Report No. PID10713

Project Name	Mongolia-Financial Capacity Development (@)... Project
Region	East Asia and Pacific Region
Sector	Financial Sector Development
Project ID	MNPE71023
Borrower(s)	GOVERNMENT OF MONGOLIA
Implementing Agency	

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Environment Category	C
Date PID Prepared	April 4, 2002
Auth Appr/Negs Date	April 4, 2002
Bank Approval Date	May 30, 2002

1. Country and Sector Background
Introduction. Mongolia started a peaceful transition to democracy in the early 1990s following the collapse of the Soviet bloc. Since then, the Government of Mongolia (GOM) has adopted a policy stance that encourages economic liberalization. Today Mongolia's economic landscape is quite different from the Soviet model of the past. With donor support, Mongolia has established the basic legal framework for a commercial banking system (see Annex 8: Documents in Project File, Mongolia Banking System: Major Regulatory Changes). However, the pace of reforms has been uneven, and the economy remains vulnerable to external shocks.Sector structure. The financial system is still evolving to support the development of a market-based economy. Total financial sector assets are about US$276 million, as compared to a GDP of over US$1 billion. Gross loans to total assets account for 45 percent. Loans to Government (excluding Bank Restructuring Bonds) account for half percent of total assets, and are 11 percent if the BR-Bonds are included. Loans to public sector is 3 percent of the total assets. Loans to private sector has increased to 38 percent of total assets. Fixed assets are 6 percent of the total assets. There are 16 commercial banks, but many of them are start-ups (See Annex 8:

Documents in the Project File: Mongolia Financial Sector Market Review). Of the four large banks, the state-owned Trade and Development Bank (TDB) is the largest, accounting for about 34 percent of total assets. Golomt Bank is the largest private bank, accounting for 14 percent of total assets. The assets of the state-owned Savings Bank amount to 14 percent of total assets, but are largely composed of non-tradable government bonds. The Agricultural Bank has the most extensive branch network, and is currently under a management contract arrangement between the Ministry of Finance and Economy (the owner representative) and the Bank of Mongolia (the receiver), and a foreign consulting firm. Non-bank financial institutions are at an early stage of development. The stock market is small and illiquid, and insurance and leasing businesses are embryonic.Main issues. Despite the initiatives to strengthen and liberalize the financial system, the banking sector has experienced recurring crises and failures, most notably in 1994, 1996 and 1998/99. While the sector appeared to recover substantially after the crises, these recoveries turned out to be transitory. The 1999 Financial Sector Review, the 2000 Financial Sector Adjustment Credit (FSAC) identify among the policy distortions and structural weaknesses, the following issues during this turbulent period.Eroded public confidence in the financial system and low level of monetization. The deposit base of the banking sector was small, accounting for 15% of GDP. The basic measures of financial depth were quite low: the ratio of M2 to GDP is 25%, while the ratio of claims on nongovernment sector to GDP was only 7 percent. Of the total net banking assets, 19 percent were non-negotiable Bank Restructuring Bonds (BR-Bonds). On the one hand, the economy was over banked (12-14 banks for a population of 2.6 million), leading to losses and inefficiency. On the other, a large portion of transactions between enterprises were in the form of barter trade, and households operated on a cash economy parallel to the formal financial system.Crowding out of private sector development. The real interest rates in Mongolia remained at an unsustainable levels: for local currency, the average lending rate in 1999-2000 was 28 percent, and the average deposit rate 18 percent; for US dollar loans and deposits, the average rates were 23 percent and 4 percent. A number of factors contributed to the problem, including high expectations of currency devaluation, excess government demand for credit, and huge explicit and implicit NPLs. Total credit to private sector accounted for only 4 percent of GDP.High Non performing loans. Reported Non Performing Loans (NPLs) stood at 19 percent of total loans. Most of the NPLs were incurred due to poor credit risk management. While the official NPLs number appeared to be quite stable, there were incidences of "hidden" NPLs due to liberal assets classification practices and accounting entries. All loans in Mongolia were collateralized, but banks found it difficult to verify the legality and value of the collateral. When a borrower defaulted, it was difficult for the creditor to repossess and liquidate the asset. Slow assets recovery. Of the US$35 million impaired assets taken over by the Mongolia Assets Recovery Agency (MARA) in 1997, only about 14% were recovered by 2000. In 2001 another US$10 million liquidated assets were transferred to MARA from the closed ITI Bank and Reconstruction Bank. It was estimated that most of those assets have little residual value if marked to market. Weak financial sector infrastructure. Underlining the above issues is the weak infrastructure of the banking system.Banking laws and regulations are often copied from different legal systems (e.g. a continental law civil code and a common law securities law), although similar in words to those effective in the developed economies. The synergy, conflicts and applicability of those legal documents are not clearly understood. There are loopholes regarding the relationship between lenders and borrowers and private property right transfers. Banks do not have the power to adopt readily enforceable default conditions and remedies. Training of bankers and borrowers of the laws are limited. Law administration and enforcement are weak. The accounting practices are yet to comply with the International Accounting Standards (IAS). While Mongolia adopted the IAS in a law about nine years ago, training in IAS are seriously lagging behind. While the new amendments to the Accounting Law effective April 2002 require all business entities to maintain their accounts on the accrual basis, it will take time for many enterprises to switch from the cash based accounting. There is evidence that interim bank accounts are not in compliance with IAS, and therefore may not be much use as a basis for good management decisions. Banking decisions are based on personal references and physical evidence as financial statements are either unavailable or unreliable. In cases where financial statements are provided, they are prepared for tax purposes, and therefore don not provide sufficient information for credit analysis.Prudential regulation and supervision need to be further strengthened. Although BOM has come a long way to bring the prudential regulation and supervision closer to the Basel Core Principles, there are discrepancies in off-site reporting requirements, CAMEL and CAEL rating systems, and on-site examination procedures. Licensing of new banks tends to rely heavily on minimum capital requirement, without thorough review of the suitability of senior management and board directors, and the quality of business plan including market analysis and financial projections. The regulatory framework and supervision of Non Bank Financial Institutions (NBFIs) are weak.Corporate governance and internal control are very weak. Bank boards are yet to become effective governors of the institutions. Their role and accountability are not clearly understood. Personal liability of bank board members and senior managers for gross negligence is either missing in laws or not enforced. Internal control is equated to internal audit. There is a lack of control environment which entails senior bank management commitment. The internal control offices in banks are not independent of the management and do not have the mandate and skills to monitor bank-wide risks.Human resource development policies do not support a culture of accountability and responsibility. There are few measurement techniques to evaluate performance. As good performers are not sufficiently rewarded, poor performers have no worry of being penalized. Mongolian banks have received lots of training supported by donors, but training activities tend to be on an ad hoc or opportunistic basis without management follow up to ensure implementation. There is the need to develop and implement a core curriculum of systemic, phased-in training activities that are closely related with banks daily operations.Recent developments. The year 2001 witnessed some positive developments in the sector. Public confidence in the banking system started to recover as the total deposits as a percentage of GDP increased to 20 percent from 15 percent in the previous year. Cash outside the system as a percentage of M2 dropped to 33 percent as compared to 39 percent in 2000. Real interest rate for local currency loans was 30 percent, but that of local currency deposits dropped to 13 percent; real interest rates for US dollar loans and deposits declined to 11 percent and 2 percent. NPLs declined from 23 percent of total loans in 2000 to about 8 percent, thanks mainly to write-offs, better collection of overdue loans and a large portion of new loans that were yet to become problematic. The privatization process of Trade and Development Bank was initiated, and a foreign investor is expected to acquire a controlling share-holding by June 2002. IFC and ADB may also invest in this bank. The AgBank met the BOM capital adequacy ratio, and became profitable under the foreign management team. Most banks showed strong growth in profitability due to the loan growth and high interest spread. An amendment to a relevant law gives banks powers over the execution of collateral. This legal improvement and the pent-up demand for credit in the economy were said to be the main causes of the 100 percent growth in total loans. Provisions on prompt corrective action are incorporated into relevant law and regulations, and the new BOM regulation on assets classifications places 50 percent weight on qualitative analysis. As the MOFE started to redeem the BR-Bonds under the FSAC framework, the bonds accounted for 10 percent of total banking assets, a drop of 54 percent from that of 2000. MARA also made progress: of the total NPLs transferred to the agency: about 11 percent recovered at full value, 38 percent received favorable court decisions, 2 percent to be written off soon, and 49 percent remain to be recovered or disposed of. While the improvements are encouraging, the fundamental deficiencies described above prove difficult to remove. The rapid growth of loan outstanding in 2001 is clearly not sustainable and there is a significant risk that the weak banking infrastructure will be unable to adequately monitor and control the risks. Because of the dramatic increase in new loans, loan loss reserves to total loans declined by 66 percent. Note that Mongolia banks provide for loan loss reserves only on the NPLs classified according to the BOM norms, and have little experience in forward-looking, qualitative analysis. Total capital as a percentage of total assets remain almost unchanged between 13-14 percent. Another trend that calls for close attention is the rapid increase in the number of start-up institutions in the sector. Over the last 8 months, the central bank licensed 4 commercial banks and 17 NBFIs in an already overbanked economy. In terms of the number of banks per 100,000 people the country ranked 54th in a group of 108 countries in 1999 (see Section B.3 for further comparison). Sector issues to be addressed. The project seeks to address financial infrastructure weaknesses in the two critical areas: credit risk management and payments system modernization. The project will also assist the government to deal with potential systemic risks by developing and implementing a Savings Bank resolution strategy and plan.Credit risk management. The recurrent banking crisis and the existing systemic fragility can be attributed to a large extend to poor credit risk management in the banking sector. Loans are made by personal references, without sufficient borrower and market analysis. There is excessive reliance on collaterals which are not marked to market. There is a lack of forward looking cash flow analysis. Loan supervision is of a cursory nature. Bank management often fails to control and audit the credit process effectively. In many banks the credit review and portfolio management functions are missing. In recent years progress has been made in providing basic infrastructure for credit risk management. The BOM now requires that banks to submit loan information on all borrowers on a monthly basis to its Credit Information Bureau (CIB), which provides information on outstanding loans and classification of such loans, although it only covers the Ulaanbaatar (the Capital) area borrowers. Banks can also check for prior liens on proposed collateral with the Immovable Property Registration Agency managed by the Ministry of Justice. However, compliance with the registration requirements is not steady and the information may or may not be factored in when lending decisions are made. As the banking system is coming out of the recent crisis, the commercial banks in Mongolia have become increasingly exposed to credit risk. Because SME loans are gaining a high profile, many banks plan to offer this type of loan, although in general they do not have much experience with the product. The increase in high risk assets in the form of loans can result in an overall erosion in capital adequacy, profitability and liquidity. As the business of bank, lending determines a bank's quality and performance; and good lending policies and procedures are a key element in the framework for proper management of a banking institution. A bank's organization structure is also critical to its successful management of risks, particularly in the loan portfolio. The improvement in credit risk management would no doubt help to reduce systemic risks, and improve banking system profitability and efficiency.Payment System Modernization. Recent development in the area have been focused on the development of a real-time clearing and settlement system integrated into the core general ledger of the Bank of Mongolia (BOM) which also maintains the settlement accounts of the commercial banks. This BOM clearing and settlement system operates as a "Periodic Gross Settlement System", and works by each bank periodically dialling in and submitting files of payments which are processed one at a time across the bank's settlement accounts according to standard RTGS credit availability rules. Supporting advice received from the IMF during the past year has concentrated on the issues relating to the implementation of monetary policy targets and thus this advice has focussed on the efficiency of the interbank funds management and control, and the budget control and liquidity management duties of the Ministry of Finance - as a subset of the management of liquidity in the short run economy. Importantly, this earlier advice has correctly identified a number of relevant legal and central bank management powers and authorities which need to be institutionalized, exercised, and observed by all relevant parties -especially in regard to risk identification and management. Noticeably absent from this advice has been a more thorough-going and integrated solution for the transfer of funds by non-cash payments in all sectors of the economy - including:Interbank transfers,Disbursement and collection of government payments and revenues,Business payments and collections, andConsumer payments.There are several critical impediments to the development of an efficient and widespread payments system in Mongolia. Mongolia is a sparsely populated country with an average per capita income of US$40-90 per month. This does not reduce the demand for payment services, but it does dictate that any solution must be cheap and have acceptable low "per transaction" costs. The eroded confidence in banks also affected the development of the payments system. The banking systems currently in use in Mongolia are all running on PC platforms. In total, there are no more than 150,000 - 200,000 commercial bank accounts in Mongolia, and yet all non-cash payments must ultimately be posted to one of these accounts. The PC banking systems are relatively unsophisticated, but have proved entirely adequate to date where most banking transactions either start or complete as a cash transaction. With the introduction and widespread use of non-cash payment instruments, banking systems will need to become more sophisticated with online links between branches being highly desirable. This future target is achievable given that there are a number of initiatives, one of it funded by the ADB, to upgrade banking application systems and network services. These developments will increase the sophistication of the banking systems operating in the commercial banks in Mongolia - which greatly increases the potential for introducing new non-cash payment instruments. The network options available for online banking and related non-cash payments are widening rapidly with the only effective constraint being price levels. Technical skills in the market are limited but willing and able within a relatively narrow range of technical options. Networking skills are scarce but the available resources are reasonably well organized into a few local Information Technology services companies. In mitigation of these constraints, the concentration of investment in low end, small systems and industry standard Microsoft products and related skill sets is suitable for most IT demands in Mongolia - but some widening of these skills to cover other internationally widespread technology is appropriate. At the operational level, increased knowledge and skills with operational utilities such as system and network management tools and "Help Desk" facilities is mandatory.Cash is both the major payment medium in Mongolia as well as being the major store of value. Official BOM statistics show that 37 percent of M2 is held as cash, which translates as MNT116.3 billion (US$100 million) in cash circulating as outside the banking system. Recent developments in the start-up of card-based services have added card-based payments to the available payments instruments. The BOM interbank payment order used in the real-time interbank clearing and settlement system is the most recent form of a non-cash payment order which is supported by appropriate regulation. However, this payment instrument can only be used for interbank funds transfers between the Head Offices of the banks and the BOM. In addition, different banks use different formats and internal instructions for making inter-branch payments, and for taking various remittance and transfer instructions from customers. It should be also noted that government budget entities use a standard system of authorization letters and forms which act entirely like a payment order. All of these forms of non-cash payment would benefit from the standardization of the associated forms to ensure that such forms are easy to recognize, store, and process through manual or automatic systems. In addition, the contents of such forms should comply with certain minimum criteria to ensure that sufficient details are carried on the forms to enable them to be converted uniquely to electronic format, and to comply with the legal provisions of Mongolia relating to non-cash value transfers. Modernization of payment systems and payments instruments in Mongolia is a high priority matter, as is increased confidence in the banking system. It would reduce the economy's dependency on cash through easier and more convenient access to and use of the banking system. It would also facilitate the use of the available liquidity in the banking sector without increasing banking sector risks. Savings Bank Resolution. Savings Bank was created as a specialized deposit taking institution following the 1996 banking crisis. All household deposits of two insolvent state banks were transferred to the bank, and the government placed the same amount of BR-Bonds with the bank. These bonds were non-tradable IOUs, and did not have the standard features of a government security. In 2001, the MOFE "standardized" the BR-Bonds held by the bank, which now have a floating coupon rate that is linked to the central bank bills (monthly average yield of the 91-day BOM-Bills + a premium). Interest payments are made monthly and the maturity is five years. The bank also received a limited lending license from the BOM last year, which puts a cap on the annual loan growth. The loan portfolio stands about 2.5 percent of total assets and 3 percent of total deposits. The bank earned some profit and paid income tax for the first time in 2001, as it benefited from low deposit rates, little or no provision for loan losses, and low operating expenses due to the lack of a normal banking infrastructure. It should be noted a large portion of the bank's revenue came from the interest income on the BR-Bonds. While the savings institution is a bank in name only, it is extremely sensitive to interest rate risk. It suffered losses in the past when the government could not service its debt on time. A stress test conducted by IMF staff last November reveals that one percent reduction in the interest rate of government securities would immediately cause a 10 percent loss of capital. Meanwhile one percent increase in deposit rate would lead to a 9 percent capital loss. Because of its importance to system stability, the government has kept Saving Bank open, despite budget impacts (interest payments amount to over 2 percent of GDP, and non-cash transfers about 6.5 percent of GDP). As the government has committed itself to replace the BR-Bonds with tradeable securities under the FSAC framework, the MOFE started to retire the bonds in 2001. This would have significant implications for the savings institution, as it holds more than 55 percent of the total BR-Bonds outstanding. While it is too risky for the bank to rapidly expand its loan portfolio, the retirement of the higher-earning bonds would further squeeze the bank's thin profitability. The BR-Bonds currently earn 16 percent, while 3-month T-Bills yield between 8-13 percent and the same maturity BOM-Bills about 14 percent. The MOFE wanted to redeem MNT3 billion in 2001, but ended up with only MNT250 million retired because Savings Bank could not invest the would-be additional cash for good returns.The government has realized that the status quo cannot be maintained, and is committed to adopt a time-bound privatization action plan under the FSAC framework. There can be different options for Savings Bank resolution. Immediate wholesale privatization is not possible since no outside strategic investors would be interested in the bank's present form, and the bank may be too large for any domestic investor with banking experience to take on a controlling majority. While the government has ruled out this option, there are discussions of transforming the savings institution into a full-fledged commercial bank or merge it with the AgBank. The disadvantages of those options clearly outweigh the advantages. Savings Bank has little experience in lending and the basic institutional infrastructure for commercial banking is missing. A rapid expansion of the loan portfolio is too risky while a gradual approach may take too long. Above all the economy is overbanked and does not need another weak full-service bank at present. As the following table shows, in terms of number of banks Mongolia has 5 times more banks than such economies as Turkey and South Africa. By contrast, Mongolia's per capita GDP is about 13 percent of that of Turkey and 10 percent of that of South Africa; and its financial sector accounts for about 30 percent of GDP as compared to the ratio of 70 percent in Turkey and 90 percent in South Africa. # of banks per 100,000 peoplePopulationPer capital GDP(USD)Total financial assets to GDP(%) Mongolia0.5 2,398,000 39027South Africa0.142,800,9923,12069Turkey0.165,311,0003,98590Source: Year 2000 data from BOM, World Bank, IMF.It seems that a controlled divestiture of a large portion of the bank's assets and liabilities may be a better option to alleviate the budget burden and resolve the Savings Bank problem. Once the bank has a balance sheet structure similar to that of a typical Mongolian commercial bank (e.g. a loan-to-deposit ratio of 60 percent), it may become privatize-able, or can be taken over by a stronger private bank. However, since the bank is regarded by many small depositors as the safe haven, strong leadership by the MOFE is necessary to centralize and coordinate the process of finding a solution.Government strategy. Since early 1990s, successive governments have attempted to develop the banking sector. Considering where the government started, the progress is impressive. In 1998, the then government began implementing a new round of financial sector reforms that are focused on:Establishment of a financial sector infrastructure (banking skills, accounting standards, bank resolution procedures, etc.);Consolidation of the banking system;Divestiture of government ownership in TDB (the largest bank);Development of effective regulation and supervision;Improvement of payments system; andTimely servicing of government bonds.The current government which came to power in June 2000 has repeatedly expressed its commitment to the strategy. Meanwhile, in its Interim Poverty Reduction Strategy Paper (I-PRSP) the government states that the structural adjustments will continue in the banking sector in the next 4 years, including:Shift to indirect monetary instruments,Strengthening of bank supervision,Privatization of state-owned banks,Tightened legal procedures regarding commercial contract enforcement, and Improved financial intermediation.

2. Objectives

The project is to support institutional capacity building of the Mongolian banking sector to reduce systemic risks and enhance financial intermediation through (i) improved commercial bank risk management; (ii) modernization of payment systems and instruments; and (iii) Savings Bank resolution.

3. Rationale for Bank’s Involvement

As described above, policy distortions and structural problems exist in every corner of Mongolia’s banking system. The capacity gaps are monstrous. The temptation is to address all the issues under one project, but this would be a recipe for failure. The achievement of the project objectives is a function of the overall legal and regulatory framework and the financial sector infrastructure. Recently, with the unfolding of several major donor programs in the sector, progress has been observed in improving the overall banking environment. The amendment to the Civil Code provides banks the powers to posses and dispose of collateral without lengthy court procedures. The BOM requires banks to register all loans with basic borrower information at its Credit Information Bureau, and the upgrading of the system is underway as a component of the on-going Private Sector Development Project. The BOM has also strengthened its prudential regulations and supervision of the banks. The new assets classification regulations place 50% weighting on qualitative factors, which is a good improvement. The Country Financial Accountability Assessment (CFAA) has identified areas of noncompliance with the International Accounting Standards (IAS), and a new operation is being considered to address the issues. In addition, many of the policy and structural issues, such as monetary policy instruments, judiciary reforms and education, banking system upgrading, are covered by other on-going Bank operations or other donor programs (see Section D. 2 below). The project therefore focuses on the three areas that have received less technical assistance and are the key to the achievement of the Government’s financial sector reform objectives as described in the FSAC policy matrix and the I-PRSP. The focused scope of the project also takes into consideration the limited capacity of the government.The Bank's involvement has helped to bring about many structural changes in Mongolia's banking sector since early 1990s. The operation with the most far-reaching impact on the policy environment of the banking system is the FSAC. However, a good policy framework needs solid structure and building blocks to support it. The FCDP project, which is closely linked with the FSAC, is to assist the government and the banks to build institutional capacity in three key areas of financial sector infrastructure and stability, so that the policies adopted under the FSAC may be turned into realities. At the institutional level, the commercial bank risk management component builds on the outcome of previous bank projects, but is more focused on developing and implementing a risk management framework and the internalization of good policies and procedures. In the areas of payments system modernization and Savings Bank resolution, the government is yet to receive comprehensive assistance, and the benefits and outputs of those two components are described in the previous sections. In general, the project enhances the strategic objectives of the Bank's support program, and is a major operation in the area of banking sector capacity building.

4. Description

The project consists of the following components. Component 1: Commercial Bank Risk Management is to assist the participating banks in re-engineering their lending process and creating a strong credit culture. It would enhance the effectiveness of commercial banks' credit risk management and compliance with Bank of Mongolia (BOM) regulations and international banking practices. At the present three commercial banks (Anod Bank, Mongol Post Bank and Zoos Bank) are eligible based on the agreed selection criteria (see Annex 2: Detailed Project Description). An international specialist will be retained to work full time in a senior management position such as head of credit or chairman of ALCO, who reports directly to the bank's CEO. Allocations are also made for short-term staff secondment in foreign commercial banks and risk management systems upgrading.Component 2: Payments System Modernization is to assure the availability of an appropriate set of cost effective payment systems and payment instruments that satisfy the evolving needs of all sectors of the economy with particular emphasis on the needs of government, business, and individual consumers to make and receive non-cash payments. The component will assist the BOM to a) acquire and install a Switch/Clearing House processor and software, and adopt related procedures and operating rules; b) develop new payment instruments and the legal and regulatory framework to support their use; and c) establish a Shared Financial Network with multiple functions for the banking sector. The estimated cost of the Switch/Clearing House accounts for a major portion of the Credit. Allocations are also made to fund the hardware and software costs of the network management software utility and related "Help Desk" software. Related costs of expert technical assistance are also covered. On the job training are to be provided by the supplier and the consultants. There is a small budget for a study tour by the BOM staff to selected countries where a Switch system has been in operation for years.The objective of Component 3: Savings Bank Resolution is to assist the government to develop and implement a carefully managed divestiture process of Savings Bank, to diversify systemic risks and reduce government subsidies. Adoption of a time-bound action plan for Savings Bank privatization is a condition for the release of the second FSAC tranche, and is in conformity with the announced government policy of withdrawing state ownership from the banking sector. However, with the current size and structure of its balance sheet, Savings Bank is not privatize-able. The controlled divestiture process would reduce the bank' size by about 80-90 percent, and result in a balance sheet similar to that of a typical Mongolian commercial bank (a loan to deposit rate of 60 percent). The bank can then be privatized, or taken over by a stronger private bank. Under this component the MOFE will hire international advisors to develop and implement (i) a workable BR-Bonds redemption/replacement plan, and (ii) a divestiture program to auction carefully packaged assets and liabilities. A small allowance is provided for a study tour to selected countries with rich experience in bank restructuring/resolution.The project is expected to bring about the following benefits on the macro-level:Improved competition in the banking sector through strengthened credit risk management of selected private-owned banks;Enhanced banking system liquidity management through upgraded payments system and a shared financial network;Extended access to formal banking services through new electronic payments arrangements;Reduced systemic risk and improved government cash management through Savings Bank resolution; andEnhanced human capital in the key areas of the banking sector.Specific benefits would include:Component 1:For each participating banks, development of a clear understanding of risks the bank is undertaking, the level of risk the bank wishes to assume in the broadest terms and the structuring of loans consistent with the level of risk. Development of a culture of individual responsibility and accountability for loan quality.Establishment of a Credit Review Unit whose exclusive task would be to monitor the on-going quality of the loan portfolio. Development of policies and procedures for credit and other risk management as appropriate. Improvement in rating loans on a qualitative basis.Development of a credit system which can be adjusted to reflect market conditions and changed environment.Acquired skills to assess credit risk and identify an emerging problem with a borrower's ability to repay.Component 2:A shared financial network that promotes "Real Time Gross Settlement", secondary financial markets, and cost-efficient investment in terminal infrastructure.A common low cost payments processing system that reduces the transaction load on the BOM's own processing environment.Development and enforcement of standards for payments orders and new electronic instruments that comply with the international practices.Adoption of common standards for electronic security and banking operational procedures and a supporting legal framework.Improved effectiveness of the ongoing development initiatives financed by other donor programs (e.g. the ADB program of six-bank banking software, and the IMF program of Treasury Single Account).Component 3:Implementation of a redemption/replacement plan for the government to retire the costly BR-Bonds that takes into account the government's cash flow situation, the market demand and banks liquidity position, and the BOM's monetary policy operation.Preparation and implementation of a carefully packaged divestiture process.Experience in dealing with distressed financial institutions.There would be two target groups. Professional staff in the participating banks, the BOM and the MOFE would upgrade their skills through "learning by doing" with international specialists. The public, especially small and medium private owned enterprises and entrepreneurs, would have better access to formal banking services.

5. Financing

	Total (US$m)
BORROWER	$0.50
IBRD	
IDA	$5.00
Total Project Cost	$5.50

6. Implementation

Project implementation is expected to take about three years. The implementation agencies include the currently eligible three participating banks for the Credit Risk Management Component; the BOM for the Payments System Modernization Component; and the MOFE for the Savings Bank Resolution Component. A Project Steering Committee (PSC), headed by the Deputy Minister of MOFE and composed of the directors of Sector Development Management and Coordination Department (SDMCD) and Treasury Department of MOFE; and the First Deputy Governor and the directors of Accounting and Automation Department and Supervision Department of BOM, has been established. The PSC will provide policy direction and guidance regarding overall project implementation, evaluate project outcomes and resolve major project coordination issues. A Project Coordination Office (PCO) will be established before negotiations to serve as the secretariat of the PSC and be responsible for day-to-day administrative support to the project, e.g. routine communications between the Borrower and IDA and between the Project Implementation Units (PIU) and the PSC; and project file keeping; and organization of the required audits of project accounts. The PCO will be headed by the director of SDMCD and supported by a full time Project Coordinator. A MOFE staff will work part time for the PCO. The BOM is to establish a five-member task team as the PIU by Board date, and the office of the chief executive of each of the participating bank will serve as the PIU under the first component.

7. Sustainability

While Mongolia’s road to a sound, well-functioning banking system is likely to be bumpy, it is unlikely that the direction would be reversed. The memories of the previous banking crisis are so fresh with the public, that it is in the interest of the government to stabilize the banking system and assure improved financial intermediation. The project is first of all based on this critical assumption. The on-going donor programs, including IDA’s FSAC, IMF’s PRGF, ADB’s SFPL and other bilateral programs, all have this common goal and provide collectively a variety of leverage to assist the government to complete the country’s transition to well functioning market economy. The implementation of these programs are monitored by regular supervision missions, and are reviewed at annual donor coordination meetings. New programs under consideration, such as IDA’s Poverty Reduction Strategy Credit (PRSC), may further ensure that the government remains committed to achieving its medium-term financial sector reform objectives and private sector led economic development, as well as enhancing its overall implementation capacity especially in regards to its poverty reduction strategy and financial sector reform.Against this overall background, a number of the key features in the project design may enhance the likelihood of the sustainability of the project’s benefits: The selection of the participating banks has taken into account the representation of an important segment of Mongolian banks, i.e. the fast-growing, medium-sized, private-owned banks, so that improved risk management in participating banks can have a ripple effect in the banking sector.The recommended approach towards Savings Bank resolution may help the government contain down-side risks while removing a potential trigger of a systemic banking crisis.The envisaged payments system modernization architecture whilst being based on Mongolia's current technology environment, has the capacity to support an expanded set of market applications through modular technical upgrading at a later stage. Meanwhile it would result in a national payments system that is compatible both with medium term Mongolian needs and well established systems and standards typical of developed economies.The proposed ownership and organizational structure of the new payments system would ensure market fairness and technic neutrality.

8. Lessons learned from past operations in the country/sector
Mongolia's financial sector has received quite a lot of technical assistance from donors. The more effective donor programs such as the UNDP micro-finance program share the common features of simplicity in project design and local ownership. In less effective cases, international assistance tend to be in the form of general assessments or ad hoc consultant visits. Some times the perceived international best practice is introduced without careful analysis of the required legal, economic and institutional environment. The weak administration capacity and the interagency coordination issues also affect the performance of donor programs, especially those which span over a wide range of policy and structural areas. The 1998 Bank portfolio review, and the Client Feedback Survey confirm these lessons, as do the more recent consultations among donors. The project design has taken into account of those lessons. It targets specific, identifiable and measurable benefits. The project design also stresses Borrower ownership of the project and participation of major stakeholders. For instance under the commercial bank risk management component, for each participating bank, an international expert will be engaged to serve as a full-time senior bank manager reporting directly to the CEO. This is to avoid the marginalization of international experts which typically happens should they play only a consulting role. It can also enhance knowledge transfer between international experts and local staff. The project implementation programs of the other components also reflect this focus.

9. Program of Targeted Intervention (PTI) N

10. Environment Aspects (including any public consultation)
Issues : N/A

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Note: This is information on an evolving project. Certain components may not be necessarily included in the final project.

This PID was processed by the InfoShop during the week ending April 26, 2002.