phase, the software and equipment for individual banks will be procured and installed by an international consulting firm, which will also be responsible for providing training in its use.

D. Cost Estimates and Financing Plan

15. The total cost of the TA is estimated at about $3.039 million. It is proposed that the Bank provide a loan of SDR 2.074 million ($3 million equivalent) from its Special Funds resources to cover the estimated foreign exchange costs associated with the TA. This will cover the foreign exchange costs associated with employment of international experts, procurement of equipment and teaching aids for training institutions and procurement of software and equipment for the banks. The commercial banks will be responsible for local costs associated with office accommodation, local transportation requirements and other support, such as interpreters and secretaries for the international experts.

E. Implementation Arrangements

1. Executing Agency

16. BOM will be the Executing Agency for the proposed TA loan and will be responsible for overall implementation of the related activities. BOM will be responsible for administering the loan and ensuring that proper records are maintained.

2. Eligible Imports

17. The TA loan proceeds will be available to finance the foreign exchange costs (excluding duties and taxes) of international experts, training programs and imports of software packages and related equipment, provided that the items are procured from the member countries of the Bank.

3. Engagement of Consultants and Procurement

18. All consultants, whether for appointment as long-term advisors in commercial banks or for short-term classroom training, will be recruited in accordance with the *Bank's Guidelines on the Use of Consultants.*

19. Procurement of software and equipment will be done on the basis of limited tendering and will be subject to an ex-post review by the Bank. In the event that the appropriate procedures have not been followed, the Bank reserves the right to withhold the disbursement of funds, or to seek reimbursement. Proceeds of the TA loan will be withdrawn in accordance with the Bank's standard disbursement procedures.

4. Subloans to Commercial Banks

20. Commercial banks participating in the TA program will share one half of total costs of consulting services and banking software. The balance of expenses will be covered by the TA loan. BOM will provide 5-year loans to participating banks at the Bank's OCR rate to help them finance their share of TA expenses. The commercial banks will assume the foreign exchange risk.

F. Monitoring

21. Participating commercial banks will be required to provide quarterly reports to BOM on the progress during the preceding quarter and actions proposed for the following quarter. These reports will be the primary means of monitoring the TA. In addition, the Bank will monitor progress through regular review missions.

22. At the completion of the TA, BOM will be required to submit a completion report assessing the impact of the TA and the benefits to the participating commercial banks.

COST ESTIMATES AND FINANCING PLAN
($'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing			
1. Internationally Recruited Consultants			
a. Remuneration	1,210	-	1,210
b. Per Diem	185	-	185
c. International Travel	85	-	85
2. Software Packages	990	-	990
3. Equipment for Education Institutes	125	-	125
4. Miscellaneous Support Costs	-	50	50
5. Contingencies	355	-	355
Subtotal (A)	2,950	50	3,000
B. Local Financing			
1. Translators and Interpreters	-	22	22
2. Domestic Travel	-	4	4
3. Vehicles	-	3	3
4. Office Accommodation	-	10	10
Subtotal (B)	-	39	39
Total	**2,950**	**89**	**3,039**

PROPOSED TECHNICAL ASSISTANCE FOR STRENGTHENING THE SUPERVISORY AND RESTRUCTURING CAPACITY OF THE BANK OF MONGOLIA

A. Objective

1. The TA will support the implementation of the Government's financial sector reform program by strengthening the capacity of BOM to regulate, supervise, and restructure the commercial banking system.

B. Scope

2. The TA will provide consulting services to assist BOM in the (i) developing a core group of qualified banking supervisors through classroom and on-the-job training; (ii) developing bank examination methodologies and procedures; (iii) preparation of regulations pertaining to banking supervision, bank licensing, and conservatorship; (iv) enhancement of bank accounting standards and regulations in line with international practices; (v) operational and financial restructuring of selected banks, and (vi) liquidation of banks. (See paras 8-15 for detailed terms of reference).

C. Implementation Arrangements

3. Four international consultants (a bank restructuring specialist, a banking supervision specialist, a bank accounting specialist, and a legal advisor, will be recruited on an individual basis in accordance with the Bank's *Guidelines on the Use of Consultants* to provide a total of 36 person-months of services over a period of 20 months starting on or about January 1997. The international consultants will arrange for the local interpreter/translator services.

4. BOM will be the Executing Agency for the TA. It will assign senior managers in its banking supervision department in charge of banking supervision and bank restructuring to work with the consultants and provide relevant data and other information as requested by the consultants.

5. The TA will also finance study tours of selected BOM supervisors and staff of the Bank Restructuring Unit (BRU) to foreign bank restructuring agencies and banking supervision institutions. The bank restructuring specialist and the banking supervision specialist will assist in the identification of appropriate organizations and in the organization of the overseas visits.

D. Reporting Requirements

6. The consultants will submit monthly reports on their activities and findings to BOM and the Bank. In addition, the bank supervision specialist and the bank accounting specialist will submit all their training materials to the Bank and BOM. The legal advisor will provide drafts of the regulations on bank licensing, supervision, and conservatorship to BOM and the Bank for comments in due time. Each consultant will prepare a final report to be submitted to the Bank and the Government two weeks before the end of the assignment. Tripartite meetings will be held in Mongolia, as required.

E. Terms of Reference

1. **Bank Restructuring Specialist** (about 15 person-months)

7. The bank restructuring specialist will advise BOM in banking restructuring issues. In particular, the consultant will:

(i) monitor the implementation of BOM restructuring plans for the Agricultural Bank and BITI, and advise BOM on corrective measures to be taken if bank does not comply with the plans;

(ii) assist BOM in the development of remedial action programs for troubled banks;

(iii) advise BOM on conservatorship/receivership issues;

(iv) assist BOM conservators in their work, as required;

(v) assist BOM in determining appropriate resolution strategies for failing banks;

(vi) advise BOM on the closure and liquidation of banks and assist BOM and/or the appointed receiver in the process;

(vii) train BRU staff in financial and operational bank restructuring methods;

(viii) advise BOM on how to anticipate systemic liquidity problems of the banking system before they occur and how to deal with such problems once they occur;

(ix) assist BOM, in consultation with the Bank, in the identification and recruitment of consultants to provide training to commercial banks; and

(x) assist BOM in the preparation of a strategy for divestment of direct and indirect state holdings in commercial bank.

8. The consultant will have a background in commercial banking and/or management consulting. Extensive experience in advising on bank restructuring is required. Previous exposure to banking systems in transitional economies is desirable.

2. **Banking Supervision Specialist** (about 9 person months)

9. The banking supervision specialist will assist BOM in strengthening its on-site and off-site supervision capabilities. In particular, the consultant will:

(i) advise BOM on how to strengthen its on-site inspection function (organization, methodologies, procedures, including workpaper documentation procedures);

(ii) prepare an on-site inspection manual and train BOM supervision staff in its use;

(iii) train BOM supervision staff in the qualitative analysis of loans, the use of the CAMEL[1] approach in assessing banks, the review and evaluation of credit, risk management and internal control systems and procedures of commercial banks;

(iv) assist BOM in on-site inspections of banks;

(v) advise on the organization, information requirements, and procedures for adequate off-site inspection of commercial banks;

(vi) train BOM staff in off-site inspection (in particular, procedures and computer-based balance sheet and income statement analysis);

(vii) advise BOM on an examination system for banking supervisors;

(viii) train selected BOM staff on how to act as conservators/receivers for banks;

(ix) assist BOM staff in the closure and liquidation of banks;

(x) assist the legal advisor in the preparation of regulations on bank supervision, licensing, and conservatorship, and draft related procedures;

(xi) improve the compilation and presentation of financial information on commercial banks to facilitate the decision making process of BOM management;

(xii) advise BOM on how to assess banking license applications by domestic and foreign applicants; and

(xiii) advise BOM on the supervision of foreign banks operating in Mongolia.

10. The consultant will have extensive banking supervision experience at senior level, as well as training and/or consulting experience.

3. **Bank Accounting Specialist** (about 9 person-months)

11. The Bank accounting specialist will assist BOM in strengthening its capacity for regulating and supervising accounting by commercial banks. In particular, the consultant will:

(i) advise BOM on strengthening existing regulations on commercial bank accounting in line with international standards and practices;

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[1] The CAMEL system provides a method to evaluate bank viability by assessing five factors and assigning a weighted score for each: Capital adequacy, Asset Quality, Management, Earnings, and Liquidity.

(ii) develop a detailed implementation schedule for the conversion of all commercial banks to international accounting standards and monitor its implementation on a quarterly basis;

(iii) train BOM banking supervision staff in commercial bank accounting standards, methodologies, systems, and procedures;

(iv) assist BOM staff in on-site inspections of commercial banks, in particular in the review and evaluation of bank accounting systems and procedures;

(v) assist BOM receiver in determining the closing balance and the liquidation value for an insolvent bank; and

(vi) assist BOM staff and bank restructuring specialist, as requested, in reformatting bank balance sheets in line with international accounting standards to facilitate the monitoring of bank restructuring programs.

12. The consultant should be a chartered accountant or equivalent with extensive experience in bank accounting systems gained in a commercial bank or accounting firm. The consultant should have training experience and be familiar with Soviet-style accounting systems.

4. Legal Advisor (about 3 person-months)

13. The legal advisor will:

(i) advise BOM on legal issues pertaining to the conservatorship and receivership of commercial banks;

(ii) assist BOM in the liquidation of banks; and

(iii) assist BOM in the preparation of regulations on banking supervision, bank licensing, and conservatorship.

The consultant will have an advanced law degree and have extensive knowledge of banking and bankruptcy laws. Drafting experience and previous exposure to transitional economies gained through consulting assignments are required.

COST ESTIMATES AND FINANCING PLAN
($)

Item	Foreign Exchange	Local Currency	Total Cost
A. Bank Financing			
1. Internationally Recruited Consultants			
a. Remuneration	648,000	-	648,000
b. Per Diem	116,000	-	116,000
c. International Travel	41,000	-	41,000
2. Computer and Office Equipment	15,000	-	15,000
3. Communications and Reports	11,000	-	11,000
4. Overseas Training	40,000	-	40,000
5. Translators/Interpreters	-	12,000	12,000
6. Domestic Travel	-	3,000	3,000
7. Observers at Contract Negotiations	2,000	-	2,000
8. Contingencies	110,000	2,000	112,000
Subtotal (A)	983,000	17,000	1,000,000
B. Government Financing			
1. Counterpart Services	-	7,500	7,500
2. Office Expenses and Logistical Support	-	7,500	7,500
Subtotal (B)	-	15,000	15,000
Total	**983,000**	**32,000**	**1,015,000**

LOGICAL PROGRAM FRAMEWORK

DESIGN SUMMARY	TARGETS	PROGRAM MONITORING MECHANISMS	ASSUMPTIONS/RISKS
1. GOAL Efficient mobilization and allocation of resources for economic growth	1.1. Increase in M2/GDP 1.2. Increase in savings rate 1.3. Increase in lending volumes of banks (in real terms) 1.4. Decrease in financial intermediation costs	BOM/MOF statistics	Full implementation of the Government's long term financial sector strategy, in tandem with macroeconomic adjustments and stabilization measures.
2. PROGRAM OBJECTIVE Establishment of a sound market-based banking system	2.1.1. Autonomous, commercially oriented financial institutions 2.1.2. Commercial banks adequately capitalized 2.1.3. Financial system adequately regulated 2.1.4. Market-determined interest rates	Review Missions BOM statistics BOM call reports	Strong Government commitment to the Financial Sector Program, supported by commercial banks
3. OUTPUTS 3.1. Legal and regulatory framework for financial sector operations strengthened		New banking legislation was enacted in September 1996 Review Missions	BOM is willing to use its enforcement powers Bank, World Bank, and GTZ technical assistance in place and effective
3.1.1. Debt recovery facilitated	3.1.1.1. Adequate legal basis and enforcement mechanisms for debt recovery created 3.1.1.2. Loan collateralization process improved	Quarterly progress reports Reports under associated TA	Parliament passes the necessary laws.
3.1.2. Banking supervision improved	3.1.2.1. BOM's enforcement powers strengthened by law 3.1.2.2. BOM's supervisory skills and capacity strengthened 3.1.2.3. Adequate prudential norms and capital adequacy standards introduced 3.1.2.4. Banks' reporting to BOM improved	Reports by World Bank legal consultants	
3.1.3. Legal Framework for regulating NBFIs established	3.1.3.1. BOM empowered to regulate NBFIs, and regulations for NBFIs in place		Bank provides a TA to examine the regulatory framework as part of the 1997 Program.
3.1.4. Enforcement of financial sector related laws facilitated	3.1.4.1. Judges and lawyers trained in the implementation of financial sector related laws		World Bank finances training for judges and lawyers related to the financial sector
3.1.5. Financial information on banks improved	3.1.5.1. Adequate loan classification and loan loss provisioning by banks 3.1.5.2. International bank accounting standards implemented 3.1.5.3. Financial information on banks available to the public		
3.2. Financial intermediaries strengthened		Consultants reports under piggy-backed TA and TA-Loan	
3.2.1. Bank's credit and risk management policies and systems improved	3.2.1.1. Adequate credit policies approved and implemented 3.2.1.2. Adequate financial information and risk management systems implemented 3.2.1.3. Skill levels of bankers improved	Review Missions Quarterly progress reports	Banks use technical assistance to upgrade their credit, risk management systems and management information Banks comply with restructuring targets Depositors maintain confidence in the banking system

DESIGN SUMMARY	TARGETS	PROGRAM MONITORING MECHANISMS	ASSUMPTIONS/RISKS
3. OUTPUTS (continuation)			
3.2.2. Commercial banks restructured to solvency	3.2.2.1. Insolvent banks that do not show long-term viability closed down 3.2.2.2. All viable banks operationally and financially restructured to meet acceptable capital adequacy standards	BOM call reports	
3.3. The role of market mechanisms in the financial intermediation process strengthened		FSPL review missions	Government will not revert to issuing credit directives
3.3.1. Government interference with banking activities curtailed	3.3.1.1. Government interference with credit allocations decisions discontinued 3.3.1.2. Strategy for divestment of State shareholdings in banks developed 3.3.1.3. Taxation of banks does not distort business decisions	Quarterly progress reports Reports submitted by consultants recruited under the TA loan.	Banks' credit decisions will be free from undue external pressures Government and BOM agree on divestment strategies for banks
3.3.2. Shareholder access to credit restricted	3.3.2.1. Bank lending to shareholders restricted		Monetary conditions allow shift to indirect monetary instruments
3.3.3. Interest rates determined by market conditions	3.3.3.1. Interest rate subsidies discontinued 3.3.3.2. Bank deposit costs market-based 3.3.3.3. BOM credit market-based		
4. ACTIVITIES			
4.1. Strengthening of the Legal and Regulatory Framework for Financial Sector	4.1.1. Working Group to consider current deficiencies in the Civil Code pertaining to debt recovery established	BOM progress report/Review missions	Adequate capability of BOM and Government to manage reform process
	4.1.2 Civil Code to take account of recommendations of Working Group	Review missions	Measures under the Program including all second tranche conditions complied with.
	4.1.3. Property registration division established within Ministry of Justice to consider strategies for setting up a registration agency	Appraisal Missions	
	4.1.4. Action Plan on Property Registration (for immovables) submitted to Parliament	Review Missions	
	4.1.5. Draft Law on Secured Transactions (for movables) prepared by MOJ	Review Missions	
	4.1.6. Banks permitted to exchange credit information on borrowers	Banking Law enacted on 3 September 1996	
	4.1.7. Working Group to revise Bankruptcy Law established	BOM progress report	
	4.1.8. Bankruptcy Law amended to facilitate debt recovery and to give preferred status to secured creditors	Review Missions	
	4.1.9. Structure, financing, and operations of the bailiff system reviewed	Review Mission	
	4.1.10. Duties and responsibilities of management of commercial banks classified	Banking Law enacted on 3 September 1996	
	4.1.11. Right (conferred on BOM) to replace bank management	Banking Law enacted on 3 September 1996	
	4.1.12. Banks prohibited from directly engaging in equity market activities for their own account	Banking Law enacted on 3 September 1996	
	4.1.13. Banking Law to confer on BOM powers relating to the conservatorship, receivership, and liquidation of commercial banks	Banking Law enacted on 3 September 1996	
	4.1.14. Regulations and implementation procedures for the liquidation of banks approved by BOM	BOM regulations #239 of 1996	
	4.1.15. Shareholders disallowed to take out their paid-up capital in banks other than through sale of shares	Banking Law enacted on 3 September 1996	

DESIGN SUMMARY	TARGETS	PROGRAM MONITORING MECHANISMS	ASSUMPTIONS/RISKS
4. ACTIVITIES (continuation) **4.1. Strengthening of the Legal and Regulatory Framework for Financial Sector**	4.1.16. Lending to any one borrower or related groups of borrowers limited to 20 percent of paid-up capital of bank	Banking Law enacted on 3 September 1996	
	4.1.17. Minimum capital to risk-weighted assets standards for all banks set in line with BIS standards: 2 percent (tier one capital) by 30 June 1998 4 percent (tier one capital) by 31 December 1999	BOM prudential regulations	
	4.1.18. Banking Law to enhance BOM 's powers to enforce prudential regulations	Central Banking Law enacted on 3 September 1996	
	4.1.19. Banks report all loan reschedulings for loans above Tug 10 million to BOM on a quarterly basis	BOM reports and Banking Supervision Consultant under piggy-backed TA	
	4.1.20. Banks provide quarterly status reports on collection efforts for all loans classified as substandard, doubtful, and loss to BOM	BOM reports and banking supervision consultant under piggy-backed TA	
	4.1.21. Banks provide monthly status reports on new lending and loan repayments to BOM	BOM reports and banking supervision consultant under piggy-backed TA	
	4.1.23. Adequate regulatory framework for NBFIs approved	Review of BOM regulations	
	4.1.24. Long-term program within IAMD to train judges and lawyers in the implementation of laws related to financial sector operations developed	Bank TA	
	4.1.25. Full compliance with new accounting standards and regulations based on GAAP for all commercial banks enforced by BOM	Reports of Bank Accounting Advisor under piggy-backed TA/BOM inspection reports	
	4.1.26. Full compliance by all commercial banks with provisions on recognition of interest income under new BOM accounting regulations enforced by BOM	BOM resolution #283 of 1996 and BOM inspection reports	
	4.1.27. BOM to enforce full compliance with BOM loan classification and loan loss provisioning requirements	BOM call reports	
	4.1.28. Tax deductibility for loan loss provisions allowed	Banking Law enacted on 3 September 1996	
	4.1.29. Banks subject to an annual external audit and required to publish annual financial statements	Banking Law enacted on 3 September 1996	
4.2. Strengthening of Financial Intermediaries	4.2.1. All banks required by BOM to approve credit policies that reflect sound banking principles by 1 October 1996	BOM resolution #290 of 1996	
	4.2.2. All banks prohibited by BOM to make new loans to borrowers in default	BOM resolution #150 of 1996	
	4.2.3. All banks prohibited by BOM to automatically reschedule loans to borrowers in default without negotiated repayment schedules that ensure borrowers' debt servicing capacity	BOM resolution #203 of 1996	
	4.2.4. All banks established adequate loan workout departments/units	BOM supervision reports	
	4.2.5. All banks with assets above Tug10 billion established asset/liability management committees	BOM supervision reports	
	4.2.6. Payment of dividends and any other distribution of profits by banks that do not fully comply with BOM prudential norms and capital adequacy standards prohibited	Central Banking Law of 3 September 1996	

DESIGN SUMMARY	TARGETS	PROGRAM MONITORING MECHANISMS	ASSUMPTIONS/RISKS
4. ACTIVITIES (continuation) **4.2. Strengthening of Financial Intermediaries**	4.2.7. Cease and desist orders issued for all insolvent banks specifying an interim program of remedial actions to be undertaken by 31 December 1996	BOM cease and desist orders	Adequate capability of BOM and Government to manage the reform process
	4.2.8. Restructuring strategies determined by BOM for BITI and Agricultural Bank that are acceptable to the Bank	Report of Consultant under TA No. 2605	Measures under the Program including all second tranche conditions complied with
	4.2.9. BOM enforces compliance of BITI and Agricultural Bank with restructuring strategies	Report of bank restructuring consultant under associated TA	
	4.2.10. Banks capitalize interest in arrears on unrecoverable inherited and directed loans, and show loans separately on their balance sheets	BOM decree of March 1996 BOM call reports	
	4.2.11. Strategy acceptable to the Bank for removing directed and inherited loans from banks' balance sheets determined by Government	Joint MOF/BOM resolution #90/18 of 1996	
	4.2.12. Inherited and directed loans substituted with interest-bearing Government securities for all eligible banks	Government decree	
	4.2.13. Insolvent banks that do not indicate long-term viability put into receivership and receiver to sell their assets to an Assets Recovery Agency (ARA) against bonds.	BOM progress report/ Consultants' report	
	4.2.14. Household deposits of banks under 4.2.13 transferred to a newly established savings bank		
	4.2.15. Performing loans of banks under 4.2.13 transferred to a newly established savings bank		
	4.2.16. Receivership provisions under the Banking Law fully enforced for insolvent banks	BOM call reports/Report of bank restructuring Consultant under piggy-backed TA	
4.3. Financial Intermediation Process based on Market Conditions	4.3.1. Issuance of Government credit directives to BOM and financial institutions	Review Missions	
	4.3.2. Extension of BOM credit to the Government including public enterprises and local Governments limited	Central Banking Law enacted on 3 September 1996	
	4.3.3. Trade and Development Bank incorporated under the Company Law	Cabinet decision	
	4.3.4. Ownership of banks classified and definite lists of shareholders issued by BOM/MOF	BOM report	
	4.3.5. Strategy, acceptable to the Bank, for the divestment of direct and indirect state holdings in banks prepared by Government	BOM progress reports/Review missions	
	4.3.6. BOM/MOF Working Group established to review taxation of commercial bank branches	BOM progress report	
	4.3.7. Lending to one single shareholder to no more than 5 percent of paid-up capital of the relevant bank and lending to all shareholders to no more than 20 percent of total paid-up capital	Banking Law enacted on 3 September 1996	
	4.3.8. Banks report all lending to shareholders with shareholdings of more than 1 percent of bank shares to BOM	BOM resolution #170 of 1995 and reports of Banking Supervision Consultant under associated TA	
	4.3.9. Lending by Government to non-financial institutions discontinued unless authorized by BOM	Banking Law enacted on 3 September 1996 BOM decree #259 of 1996	
	4.3.10. Interest rate floor on time deposits removed	BOM decree #259 of 1996	

DESIGN SUMMARY	TARGETS	PROGRAM MONITORING MECHANISMS	ASSUMPTIONS/RISKS
4. ACTIVITIES (continuation)			
4.3. Financial Intermediation Process based on Market Conditions	4.3.11. Banks pay interest on Government deposits in line with market conditions and Government adequately compensates banks for all services rendered in connection with the transfer and distribution of social security, pension, and budget funds	Cabinet decision	
	4.3.12. Auction mechanism used for BOM refinance facility	BOM decree of March 1996	
	4.3.13. BOM enforces limits on banks' access to its refinance facility	Review missions	
	4.3.14. BOM establishes discount window for central bank bills	BOM decree of June 1996	
	4.3.15. BOM discontinues clearing loan facility	BOM decree	
	4.3.16. BOM restricts the provision of credit or liquidity to commercial banks outside its refinancing or discount facility to emergency support for illiquid banks in accordance with the provisions of the Central Bank Law	BOM decree	