

# Banking Sector Transition in Mongolia Since 1990

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## Abstract

*Mongolia has been recognized as one of the major destinations of world mining industries. The country with 3 million of population has US\$1 to US\$3 trillion worth of copper, gold, coal, oil, and other resources, close to growing markets in China and elsewhere in Asia<sup>1</sup>. Contrary to the rich mining sector, the rest of the economy is still relatively unknown. Thus, this article deals with one of the key components of the rest of the Mongolian economy—banking sector. The Mongolian banking sector is a mirror of its economy: it represents country's economic transition, authorities' approach to economic reforms, as well as relationship with its neighbors, Russia and China. Also Mongolia's banking sector transformation provides precious lessons why banking transformation has been so difficult, time-consuming and full of mistakes even for one of the most successful cases.*

Keywords: Transition from Monobank to Two-tier Banking System in Mongolia, Bank failures and Resolutions, Globalization and Banking Transition, Mining, Economic development and Banking, Comparison of Banking reforms in Mongolia and Central Asia

## 1. Soviet Banking System in Mongolia

In 1924 the first ever sustainable banking reform was introduced in Mongolia by the USSR. The Bank was established as 50/50 joint venture with USSR and Mongolia and called “Mongolian Trade and Industrial Bank” or “Mongolbank”. Almost all the staff and managers were sent by the USSR. Initially, it was a typical NEP bank, which operated conventional banking activities based on sound banking principle. It conducted bill discount operations, provided term loans, dealt with remittances, and exchanged foreign currencies and achieved a profit in a relatively short time since the start.

In December 1925 the Mongolbank started issuing national currency, the tugrik, to supplant the various media of exchange: Chinese and Russian currencies, and commodities such as tea and cattle. The currency was backed by 25% precious metals and 75 % short-term obligations and easily saleable goods. No explicit charge was made for currency conversion, an important inducement because then prevailing Chinese moneylenders and currency changers made such charges. By April 1928, all foreign currencies had been withdrawn from circulation, as the bank did not reissue foreign currencies it had exchanged for tugriks. It was declared that the tugrik is the sole Mongolian legal tender<sup>2</sup>.

In 1929 government monopoly was introduced in foreign trade. This substantially cut the ground out from under private money-lenders (mostly Chinese), and legislation passed shortly thereafter forbidding them to operate in Mongolia. By 1929–30, foreign capital in Mongolia had all but ceased to exist—the money and credit system was entirely in the hands of the state<sup>3</sup>.

Following the trend in the USSR, since early 1930s it strengthened its function as the USSR-style Monobank. All state and cooperative enterprise were required to deposit all its currency receipts with the Mongolbank and make all its expenditures through withdrawals from the Bank. In this way all economic enterprises were forced to conduct their business transactions under the close supervision of the Bank. Eventually, all state and cooperative enterprises were

prohibited from settling any debts of 100 tugriks or more in cash. All payments were completed through offset book entries by the Mongolbank and the money economy was effectively restricted to the household sector. Thus, the Mongolbank, which was firmly under government control, was able to monitor and to supervise the business transactions of all enterprises<sup>4</sup>.

The Mongolbank grants short-term credits to state and cooperative enterprises. It also extends long-term credits to capital investments in the industrial sector of economy. Its credit policies, as well as the amount of loans granted to any borrower, are determined by the five-year plan and the annual state budget.

In April 1954, the Soviet Union handed over its shares in the Mongolbank, which was renamed the State Bank of the Mongolian People's Republic. The responsibilities and powers of the State Bank were established by Council of Ministers' decrees of 1954. The State Bank had been responsible to the People's Great Khural (Parliament), with operational review by the Council of Ministers. The Chairman of the State Bank had ministerial rank<sup>5</sup>.

Reflecting the economic difficulties in the USSR, credit suddenly slowed to only 8.6% growth during 1985–1990. At the end of 1989, credit to the state enterprises continued to account for approximately 95% of total outstanding credit; credit to state cooperatives accounted for 4% and credit to the private sector, 1%. By the end of 1989, some cooperatives, mainly agricultural, were clearly bankrupt. In April 1990, the Council of Ministers cancelled 45 million tugriks of outstanding credit (about 13% of total)<sup>6</sup>.

Interest rates on both loans and deposits in Mongolia were low and highly distorted. Key loan interest rates were even lower than deposit rates. Loans to the agricultural sector for all types of credit are made at preferential rates, with interest on short-term loans set at 0.5 to 1%. Industries engaged in producing and processing agricultural raw materials also receive a preferential rate of 1%, while all other short-term and long-term lending rates carry a 2% rate of interest.

Commercial banking operations are undertaken by the branches and by the divisions, subdivisions, and savings institutions of these branches. There are 21 regional branches, 1 in each of the 18 aimags (provinces) and 1 in each of the 3 largest cities, Ulaanbaatar, Darkhan, and Erdinet. The 19 regional divisions and 164 regional units, provide full banking services, including accepting deposits and extending credit; the 260 teller units do not undertake credit operations. The principal commercial banking functions are to provide credit, facilitate orderly payments between economic units, promote investment within the guidelines of the annual plan, and act as depository for population's savings. The Mongolia's banking activities during the USSR period resembled to budget operation rather than banking in the western standard<sup>7</sup>.

From 1924 to the late 1980s Mongolia's banking sector continued to be very small. The credit amount of the Mongolian State Bank was 0.38% of the total credit of the USSR in 1970 and 0.32% in 1985. It was far smaller than any of the Central Asian republics, for instance, it was about a sixth or a fifth of credit of Tajikistan or Kyrgyzstan in 1970 and 1985.

## **2. Banking sector Reforms in Mongolia, 1990–1992**

### **2.1 Economic reforms, 1987–1991**

In 1987, a new strategy of economic restructuring, framed on the Soviet policy of

perestroika, was implemented in Mongolia. Under this policy, the role of state planning was limited to setting overall investment policy, while the ministries and state committees were responsible for its implementation. Similarly, state enterprises were accorded increased autonomy, although production, profits, and distribution remained centrally planned<sup>8</sup>.

In 1988–89, the pace of reform quickened, although measures continued to aim principally at improving the efficiency of the command economy. A new Law on Cooperatives permitted the formation of cooperatives, with participation from the private sector. To encourage surrender of convertible currencies to the State Bank, the authorities introduced a preferential rate of tugrik 20 per U.S. dollar, compared with a commercial rate of tugrik 3 per US dollar. The new Law of Enterprises enacted in 1988 and implemented in 1989. The autonomy of enterprises was also increased with regard to production and distribution, and, for those industries making a profit, with regard to wages. Selected retail prices were raised and limited flexibility was introduced. Monopolies enjoyed by state foreign trade companies were eliminated, and trade licenses were issued directly to state enterprises. The amount of foreign exchange that could be retained by state enterprises and cooperatives was increased<sup>9</sup>.

Mongolia also expanded its international connections during this period and, by the end of 1988, maintained diplomatic relations with over one hundred countries. In 1989, the USSR began a phased withdrawal of its forces and technicians.

After popular demonstrations in March 1990 and the country's first multiparty elections in July 1990, a new coalition government was formed that pledged to "construct a market-oriented economy". Since then, the government has embarked upon a comprehensive program of reforms covering the entire spectrum of economic policies, including privatization, price liberalization, and the establishment of new institutions for macroeconomic management<sup>10</sup>. As a first step, the Government eliminated all restrictions on private ownership of herds and announced increases in farm gate prices effective January 1991. In January 1991, most retail prices were doubled; civil service wages, pensions, and other benefits were raised to compensate partly for the higher prices. The authorities actively promoted development of private sector enterprises and cooperatives and eased their access to domestic bank credit.

## 2.2 Creation of Two Tier Banking, 1990–1992

Financial sector reform is a key component of Mongolia's economic transformation toward a market-based economy. The initial step in the reform centered on shifting from a monobank system to a two-tier banking system; this was to be followed by other reform actions aimed at developing an institutional framework for indirect monetary management, fostering competition in the banking system, building a supervisory system, and establishing money and securities markets.

In August 1990, the Central and commercial banking functions of the State Bank were separated and two new specialized commercial banks were created; the Bank of Investment and Technological Innovation (ITI Bank) and State Bank International. All the large, capital intensive clients of the former State Bank, including the large copper mining company, Erdenet, the petroleum import concern, and the Central Energy System, were allocated to ITI Bank; while State Bank International was given responsibility for all international financial activities<sup>11</sup>.

In 1990 two more banks were introduced. Mongol Insurance Bank was established by the initiative of the Mongol Insurance Company with 22 enterprises, economic organizations and

individuals. The main purpose of the Bank is contributing the financial and economic operations closer to their partners. Another bank, Mongolian Cooperative Bank, is an independent commercial bank<sup>12</sup>.

In 1991 another two key banks were created by splitting branches from the State Bank: The People's Bank was formed from savings banks in Ulaanbaatar and handles most of the Government accounts. The Agricultural Cooperative Bank (later renamed as Agricultural Bank) inherited a massive structure from the State Bank, including 326 rural branches and settlement centers employing more than 2,600 people, demand deposits of 2.2 billion tugriks, and loan debts of 2.3 billion tugriks. The Bank was initially owned by state agricultural cooperatives, which were later broken apart into private agricultural enterprises.

By the end of 1992, divestiture of all commercial banking operations was complete, and 11 commercial banks were in operation: one solely owned by government, one joint-venture with a foreign partner, two privately owned, and seven operated as joint-stock companies owned by principal depositors, with majority owners being state enterprises. The banking system at the end of 1992 was dominated by five large institutions (People's, ITI, Agricultural, State Bank International and Insurance Banks), which together accounted for 90% of total deposits and 80% of total loans of the banking system (table 1)<sup>13</sup>.

**Table 1: Loan outstanding by banks, 1991–92 (1st of period, In million tugriks)**

Name	April 91	July 91	January 92	April 92	July 92
ITI Bank	1,472	2,720	4,000	4,271	4,571
Cooperative Bank	101	188	214	360	518
Insurance Bank	157	598	967	1,400	1952
Industrial Bank	112	135	83	267	533
Agricultural Bank	191	985	2,306	2794	4087
People's Bank	-	-	3,840	3,803	4136
Autoroad Bank	35	82	68	78	84
State Bank International	7,988	7,038	1,374	1,566	1,881
Central Asian Bank	-	-	-	-	127
Total loan outstanding	19,056	11,746	12,854	14,540	17,958

Source: USAID, Mongolia's Private Commercial Banking Potential

During the reform period, Mongolia faced with the unprecedented economic challenges. The Soviet Union abruptly ended its financial and technical assistance to Mongolia on 1 January 1991, except for completion of ongoing turnkey projects. Financing aid averaged 30% of GDP during the 1980s, decreasing to 25% of GDP in 1990, prior to the termination in 1991. Also in early 1991 the CMEA (Comecon) trade and finance system collapsed. As a consequence, trade with the former Soviet Union fell by 50%, supplies of essential commodities such as fertilizers, petroleum and spare parts became increasingly irregular, and the former Soviet technicians withdrew from Mongolian enterprises and factories. The economic collapse caused by these external shocks was severe. The economic as well as banking reforms became extremely challenging due to the sharp deterioration of economic environment. Mongolia concentrated to implement radical reforms<sup>14</sup>.

### 2.3 Strengthening of Central Bank's Functions

The Bank of Mongolia eventually retained 21 branches in key regional centers. The Banking Law provides the framework for the development of a fully functioning central bank capable of managing money and credit using indirect instruments, leaving the allocation of resources to markets<sup>15</sup>.

Steps were initiated to develop indirect monetary management, including the introduction of reserve requirements and the liberalisation of interest rates in August 1991. Under the latter action, commercial banks were permitted to determine their lending and deposit rates freely, thus laying a basis for the active use of interest rate policy by the central bank<sup>16</sup>.

Foreign reserve management functions were formally assumed by the Bank of Mongolia effective April 1993, and reserve assets and liabilities held by State Bank International (which was renamed as Trade and Development Bank), except for those balances related to its commercial banking operations, which have been transferred to the Central Bank. An interbank payments clearing and settlement system was introduced.

The Central Bank has also begun to exercise its supervisory and regulatory functions. Banks established prior to May 1991 Banking Law were relicensed, and those that did not meet the Law's capital adequacy requirements were combined with other banks. The Bank of Mongolia developed regulations and supplementary legislation to the Banking Law covering such matters as leasing, debt recovery and accounting standards<sup>17</sup>.

Some preliminary prudential regulations, notably on capital adequacy, were issued in 1992, and a system of on- and off-site inspection was established. Subsequently, prudential regulations were extended and strengthened. However, resource limitations, poor record keeping and internal controls at the commercial banks limited the effectiveness of supervision. When breaches of regulations were uncovered, the Bank of Mongolia was often unable or unwilling to impose sanctions or to force bank management to take corrective action.

### 2.4 Difference between USSR and Mongolian Banking Reforms

Although the Mongolian reform clearly followed after the Perestroika banking reform of the USSR during 1987–1990, there are clear differences between the two.

Firstly, the weight of Agricultural Bank was different. In the USSR banking reform the majority of loan portfolio was initially allocated to the Agricultural Bank, and in Kazakhstan it reached 78% of the total loans in 1988<sup>18</sup>. In 1990 it was still about two thirds of total loans in Kazakhstan (Table2). As Agricultural bank was the worst performing bank with full of political influences, it posed long lasting negative impact to the result of USSR's (and its successor states') banking reforms. In Mongolia, Agricultural bank's share was rather modest (18% of total in 1 Jan 1992) and the bank was not a serious hindrance of the banking reform.

**Table 2: Comparison of Banking structures, USSR, Kazakhstan and Mongolia (loans, %, USSR 1 Jan 1991, Kazakhstan 31 Dec 1990 , Mongolia 1 Jan 1992)**

Sector	USSR	Total	Kazakhstan	Mongolia	
Agriculture	Agroprombank	39.8	64.4	Agricultural Bank	17.9
Industry	Promstroibank	31.4	23.2	ITI Bank	31.1
Foreign Trade	Vneshekonombank	6.1	-	State Bank Int'l	10.7
Retail	Savings Bank	2.9	2.4	People's Bank	29.9
Other State bank	Zhilsotsbank	11.7	5.8	Insurance Bank	7.5
New Commercial Banks		8.1	4.1	Other banks	2.8
Total		100.0	100.0		100.0

Source: USAID: Mongolia's Private Commercial Banking Potential; IMF: Kazakhstan pre-accession economic report; Barkovsky: *Memuarui Bankira 1930–1990*, P106

Secondly, after the sectoral split of banking activities in 1988, republican and regional split of these sectoral banks occurred during 1990–1991 in the USSR. The continuous split of banking system in the USSR contributed to the loss of control on reform process, asset stripping by bank management, corruptions, and uncontrollable credit expansion. Mongolian banks maintained their regional unity which contributed more organised banking sector reforms.

Thirdly, after the demise of the USSR, the successor republics formed short-lived monetary arrangement called “ruble zone”. Ruble zone was a de-facto currency union with a big defect — one currency issuing center (Central Bank of Russia) with 15 credit issuing centers (republican central banks), with limited co-ordination mechanisms. In certain degree, the ruble zone arrangement worked as a shock absorber of successor countries' economic difficulties, though, it was also a source of serious moral hazard within the banking system. Some of the republican central banks issued excessive ruble credits to local banks to salvage state enterprises and agricultural cooperatives.

This sudden expansion of credit ruble had serious side-effects: high inflation in all the USSR successor states; and commercial banks' heavy dependence on Central Bank's credit. The latter was very serious in Central Asia. For instance, commercial banks' reliance on Central Bank funding late 1992 reached 63% in Kazakhstan and 60% in Uzbekistan<sup>19</sup>. This further weakened the banking situation, delayed significantly reform effort, and undermined public confidence against banking sector. As Mongolia was not a part of “ruble zone” arrangement, it was unaffected by the negative impact. Credit expansion was modest (Table 1) compared with the inflation. Also commercial banks' reliance on Central Bank credit was about 12% on 1 January 1992<sup>20</sup>.

Fourthly, the USSR's savings bank was initially designed as a pure deposit taking bank (i.e., no significant function as lending bank, thus it had to redeposit majority of savings to the Central Bank)<sup>21</sup>, while in Mongolia it was designed as a retail bank mainly dealing with Ulaanbaatar region—it had deposits in the liability side while loans in the asset side. As the USSR Savings

Bank was divided in 1991–1992, the successor banks suffered by the lack of design as sustainable banks and lack of staffing (in particular, if the banks were to aim at lending banks).

Fifthly, the majority of the USSR republics took relatively liberal licensing policies toward new banks, while Mongolia maintained a fairly cautious approach towards new banks. Mongolia had 11 banks in late 1992 when Russian had 1,747 banks and Kazakhstan –155. This policy had pros and cons: too relaxed liberal policy produced many risky banks, while too restrictive licencing policy killed opportunities for market oriented banking sector development. The rest of Central Asian republics (except Kazakhstan) took very conservative licensing policies compared with the rest of the USSR republics. For instance, Uzbekistan had only 30, Turkmenistan 18, Kyrgyzstan 15, and Tajikistan 10 in late 1992<sup>22</sup>.

These initial conditions severely affected the development of the banking sector. Although Mongolia's financial situation was one of the worst among all the transition economies, the precondition for banking sector reforms was not the worst.

### **3. Banking Crisis in the second half of 1990s**

As in other economies in transition, portfolios of most commercial banks in Mongolia suffered from a number of structural weaknesses. These include an excess of loans over deposit liabilities, a high sectoral concentration of loans, a low level of liquid assets relative to total assets, and a dominance of large state enterprises in the loan and deposit portfolios. Consequently, most commercial banks face a large amount of nonperforming loans, a substantial portion of which was associated with lending operations to state-owned enterprises under the Monobank system<sup>23</sup>.

The Bank of Mongolia began in 1993 to reclassify bank portfolios and identify nonperforming loans to improve their financial position over the medium term. Preliminary findings of loan classification showed that outstanding nonperforming loans accounted for about one fourth of total bank loans at late June 1993. Two of the smaller banks, Selenge Bank and Cooperative Bank, were merged into People's Bank and ITI Bank in 1994 respectively. The Autoroad Bank closed in 1995 due to being unable to meet the minimum capital requirement<sup>24</sup>.

#### **3.1 1996 Banking Crisis**

The share of recorded nonperforming loans rose sharply from 2.5% at late 1991 to over 50% at late 1996, equivalent to over 7% of GDP. Despite a decision in November 1993 to gradually raise commercial banks' minimum capital base from 50 million tugriks to 400 million tugriks by January 1995, the capital of most commercial banks was insufficient to cover potential losses<sup>25</sup>. Several banks started to fail to meet prudential norms, credit ceilings, and reserve requirements. On occasion depositors were unable to withdraw funds on demand.

Among the major banks, Insurance Bank nearly ceased operating, and People's Bank, Agricultural Bank, and ITI Bank experienced periods of illiquidity and admitted to significant losses. The situation of one small bank, Central Asian Bank, deteriorated to the point where in June 1996 Bank of Mongolia (BOM) decided to close it down. The value of the bank's deposits amounted to (approximately US\$2 million, owed to about 3,000 mostly small depositors. The authorities announced that depositors would be compensated for losses up to 100,000 tugriks. The assets of the Central Asian Bank were found to have been almost entirely worthless. The

failure of the bank contributed to a growing public distrust of the banks<sup>26</sup>.

The authorities developed a comprehensive bank restructuring strategy in the latter part of 1996 in close collaboration with the IMF, the World Bank and the Asian Development Bank. The strategy focuses on reducing the overhang of old nonperforming debt, strengthening market disciplines, eliminating sources of moral hazard, while averting the possibility of a run on the banking system. The Banking Law and the Central Bank Law have been extensively amended to enable the authorities to take the necessary strong corrective actions<sup>27</sup>. Among other provisions, the new law gave the BOM legal authority to appoint conservators and/or close insolvent banks, and, in such cases, established specific priorities in meeting creditor claims of depositors<sup>28</sup>.

With the legal framework in place, in December 1996, the authorities closed and began the liquidation of two insolvent banks (People's and Insurance), which together accounted for over 60% of banking system deposits. Both banks had sufficient resources to cover household deposits, which have the highest priority, and the value of the banks' remaining assets was paid to non-household depositors, who received 80% at one bank and 50% at the other. With all assets allocated to depositors, the BOM lost claims on the two banks amounting to 7 billion tugriks (14% of assets), which were written-off against BOM income in 1996.

Two new banks—Savings Bank and Reconstruction Bank were created to provide some continuity of services to depositors and good borrowers. Savings Bank allowed to accept only household deposits and is allowed to invest only in cash, government and central bank securities, and fixed assets. The written-down deposits of enterprises, along with the performing loans of the liquidated banks and 6.6 billion tugriks in restructuring bonds, were transferred to Restructuring Bank. The Mongolian Asset Recovery Agency was established under the Ministry of Finance with the nonperforming loans of the two liquidated banks.

Two other large weak banks (ITI Bank and Agricultural Bank) signed Memoranda of Understanding with the Bank of Mongolia, which contain a detailed three-year timetable beginning in early 1997 for the implementation of corrective measures, including changes in banking practices, new injections of capital, raising reserve and capital adequacy ratios, and the temporary non-payment of dividends<sup>29</sup>.

Restructuring bonds were issued to replace the nonperforming loans that had been made by all five large banks during the first half of the 1990s at the direction of the government. The cost of bank restructuring borne by the public sector—estimated at 11% of GDP—is high<sup>30</sup>.

In the initial aftermath of the closing operation the situation in the banking system remained generally calm, and there were signs of a return of confidence. The real money stock recovered in 1997, led by a rise in the real value of deposits at commercial banks<sup>31</sup>. After the resolution, three large commercial banks (the Trade and Development Bank, the Investment and Technological innovation Bank, and the Reconstruction Bank) comprised on aggregate about 55% of total system's deposits. Two specialized banks followed: the Agricultural Bank (10% of total deposits) that focuses on nationwide deposit gathering and agribusiness 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 small banks (about 8% of total deposits) compete primarily for Ulaanbaatar-based customers<sup>32</sup>.

### 3.2 1998–99 Banking Crisis

The delicate banking sector was shaken again by the Asian financial crisis in end 1997

and the Russian Financial crisis in summer 1998. The share of non-performing loans in the banking sector rose sharply to over 30% in 1998. Mongolia took significant steps to implement a comprehensive banking sector reform strategy, which aimed to eliminate bank insolvencies, obtain a substantial reduction in government stake in banks, and strictly contain the public sector costs of restructuring, while preserving a core banking system<sup>33</sup>.

To resolve the insolvency Investment and Technological Innovation Bank, Reconstruction Bank, and Agriculture Bank were placed under conservatorship. Under conservatorship, these banks ceased lending activity and stopped accepting new deposits. The conservators undertook an aggressive program to rationalize operations and downsize the banks. The conservator's efforts notwithstanding, the extent of insolvency in the banks increased as closer examination and more accurate classification has necessitated an increase in the share of loss loan assets. In addition, further doubts arose about the quality of the 'performing' portfolio and the cash value of the pledged collateral. Recognizing the need for quick action, the BOM placed all three banks into receivership in October. The ITI Bank and Restructuring Bank were to be liquidated, and their licenses were revoked. The Agricultural Bank was downsized further and restructured along the lines of an agreed plan.

During 1999, the BOM took several important steps to strengthen banking regulation and supervision. A new chart of accounts and a revamped accounting framework were introduced in January 1999 with emphasis on public disclosure requirements. Under the new regulations on prudential ratios, a minimum requirement for paid-up capital was set at 1 billion tugriks. Banking-related legal amendments were enacted. These amendments are intended to strengthen the powers of conservators and receivers, provide explicit powers for writing down shareholders capital in insolvent banks, assure enforcement of court orders and speed up the enforcement of collateral, and improve loan recovery.

As a result, eight of 20 banks were closed between June 1998 and December 1999, while some of the others were kept in operation through frequent injections of liquidity by the central bank and recapitalization of five of the largest commercial banks in line with capital adequacy requirements. The Government also assumed responsibility for the directed and inherited loans. The non-performing loan ratio declined from a high of 54% in 1999 to a level of 7–11% during 2000–2004<sup>34</sup>.

The key players in the new banking market were two former specialized banks (Trade development Bank and Agricultural Bank) and three newly emerged private banks since mid-1990s (Golomt, Anod and Zoos Banks).

### 3.3 Comparison with Central Asian Bank Resolutions

Through the major Banking resolutions in 1996 and 1998–99, Mongolia lost three major banks, People's Bank, Bank for Industrial and Technological Innovation, and Insurance Bank as well as one of their successors, Reconstruction Bank. This is one of the harshest banking resolutions among the transition economies.

Similar harsh banking resolutions were applied in some of the CIS countries, including Kazakhstan and the Kyrgyz Republic. Both of them adopted market oriented stringent banking reforms, and during mid-1990s to early 2000s Kazakhstan lost Agricultural Bank (which was the biggest in Central Asia during end 1980s and early 1990s), merged the two big troubled banks (Turan Bank, former Industrial Construction Bank, and Alem Bank, former Foreign Economic

Bank). Housing and Social Infrastructure Bank merged with an emerging new bank. The only successfully transformed bank in Kazakhstan was the Savings Bank (Halyk Bank). In the Kyrgyz Republic, both Agricultural and Savings Banks went bust with heavy non-performing loans in mid 1990s. Other key banks, Industrial Bank and Social Infrastructure Bank experienced heavy losses and reorganised by injection of new capital by their shareholders.

#### 4. Banking in the Global Boom and Crises

Since early 2000s to 2007/08 the global financial market enjoyed very expansionary and favourable monetary conditions then suffered by very tight and unfavourable conditions since 2007/2008 global financial crisis. Most of the market oriented transition economies enjoyed in the first period and suffered in the second period, though, in different degrees (Table 3). For instance, Kazakh banks issued large amount of bonds and equity in the global markets and provided credits mainly in Almaty property and construction markets. The banking sector expanded 13 times during the period of 2002 to 2007 and stagnated in the following years (less than 30% increase in the seven years). The banking system in the Kyrgyz Republic enjoyed sudden inflow of Kazakh's banking capital in the boom years, expanded nearly 7 times in the same 5 years then stagnated (just 2 times increase) in the following 7 years mainly due to the exodus of Kazakh capital and banking instability caused by political instability. Mongolia was one of the best performers during this turbulent period: nearly 7 times growth in the first 5 years then 4 times growth in the second 7 years. The country was luckier than its peers: the banking sector was less open to the global market than Kazakhstan, and less open to foreign capitals than the Kyrgyz Republic. Also China, the biggest buyer of Mongolia's key commodities, boosted its economy to address 2008 crisis.

**Table 3: Development of the Banking sector, Mongolia and Central Asia, 2002–2012**  
(assets, billion US\$, %, times, end of year)

	banking assets			growth (times)	
	2002	2007	2014	2007/2002	2014/2007
Kazakhstan	7.4	96.9	123.1	13.1	1.3
Uzbekistan	4.4	7.1	23.2	1.6	3.3
Turkmenistan	3.0	4.5	19.4	1.5	4.3
Kyrgyz Rep.	0.2	1.2	2.3	6.8	1.9
Tajikistan	0.2	1.0	3.8	6.2	3.8
Mongolia	0.45	3.0	12.3	6.6	4.1

Note: The 2014 data of Tajikistan and the Kyrgyz Republic are those of end September 2014. The figures of Uzbekistan and Turkmenistan are calculated with official exchange rates.

Source: IMF Statistics June–December 2014; 2003 Standard & Poor's Report; Mongolia IMF Statistics Year Book 2014; UzReport, etc.

##### 4.1 Recovery and Credit Boom, 2000–2008

After the drastic banking resolution, confidence in the banking sector was regained and the banks' liquidity position improved substantially in early 2000s. Deposits as a percentage of GDP increased from 17.6% in 2002 to 31.4% in 2006. This was due to the expanding economy,

increased remittances by Mongolian workers abroad and foreign direct investment inflows. The increasing deposits enabled the banks to expand their lending considerably, mainly to the private sector. Loans outstanding as a percentage of GDP increased from 18.7% in 2002 to 38.6% in 2006. Non-performing loans were further reduced to about 5% of loans in the mid-2000s.

Two major banks — the Trade and Development Bank and the Agricultural Bank, which was renamed as Khan Bank — were sold to foreign investors in 2002 and 2003 following international tenders. This opened up the banking sector to further international investment and management. After the privatisation of the Savings Bank, all 16 banks were in private hands. In January 2007, the Trade and Development Bank issued a euro-bond for USD 150 million, the first Mongolian entity to issue bonds on the international capital markets.

During this period new initiative in the financial sector also took place, those include micro-financing, leasing, and insurance. One of the most prominent cases was Xac Bank, which started as a microfinance institution based on donors funded micro finance development project in end 1990s and was incorporated by major NGOs. The micro finance institution converted as a bank and finally took the fourth position in Mongolian banking market by the end of 2000s.

#### 4.2 Global Crisis and Banking Resolutions, 2008–2015

Mongolian banks were hit by the global financial crisis in 2007/2008 and subsequent mineral prices collapse. The reduced liquidity of banks constrained their lending, especially for longer-term commitment such as construction financing and mortgages. Over this period asset quality deteriorated rapidly and the proportion of non-performing loans rose to 13.7% by July 2009 from 2.7% in May 2008.

In December 2008, Anod Bank—the fourth largest bank— was placed under administration by the central bank<sup>35</sup>. To restore public trust, the government issued a blanket deposit guarantee in November 2008, but it left many customers in uncertainty about which deposits were included, while real interest rates on tugrik deposits were negative<sup>36</sup>. Ratio of non-performing loans peaked at 25% in November 2009, gradually declining to around 21% at the end March 2010.

Bank failures and their resolutions continued. The authorities also appointed a receiver at Zoos Bank, following a significant loss of the bank's deposits and the discovery that the bank was insolvent, in part a result of significant accounting irregularities. The resolution of these banks was finally dealt with by the establishment of new Bank called "State Bank" in 2009. This was followed by the failure of Savings Bank. Privately owned Savings Bank accounted for 8% of total banking assets (fifth-largest in the country). Reflecting its historically broad branch network, it processed over half of government financial services transactions including payments of pensions, child allowances, and subsidies. The intervention included the appointment of a receiver and transfer of most of the bank's assets and liabilities to State Bank. The BOM linked the failure to loans to related interests of the bank's only shareholder. The related-party loans in this instance exceeded capital by more than 2 times<sup>37</sup>.

After the series of bank failure resolutions, the banking sector is dominated by four big banks, which holds three fourths of the total bank assets. The sector increased its size from US\$0.73 billion in end 2003 to US\$13 billion in end 2013 mainly because of mining and construction boom. However, it faced challenges caused by downward trends of mining cycle. Due to the depreciation of tugrik, the banking sector assets reduced by 5.4% in US\$ term in from 2013 to 2014.

### 4.3 Challenges Ahead

As mentioned, Mongolia managed the banking transition relatively well since its inception in 1990. The very modest banking sector in late 1980s, which had only a fifth of Kyrgyzstan (which has twice bigger population of Mongolia), has now more than 5 times bigger than it. This has been achieved by thorough and continuous reform efforts and by addressing three major banking crises. As the Banking reforms of Mongolia and Kyrgyzstan are very similar and social and historical backgrounds were the closest, the main factor for this large discrepancy could be attributed to the difference of the nature of the mining sectors. Mongolia has several world class mines while the Kyrgyz Republic has only one big goldmine called Kumtor.

However, extraordinary potential of mining could also undermine sound development of Mongolian banking sector. Firstly development of non-mining industries would severely be undermined by strong exchange rate, by high labor costs, by lack of skilled labors, etc. This will make banks portfolio management very difficult.

Secondly, the sudden massive inflow and outflow of foreign capital in mining sector will also continue to be a challenging factor for sound development of the banking sector. The sector would repeat over-heating and stagnation based on mining business cycles and trends of neighboring economies. The size and stability of the banking sector could be significantly increased in the future if the steady inflow of mining capital is guaranteed. This heavily depends on political stability and conducive business environment.

Along with the increased size, the issue of foreign participation in the banking sector would become even more sensitive. So far Mongolian authority applied pragmatic licensing policy to foreign banks (mainly used for failed bank resolutions), but it would be also a challenging issue how foreign involvement, including two big neighbors, in the banking sector should be conducted.

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<sup>1</sup> IMF, Mongolia: 2015 Article IV Consultation—Staff Report, p.31.

<sup>2</sup> Ocherki Novoi i Noveishei istorii Mongolii, p.113.

<sup>3</sup> Mongolian People's Republic (Outer Mongolia) Vol. 2, p.907.

<sup>4</sup> Area Handbook for Mongolia, p.389.

<sup>5</sup> IMF, The Mongolian People's Republic: toward a market economy, p.39.

<sup>6</sup> *ibid*, p.22.

<sup>7</sup> *ibid*, p.39.

<sup>8</sup> *ibid*, p.9.

<sup>9</sup> *ibid*, p.11.

<sup>10</sup> The World Bank, Mongolia, Toward a Market Economy, p. ix.

<sup>11</sup> IMF, Mongolia: Recent Economic Developments, p.21.

<sup>12</sup> The Mongolia Society Newsletter, January 1991, p.69.

<sup>13</sup> IMF, Mongolia: Recent Economic Developments, pp.21–22

<sup>14</sup> Mongolia: Restructuring for a Market Economy, United Nations Industrial Development Organization, 1993, p.2.

<sup>15</sup> Country Economic Review: Mongolia, ADB 1996.

<sup>16</sup> IMF, Mongolia: Recent Economic Developments, p.21.

<sup>17</sup> IMF, Mongolia Background paper Nov 1994, p.15.

<sup>18</sup> IMF, Economic Review, Kazakhstan, 1992, p.48.

<sup>19</sup> calculated based on IMF's and World Bank's reports on Kazakhstan and Uzbekistan during 1992–1994.

- <sup>20</sup> calculated based on the table of commercial banks' balance sheet (p.77) of USAID's report on Mongolian Banking sector (November 1992) .
- <sup>21</sup> A Study of Soviet Economy Vol. 1, pp.112–113.
- <sup>22</sup> Figures are from EBRD's Transition Report 1999 and 2000 and IMF report on Turkmenistan (1992).
- <sup>23</sup> Mongolia Background paper Nov 1994, IMF, p.15.
- <sup>24</sup> Country Economic Review: Mongolia 1996, p.24.
- <sup>25</sup> IMF, Mongolia: Recent Economic Developments, p.22.
- <sup>26</sup> *ibid*, p.22.
- <sup>27</sup> *ibid*, p.17.
- <sup>28</sup> *ibid*, p.24.
- <sup>29</sup> *ibid*, p.25.
- <sup>30</sup> *ibid*, p.17.
- <sup>31</sup> *ibid*. p.24.
- <sup>32</sup> Hongjoo Hahm & Demir Yener, p.3.
- <sup>33</sup> IMF, Article IV Mission Staff report, Mongolia, Jan 2000, p.20.
- <sup>34</sup> Evaluation study, Financial Sector in Mongolia—Transition to a Market Economy Built on Successful Asian Development Bank, Financial Reforms, October 2008, p.4.
- <sup>35</sup> The World Bank, Mongolia Economic Retrospective: 2008–2010, pp.1–2.
- <sup>36</sup> *ibid*, p.5.
- <sup>37</sup> IMF, Mongolia: 2013 Article IV Consultation—Staff Report; Press Release and Statement by the Executive Director for Mongolia, March 2014, p.10.

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