Financial Sector Reforms in Mongolia

Hongjoo Hahn and Demir Yener
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Abstract

This working paper reports the current state of the Mongolian financial system on its way to become a completely market-based economy. A thorough discussion of the structure and the financial position of the banking system, the government reforms in the banking sector, a restructuring strategy, bank supervision, and the cost of bank restructuring, and the future of the banking system in Mongolia follows a brief background of the economic conditions. The paper also looks into the non-bank financial sector such as the securities markets, insurance, pension funds, insurance companies and factoring and leasing as an alternate source of capital for economic activities, with the consideration that this sector, given proper regulatory and legal frameworks, will develop in parallel to the ailing banking sector. The paper is concluded by providing an agenda for the future and recommendations for policies for faster economic growth.
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Foreword

The Economic Development Institute’s mission is to help build capacity of clients in their development efforts through learning programs. In this context, the Regulatory Reform and Private Enterprise Division (EDIRP) delivers programs in client countries to promote private sector growth and entrepreneurship, public sector reform and privatization, and financial sector reforms. EDIRP’s banking and finance programs encompass both the macro and micro approaches to the field of financial sector development throughout a variety of programs, workshops, and seminars targeting senior policymakers, banking officials, academics, parliamentarians, securities markets regulators and other high level officials.

As a part of the finance and banking related programs, EDI periodically publishes working papers and other training materials that can help and assist in the capacity building process through training programs delivered in collaboration with the Bank operations. This particular study emanates from such a close cooperation effort between the EDI and the East Asia and Pacific Region, in which the authors, Hongjoo Hahm, an economist (EASFP) and Demir Yener, a financial specialist (EDIRP) worked together in the Mongolia Bank and Enterprise Restructuring program. The Division would like to acknowledge the contributions of James E. Quigley in production assistance. The views expressed are entirely those of the authors, and do not necessarily reflect the views of EDI and the World Bank.

Danny Leipziger
Chief, Regulatory Reform and Private Enterprise Division
Financial Sector Reforms in Mongolia

As the world's financial markets rapidly evolve into an integrated marketplace, the transition economies continue their financial reforms. In this regard, Mongolia, a land locked country located between Russian Siberia and northern China, has taken strides towards sweeping reforms in its economy and society, to allow placing the country within the international marketplace by building its financial institutions, reforming its banking systems and to develop its capital markets. The subject of this paper is to provide a first hand background of the recent financial and economic reforms in Mongolia, culminating from the various missions by the World Bank and Economic Development Institute specialists to the country over the last few years.

Mongolia's financial sector is in its early stages of development in its transition to a market economy, under a severely distressed financial system. As is the case in many other transition countries, Mongolian economy is characterized by its fragile environment, limited banking skills, and a history of government interventions in banking, which have contributed to the depletion of the liquidity and capital base of commercial banks. In 1996, four insolvent banks, representing about 50 percent of the country's banking assets, were closed. On-site and off-site examination of other banks reveal that the majority of remaining banks are also troubled.

In parallel to the privatization efforts, Mongolia has also established a securities market in which the shares of the privatized state owned enterprises would be traded to provide the liquidity for the orderly development of securities markets. The role of the stock exchange is thus a very important one in the development of private sector and in parallel to the banking sector, the development of the non-bank financial institutions in Mongolia.

The purpose of this paper is to discuss the current state of affairs in the Mongolian financial system on its way to become a completely market based economy. Following a brief background of the economic conditions, the paper provides a thorough discussion of the structure and the financial position of the banking system, the government's reforms in the banking sector, a restructuring strategy, bank supervision, and the cost of bank restructuring, and the future of the banking system in Mongolia. The paper also looks into the non-bank financial sector such as the securities markets, insurance, pension funds, insurance companies and factoring and leasing as an alternate source of capital for economic activities, with the consideration that this sector, given proper regulatory and legal frameworks, will develop in parallel to the ailing banking sector. The paper is concluded by providing an agenda for the future and recommendations for policies for faster economic growth.

I. Background
The Mongolian Government has made reform efforts at a rapid pace, and is well under way to real-
ize its vision of private sector led growth as indicated in its mission statement. New banking laws were passed and some insolvent banks were closed; it restructured the public administration and it is preparing a far reaching privatization program. These and other actions are a good start to revamp the troubled economy.

The Mongolian economy cannot continue to develop, let alone grow and thrive, without a healthy financial system. Further reforms are needed to ensure that banks can fulfill their roles as financial intermediaries. Since banks do not operate in a vacuum and have a symbiotic relationship with their customers, banking reform, therefore, must be conducted concomitantly with legal, regulatory, capital market and enterprise reforms. This is especially true for the development of long-term finance and specialized finance for rural and agricultural borrowers. International experience confirms that countries with well-developed financial systems grow faster and more consistently than those with weaker systems.

The diversity of financial needs in the economy requires integrating non-bank financial intermediaries into the financial system. This includes non-bank financial institutions, such as investment privatization funds venture capital funds, and leasing and factoring companies. They can fill the intermediation gap now prevalent in many transition countries. The challenge for the Mongolian authorities is to find a way to help the financial system overcome the legacy of central planning, while nurturing the development of a new system in which banks and other financial institutions stand on their own two feet.

II. The Banking System

Structure of the Banking System

The Mongolian financial system is dominated by commercial banks. Assets of insurance companies and pension funds are minuscule, and a commercial bond market has yet to be developed. Prior to 1990, Mongolia had a monobanking system administered by the State Bank, and its main function was to transfer government resources to public enterprises. The aggregate credit amount was centrally determined and loans were extended without the due process of risk assessment, project screening, and selection against a reasonable collateral value. In 1991, the monobanking system was replaced by a two-tiered banking system. Five banks devolved from the divested portfolio of the former State Bank, and nine were created de novo. In 1994, the five large banks controlled 94 percent of total deposits and 89 percent of total loans, while the small banks, on a combined basis, had a deposit base smaller than the smallest of the five large banks.

The ownership structure of Mongolian banks are diverse. Banks were spun off from the monobank by granting equity shares to enterprises and cooperatives which may have later resold the shares. These banks were then privatized when their owners were privatized. Since the shares were not purchased, shareholders often felt little interest in corporate governance beyond dividends. When weak bank earnings could not sustain dividend payments, shareholders lost whatever remaining interest they had in governance. Thus, the normal discipline applied by shareholders on management to responsibly manage assets was lacking in Mongolia. The structure of the commercial banking system, as of January 1997, is shown in Table 1.

Since the establishment of a two-tiered banking system, several banks have failed. In September 1994, the Government forcibly merged two troubled small banks with two large banks, and provided highly subsidized loans to cover the cost of the mergers. In the summer of 1996, two additional small banks were closed, prompting widespread deposit withdrawals. The Bank of Mongolia (BOM) injected large volumes of liquidity in response, but public confidence in the banking sys-
Financial Sector Reforms in Mongolia

Table 1: Structure of Commercial Banks

<table>
<thead>
<tr>
<th>Commercial Banks</th>
<th>Establish</th>
<th>Offices</th>
<th>Employees</th>
<th>Physical Shore of Ownership (%</th>
<th>Gov't</th>
<th>SOEs</th>
<th>Private</th>
<th>Individual</th>
<th>Coops</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reconstruction</td>
<td>12/96</td>
<td>-</td>
<td>-</td>
<td>100.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Savings</td>
<td>12/96</td>
<td>-</td>
<td>-</td>
<td>100.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>T &amp; D</td>
<td>1/91</td>
<td>3</td>
<td>79</td>
<td>100.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>ITI</td>
<td>11/90</td>
<td>74</td>
<td>726</td>
<td>-</td>
<td>78.8</td>
<td>21.0</td>
<td>0.2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>ITI</td>
<td>11/90</td>
<td>74</td>
<td>726</td>
<td>-</td>
<td>78.8</td>
<td>21.0</td>
<td>0.2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Agriculture</td>
<td>12.91</td>
<td>358</td>
<td>2,590</td>
<td>7.6</td>
<td>41.3</td>
<td>0.5</td>
<td>50.6</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Mongol Post</td>
<td>3/93</td>
<td>1</td>
<td>12</td>
<td>11.6</td>
<td>58.5</td>
<td>29.9</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Export-Import</td>
<td>6/93</td>
<td>1</td>
<td>22</td>
<td>-</td>
<td>28.6</td>
<td>71.4</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Industrial</td>
<td>12/91</td>
<td>2</td>
<td>28</td>
<td>-</td>
<td>2.0</td>
<td>69.7</td>
<td>26.3</td>
<td>2.0</td>
<td>-</td>
</tr>
<tr>
<td>Business</td>
<td>3/93</td>
<td>1</td>
<td>10</td>
<td>-</td>
<td>85.6</td>
<td>14.4</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Mercury</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>11.0</td>
<td>79.7</td>
<td>8.4</td>
<td>0.9</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Golomt</td>
<td>6/93</td>
<td>1</td>
<td>23</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Boyanbogd</td>
<td>10/92</td>
<td>1</td>
<td>11</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: There is some controversy over the shares of ownership. Lists prepared by BOM, the banks, and the State Property Committee are not identical.

Source: BOM, 12/17/96.

tem continued to erode. In December 1996, the Government closed two large insolvent banks.

Currently, 13 commercial banks operate in Mongolia. The three large commercial banks are the Trade and Development Bank (T&D), the Investment and Technological Innovation Bank (ITI), and the Reconstruction Bank, comprising about 55% of total system deposits. The two specialized banks are the Agricultural Bank (10% of total deposits) that focuses on nationwide deposit gathering and agri-business lending, and the Savings Bank (27% of total deposits) that collects household deposits and invest in low-risk government paper and central bank bills. The eight smaller banks (about 8% of total deposits) compete primarily for Ulaanbaatar-based customers.

Financial Position of the Banking System

The banking system as a whole is illiquid and experienced significant deterioration in 1996. Total assets of the banking system increased from Tg102.1 billion in 1995 to Tg127.6 billion in 1996—a 21.5% decline in real terms; total loans outstanding increased from Tg62.7 billion
**Box 1: Chronology**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1990</td>
<td>First multiparty elections held; Mongolia People’s Revolutionary Party (MPRP) wins 85% of seats in Parliament</td>
</tr>
<tr>
<td>December 1990</td>
<td>Investment and Technological Innovation Bank (ITI) and Trade and Development Bank (T&amp;D) are separated from the State Bank of Mongolia</td>
</tr>
<tr>
<td>April 1991</td>
<td>Banking Law passed, establishing the central bank, the Bank of Mongolia, and providing new banking licenses for commercial banks; by year-end, People’s, Insurance, Agricultural, Industrial, and Cooperative Banks were formed</td>
</tr>
<tr>
<td>December 1991</td>
<td>Soviet Union dissolved; trade with Russia collapsed; real GDP declined by 10%</td>
</tr>
<tr>
<td>1992</td>
<td>Eight new small banks established—Mongol Post, Ardan, Export Import, Central Asia, Mercury, Selenge, Auto Road, and Bayanbogd Banks</td>
</tr>
<tr>
<td>June 1992</td>
<td>Second Parliamentary elections—MPRP wins 93% of seats on 57% of popular vote</td>
</tr>
<tr>
<td>September 1994</td>
<td>Cooperative and Selenge Banks forced to merge with People’s and ITI Banks</td>
</tr>
<tr>
<td>1995</td>
<td>First private bank, Golomt, with foreign equity participation established</td>
</tr>
<tr>
<td>June 1996</td>
<td>Third Parliamentary elections—Opposition Coalition parties with 90% of the popular vote, ending MPRP control of Parliament; new Prime Minister sworn in with mandate to initiate radical reforms</td>
</tr>
<tr>
<td>July 1996</td>
<td>Ardan and Central Asia Bank closed due to insolvency</td>
</tr>
<tr>
<td>August 1996</td>
<td>Second foreign equity bank, IMM Bank, established</td>
</tr>
<tr>
<td>September 1996</td>
<td>People’s Bank temporarily put under central bank conservatorship</td>
</tr>
<tr>
<td>October 1996</td>
<td>MPRP wins 65% of popular vote in local elections</td>
</tr>
<tr>
<td>December 1996</td>
<td>People’s and Insurance Banks closed; Savings Bank, Reconstruction Bank, and Mongolian Asset Recovery Agency established</td>
</tr>
</tbody>
</table>

To Tg70.3 billion—a 29.5 percent real decline; and total deposits grew from Tg55.6 billion in 1995 to Tg57.8 billion in 1996—a 34.6 percent real decline. It is unwise for banks to have more loans than deposits, especially if they have liquidity problems. Total liquid assets (cash, bank reserves, and central bank bills) fell from Tg13.4 billion in 1995 to Tg6.9 billion in 1996, a 68 percent real decline. A combination of low confidence in the banking system and the development of a sizable unofficial money market has meant that money circulating outside the banking system increased, and cash represented a large share of the money stock. Clearly, there is disintermediation out of the banking system.

A basic requirement of public confidence is that depositors should believe that they have access to their funds whenever they need. With this belief, they will be confident that they are incurring no risk in depositing their money in a bank. Depositors are thus legitimately interested in the bank’s liquidity position as are regulators and bank management. During 1996, the liquidity ratio for the banking system as a whole more than halved, dropping from about 11 percent in 1995 to 5 percent in 1996. Only one commercial bank was able to maintain adequate reserves in the central bank. Other illiquid banks had to rely increasingly on BOM funding and government deposits, which increased from Tg7.4 billion in 1995 to Tg10.9 billion in 1996.

At year-end 1996, over 50 percent of total loans outstanding of the banking system were non-performing. In all banks which had on-site
inspections, significant problems have been identified, and in all cases, loan loss provisions have to be increased. The actual size of the loan loss provisions should be determined according to an effective classification system, that is driven by internal risk management process rather than by external regulatory inspections. Proper loan loss provisions are required for doubtful and substandard loans, while bad loans should be written off when a reasonable determination is made that it is irrecoverable. The loan loss provisioning process, however, is still weak in Mongolia. Interest continues to accrue on defaulted loans beyond 12 months overdue. Formal write-offs are rare, as they are interpreted by the borrower and the legal system as recognition of elimination of the claim against the borrower. Inadequate recognition given by the tax authorities, and the reluctance of banks to write off unrecoverable loans, further impairs asset quality of the banking system.

III. Government Banking Reforms

Bank Restructuring Strategy

In response to a growing crisis in the banking sector, in November 1996, the Government developed a

![Figure 1: The Anatomy of a Banking Crisis](image)

The banking system faced financial disintermediation.

Currency in circulation outside the banking system increased,

liquidity within the banks decreased,

requiring banks to increasingly rely on Government deposits and BOM credit.

Source: BOM.
bank restructuring strategy with input from international financial institutions. The strategy entailed closing down two large insolvent banks; closely monitoring the performance of the other large banks; and aggressively pursuing recovery of non-performing loans through the creation of an asset recovery agency. In December 1996, the first steps in the bank restructuring strategy were implemented with the Government closing two large insolvent banks. Within the framework of the newly enacted Central Bank Law and Banking Law (1996), the Government guaranteed fully household deposits, but limited protection for enterprise deposits. The authorities then created successor institutions—a savings bank, a reconstruction bank, and a Mongolian Asset Recovery Agency (MARA). The savings bank is supposed to only invest in safe assets to support its deposits, comprised primarily of retail deposits of the closed banks. The reconstruction bank retained all the performing loans of the two liquidated banks, and will lend only to non-defaulting enterprises; and MARA will aggressively engage in loan recovery of non-performing loans.

The BOM signed Memoranda of Understanding with the owners and senior management of the two other troubled large banks. The Memorandum of Understanding details actions and conditions for their rehabilitation, and contain criteria under which progress toward rehabilitation will be monitored. These banks will be audited in 1997 on appropriate loan classification and provisioning norms, as well as on all relevant regulations. The audits aim to produce and maintain a set of realistic financial statements, including a balance sheet to measure solvency, an income statement to assess profitability and viability, and a cash flow analysis to appraise liquidity generating capacity.

**Bank Recapitalization.** Bank restructuring generally requires that non-performing assets be

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**Figure 2: Asset Quality of the Banking System Improved as a Result of Restructuring**

<table>
<thead>
<tr>
<th></th>
<th>As of 10/30/96</th>
<th></th>
<th>As of 1/31/97</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pass</td>
<td>49%</td>
<td>Loss</td>
<td>65%</td>
</tr>
<tr>
<td>Doubtful</td>
<td>18%</td>
<td>Overdue</td>
<td>11%</td>
</tr>
<tr>
<td>Substandard</td>
<td>7%</td>
<td>Substandard</td>
<td>5%</td>
</tr>
<tr>
<td>Overdue</td>
<td>9%</td>
<td></td>
<td>10%</td>
</tr>
<tr>
<td>Loss</td>
<td>17%</td>
<td></td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: BOM.
Financial Sector Reforms in Mongolia

identified and stripped out, that the bank be recapitalized, and that the restructured bank be completely viable. The first best option in recapitalization is to write-off existing liabilities and to create income by eliminating interest expense on the existing liabilities. To the extent that there are no more liabilities to write-off, the next option is to issue bonds, by swapping non-earning assets on the balance sheet with interest-bearing government bonds. This recapitalizes the bank and provides them with a positive earning stream. The Government has taken responsibility for the inherited and directed loans, and has replaced the principal and interest accrued on these loans with government bonds. In addition, the Government has taken over the non-performing loans of the two failed banks, substituted them with government bonds, and placed them in MARA. By removing the non-performing loans from the balance sheet of those two banks, the Government immediately and significantly improved the asset quality of the banking system.

The restructuring process should ensure that the recapitalized banks meet a 2% risk-weighted capital adequacy ratio by the end of 1998. T&D bank and ITI bank should be able to meet this target and recapitalize through their own earnings. Agriculture bank will require a combination of earnings and new equity injections by shareholders. Some of the small banks may not be able to maintain solvency, resulting in market-driven consolidation. The 2% capital adequacy ratio target is far below the 8% recommended by the Basle Agreement. It is only relevant if loans are properly classified and the accounting and auditing are properly done. A bank's capital forms the safety net that allows it to remain solvent and to continue operating despite unexpected macroeconomic or institutional difficulties. It also enforces discipline on private banks since they must subject themselves to market scrutiny in order to augment their capital base. The lower capital adequacy standards, therefore, will provide only a thin margin of protection for both depositors and creditors against unanticipated losses that may be experienced by the bank.

Loan Recovery

As a result of the recapitalization exercise, the Government owns some Tg 21 billion in non-performing loans that are now controlled by MARA. Several approaches to resolving the problem of large amounts of non-performing loans have been tried by various countries. In Hungary, Uganda and elsewhere, the Government established central loan collection agencies; whereas in Poland, the rehabilitation approach stressed the need to establish loan collection services within the banks themselves. Mongolia has adopted a two-pronged approach, where a centralized collection agency, i.e. MARA, would aggressively collect loans, especially small-scale non-viable loans to individuals, and commercial banks would engage in further developing their debt workout units. In the future, the Government should consider fusing the loan collections efforts by MARA and the commercial banks, through outright sales of government-owned assets to bank and/or through contractual fee arrangements for banks to service/collect MARA loans. To facilitate loan recovery activities, the authorities must concomitantly implement broader reforms that will strengthen the legal, institutional and supervisory support services for loan collection.

Mongolia Asset Recovery Agency. MARA was established as part of the bank restructuring in December 1996. MARA has about 30 employees, and has opened field offices in almost all aimags. MARA has about Tg 26 billion in assets, with five locations having more than Tg 1 billion each, and ten locations having under Tg 150 million. The assets are widely scattered throughout the country including in very remote areas. The objective of MARA is to recover all the non-performing assets that were transferred to it within the next three
years. For now, MARA is concentrating on reviewing piles of loan documents, categorizing each loan (by size, borrower, and origin) and classifying them based on recovery potential. About 70 percent of MARA's assets are defaulted small to medium-sized loans to individuals, used primarily for service, trade, and agriculture-related activities. The remaining MARA assets are defaulted loans to enterprises for large investment projects that require extensive loan workout.

MARA has begun its loan recovery operations, with modest success. Future success will depend on support from the judiciary and enforcement agencies to allow MARA effective use of all legal course of action available to it. In the coming months, MARA could consider a bulk sales program for modest-sized loans to expedite the liquidation process. However, Mongolia does not have a ready market for MARA to sell its defaulted loans. MARA will have to build a cadre of investors interested in acquiring government-owned bank assets, by selling weak and poor quality loans to investors, other than commercial banks, at substantial discount and by accepting compromise settlements. MARA should not be overly concerned if some of its early bulk sales result in investors making significant profit from their acquisitions. As news spread of profit opportunities arising from the acquisition of MARA assets, it will attract more investors and should foster the development of an investor base in Mongolia.

In the very near future, MARA should consider delegating its debt recovery activities to other institutions, especially commercial banks. Debt recovery expertise is scarce in Mongolia, and it should be kept in the banks to the maximum extent possible. Contractual servicing arrangements for loan recovery and/or outright sales of assets could be considered between the banks and MARA. One intermediate proposal is to introduce a pilot bulk servicing program that will address the large non-performing loans. Under this proposal, MARA would pool a modest portion of its assets, and have a servicer (i.e., a commercial bank) manage and collect the assets. The commercial bank chosen would earn a fee for its loan collection efforts. Through MARA, the Government should examine ways to develop a secondary market for debt, allowing any bank or institution to purchase the non-performing loans, and aggressively initiate loan recovery. Emphasis should be placed on assisting MARA to sell or otherwise transfer the carved out loans to existing banks, to be handled through workouts, foreclosures, or liquidation's.

**External Factors Related to Loan Recovery:** To aggressively pursue loans, the authorities must address several external factors. These include: A legal environment that provides adequate and impartial enforcement of contractual agreements and support to lenders of seizures and liquidation of collateral duly pledged in support of defaulted loans, and an unwillingness on the part of the banks to use this process. A good Credit Information System that can protect banks from extending credit to proven defaulters. Recently, the authorities have established a Credit Information Bureau in BOM listing all defaulting borrowers. Sharing confidential credit information between lending banks improves public credit discipline, and the absence of such a system is an indication of potential structural weaknesses. An auditing environment that allows auditors to test the value of risk assets and force the bank to provide adequate reserves against potential credit losses. A tax environment that allows the write-off of loans when no reasonable prospect of recovery exists. And a prudential supervision system that monitors the portfolio quality of commercial banks.

**Strengthening Banking Supervision**

The BOM banking supervision function is already an important part of the banking environment, but falls short of acceptable performance due to capacity constraints. Current financial off-site analysis
carried out by the supervision department is fragmented and inconsistent, delayed by lack of accounting standards and weak information infrastructure. On-site examinations have been performed but on scheduled and ad-hoc basis. Banking supervision needs to be extended to more branches to examine and verify data, evaluate asset quality, appraise management, assess funds management practices and determine compliance with internal policies.

At present, the BOM supervision department is confronted with an onerous workload. Twelve examiners, located in Ulaanbaatar, are responsible for audits, off- and on-site inspections, and bank supervision. The physical size of the country, booking of loans in distant provinces, and lack of telecommunications make the task all but impossible.

Central bank aimag branches do not have the capacity to provide proper supervision in the aimags directly, mainly due to a lack of qualified personnel. Audit capabilities are further limited by the lack of credit history and credible credit files in the commercial banks themselves.

A significant concern involves the quality of reported data. The BOM has instituted strict reporting requirements on commercial banks requiring information to be reported directly to BOM's supervision department. Along with the usual monthly reports, balance sheets, profit/loss accounts, ten largest loans, and quarterly reports, sector lending, classification of inherited loans, classification of non-performing loans, and semi-annual reports on paid-up capital comprise the set of new reports that commercial banks will provide to

Table 2: Estimated Bank Restructuring Cost to Government in 1997

<table>
<thead>
<tr>
<th>Description</th>
<th>In Tg billions</th>
<th>In % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Expenditures (budgetary items)</td>
<td>17.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Interest on bonds</td>
<td>16.0</td>
<td></td>
</tr>
<tr>
<td>Service payments to Agriculture Bank</td>
<td>1.6</td>
<td></td>
</tr>
<tr>
<td>Non-cash Transactions (excluded from budget)</td>
<td>40.2</td>
<td>6.1</td>
</tr>
<tr>
<td>Bonds issued</td>
<td>35.0</td>
<td></td>
</tr>
<tr>
<td>Held by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Savings Bank</td>
<td>20.5</td>
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<tr>
<td>Reconstruction Bank</td>
<td>5.6</td>
<td></td>
</tr>
<tr>
<td>Bank of Mongolia</td>
<td>8.9</td>
<td></td>
</tr>
<tr>
<td>Loss of Government Deposits</td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>Loss of Government Equity in Failed Banks</td>
<td>2.7</td>
<td></td>
</tr>
<tr>
<td>Total Costs</td>
<td>57.8</td>
<td>8.7</td>
</tr>
</tbody>
</table>

Source: BOM, MOF, and World Bank Staff Estimates.
Figure 3: Banking Crises Are All Too Common and Carry Enormous Fiscal Cost

Argentina (1980–82)
Chile (1981–83)
Uruguay (1981–84)
Israel (1977–83)
Côte d'Ivoire (1988–91)
Venezuela (1994–95)
Senegal (1988–91)
Bénin (1988–90)
Spain (1977–85)
Mexico (1995)
Mauritania (1984–93)
Bulgaria (1995–96)
Tanzania (1987–93)
Hungary (1991–93)
Mongolia (1996)
Finland (1991–93)
Brazil (1994–95)
Sweden (1991)
Ghana (1982–89)
Sri Lanka (1989–93)
Colombia (1982–87)
Malaysia (1985–88)
Norway (1987–89)
United States (1984–91)

the supervision department. The additional reports will furnish information on bad loan provisioning, details of lending to shareholders, ten largest borrowers and reports of foreign currency positions. Although these requirements have improve financial information and reporting by commercial banks, nonetheless, further progress is warranted to strengthen enforcement and accuracy of the reports.

**Privatization Strategy and the Cost of Bank Restructuring**

The Government issued a total of Tg35 billion in bonds at a variable coupon rate indexed to the central bank bills rate to finance the bank restructuring. Tg21 billion in government bonds were issued to cover the non-performing loans of the two failed banks. The Government issued Tg8.9 billion in bonds to BOM, Tg20.5 billion in bonds to the savings bank, and Tg5.6 billion in bonds to the reconstruction bank. This translates to Tg16 billion in cash expenditures from the 1997 budget, consisting of interest payments on the bonds and direct capitalization of the new banks. In addition, starting from 1997, the Government will make cash payments of Tg1.6 billion in 1997 to the Agriculture bank for services rendered in distributing pensions and social services.

As part of the bank restructuring strategy, the Government intends to privatize the 100% state-owned banks. Success of the bank privatization will not only determine the growth prospects for the economy, but also the ultimate cost of bank restructuring exercise. These cost are lower now than estimated in December, but they still amount to a whopping 8.7 percent of GDP. Since the Government directly or indirectly owns these banks, strong turnaround in these banks will increase the value of this investment, which will eventually be recovered when the banks are privatized. The cost of the bank restructuring exercise is reduced substantially as proceeds from the privatization is added to government revenues. Moreover, any proceeds made from loan recovery efforts by MARA will augment government revenues. Non-cash expenditures from the budget, that is the government bonds issued for the bank restructuring exercise, are Government equity stakes in state-owned banks that may yield dividends to Government in the interim.

Privatization of large state banks through cash sales has been rare in most transition economies. Political concerns usually complicate the pricing and methods of sales of these banks, particularly to foreign buyers. The potential for cash sales to domestic investors is also limited because the local stock market lacks depth and expertise. The Mongolian authorities should develop clear privatization plans for its state-owned banks, with particular emphasis on developing its securities market and introduction of bank twinning arrangements to facilitate entry by foreign commercial banks in the domestic market. These actions should increase the potential for privatizing the fully state-owned banks in the future, and reduce the cost of bank restructuring. However, privatization is not a panacea and it has to be done very carefully or it could end up undermining rather than improving governance and bank performance. Moreover, no privatization plan will succeed without renewed viability in the banking sector.

**IV. The Future of the Banking System**

**Eventual Structure of the Banking System**

Transition creates a difficult banking environment in which sizable loan losses are unavoidable, especially when real interest rates rise and firms have trouble servicing their loans. Throughout the 1990s, many transition economies have faced major financial crisis originating from troubled banks, especially when Governments did not act decisively. Resolving financially distressed institutions requires three steps. First, financial flows to insolvent banks,
whether from Government or from deposits attracted by high interest rates, must be stopped. Likewise, the flow of funds to insolvent or non-performing borrowers must also stop. Second, bank management, often a primary source of the problem, must almost always be changed. Third, to reduce incentives for excessive risk-taking, private shareholders should completely lose their stakes in liquidated or restructured banks. Estonia approached these problems forcefully in late 1992, and Croatia, Lithuania, Kazakhstan, the Kyrgyz Republic, and FYR Macedonia have also taken steps to liquidate or drastically restructure weak banks. Mongolia now joins this rank.

With its December 1996 actions, Mongolia has moved quickly and decisively to close problem banks, and remove management. Now, to restore confidence, the Government should aim to certify a few reliable institutions and try to protect the payments system from bank failures. Entry by foreign banks is one quick way to increase the quality of banking, as was adopted in Armenia, Estonia and Russia. Another approach, adopted in a number of transition countries, is to single out a few select banks for financial and technical assistance. Poland adopted just such an approach. The Polish Government restricted its banks from making new loans to enterprises that were in arrears on past loans, and required regular audits of all banks according to international standards to encourage transparency and expose the magnitude of the bad loan problem. The Polish restructuring program further required banks to set up debt workout units and take actions to resolve loans that had been classified as non-performing. Complementary reforms were required that focus on improving the governance of state banks and ensuring a strong commitment to privatization. Still another route, adopted in many NIS countries, is to establish a "safe" bank that would primarily collect household deposits and be allowed to invest only in safe assets. The presence of a safe bank can help restore confidence in the banking system and allow authorities to remove, or at least reduce, the implicit deposit insurance now provided to commercial banks.

Upon completion of the bank restructuring, the Mongolian banking system will comprise three large commercial banks, a specialized savings bank, an agricultural bank, and a few smaller commercial banks serving niche markets. The authorities have established a safe bank, the specialized Savings Bank, that will invest only in safe assets to service its deposit base. The authorities should maintain a safe bank during the difficult transition process, at least until the bank restructuring bears fruit in the form of a core group of healthy banks. However, in an environment where credit discipline is poor and demand for loans are low, the authorities must ensure that safe banking does not crowd out market access for emerging banks to adequate amounts of safe government debt instruments in order to protect their deposits from risks. In this regard, the authorities have singled out a few banks for financial and technical assistance. These banks form the core of the banking system, and are prime candidates for future privatization. The authorities will also launch a

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**Box 2: Russia’s Radical Bank Reforms**

Financial reform that stressed entry of new banks, including foreign banks, have benefited countries that generally had poor initial conditions. A period of relatively free entry can stimulate decentralized institution building, as was witnessed in Russia and Estonia. Russia’s approach to banking reform resulted in a rapid, and partly unintentional, explosion in the number of commercial banks: from 5 in 1987 to 1,500 in 1992 and 2,500 in 1995. Rampant inflation in Russia provided the new banks with an opportunity to gain market share quickly. However, as stabilization has taken hold, the environment for banking has become more difficult. A third of Russia’s banks reported losses after real interest rates turned positive in 1995.

bank twinning exercise for the T&D Bank to attract reputable foreign banks, as a means to improve the overall quality of banking services and to promote competition.

The successor banks face formidable challenges. Both the Savings and Reconstruction banks lack sufficient banking expertise—from accounting skills to basic asset-liability management analysis. The Reconstruction Bank, which was to service only performing enterprise loans according to its mission statement, within days of its setup reported new non-performing loans. The authorities should evaluate the objectives and need for the Reconstruction bank, and adjust the institution's setup and manning accordingly.

Further system restructuring requires reducing the size and number of banks operating in Mongolia. Many of the eight smaller banks face probable liquidation, as several banks are troubled and are unlikely to continue as independent concerns. The consolidation/liquidation process should use policies that promote self-help for banks to encourage them to build up their capital base, by increasing the minimum paid-in capital for banks, for example, instead of relying on recapitalization and other forms of Government support. The number of banks in Mongolia should be sufficient to preserve competition in Mongolia, but limited to be properly supervised by the central bank. Care must also be taken to screen new bank applicants, including foreign banks; and to increase transparency, including accounting and disclosure standards, supported by a well-developed auditing profession and enforced by competent banking supervisors. There is no "correct" number of banks in this regard. The critical issue is to make sure that the surviving banks are well managed, liquid, appropriately capitalized and adequately supervised. Moreover, no single bank should be so large that its failure could not be absorbed by the system.

Deposit Insurance
Recent Government actions have implicitly assured the public of at least partial guarantees of deposits. This raises question on the advisability of a formal deposit insurance program. Deposit insurance is not recommended when the solvency of the entire banking system is in question. This potentially puts the risk of the entire system on the Government budget and removes the urgency of reforms within the banking system. It also sends wrong messages to bank managers, shareholders and customers. Deposit insurance programs are appropriate when the expected costs are estimable, controllable and affordable. Placing an element of risk on the depositor maintains pressure on all parties to assess that risk and undertake the reforms necessary to stabilize the system. When the banking system has been rationalized and stabilized, deposit insurance programs could be entertained.

International experience, however, has shown that deposit insurance is not recommended for developing or transition economies. Deposit insurance presents enormous incentive problems, i.e. a moral hazard problem for commercial banks, and requires additional regulations and close supervision to make it work in the short run. These conditions demand much from bank regulators, and it is doubtful that these skills exist at present in Mongolia. What plans could a policy maker offer that would not have all the perverse effects of deposit insurance? History provides at least one alternative: regulators could require each bank to offer deposit accounts that are segregated, treasury bill mutual funds. Banks could then advertise these funds as safe assets, perhaps guaranteed or backed by the government. This type of account is in effect insurance from the government, offering the same guarantees as government bonds, but it removes the wrong incentives for financial institutions that arises from insuring bank deposits.

An important principle that the authorities should examine before considering a deposit in-
Insurance program is that the commercial banks should pay for the deposit insurance, and hence the cost of bank failures, not the Government. Commercial banks should pay for the cost of the examiners, the cost of bank liquidation’s as well as other expenses to run the nationwide deposit insurance scheme. In addition, banks should provide funds to ensure that the deposit insurance scheme is fully capitalized to a healthy level.

If Mongolia had its own nationwide deposit insurance system with an independent Corporation, it could authorize the number of examiners needed, to properly pay good liquidation staff, and to pass all such costs on to the ultimate beneficiary, the banking system. Due to significant risk factors inherent in Mongolia’s banking system, the deposit insurance fee assessment should be high. The larger deposit insurance fees will be more than offset by lower costs of deposit gathering for the insured banks. Furthermore, the fund should be capitalized at a level twice that in the US, i.e. 2.5% of insured deposits. In any such system, it is important to allow only the better run banks into the deposit insurance system. Only the best banks should be allowed to join, and bank that are substantially insolvent should not be able to join. Joining the deposit insurance program should be voluntary and its costs should be considered as nominal relative to the probable flow of cheaper funds due to the prestige of being approved a member of the deposit insurance program. Depositors should then decide whether they want their money in an insured bank or an uninsured one. Such a scheme is a method of consolidating the banking system, where weaker banks would be ineligible to join the deposit insurance system, left to fend for themselves, and face potential failure.

Rural and Agricultural Finance
Mongolia has 21 provinces (aimags) with the capital city of Ulaanbaatar as an independent. Ulaanbaatar, with 26 percent of the country’s population and the vast majority of all enterprise headquarters, is clearly the prime market for any bank, and all of Mongolia’s 13 banks have their headquarters and a branch there. Total outer region population is 1,655,000 which is served by about 450 banking offices. Bank presence in the aimags is generally limited to 2–3 bank branches in the aimag capitals. Only the Agriculture bank has branch offices in most districts (soums). The Ulaanbaatar market is a net provider of funding to the outer regions. Total outer region loans is Tg26.8 billion versus Tg19.2 billion in deposits. This relationship, however, is heavily skewed by the borrowing needs of the agricultural region of Selenge.

The typical banking office has many small accounts with volumes too small to cover costs. Offices average 157 depositors and 23 loans. The average loan size in the outer regions is Tug 2.4 million, while deposit accounts average only Tug 0.3 million. The problems of small customer bases is particularly accentuated by Agriculture Bank’s 303 sub-branches in the soums. These offices primarily take deposits, distribute pension checks without compensation and frequently do not lend. Despite being the only banking facility in these districts, almost all of these offices lose money.

The restructuring program needs to take into account the conflicting needs of the banks to operate profitably and the Government’s desire to provide minimal banking services throughout the country. Agriculture has been particularly distressed in recent years with many troubled enterprises burdened by rising costs, high interest rates and weak markets. There are potential synergies between the surplus savings of the cities and the seasonal credit needs of the surrounding agriculture areas. Mongolian banks should therefore diversify its credit risks, balancing its city-based operation with its rural operations. Opportunities to strengthen the banking system through bank rationalization exist mainly in the outlying regions, which are generally over-banked. Elimination of
Table 3: Branch Data by Aimag (in Tg millions)

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<td>TOTAL</td>
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<td>554</td>
<td>685</td>
<td>137</td>
<td>926</td>
<td>2.44</td>
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some unprofitable offices can be achieved without leaving any aimag unserved. Each soum also has a post office, and future research might study the feasibility of combining the two functions into a single postal savings network.

**The Prime Market.** The prime market is defined as those which had sufficient economic activity to support competitive banking. Stronger banks (T&D and ITI) would benefit by expanding their presence, and borderline banks (Agriculture) might benefit by maintaining their presence while restructuring. Ulaanbaatar, Darkhan and Selenge are the only prime markets. ITI and T&D are already in the prime markets, and Agriculture Bank has a presence in Darkhan and Ulaanbaatar.

**Strategic Opportunity Market.** This market is defined as those having sufficient economic activity to provide an attractive opportunity banks to expand their presence. These regions all have rail connections facilitating trade and industry. Orkhon and Bulgan (Erdenet) are attractive sources of deposits. Dornod and Dornogov may establish free trade zones facilitating trade with China and Russia. Except for a small presence in Dornod, T&D Bank does not have a presence in these markets and did express an interest in eventually expanding into regions serving trade with China and Russia.

**Over-banked Market.** This market is defined as those which offered few attractive customers and are served by competing weak banks. The strength of the banking system might be better served by rationalizing the competing branches, expanding the scope of the surviving bank, and removing the drain on the selling bank. Gov-Altai, Dungov, Henti, Omnogov, Sukhbaatar and Uvs aimags particularly fit this description. Given the small average size of loans, deposits and transaction volumes, every market outside of the prime ones can be considered to be over-banked and appropriate for branch rationalization.

The Government wants to ensure adequate financial support for the rural areas, and considers developing a government-sponsored institution to undertake rural finance. This strategy, however, introduces difficulties into the financial market. Unproductive sectors and enterprises may gain access to scarce financial resources, depriving more creditworthy borrowers. Furthermore, a government-sponsored institution could prove to be a formidable competitor for private lenders, crowding them out of the most productive relationships. The economy is better served by the encouragement of competitive private sector initiatives than by applying government resources without mitigating the underlying risks. Any Government participation in rural lending should be clearly reflected in the budget to limit its scope and maintain its transparency.

**Long-term Finance**

Like many developing countries, Mongolian banks are unable to provide long-term finance to its borrowers. Current credit structures are typically less than one year (usually 90–180 days), and documented by rudimentary credit agreements. Credit structuring in Mongolia typically does not factor in the use of the loan proceeds or the source of repayment. Loans, therefore, frequently mature before the enterprises can repay them, even though the underlying transaction may be proceeding as planned. This problem is particularly pronounced with longer term asset conversion cycles such as construction, plant and equipment investment, and even agriculture. There are three potential reasons for the lack of long-term finance in Mongolia. First, macroeconomic factors limiting the supply side; second, institutional factors specific to the financial sector; and third,
legal and financial infrastructure weaknesses that constrain the development of term financing.

A key reason for the absence of long-term financing is high inflation and unstable macroeconomic conditions. Attempts to increase the supply of long-term credit without addressing inflation could easily prove to be short-lived and costly. High real interest rates may reduce the effective demand for credit—enterprises will say they want more credit, but not at market prices. Few enterprises can profitably invest capital borrowed at real rates of up to 60 percent. Stabilization of prices, and therefore interest rates, is critical to giving businesses and banks the ability to predict costs. Addressing the factors that account for high real interest rates may in the long-run pay off more than attempts to force banks to lend long. Only when inflationary expectations and bank solvency have been stabilized, will sound banks become repositories for term deposits and attractive issuers of term notes to investors.

A second factor accounting for the scarcity in long-term credit is institutional, related to the banks themselves. Bank managers in Mongolia generally lack asset-liability and credit structuring skills. This is understandable in that liability management skills was not a requirement of bankers in the previous era. Instead, banks have sought to minimize credit risk by only lending for short periods. Short term loans are uniformly given regardless of the underlying transaction, and they are usually rolled-over upon request unless the bank has cause for concern. This practice undermines bank monitoring of the customer's business and exposes both borrower and lender to funding risk.

Mongolian banks do not have matching sources of term funding, and the financial condition of the banks makes it unlikely for depositors...
Box 3: Development Bank

There is currently much discussion in Government circles about establishing a policy-based development bank. A range of countries have developed banks to fund projects which Governments deem beneficial to the economy. While some countries (Germany, Japan, Korea, Singapore) have been successful in operating development banks, many development banks have failed under the burden of unrepaid debt and below market interest rates.

Successful development banks have usually been only one element of a well-designed sectoral policy supported by other government instruments. The development bank funding was only one step in a process of consultation and selection between government and the private sector. The contribution of development banks has been careful project selection, using clear criteria of viability and creditworthiness. Development banks were rarely the only financier of a project, but usually co-financed on a pro rata basis by depositors, including Government, and the private sector. The absence of long-term fixed rate instruments prevents the hedging of interest rate risks. Moreover, the forward foreign exchange market is not developed enough to allow Mongolian banks to hedge interest rate risk by fixing future payments to foreign currency equivalents.

A third reason for a lack of term financing in Mongolia is the weak legal and financial infrastructure. When the legal system is inefficient or costly to use and when accounting and auditing systems are underdeveloped, banks prefer short-term credit over long-term debt. Short-term financing reduces the expropriation of creditors by borrowers. Short maturity allows creditors to review the firm’s decision frequently and, if necessary, to vary the terms of the financing before sufficient losses have accumulated to make default by the borrower optimal.

If complicated loan covenants could be enforced at a lower cost, the supply of long-term credit would be greater. Ignoring these deficiencies and establishing government banks to lend long-term certainly is faster and less difficult than trying to address the information and contractual enforcement problems. But these banks will have to cope with the same issues private banks would confront, and will have additional incentive problems as well.

V. Non-bank Financial Intermediaries

The financial condition of Mongolia’s banking system may lead to the accelerated development of
non-bank financial institutions (NBFIs) in parallel to the banking system as an alternate source of capital for economic activities. For instance, leasing and factoring of receivables may well be a suitable source of funding for the small and medium sized enterprises needing to replace their fixed assets such as machinery and equipment, or to finance working capital needs. The parallel development of a securities market will allow firms to raise equity and debt capital, as well as to support long term housing finance in view of the upcoming housing privatization program. Additionally, pension and social security funds will need to adjust to the upcoming pension and social security reform. However, at present, NBFIs are practically invisible in the financial sector. The informal sector of the economy seems to be the only active portion of the NBFI market, turning out healthy profits for its participants and creating significant turnover in curb-side foreign exchange operations.

International experience shows that an active NBFI market promotes economic growth. A liquid stock market may make it easier for firms to raise capital for investment. Many profitable activities require a long-run commitment of capital. Yet investors are reluctant to relinquish control of their savings for long periods. Liquid stock markets ease this tension. In liquid markets, savers hold an asset-equity that they can sell quickly and cheaply. At the same time, firms have permanent access to the capital raised through equity issues. By making investments with long term horizon more attractive, liquid stock markets may boost investment, enhancing the prospects for long-term economic growth. On the negative side, stock markets are sometimes seen as "casinos" that have little positive impact on long-term growth. By enabling investors to sell quickly, liquid markets may reduce investors' incentives to oversee managers and monitor firms' performance and prospects, so that they fail to exert corporate control.

Evidence strongly supports the view that access to a liquid stock market increase long-term economic growth. In a set of thirty-eight countries divided into four groups according to the initial liquidity of their stock markets, the nine countries with very liquid markets in 1976 grew much faster over the next 18 years than countries with illiquid markets. This comparison is based on a measure of liquidity that is defined as the total value of equity traded as a share of GDP. A well developed banking system is also a prediction of economic growth. Dividing the countries into four groups based on stock market development and bank development (as measured by bank loans to private enterprises as a share of GDP) revealed that countries with liquid stock markets and well developed banks grew much faster than countries with illiquid markets and poorly developed banks. Moreover, stock market liquidity and banking development are independently strong predictors of future economic growth: greater stock market liquidity implies faster growth, no matter the level of banking development, and greater banking development implies faster growth, no matter the level of market liquidity. Liquid markets also boost both the quantity and quality of investment. Countries that started with more liquid stock markets had more investment—therefore faster rates of capital accumulation and better quality investment—and thus more rapid productivity gains.

Securities Market
The initial step of Mongolian plan to an efficiently functioning market economy through the privatization of state owned assets was entered when the complex policy measures of restructuring the whole economy, introducing fair market competition, and the sustainable encouragement of a viable private sector development were taken by the Government. In order to achieve these objectives in the shortest time frame, and to provide the basis for a more efficient allocation of economic resources, regulat-
Table 4: State-owned Share Transfers to the Public (as of January 1997)

<table>
<thead>
<tr>
<th>No.</th>
<th>Listed Company</th>
<th>Initial state share ownership (percent)</th>
<th>Transferred to public ownership (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Erdenet Selenge</td>
<td>51</td>
<td>51</td>
</tr>
<tr>
<td>2</td>
<td>Tasun</td>
<td>51</td>
<td>51</td>
</tr>
<tr>
<td>3</td>
<td>Zoluchid</td>
<td>52</td>
<td>31.9</td>
</tr>
<tr>
<td>4</td>
<td>Chandman Erden</td>
<td>29.7</td>
<td>19.9</td>
</tr>
<tr>
<td>5</td>
<td>Ardin Zorig</td>
<td>51</td>
<td>51</td>
</tr>
<tr>
<td>6</td>
<td>Ar Gunt</td>
<td>51</td>
<td>51</td>
</tr>
<tr>
<td>7</td>
<td>Bayanchulun</td>
<td>51</td>
<td>51</td>
</tr>
<tr>
<td>8</td>
<td>Tsagaan Erdene</td>
<td>51</td>
<td>21</td>
</tr>
<tr>
<td>9</td>
<td>Altan toria</td>
<td>51</td>
<td>51</td>
</tr>
<tr>
<td>10</td>
<td>Tushig uul</td>
<td>20</td>
<td>20</td>
</tr>
</tbody>
</table>


The role of securities markets is to facilitate the reallocation of property rights. However, much of the standard benefits of securities markets, such as compliance with the disclosure requirements, the internationally accepted accounting principles, and the improvement of corporate governance by monitoring managers and trading shares actively, have not yet materialized in Mongolia.

Investment funds have been operating in the MSE since its incipience, with varying degrees of success. There are 12 investment funds, 19 mutual funds, and 476 listed but 437 traded equities operating in the MSE today. Total market capitalization is about Tg 14 billion, daily trading ranges from Tg 16 million to Tg 80 million for 80,000 to 300,000 shares traded. The total number of share-
holders that had an active account at the MSE was slightly above 135,000. The average price per share of equities traded in the MSE ranged from Tg 100 to Tg 220, making investment in the securities market accessible to the general public. Yet, trading volume remained low and the general level of stock prices depressed throughout 1996.

While market capitalization is relatively high, the turnover ratio is extremely low in Mongolia, reflecting a lack of liquidity in the market, investor perceptions that the market is risky, widespread non-compliance with disclosure requirements, and Government indecision to further the privatization process by releasing state held shares to the public through the MSE. It also shows that many of the listed companies are inactive and uninteresting to investors, and that trade has been limited to a few companies.

No initial public offering of a new private company has been carried out yet, but a public offering of an already listed company to increase its capital was successfully completed last year. There are many private companies that would like to go public, but they have not received approval from the Securities Commission. Most of these companies are very small in size and do not meet the requirements to bring stability in the stock trading environment. There is a lack of necessary regulations governing new public offerings, and both the Securities Commission and commercial banks lack experience in underwriting.

At this time, an interesting issue is the regulation requiring all block purchases exceeding 20 percent of the shares of a firm to be registered at the Securities Commission, which initially

![Figure 5: MSE Trading Information](image)

*Source: Mongolian Securities and Exchange and MSE records, December 1996.*
was introduced to protect the individual investor rights. On the other hand, this same regulation seems to interfere with the State Property Commission desire to the rapid privatization of state owned assets.

A recent ruling by the Mongolian Supreme Court has lifted the 20 percent registration requirement if the transaction was carried outside of the stock exchange, thereby creating inter agency conflicts between the Securities Commission which
Financial Sector Reforms in Mongolia

desires to enforce strict securities market discipline to protect the right of the investors, the State Property Committee whose mission is rapid privatization, and the Mongolian Stock Exchange which is trying to provide liquidity and depth and breadth in the market to provide a suitable investment medium and concentration of ownership.

Boosting the demand for securities in Mongolia will require a concerted effort on the part of the Government to provide a stable macroeconomic environment to raise the level of savings as well as the emergence of a strong base of institutional investors, such as pension funds and insurance companies.

It will require a well-functioning banking system to process payments and to act as custodians; and require improving the institutional and regulatory framework for securities transactions. Policy makers will need to improve protection for creditors and investors, and vigorously enforce the laws and regulations governing securities market transactions.

In developing and improving the rules of conduct in the securities markets, a balance must be sought between the top-down approach in which the government takes a pro-active regulatory action, and the bottom-up approach which is characterized by market transactions preceding the imposition of rules, regulations and laws. Top-down strategies may deliver high standards, but risk overregulating and constricting the fast transaction speed of the market. The bottom-up approach provides an effective way to develop competitive demand and supply conditions. There is also evidence that, market participants, concerned about protecting their own interests, tend to self regulate through cross-monitoring during trades, professional conduct, standards, licensing and certification of market participants. The bottom-up approach still requires a supportive role from the Government especially in promoting the necessary institutional frameworks in creating the enabling environment for market transactions.

Pension and Social Security Funds

Social security and pension plan system is the largest non-bank financial institution in Mongolia in terms of assets. However, it supports around 400,000 contributors, and is severely under-financed. The pension fund is a Government budget supported, pay-as-you-go system that is open to private company employees. There are five different types of social security funds in Mongolia: (1) pension insurance funds; (2) health insurance fund; (3) unemployment insurance fund; (4) survivors' benefits fund; and (5) accident fund. The Government has been subsidizing the funds from the central budget, on average, at a rate of Tg 10 billion a year. It will be higher in 1997, about Tg 13 billion, since the amount of Social Security and Pension Fund assets in the banking system is about Tg 4.5 billion as of end-1996, while the Government projects about Tg 32 billion to be spent on pension transactions in 1997.

Insurance and Leasing Companies

There are seven insurance companies operating in Mongolia. Mongol Daatgal Company, the state owned insurance firm, is by far the largest insurance company in the country. The rest are privately owned companies, providing a wide range of insurance services ranging from international travel, health, fire hazard, auto, property, business and general accident insurance. The insurance industry is still in its infancy in Mongolia, and is practically restricted to shipping and automobile insurance activities. The annual insurance firm revenues for 1995 was Tg 751.6 million, of which Mongol Daatgal Company has Tg 734 million in revenues; and was Tg 1,277.3 million in 1996, with Tg 1,243 million raised by Mongol Daatgal Company.
While the basic legal framework for leasing is in place, further work needs to be done and is currently being carried out with the assistance of the International Finance Corporation. Due to present problems of collateralization, leasing would seem to be a safer way of financing the private sector than loan financing. At present, there is already one private leasing company operating on a small scale in Mongolia. It started operations in late 1995 and has been offering leasing services for office equipment. This service could easily expand to provide the machinery and equipment leasing as a means to finance expansion or enterprise restructuring. The prospects for lease financing are bright, especially in the mining sector, and new leases of about $2 million are expected in the mining sector in 1997.

Since it is usually easier to assess the value of a leased asset than the credit of a firm, particularly one with a short credit history, leasing has come to finance a large portion of new investments by small and medium size enterprises in transition economies — up to a third in the case of Slovenia, and about one-sixth in some other countries. Small and medium sized enterprises find leasing particularly attractive, as leasing of machinery and equipment or vehicles offers many advantages over the traditional bank loans. Leasing may be one financial service that Mongolian policy makers may wish to consider developing in the near future. Leasing will also complement the development of other forms of finance including bond and commercial paper markets, as well as support a more general improvement in the regulatory and legal frameworks in place for lending.

The first step is to provide for proper legal regulations and institutional arrangements. Once this is in place, it will be necessary to attract foreign technical partners, both in leasing as well as in the insurance industry to provide for the necessary capital and expertise to allow a quick development of these industries. The International Finance Corporation is currently providing assistance on the legal and regulatory framework for leasing and is planning to assist in setting up the first major leasing company in Mongolia. It could therefore reasonably be expected by late 1997, that the leasing industry would make a substantial step forward, which would also have spill-over effects on other capital markets activities.

Informal Financial Sector
Since the initiation of political and economic reforms in 1990, Mongolian traders have been actively engaged in cross border trade activities. Mongolian traders travel abroad to purchase goods and bring them in the country in suitcases to sell in the domestic markets, or simply re-export. Using rough estimates based on Bank of Mongolia records, informal traders generated over $90 million in export revenues and over $80 million in import receipts in 1996. There are 110 foreign exchange traders registered in the General State Department of Taxation Agency, from where informal traders obtain their foreign currency for trade. This informal market had an estimated turnover of about $15 million worth of currency trade in 1996. The curb side foreign exchange trade is useful in supporting and stimulating informal trading activity. Unfortunately, it is not easy to estimate the total value of the domestic informal market activity in Mongolia, as in any other country due to non-traceable nature of the activity. Many countries including Mongolia, with a considerable informal sector are now considering various approaches to keep the tabs on this segment of the financial sector, however, it will require many incentives as well as changes or amendments in the laws ranging from banking and securities markets to civil code, debtor-creditor laws to bankruptcy and to tax codes. From another perspective, this is still a marginal segment of the financial sector, and it will eventually become integrated in the mainstream as the size of the business become large enough.
The Regulatory Framework

The objectives of regulation in financial markets are to ensure the integrity of the financial system by reducing systemic risks, to safeguard the solvency of individual institutions, to encourage effective and stable securities delivery system, and to prevent fraud, manipulation, insider trading and other abuses which threaten market integrity. Regulators ensure fairness and market efficiency, by keeping records of transactions and ensuring adequate disclosure requirements, and by licensing and registering market participants. The function of Government in securities market regulation, in this regard, is to design the overall regulatory structure, to accept responsibility for overseeing the implementation, and to commit to holding the balance of competing interests.

The disciplinary roles of securities regulation can contribute to better organized and more efficient securities markets. However, market efficiency can suffer from both excessive and a lack of regulations. Regulations should create an enabling environment in which securities markets can flourish and provide the market participants with a liquid, fair, transparent and an efficient medium of exchange. The purpose of any regulatory scheme should be a framework in which business can be honestly and at the same time profitably conducted. A sound regulatory structure inspires confidence and is commercially beneficial for market participants.

The twin core principles of securities market regulators are investor protection and the protection of the rights of shareholders. However, there is also the concept that the buyer should be beware, and that the investor must take some personal responsibility for his own decision to buy or sell. The best protection for all market participants is the availability of promptly disseminated and accurate information about the listed enterprises and all trading that takes place in their securities. Advances in electronic communication have enabled markets to achieve high levels of transparency in recent years. In addition all relevant laws, regulations and rules must be properly and promptly promulgated and made available to those who need to understand them. Regulators in developing countries have the additional responsibilities of assisting in market development. Regulators need to be involved in proactive as well as preventative work and be able to work with practitioners to develop a high quality market.

There is no one set of international standards for securities regulation and legislation (as there is, for example, for the accounting profession). It is possible to distill an overall set of good standards, derived from forums such as IOSCO (International Organization of Securities Commissions), FIBV (Fédération Internationale des Bourses de Valeurs), and the Group of Thirty. IOSCO attempts to set standards such as in the area of capital adequacy of intermediaries but they are not always successful in encouraging implementation of their recommendations on a worldwide scale. It is difficult to get uniform standards in a line of business where regulatory arbitrage can be commercially beneficial. National exchanges may wish to lower their standards to attract particularly interesting overseas companies to list on their exchanges. Equally important are certain accepted modern practices, which ensure service to and protection of the investor and the overall minimization of risk. The principles of 'full, fair and timely disclosure', 'transparency' of dealing information and 'minority protection' are all accepted as making a market attractive to investors. The existence of efficient trading, settlement and clearing systems can also add to a market's attractiveness.

Securities regulation around the world presently go back to no more than a hundred years; the oldest one being in the US, and the newest in a major developed market are those of the UK, which had no law until 1986. Types of laws adopted depend on the nature of the underlying legal structure, e.g., whether there is a framework of com-
mon law, the nature of the prevailing companies law, etc. Developing markets can adapt what suits them from the experience of overseas markets, based on the form of their overall regulatory infrastructure. History has shaped the securities laws of different countries in different ways. Economic, political and social realities have to be considered. Regulation cannot be considered separately from these issues especially in a developing market.

International and global markets increasingly do not lend themselves to regulation in the conventional sense. Modern technology means that securities can be traded and settled on electronic systems which have only a limited physical presence in any one country. When such systems provide a global, screen-based market, it is difficult to determine how and where they should be regulated.

The cornerstone to good regulation is consistent and thorough enforcement. However a new market regulator will not always have the capacity to follow up every single misdemeanor. It is necessary to set priorities. All forms of market manipulation are wrong but ‘insider dealing’ may not be the most detrimental to the market on every occasion.

VI. The Agenda
In its present condition, the Mongolian banking system is not conducive to the development of the private sector and is not integral to the savings-investment intermediation process. Reforms are needed to ensure that banks are able effectively to fulfill their roles as collectors of savings, allocators of credit, and managers of the payment system. All transition economies face similar obstacles in building strong, active financial systems. For Mongolia, it is important that the Government minimizes its direct and indirect role in the allocation of resources. Given the bank restructuring program adopted by the Government, additional, premature bailouts should be avoided at all cost, it undermines the credibility of the reforms taken to date. The Mongolian authorities should instead encourage banks to be more self-reliant in building capital, for example, through more generous loan-loss provision rules, and improve the general framework for debt collection.

Banking reforms in any transition economy will be ineffective and unsustainable without comprehensive reforms in the enterprise sector where most of the important clients of the banks are located. Enterprise reforms should facilitate liquidation of non-viable enterprises, restructuring of potentially viable ones, efficient functioning of existing viable enterprises, and entry of new enterprises.

Accelerating the development of non-bank financial institutions is important in all transition economies, because such institutions often finance the small, dynamic new firms that are proving central to economic growth. Capital markets are essential for raising financing and improving the governance of firms. Policies to develop stock markets need not undermine existing banking systems, and stock markets and banking can develop simultaneously. In the long run, the role of banks, capital markets, and other intermediaries are complementary, and all have a positive influence on development and growth.

In stating the reform agenda for the future, it is popular to look for best practices and apply that best practice to the country in question. However, a difficulty in applying the best practice, such as applying an International Bankings Standard, is that it implicitly takes the industrial countries as the standard. Applying best practice in banking and bank regulation should be undertaken with care, and with the realization that institutions are crucial determinants of how well any reform can be transplanted to a new setting. The reform agenda proposed below is divided into three timeframes: short-, medium-, and long-term framework that stress the implementation capacity of Mongolia.
given its institutional setting. Most of the short-
term reform agenda focuses on financial infrastruc-
ture measures that can be implemented immedi-
ately. However, these measures will take concerted
effort on the part of policy makers and regulators
to ensure that they are sustained. For example, it is
quite easy to set up a Credit Information Bureau
of defaulting borrowers, but it is quite a different
story to ensure that its services are used regularly
by commercial bankers in the future. Furthermore,
a proper accounting framework and system also
takes time to develop. Legal and judicial reform is
another case in point. It is easy to draft an Insol-
vency Law, but difficult to ensure its steady and
consistent application. Developing effective legal
institutions is a time consuming process—to the
point that it is hard to phantom significant progress
taking place anytime in the near future. But since
these measures take so long to mature, it is neces-
sary for the authorities to devote their attention to
financial infrastructure development now, and con-
tinue to carefully monitor their development well
into the next century.

The medium-term agenda focuses on the su-
pervisory role of regulators. It mandates corrective
action to ensure a healthy financial system, lessen-
ing the extent to which supervisory forbearance
needs to occur. The recommendations concentrate
on pre-programmed changes that can be implanted
relatively quickly. However, given the relatively
weak system of governmental checks and balances,
and given Mongolia’s close knit societal structure,
it is likely that supervisors will have close links with
the regulatees and it will be difficult to oversee com-
pliance of these measures. The high level of concen-
tration of the banking system is linked to the concen-
tration of wealth and political power in
Mongolia. In this environment, the changes may
be introduced, but hesitantly, and enacted with-
out being honored. The onus of ensuring that these
reforms are implemented will fall on the authori-
ties. But that is only necessary but not sufficient in
terms of ensuring that the reforms are sustained.
The long-term recommendations therefore concen-
trate on diversification and market development.
The introduction of foreign competition, the priva-
tization of state-owned banks, the development on
non-bank financial institutions, are all elements of
diversification and long-term market development.
The proposed recommendations attempts to en-
courage a multi-pillar approach to achieving an
incentive-compatible banking system that the au-
thorities can manage and supervise.

VII. Conclusion
The Mongolian Government has made commend-
able reform efforts at a rapid pace, and is well un-
der way to realize its vision of private sector led
growth as captured in its action plan. The main
conclusion of this paper is that in order to achieve
a medium term growth of four to five percent of
GDP, the lingering serious banking problems must
be resolved and other financial sector institutions
must be rapidly developed and further deepened,
with the consistent implementation of strict mac-
roeconomic policies to restore stability. Structural
reforms will enhance the credibility of stabiliza-
tion, and will spur growth by increasing produc-
tivity of the real sectors, and improving the inter-
mediation of savings. Key reforms to accomplish
this would be; a stronger financial sector that re-
covers bad debts and finances viable new enter-
prises; a credible and feasible privatization program;
better governance and hard budget constraints for
public enterprises; well managed public finances
that reduce the social costs of transition and main-
tain Mongolia’s human capital; and, a legal and
institutional environment that promotes private
sector development.

Stabilization is essential for the sustainability of
growth. As long as Mongolia can maintain a favor-
able trade balance, growth performance can be ex-
pected to be good. In case of a reversal in the past
trend, the growth will suffer and pressures on the
budget will increase. Stability in the economy will also have a subsequent impact on the development of financial markets, however, the priority at this particular time frame would be to bring the bank and enterprise reforms into a successful closure.
Annex A: Financial Sector Policy Reform Agenda

Short-term (within 6 months)

Bank Restructuring:
- Ensure bank restructuring bonds represent true assets for recapitalized banks
- Nurture the development of the Savings and Reconstruction Banks
- Closely monitor and enforce MOUs with the Agricultural and ITI Banks
- Require regular audits of the large banks according to international standards
- Improve financial transparency through accounting and disclosure standards
- Improve bank examination and banking supervision

Loan Recovery:
- Restrict banks from making loans to enterprises in arrears on past loans
- Require banks to set up debt workout units and take action to resolve loans that have been classified as non-performing
- Establish a credit information bureau of defaulters
- Provide tax breaks for additional loan loss provisions
- Assist MARA in its bookkeeping and initial loan recovery efforts

Legal:
- Draft insolvency law for bankruptcy and liquidation
- Strengthen loan, collateral documentation and enforcement of judgments

Capital Market Development:
- Strengthen stock market

Medium-term (6 months to one year)

Bank Restructuring:
- Ensure banks increase their capital base
- Consolidate banking system through increased paid-in capital requirements
- Rationalize bank branch structure, especially in rural areas
- Initiate bank twinning arrangements for the T&D Bank
- Require regular audits of all banks according to international standards
- Improve commercial bank asset-liability and credit risk management skills
- Development plans to privatize state-owned banks

Loan Recovery:
- Initiate commercial bank workout for select major defaulters
- Initiate MARA bulk sales program
Legal:

- review Banking Law and Insolvency Law
- develop collateral (movable and immovable) registry
- improve court decision-making process, training judges and lawyers

Capital Market Development:

- explore development of NBFI, especially leasing companies

Long-term (one year and more)

Bank Restructuring:

- augment commercial banking skills
- allow foreign bank participation in banking system
- initiate bank privatization

Loan Recovery:

- merge activities of MARA with commercial bank debt workout units

Capital Market Development:

- further develop investment finance institutions to augment the banking system
Notes

1. In a simple banking environment where banks predominantly take short-term deposits and make short-term loans, and where there is little reallocation of resources between banks, liquidity can be measured as a ratio between current assets minus current liabilities divided by total assets.

2. Substandard loans are delinquent loans of up to 90 days, requiring 1% loan loss provision; 6 months, requiring 25% loan loss provision; doubtful loans are delinquent up to 12 months, requiring 50% provision; and bad loans are overdue loans of over 12 months, requiring 100% provision.

3. Inherited loans are defined as loans that were transferred from the previous state monobank to newly established commercial banks in 1991. Directed loans are defined as all loans that were granted by commercial banks on the basis of a Cabinet decision, or extended under government decrees, resolutions, or letters prior to June 30, 1994. Loans granted by commercial banks to borrowers, using their own credit evaluation procedures, are categorized as freely decided.

4. For example, the disasters of the commercial banking and savings and loans in the USA after the 1970s were the result of allowing insured banks to enter more risky areas of activity, while limiting examinations, supervision, and discipline.

5. Based on 6/30/95 data provided by BOM.

Bibliography


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