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Mongolia: Banking Sector

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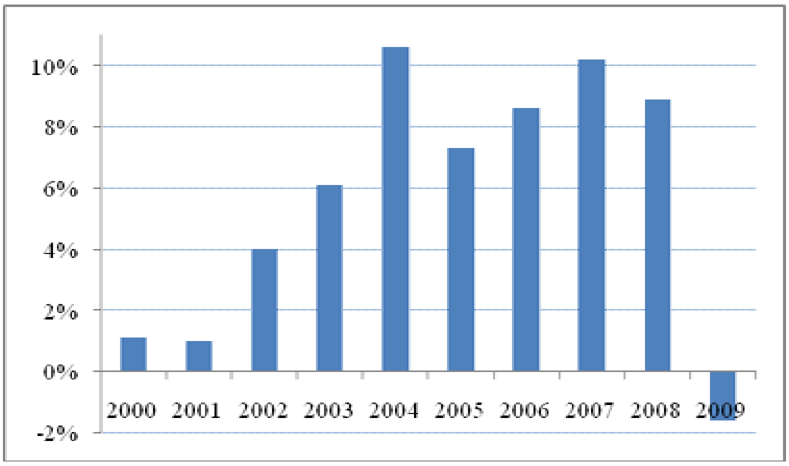
Overview of the Economy

Mongolia embarked on the transition from central planning to a market-oriented economy in the 1990s. In the more recent years, Mongolia has made great strides, but continues to face important challenges.

The recent global crisis hit the Mongolian economy hard. Mongolia's GDP had been growing consecutively in recent years, but it became a negative growth of −1.6% in 2009. However, a strong policy response from the Mongolian authorities, supported with financial resources from international financial institutions and donor countries, together with the beginning of the global recovery, strong demand from China and a rising trend in copper prices on the world market, resulted in a fair prospect for future growth. According to projections, growth will reach approximately 7.5% this year, generated mostly by the increase in the price of copper and investment inflows. The main task for the Mongolian authorities will be sustaining moderate economic growth despite fluctuating world market prices for key export products. Besides the influence of world market prices for copper and gold on the country's earnings, adverse weather conditions continue to be a serious risk for animal husbandry. Agriculture, to a large extent livestock production, accounts for more than a fifth of GDP. Mongolia suffered an extremely harsh winter last year which claimed approximately 10 million head of livestock.

Figure 1: GDP Growth (%)



Source: National Statistical Office of Mongolia

In the second half of 2008 and early 2009 foreign exchange reserves were being exhausted. The togrog[1] exchange-rate volatility intensified due to capital outflows and a drop in foreign exchange inflows. The Bank of Mongolia (the Central Bank) implemented a flexible exchange rate regime with limited intervention. Intervention was transparently carried out through twice-weekly auctions in the domestic foreign-exchange market. This new regime was supported by tightening monetary policy. As a result, the foreign exchange market stabilized and net international reserves grew to US$1.2 billion at the end of June 2010 from US$637 million at the end of 2008.

The annual rate of inflation accelerated from the second half of 2007, reaching a peak level of 33.7% in August 2008, and subsequently declined to the single-digit level of 1.9% at the end of 2009. As of June 2010, annual inflation was 12.6%. The rise in the price of food, especially meat and meat products, owing to the loss of livestock during the harsh winter, had a substantial impact on the increase in inflation. On the other hand, expansionary fiscal policy and broad-based social transfers have greatly contributed to the growth of inflation. The Bank of Mongolia has appropriately tightened monetary policy to deal with rising inflationary pressures. Furthermore, the Mongolian parliament passed a fiscal responsibility law that strengthens fiscal discipline. A new social transfer reform law, that will strengthen the social security system, addressing the protection of the poorest, has been submitted to parliament.

Financial Sector

The financial sector of Mongolia consists of the Central Bank, the Financial Regulatory Commission, commercial banks, non-bank financial institutions, securities companies, insurance companies, and savings and loan cooperatives.

The Bank of Mongolia's legal mandate is to ensure the stability of the national currency, the togrog. As defined in the Law of Mongolia on the Central Bank (1996), the Bank of Mongolia shall "promote balanced and sustained development of the national economy through maintaining the stability of money, financial markets and the banking system."

[1] Mongolian national currency, also denoted by "MNT"

The Financial Regulatory Commission[2] monitors developments in non-bank financial institutions, securities companies, the insurance sector, and savings and credit cooperatives. The Financial Regulatory Commission's activity is aimed at stabilizing the financial markets, regulating financial services, supervising compliance with the relevant legislation, and protecting the rights of investors and clients.

As of June 2010, 16 banks, including 2 banks in receivership, 188 non-bank financial institutions[3], 16 insurance companies[4], 49 securities companies and 190 savings and loan cooperatives were operating in Mongolia. Although financial institutions other than banks have developed, their share in the financial market remains small. Non-bank financial institutions' total assets comprised 2.3% of the banking sector's total assets, while loans made up 2.4% of the banks' total credit. Savings and loan cooperatives' total assets and loans made up 0.9% and 1.3%, respectively, while their deposits accounted for 1.1% of the banks' deposits. The share of insurance companies (0.9%) and securities companies (0.9%) was negligible.

In conclusion, the Mongolian financial system is dominated by the banking sector.

Banking Sector

Central Bank

The Bank of Mongolia (BOM) formulates and implements monetary policy to achieve its main objective of the stability of the national currency. The BOM functions include management of interest rates and exchange rates, oversight of government borrowing, supervision of inter-bank settlements and lending, printing and issuance of banknotes, management of Mongolia's international reserves, and financial supervision of banks. The BOM is independent from the government. The governor of the BOM is appointed by the State Great Khural (parliament) for a six-year period and reports to the parliament.

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[2] The Law on Legal Status of the Financial Regulatory Commission was approved in 2005, and the Financial Regulatory Commission started operating in 2006.

[3] According to the Law on Non-Bank Financial Activity (2002), non-bank financial institutions are prohibited from collecting deposits.

[4] In accordance with the Law on Insurance (2004), the insurance companies are not allowed to provide loans, or buy shares and other equity.

In the early 1990s, the banking sector, as part of Mongolia's whole economy, suffered after the collapse of the socialist system. The government had been intervening in lending processes with the purpose of providing loans to ineffective public enterprises. Although the directed credits were phased out in mid-1994, the consequences of the government's involvement and the associated moral hazard problems were the main factors which led to the banking crises in 1996 and 1998–1999. The main task of the BOM was to decelerate the high inflation and shore up confidence in the troubled banking sector.

The banks' credit ceilings, deposits and loan-interest-rate control that had been imposed in the initial transition stage were eliminated with the development of the banking sector. In addition, the BOM introduced reserve requirements on deposits attracted in 1991, Central Bank Bills in 1993, and a regular refinancing auction at market-determined rates in 1995. These measures coincided with the privatization of some state-owned banks. As a result of the implementation of an appropriate monetary policy, the confidence of enterprises and individuals in the banking system has been restored, and financial intermediation has deepened.

Although the recent economic and financial turmoil had not directly hit the Mongolian financial market, the economy suffered from the fall in prices of the main export commodities and the drop in foreign capital inflows as global investment flows dwindled. Expanding government consumption in the form of raised public wages and universal social transfers, on the demand side, and soaring food and imported petroleum product prices, on the supply side, resulted in high inflation that peaked in August 2008 at 33.7%. As a response, the BOM continued its monetary-tightening policy.

The BOM's main policy instruments are open market operations, using Central Bank Bills in primary and secondary markets, along with reserve requirements. The primary monetary variable has been reserve money (bank reserves plus the money outside banks), but in 2007 the BOM changed the monetary policy framework, and announced the seven-day Central Bank Bills' interest rate as a policy rate. Moreover, the introduction of a new auction system for seven-day Central Bank Bills was an important step forward in money market development and has greatly contributed to the tightening of monetary conditions.

Commercial Banks

As of June 2010, 14 banks with an additional 2 in receivership were operating in Mongolia. The newly-established State Bank is the only state-owned bank. Out of the 15 private banks, 6 were foreign-invested. In 2009, the banks' total assets made up 73.0% of GDP. The ratio of outstanding loans to GDP reached 32.9%, while the ratio of deposits to GDP was 42.9%.

Efforts to restructure the banking sector during the 1990s had limited success, with banking crises (1996 and 1998–1999) requiring bank closures and costly injections of public funds. However, since 2000 financial-sector reform has progressed, especially bank restructuring and privatization. For instance, the Trade and Development Bank, Mongolia's largest state-owned bank, was privatized in 2002, and the Agricultural Bank, with numerous branches across the country, was effectively restructured and privatized in 2003. Financial intermediation has deepened, and the banking sector's performance has improved, generating renewed confidence in banks. The total assets of the banking system grew from 19.2% of GDP in 2000 to 73.0% of GDP in 2009.

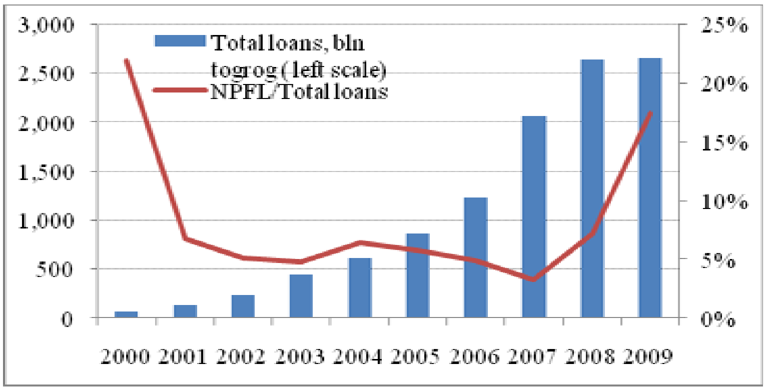
Table 1: Banking Sector Indicators (%)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
M2/GDP	25.4	29.7	37.9	48.1	39.4	41.0	41.4	52.2	37.7	47.6
Total assets/GDP	19.2	25.9	34.9	49.8	51.5	57.0	62.3	73.6	60.6	73.0
Loans/GDP	6.6	12.1	18.7	26.6	28.2	30.9	32.9	32.9	32.9	32.9
Deposits/GDP	13.5	17.3	24.7	34.4	32.7	35.5	36.4	46.0	32.2	42.9
NPL/Total loans	21.9	6.7	5.1	4.8	6.4	5.8	4.9	3.3	7.2	17.4
Lending interest rate	34.7	41.4	33.4	31.5	30.0	28.3	24.5	19.9	20.4	20.8
Interest rate on deposits	13.8	13.2	14.0	14.0	13.2	12.6	13.5	13.4	13.6	12.9
CB Bills' WAR	8.6	8.6	9.9	11.5	15.8	4.8	6.4	9.9	14.8	10.8
Policy rate								8.4	9.8	10.0

Source: Bank of Mongolia

In 2008–2009 commercial banks faced liquidity problems due to the global recession. Mongolians started to withdraw their savings from banks out of concern they might collapse. In 2008 the ratio of deposits to GDP diminished by 13.8 percentage points. Moreover, deteriorated loan quality posed a risk to financial sector stability. In 2009, non-performing loans comprised 17.4% of total loans, 10.2 percentage points up from the previous year.

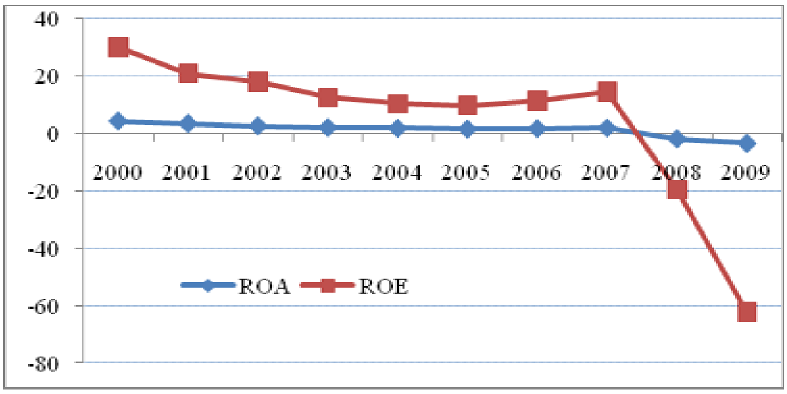
Figure 2: Bank Credit



Source: Bank of Mongolia

The banks reported aggregate losses in 2008 and 2009. The banks' poor management and weak internal control added to strains. Two insolvent banks were put into receivership. The government transferred the good assets of the foundered Zoos Bank to the newly-established State Bank. In addition two banks were merged. Thus, the issue of recapitalization of some banks became essential.

Figure 3: Bank ROE, ROA



Source: Bank of Mongolia

The breakdown of total loans by borrowers' economic activity shows that banks were issuing loans predominantly to four sectors such as construction, mining, manufacturing, and trade. The financing of the mining sector has intensified from 2009.

Table 2: Loans by Economic Sector

	2002	2003	2004	2005	2006	2007	2008	2009	2010.06
Agriculture	4.1	5.7	4.7	6.7	8.2	7.6	2.6	5.8	5.0
Electricity, gas, water supply	1.5	1.9	2.5	2.2	1.2	1.5	1.1	1.0	0.8
Construction	6.2	7.5	8.6	8.9	9.1	15.6	14.5	14.4	15.4
Mining and quarrying	15.4	8.4	8.6	9.0	7.5	6.3	6.4	13.2	13.4
Manufacturing	24.2	20.1	18.7	16.2	12.8	13.0	14.5	15.5	16.5
Wholesale and retail trade	30.8	34.0	34.6	33.2	31.5	29.2	22.7	18.0	18.5
Tourism, restaurants, catering	1.7	1.8	2.0	2.1	1.8	1.3	3.7	3.9	4.0
Transportation, storage, communications	2.9	3.0	2.8	4.3	4.3	1.7	2.7	2.9	3.1
Real estate, leasing	1.1	2.2	2.6	2.4	3.0	2.5	5.4	7.1	7.4
Health, education	0.6	0.5	1.0	0.7	1.0	0.7	1.4	1.7	1.7
Financial intermediation	0.5	1.0	0.9	1.0	1.2	0.7	1.2	0.7	0.9
Other	11.0	13.8	13.1	13.2	18.5	19.8	23.8	15.7	13.3
Total	100	100	100	100	100	100	100	100	100

Source: Bank of Mongolia

Although financial intermediation improved, and banking activity covered the entire territory of the country, the share of banks' assets in the aimags[5] within the total is less than 20%. The total assets of the banks' branches in the aimags rose by approximately 59.2% in 2006 and 59.6% in 2007. However, they showed a decline in the next two years, and in 2009 total assets dropped by 7.8% in comparison with the previous year. As of June 2010, the total assets of bank branches in aimags grew by 21% to MNT686 billion. As of June 2010, banks in the aimags issued loans and held deposits that made up 18.6% and 17.7% of the total, respectively.

[5] Aimags: administrative regions in Mongolia, not including Ulaanbaatar

Figure 4: Finance in the Aimags (billion togrogs)

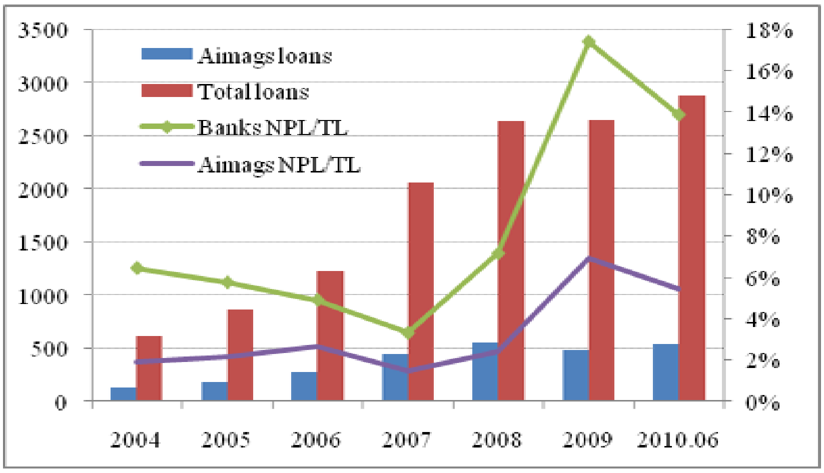
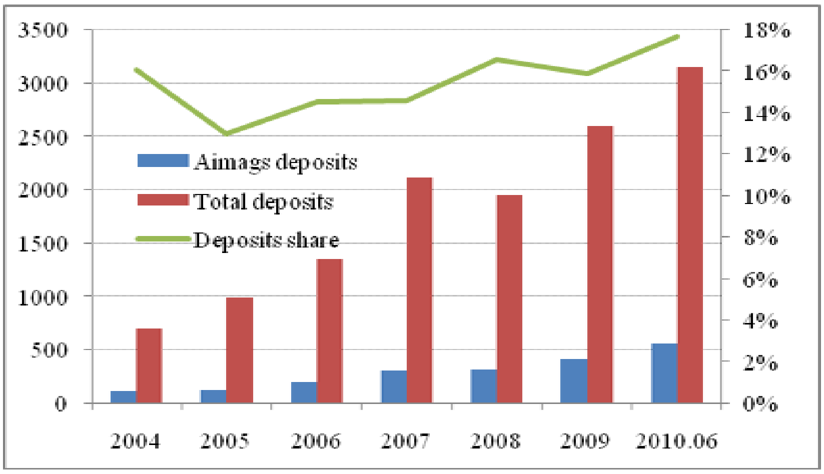


Figure 5: Deposits in Aimags (billion togrogs)



Source: Bank of Mongolia

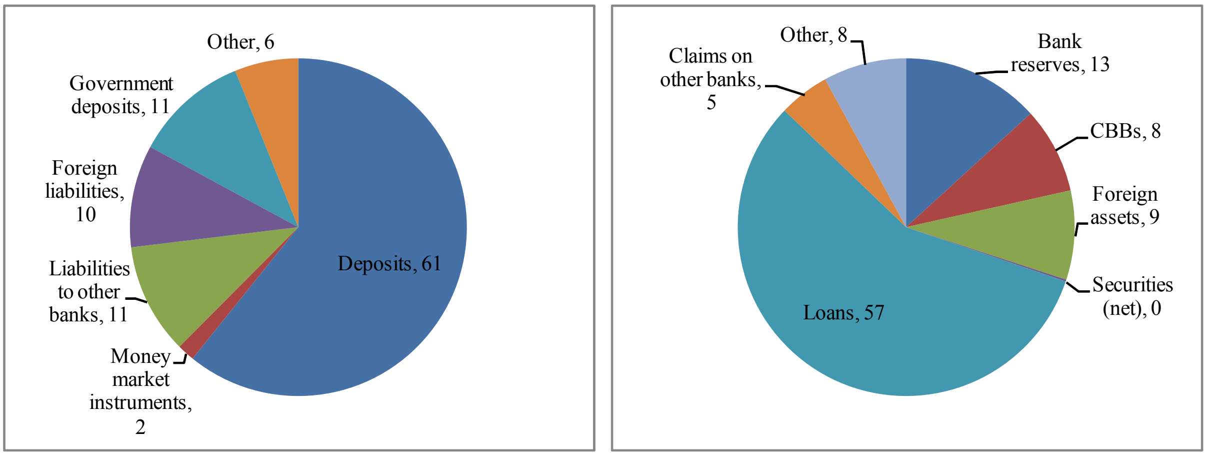
Mongolia's legislation governing foreign direct investment is considered to be among the most liberal in the world. As of June 2010, six banks which were foreign-invested held 53.1% of total deposits, provided 42.4% of total loans, and their combined assets made up 47.8% of the total assets of the banking sector.

In 2000–2009 the dollarization of assets oscillated between 41.0% and 37.4%, while the dollarization of liabilities oscillated between 43.7% and 38.3%. In June 2010, asset dollarization amounted to 33.4%, while the dollarization of liabilities equaled 38.2%.

Hence exchange rate volatility has less of an impact on the banks' balance sheets. The key issue is loan portfolio quality.

The undeveloped domestic bond market limited the allocation of resources, and loans comprised more than half of banks' total assets, while deposits attracted from residents made up 60.8% of banks liabilities in 2009. Intensive competition for customers in the domestic market led to high lending rates, however spreads between deposit and lending rates was declining in 2001-2007.

Figure 6: Composition of Assets and Liabilities (2009)



Source: Bank of Mongolia

The money market plays a significant role through efficiently distributing financial resources within the banking sector. Its development would enhance the ability of banks to mobilize and collect financial resources, and to gain experience in marketing. Increased emphasis on better risk management and adoption of the new Basel accord will provide banks with instruments other than extending loans.

The banks have had a poor history on raising funds in the capital market. Only two banks were listed on the Mongolian Stock Exchange. In 2007, the Trade and Development Bank of Mongolia, one of the largest banks issued bonds on the Singapore Stock Exchange.

The illiquid domestic capital market hinders the improvement of bank asset and liabilities management. The lack of local credit-rating agencies, weak risk management capacity, undeveloped information technology, and the shortage of highly-qualified staff have been general constraints on the development of the capital market in Mongolia. The establishment and effective functioning of local credit-rating agencies is a key to the development of the securities market. Additionally, a well-developed market of derivative instruments for hedging interest rates and credit risk exposures is needed to improve market liquidity. The development of a derivatives market, including futures, swaps, and repossession contracts will facilitate the banks' management of investment portfolios and risk. Strengthening the bond market in Mongolia would improve bank asset and liabilities management, upgrade loan portfolios, and reduce interest rate, foreign exchange and liquidity risks.

Prospects for Future Development

Monetary policy aimed at curtailing inflation pressures, combined with continued improvements in banking supervision and regulation, will reduce the vulnerabilities in the banking system. As stated in the Monetary Policy Guidelines for 2011, the Bank of Mongolia will continue to take measures to improve bank asset and liabilities management and risk monitoring.

Nowadays the rising level of non-performing loans requires continued improvement in the banking sector. With the purpose of strengthening the banking sector, the BOM tightened banks prudential ratios, raised capital requirements and strengthened banking legislation.

The parliament approved a revised Banking Law (2010) that provided the legal foundation for strengthening the banking sector. The Bank of Mongolia developed a risk-based approach to bank supervision and a regulatory framework for conducting supervision on a consolidated basis. Furthermore, the Bank of Mongolia issued new regulations in August 2010 that raised loan provisioning and tightened the treatment of related parties' loans. Although the regulations are aimed at strengthening the banking sector, its adoption will initially result in rising non-performing loans and worsening capital adequacy ratios.[6]

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[6] Loans with changes in terms will be downgraded, and provisions should be raised accordingly. Hence, the banks' expenditures will grow and capital will worsen.

In order to facilitate further development of the banking sector, enforce new banking regulations and improve bank liquidity, the Bank of Mongolia prepared, in collaboration with international financial institutions and the Mongolian government, a comprehensive restructuring and recapitalizing program and submitted it to parliament in September 2010. The Empowering the Banking Sector and Capital Support Program includes issues concerning the rational use of public financial resources that might be needed within the framework of the program's implementation.

The parliament approved amendments to the Deposit Guarantee Law which excluded from the coverage of the law: inter-bank deposits; deposit interest income in excess of the policy interest rate; and the deposits of borrowers. Introduction of a deposit insurance scheme instead of a blanket deposit guarantee will be one further step in the development of the banking sector.

The Bank of Mongolia plans to upgrade the credit information bureau, enriching it with data from non-bank financial institutions and savings and loan cooperatives, and establishing links with other databases. Moreover, banks will be regulated so that they adopt high standards of transparency and corporate governance principles.

Presently large enterprises occupy the predominant share in the loans market. They can provide the required collateral. Moreover, they have become trusted customers as a result of their continued, strong relationships with banks. These enterprises are even provided with banking services and products on favorable terms. In contrast, small- and medium-sized enterprises (SMEs) have poorer management, less capital to be collateralized and less possibility of borrowing from banks. The Bank of Mongolia will promote policies to support SMEs through enhancing access to credit from banks, reducing lending interest rates, and smoothing the lending process.

All these measures will aid banks in the more prudent allocation of credit, adoption of new services and products, and deepening of financial intermediation.

The outlook for the Mongolian economy is favorable. Various development projects are underway. The government signed an agreement with an international mining company to exploit the Oyuu Tolgoi copper and gold deposit. Project investment is estimated at US$5 billion. Moreover, the mining of the massive Tavan Tolgoi coal deposits are expected in the very near future. Hence investment is expected to rebound, driven by the mining of these deposits.

Mongolia’s substantial mineral wealth will lead to a period of economic growth. Banking sector development will become more important for sustained growth. Therefore, the banking system should develop in line with economic growth.

Macroeconomic stability is the basic condition for the development of the country. From this point of view, the Bank of Mongolia plays an important role. Maintaining inflation at the single-digit level, raising international reserves, stabilizing the exchange rates, ensuring financial sector stability, and taking timely measures to prevent potential macroeconomic risks would lead to the sustaining of macroeconomic stability, which is an essential prerequisite for the further development of Mongolia.

The role of the banking sector has been strengthened. The banking sector should develop further to facilitate sustained economic growth.

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