

An Overview of Mongolia's Banking Sector

B. Tsolmon

Former Chief Operations Officer, Zoos Bank, Mongolia

Introduction

Up until 1924 Mongolia lacked its own bank and currency and used different foreign currencies such as the US dollar, the Russian ruble, the British pound, and the Chinese Mexican silver dollar in commerce. Credits were offered by Chinese and Russian banks, the monasteries and private moneylenders. With the establishment of the joint Russian-Mongolian Mongolbank in 1924, and the introduction of the togrog (MNT) as the official national currency in 1925, all other currencies were withdrawn from circulation, and the private moneylenders were pushed out of business.

After the transfer by the Soviet Union of its shares in Mongolbank to the government of Mongolia in 1954, it was renamed as the State Bank, which until the early 1990s carried out both central banking functions and commercial banking activities.

In 1991, the government instituted a Banking Law that created a two-tiered banking system by separating the commercial functions from the State Bank.

The Development of the Banking Sector in Recent Times

The landscape of Mongolia's banking sector has changed dramatically over the last twenty years. Mongolia's banking sector, which still dominates the financial system of the country, has been growing rapidly in line with the economy as a whole. However, the extremely unfavorable external shock¹ coupled with the weakness of the banking system led to unprecedented back-to-back financial crises in 1994, 1996, and again in 1998-99. The level of nonperforming loans (NPLs) skyrocketed to 51.5% of total bank loans in mid-1999, of which 79% were concentrated in three banks. Out of 27 banks licensed in 1990-2000, 15 were closed by 2000, which led to a loss of confidence in the banking sector by the general public.

The role of banks in intermediation in the Mongolian economy has been expanding, and despite many challenges the banking system as a whole was solvent until recently. By 2005 all banks were fully privatized and held by local businessmen and/or foreign investors. The expansion of the banking sector was largely funded by an equally rapid increase in deposits, reflecting increasing public confidence in the banking system.

The increasing deposits have enabled the banks to expand their lending considerably, mainly to the private sector. Loans by banks grew, on average, 81.5% annually between 2000 and 2005, and by 42% in 2006, 68% in

2007, and 28% in 2008. This growth was primarily driven by economic recovery, a more competitive financial market structure, and foreign capital inflows. In August 2008 private sector loans as a proportion of all loans stood at 56.9% of total lending (of which 49% was in foreign currencies). The ratio of nonperforming loans as a percentage of total loans was kept at a single-digit level. The money supply (M2) increased on average by 31-35% between 2000 and 2006, and by 56% in 2007, before falling by 5.5% in 2008. The financial performance of banks improved mainly as a result of increased profits and subordinated debt. The capital adequacy ratio has been 14-24% since 1999, which is 1.8-3 times higher in comparison to the international standard of 8% set by the Basel Committee on Banking Supervision (BCBS).

Notwithstanding the adoption of a number of reforms to create a modern banking system, a similar situation occurred in mid-2008 with the collapse in mineral prices and external demand which triggered a banking-sector crisis in 2009. The banks' main sources of domestic funding—retail deposits and interbank financing—became highly volatile. Deposits fell by 12% between October and December 2008, mainly due to outflows of deposits from the banking sector. With the introduction of the blanket guarantee by the government, deposits have been slowly returning to the banking system during 2009. This resulted in total deposits reaching to the pre-crisis level of MNT2.5 trillion. Over this period asset quality deteriorated rapidly and the share of nonperforming loans rose to about 25% in November 2009 (from 2.7% in May 2008). A sharp deterioration in loan quality and a falling growth rate in loan portfolios led to bank losses of MNT204.6 billion and undercapitalization of banks. Two commercial banks became insolvent and one of them was nationalized in 2009. Most of the banks stopped providing loans in 2009, which resulted, amongst other things, in a 3% decrease in the number of borrowers.

The Current Situation

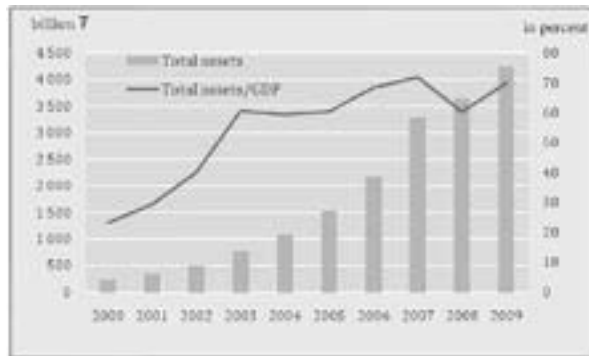
In 2010 Mongolia is making a sharp recovery with growth expected at 7% in 2010, reflecting substantial upcoming mining-related FDI inflows. Likewise with the banking sector. The banking system in 2010, with its 14 commercial banks, remains predominant in the financial sector of the country, with more than 90% of financial system assets.²

Money supply (M2) after the financial sector crisis in 2009 has increased by around 34% during the first nine

¹ The sharp falls in 1998-99 in world prices for copper, gold and cashmere, Mongolia's leading exports, caused great harm to the Mongolian economy. In 1998, export earnings plunged by an amount equal to approximately 15% of GDP, entirely due to these price declines. This led to a cumulative depreciation of the exchange rate of 35%, and to a drop in official reserves.

² The assets of the Bank of Mongolia and of savings and loans cooperatives are not included in this indicator.

Figure 1: Banking Sector Assets



months of 2010. In an attempt to generate liquidity the government has reduced the reserve rate; Mongolian banks, however, in early 2010, in similar fashion to most other banks in the world, limited their providing of loans, electing to conserve their capital. As a result of their refraining from extending loans the liquidity of the banks is improving.

Currently the minimum capital requirement (MCR) is equal to MNT8 billion, which was increased from MNT4 billion in 2004.³ The increase of the MCR for banks was intended to encourage a consolidation of commercial banks into a smaller number of sounder banks⁴ that would be able to compete, and to ensure that any new entrants into the market meet much more stringent capital requirements; the impact was minimal, however, and resulted in greatly increased competition for the same customers.

The performance of commercial banks after the financial crisis of 2009 is slowly improving. The capital adequacy ratio has been 14-16% in 2010, increasing from 12% in late 2009, and deposits continue to be the main source of funding for most commercial banks.

By the end of September 2010 total loans exceeded MNT3 trillion, showing an increase of 16% compared to the end of 2009. Nonperforming loans steadily declined from 24% in November 2009 to 13% at the end of September 2010. The banks are taking steps to meet the challenge, through strategic planning, strengthening of policies and procedures to meet international standards, product and customer diversification, development of niche markets, selective marketing, efficiency improvements in the provision of their services, and skills upgrading and capacity enhancement. The ratio of public sector nonperforming loans to total loans outstanding is negligible.

Financial intermediation is deepening as a result of the structural changes and the recovery of public confidence in the banking sector.

Mongolian banks along with basic lending and deposit products, and payment services, currently offer consumer lending backed by pensions, savings, salaries, and/or large down payments (i.e., consumer leasing) which has become

Figure 2: Changes in Bank Capital and Liquidity (as of August 2010)

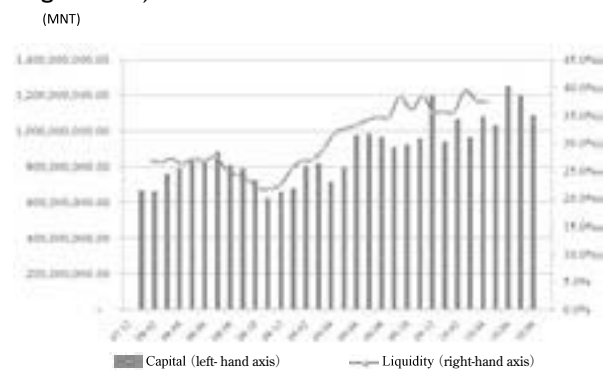
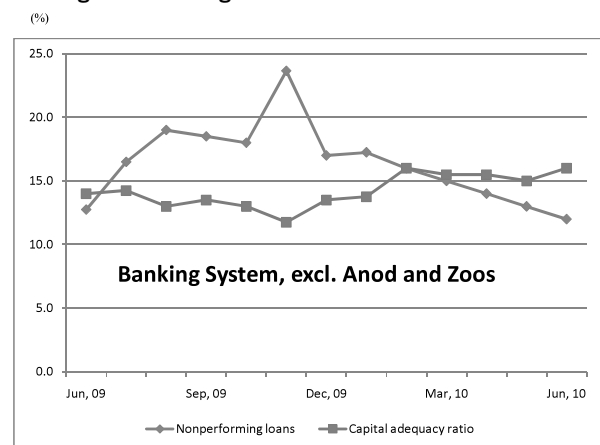


Figure 3: Change in the Banks' Balance Sheets



Source: IMF, Bank of Mongolia (BoM)

widely available and is often used by microenterprises either as working capital or for small business improvements. However, the microenterprise clients often cite the bureaucratic and collateral requirements of official loans as the driving impetus for using quick, higher-interest consumer loans. Banks are also providing bridge financing to the active residential construction sector. Banks require builders to advance 30% of project costs, which implies getting the project to the stage where the frame of the building is complete.

The penetration of banks in rural areas has improved as the banking system has grown. Banks have been reducing their reliance on corporate lending by increasing lending to households. The larger banks, which traditionally have focused on large corporate clients, have begun to downscale to target SMEs, whereas the banks predominantly focusing on microfinance are scaling up. Out of 14 banks, 3 specialize in rural areas,⁵ 2 in microfinance, and the remainder in general banking activities. They have also increased their branch networks from 682 branches in

³ It has been low relative to the size of the market, allowing easy entry into the market and resulting in a large number of banks. In 1999 the MCR was raised from MNT400 million to MNT1 billion, in 2000 it was again raised from MNT1 billion to MNT2 billion for commercial banks, effective starting 30 June 2001, except for new candidate banks, for which the increase to MNT2 billion was effective immediately.

⁴ Many consider that Mongolia is overbanked (14 commercial banks) for a population of less than 3 million and an economy of just over US\$5 billion (2010 GDP estimate).

⁵ Khan Bank [Khaan Bank] with its 425 branches in rural areas, Savings Bank [Khadgalamj Bank] with 263 branches, and XacBank [KhasBank] with 50 branches in rural Mongolia.

Table 1: Financial Intermediation

(%)

	1999	2000	2005	2006	2007	2008	2009	2010 F
M2/GDP	23.8	25.4	41.0	41.4	52.2	37.0	47.6	54.2
Loans/GDP	8.4	6.6	34.1	38.6		43.8	43.8	42.7
Deposits/GDP	11.4	9.1	27.5	31.4				
Total bank assets/GDP	22	21	60	68	62	55	68	70
Nonperforming Loans (NPLs)/ Total loans	50.8	23.1	5.8	4.9	3.3	7.2	17.4	13.3
Bank lending-weighted average interest rate for MNT loans	34.7	28.3	24.5	25.3	19.9	20.4	20.8	19.4
Banks' interest on deposits in MNT (non-weighted)	19.8	13.8	12.6	13.5	13.5	11.2	13.3	12
Real GDP growth	3.2	1.1	7.3	8.6	10.2	8.9	- 1.6	5.7
Loans to deposits			89.7	95.6	101.3	138.7	104.2	92.9

Source: Bank of Mongolia, IMF estimate

2004 to 803 in 2010 in order to spread their outreach, and with the common objective of increasing competition. In turn this contributes to lowering interest rates and lengthens the maturity of loans, thus improving access to financial services in rural Mongolia. Mongolia's demographic branch penetration is high and according to a study (2007), it ranks 16th out of a total of 97 countries. However, due to its low population density its geographical branch penetration is one of the lowest in the world.

Interest Rates

Interest rates for both deposits and loans are fully liberalized, with the banks being free to charge interest on a risk-reward basis. Market interest rates are showing a declining trend with the increasing competition and gradual decrease in the inflation rate. The interest rates are positive in real terms, with inflation running at approximately 8.3% at the end of September 2010.

The nominal interest rate in Mongolia has remained in double digits. However, both the nominal and real interest rates have been on a decline. By 2010 the nominal togrog and US dollar lending rates had fallen by more than 45% from their peak in 2000.

The lending rates have dropped from 28% in 2000 to 19% in September 2010. The lowest lending rate offered by financial institutions in 2010 was 9.6%, whereas the highest was as much as 38% per annum. The conventional wisdom in Ulaanbaatar holds that the high interest rates are the binding constraint in the limited access to finance. With a decline in lending rates and a prolongation of the loan period, the modality of lending might change with loans shifting from commerce to investment or manufacturing.

While bank spreads have been gradually converging to levels comparable to a range of peer countries, deposit rates and lending rates in Mongolia are still high. Deposit rates have dropped from about 14% in 2002 to 13.3% in 2009, and further to 12% as of the end of September 2010. A further decrease in interest rates could be expected with the rapid sophistication and expansion of the financial market.

Loan Portfolios

The loan portfolios of the commercial banks are fairly

well diversified. The credit exposure is highly concentrated, however, with three banks (Khan, Golomt, and Trade and Development) controlling 62% of the total credit exposure, and handling most of the corporate accounts, while the remaining ten banks focus on consumer and retail banking services, controlling 38% regarding loans. Credit from the three large banks has been directed primarily toward the construction, manufacturing, and wholesale trade industries. In 2010, the loans outstanding for trade (both wholesale and retail) made up the largest share of 18%, followed by the industrial sector/processing (approximately 15%), mining (12.3%), construction (11%), immovable property (13.6%), agriculture (5.1%), and others. The vast majority (82.3%) of these loans were disbursed to private enterprises and individuals. Thus, a downturn in any particular sector would not adversely affect the viability of the banking sector as a whole.

In view of this portfolio concentration, the mortgage portfolios of Mongolian banks—although showing significant growth rates—do not represent a significant share of overall lending. Agricultural lending was also declining and individual credit (mainly consumer lending) had almost reached a level equal with credit to the private sector.

The increase in lending to households, including for home mortgages, shows diversification in bank lending, but exposes the banks to real estate price risk. The Mongolian mortgage market has been emerging over the past several years. While growing rapidly, the volume of mortgage lending by banks is also still relatively low, as urban property prices are at international levels. The documentation and loan servicing requirements are much greater for mortgage lending than for other kinds of consumer credit. Relatively high lending rates, short loan maturities, and accordingly conservative underwriting standards limit mortgage lending to middle- and upper-income households. Land is the asset which is the most abundant in Mongolia, but is still out of any economic and monetary circulation and far from able to secure the mortgage lending of the banks.

Mongolia's commercial banks are mostly extending short- to medium-term loans. Out of the loans provided

during the first 9 months of 2010 the share of loans with a less than 12-month term has been decreased by more than half and stands at 44.5%, compared to over 90% of loans having a maturity of less than one year in 2004. Loans with a maturity of 1-5 years comprise 48.8% of the total loans provided in 2010, and only 7.2% of loans have terms of more than five years. This bias toward short-term lending results from the short-term nature of the deposit structure.

In various reports the short maturity of loans was reported as a key impediment to access to finance. There appears to be an urgent need to develop more long-term deposit and lending instruments, particularly to promote start-ups and development of more small- and medium-sized enterprises. It seems, however, that in the short- to medium-term it will be difficult and too risky for Mongolian banks to extend their loan maturities beyond their capacity to support maturity transformation.

The loan amounts extended to borrowers are also not large. The share of loans exceeding MNT500 million accounted for less than 0.1% of the total loans extended during the peak of the credit boom in 2008. This situation shows that Mongolia's commercial banks are not able to finance the medium- to long-term investment necessary for the development of industries on the one hand, and on the other it shows that even the large banks in Mongolia are not big enough to meet the requirements for the implementation of important large-scale projects. Co-financing by banks to pool their limited resources and consequently to diversify risks for the financing of projects that require substantial funding is very rare, however.

The clientele base of Mongolian banks is also very narrow. The 50 largest borrowers accounted for over half of the banking system's loan portfolio. Some small banks only serve a few dozen borrowers.

The loan portfolios can be characterized by the fairly large content of foreign-exchange-denominated loans. The foreign-exchange-denominated loan portfolios as a percentage of the total increased from 37.6% in 2002 to 43% in 2006, and fell to 32% of total loans at the end of September 2010; this was matched by deposits in foreign currencies amounting to 33.5% within total deposits. Some of the enterprises borrowing in foreign currencies are believed to have limited or no foreign currency earnings. As long as domestic interest rates remain significantly higher than foreign interest rates in nominal terms, demand for unhedged foreign currency borrowing would be expected to increase. The borrower and the banks, however, are exposed to a foreign exchange risk in the event of a depreciation of the togrog. To guard against this risk, the foreign exchange risk is carefully assessed by banks and covered either through foreign exchange inflows, the foreign exchange deposits of the borrower, or through higher interest rates.

Bank of Mongolia regulations allow banks a net open position not to exceed 15% of its capital for one currency and 40% for all currencies. Most banks calculate the net open position on the basis of total foreign exchange liabilities to total foreign exchange assets.

Mongolian banks' dependence on foreign funding is relatively low, but it is expected to significantly increase in the near future, which would create a further potential vulnerability. This vulnerability relates to the potential

reassessment of risk by foreign investors, due for example to contagion from similar countries or global market developments, leading to a severe decline in lending and consequently domestic spending.

The banks have set up specialized departments and/or divisions for risk-management (e.g., credit risk, foreign exchange risk) and for asset-liability management, in order to reduce risks and maintain high profitability levels. The banks, however, have differing levels of sophistication in risk management. The need for improvement in this area is often commented on by international rating companies, such as in Moody's 2007 report on Khan Bank. In addition three commercial banks—Khan Bank, XacBank [*KhasBank*] and the Trade and Development Bank of Mongolia—are also rated by the agencies on their products, assets and activities.

Market Infrastructure

Payments in Mongolia are made mainly through cash, but the uses of non-cash instruments are upping in scale. Currently 12 commercial banks (compared to 5 banks in 2004) issue debit and credit cards. By the end of 2009, the number of card holders reached 1.9 million compared to 240,000 in 2004, increasing almost eight-fold; the number of card users also grew. In line with the growing number of card holders and users the number of ATMs increased by 54.5% from 2008. With the recovery of economic growth and stabilization of the banking system, the volume and value of transactions processed by the Bank of Mongolia payments system also registered high growth. All banks are required to have a settlement account with the central bank. Each bank is then responsible for its own interbank indebtedness and can settle its own account. The Bank of Mongolia guarantees the availability of funds for settlement, thus eliminating the liquidity and credit risks associated with the settlement assets of system participants.

As a response to the pressure on the payments system and to meet the economy's rising demand for timely, reliable and safe clearing and settlement of financial transactions, the banking sector recently shifted into a Real Time Gross Settlement system (RTGS) for high-value transactions. The new system also serves as a common platform for processing transactions generated by consumer cards issued by different banks.

Credit Information System

All banks are required to submit information on loans above MNT1 million, the related collateral and the borrowers, on a regular basis. The regulations covering the existing Credit Information Bureau (CIB) provide for penalties for delays in submitting the required data and misreporting of credit information. Capacity constraints, however, hamper the CIB's ability to update information quickly and maintain good data quality, and has led to efforts by some banks to establish an independent private credit information system. The industry expects the proposed bureau to be more inclusive in collecting and sharing information among financial institutions and other relevant agencies. This is an issue currently under consideration.

Corporate Governance

As the majority of commercial banks have foreign ownership, corporate governance systems are generally robust and productive, with several international members on their boards. All commercial banks have internal auditors and audit committees that report directly to their respective boards of directors. Independent external auditors audit the annual accounts of all banks, based on international accounting standards. Well-known auditing firms of international repute (Ernst & Young, KPMG and Pricewaterhouse Coopers) audit the large and medium-sized banks, while the accounts of small banks are audited by local audit firms. Based on the requirements of the Bank of Mongolia, all the banks now publish summaries of their financial statements, and adherence to prudential ratios and legal lending limits, in the country's major newspapers on a quarterly basis. All the banks are also registered as companies with the General Authority for State Registration, which requires them to observe the various rules and regulations as prescribed in the Company Law.

The Legal Environment

The general legal environment has also dramatically changed over the past 20 years. The pledging of collateral is cumbersome for both the borrower and the lender. The processing of the settlement of debt claims in the courts is extremely slow and sometimes takes up to five years. There are very liberal policies for investment and foreign exchange. According to the Banking Law, defaulters are prohibited from owning banks or holding executive positions in banks, yet the big defaulters run for high-ranking public-office positions as the existing legal provisions do not prevent them from doing so. Mongolia's bankruptcy provisions and procedures are still in their infancy.

The new regulations issued in August 2010 increased the provision of restructured loans and tightened the treatment of related-party loans. The indicators for the performance of the banking system are improving, but observing these new regulations will lead to a lowering of capital ratios and increase nonperforming loans. For some banks, the capital adequacy ratio is likely to drop below prudential regulations. In order to reduce moral hazard, the coverage of the blanket deposit guarantee is also tightened (no coverage of interbank deposits, interest earned on deposits in excess of the policy interest rate, and netted guaranteed deposits against the depositor's liabilities to the bank).

Challenges

The commercial banking system faces a number of challenges, including: i) coping with a volatile economy based on a few commodity exports; ii) competition among a relatively large number of banks; iii) the marginal profitability of some of the smaller banks, due to intense competition for deposit intake and the resulting reduced margins; iv) rapid expansion of banking operations in terms of deposits and lending; v) the need to keep nonperforming loans at a manageable level under expanding loan portfolios; and vi) the need for enhancement of staff skills and capacity to meet the expanded operations.

Table 2: Mongolia's Ranking in the World Economic Forum Global Competitiveness Index 2010-2011, (extracts from the 8th pillar, out of 139 countries)

	Financial market development	
8.01	Availability of financial services	126
8.02	Affordability of financial services	124
8.04	Ease of access to loans	139
8.06	Restriction on capital flows	97
8.07	Soundness of banks	136

Many structural and institutional weaknesses have contributed to the rigidity of the high interest rate, noticeably: a) high nonperforming loans, low operating efficiency and weak corporate governance of banks; b) a poor credit (debt repayment) culture on the part of borrowers; and c) underdeveloped market infrastructure (e.g. financial accounting and reporting, assets appraisal, and collateral repossession and disposal).

The previous weakness of the financial sector in many important areas—such as consolidated supervision, prompt corrective action, central bank governance, corporate governance of commercial banks, the legal and regulatory framework, enforcement of prudential regulation and supervision, lack of transparency of ownership structures and lending practices, flaws in corporate governance and weak risk-management practices contributing to instability in the banking sector—still exists, making the banking system fundamentally fragile.

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