ASIAN DEVELOPMENT BANK

TAR:MON 34135

TECHNICAL ASSISTANCE
(Financed by the Japan Special Fund)

TO

MONGOLIA

FOR PREPARING THE

THIRD FINANCIAL SECTOR PROGRAM

December 2003

CURRENCY EQUIVALENTS

(as of 5 November 2003)

Currency Unit	–	togrog (MNT)
MNT1.00	=	$0.0008
$1.00	=	MNT1,166

ABBREVIATIONS

ADB	–	Asian Development Bank
BoM	–	Bank of Mongolia
FSAC	–	Financial Sector Adjustment Credit
FSP	–	Financial Sector Program
GDP	–	gross domestic product
MSEC	–	Mongolia Stock Exchange Commission
NBFI	–	nonbank financial institutions
NBFS	–	nonbank financial sector
NBFSA	–	nonbank financial services agency
TA	–	technical assistance
WB	–	World Bank

NOTE

In this report, "$" refers to US dollars.

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I. INTRODUCTION

1. The Government of Mongolia requested the Asian Development Bank (ADB) for technical assistance (TA) to prepare the Third Financial Sector Program (FSP III) loan, to further the reforms implemented under the Financial Sector Program (FSP) loan and the Second Financial Sector Program (FSP II) loan. This program preparatory technical assistance (TA) is included in the Mongolia Country Strategy and Program Update for 2004–2006, and is programmed for 2004. The ensuing loan is programmed for 2005. Fact-finding for the TA was undertaken in December 2002, and in February and September 2003.[1] Agreement with the Government on the TA objectives, scope, and implementation arrangements was reached in September 2003.

II. ISSUES

2. Mongolia began a comprehensive reform program in 1991, with the goal of transforming the centrally planned economy into a market-based system. Despite challenges posed by economic and political vulnerabilities, the Government launched the first phase of financial sector reforms in 1996, supported by ADB's Financial Sector Program (FSP)[2] loan. The objective of the FSP, implemented during 1996-1999, was to lay the foundation for a sound and market-oriented financial sector. FSP reform focused on (i) establishing a legal and regulatory framework for the banking sector consistent with international standards, (ii) restructuring the banking system to strengthen viable banks and to close those that were insolvent, (iii) reducing government involvement while encouraging market orientation and commercialization of the banking system, and (iv) developing capacities to improve bank credit and risk management and banking supervision.

3. Considerable progress was made under the FSP in terms of liberalizing banking policies, strengthening bank regulations, and restoring health of viable banks while closing insolvent ones. However, the financial sector remained weak, lacked diversity, and played a limited role in the economy. In 1999 the Government formulated the second phase of reforms—the Financial Sector Reform Program (FSRP) —supported by FSP II loan,[3] and World Bank's Financial Sector Adjustment Credit (FSAC). The FSAC focused on the banking sector, and FSP I on selected banking sector reform measures and overall financial sector development. In particular, FSP II has supported (i) the strengthening of corporate governance in banks, (ii) improved loan collateral, (iii) the introduction of an interbank market, (iv) institutional strengthening of the Mongolia Stock Exchange Commission (MSEC), and (v) the development of legal infrastructure for nonbank financial institutions (NBFIs).

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[1] The TA first appeared in *ADB Business Opportunities* on December 2002.

[2] ADB. 1996. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grant to Mongolia for the Financial Sector Program.* Manila (Loan 1509-MON, approved on 19 December 1996 for $35 million, along with Loan 1510-MON: *Upgrading Skills and Systems of Commercial Banks* for $3 million, and TA 2720-MON: *Strengthening the Supervisory and Restructuring Capacity of the Bank of Mongolia* for $1 million).

[3] ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loans and Technical Assistance Grant to Mongolia for the Second Financial Sector Program.* Manila (Loan 1743-MON, approved on 22 June 2000 for $15 million, along with TA 3459-MON: *Strengthening Financial Sector Development*, for $600,000).

4. **Need for Further Development of Nonbank Financial Institutions.**[4] FSP II has provided the platform for further improvement of financial intermediation and sector stability. Led by banking sector growth, the level of financial intermediation has increased in recent years. The ratio of broad money (M2) to Gross Domestic Product (GDP), an indicator of financial intermediation, grew from 22% in 1999 to 38% in 2002. At the same time, the ratio of nonperforming loans has remained relatively stable at around 7–8%, down from a high of 55% in 1999. However, the nonbank financial sector (NBFS) remains small and does not yet play a meaningful role in mobilizing savings for medium- and long-term investments. Private sector development is largely financed by retained earnings and bank borrowings. While the number of listed companies has grown in recent years, the securities market remains underdeveloped in liquidity and market capitalization, and as a source of equity capital and debt financing for the private sector. At MNT52 billion, total market capitalization is less than 5% of GDP. Of the 403 companies listed on the Mongolia Stock Exchange at the end of 2002, only 30 had actively traded shares. Government bond (treasury bill) maturities are as short as bank term deposits, and the corporate "bond" market is limited to discount schemes for pre-construction apartment sales. Other sources of long-term funds are also limited. Only one company is licensed to provide leasing services, and mortgage lending is limited mainly to pre-construction schemes for new housing in Ulan Bataar.

5. While there are 16 insurance companies in Mongolia, the sector is dominated by one company, and is heavily concentrated in the automobile and shipping industries. In 2002 total insurance premium amounted to approximately 0.5% of GDP. The pension fund is a government-budget supported, pay-as-you-go system that is open to private company employees. The fund is severely underfinanced due to large contribution arrears and the narrow base of pension contributions relative to the coverage of pension recipients. In view of the important role of institutional investors in catalyzing capital market development, insurance and pension fund development should be an integral part of the medium-term financial development strategy. As such, there is a need to further develop NBFIs to create a more dynamic and competitive financial sector that offers a range of funding sources to businesses, and to consumers of financial services, including investors and policyholders, through consumer credit, trust services, and contractual savings in the form of voluntary private pension schemes.

6. **Regulation, Governance, and Supervision of Nonbank Financial Institutions.** Regulation and supervision of NBFIs is fragmented and has yet to meet international norms of best practice. As of April 2003, 72 companies were licensed as NBFIs and regulated by the Bank of Mongolia (BoM). The capital market is regulated by MSEC, which does not have the capacity to effectively carry out its functions as stipulated under the Law on Securities Markets enacted in December 2002. While the draft law on insurance prepared under FSP II incorporates solvency and prudential requirements in line with international standards, further assistance is required to develop the regulatory framework and to ensure compliance. The Insurance Supervisory Agency employs only five professional staff, none with prior insurance industry experience. The General Department of National Taxation supervises the savings and credit cooperatives.[5] The department collects basic tax-related data from the cooperatives but does not have the skills and resources to regulate them. Capacity constraints of individual

4 In Mongolia, the term nonbank financial institution refers to a licensee under the Law on Nonbank Financial Activities, which regulates 10 specific financial sector activities. In this paper, NBFIs are defined as all financial institutions except commercial banks, including finance and leasing companies, savings and credit cooperatives, insurance companies, pension funds, and the securities market

5 While the approximately 400 active cooperatives are small in absolute terms and relative to the banking sector (as of June 2003 their total loans outstanding were roughly 3.6% of loan outstanding by commercial banks, and deposits reached 2.1% of bank deposits) growth is rapid.

regulatory agencies, and small size of the financial sector provide a strong rationale for consolidating regulation and supervision of NBFIs, possibly in the form of a unified nonbank financial services authority (NBFSA).

7. **ADB Strategy and Operations.** Financial sector development has long been a strategic focus of ADB assistance to Mongolia. ADB has provided continued assistance to promote the development of a sound financial sector since the mid-1990s. While much has already been achieved, it is important that the momentum for reforms is sustained through continued support to develop a broad-based financial sector. ADB has coordinated closely with Mongolia's other development partners. The Government's comprehensive FSRP is jointly supported by FSP II and World Bank's FSAC. World Bank activities include support for strengthening the bank regulatory framework and risk management, and for amendment of the civil code to improve the legal process for asset foreclosure by banks. Under its Policy Support Project, the United States Agency for International Development (USAID) is helping strengthen the management team of Agricultural Bank, the bank with the largest rural coverage. A number of projects, including those supported by World Bank, the UK Government's Department for International Development (DFID), European Union-Technical Assistance for the Commonwealth of Independent States (EU-TACIS), and Canadian Cooperative Association, are aimed at improving access to credit and financial services, particularly for rural and vulnerable populations. Given the relevance of these projects, ADB will continue to coordinate with other donor agencies.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

8. Building on the reforms implemented under FSP and FSP II, this TA will help the Government formulate and design a program to promote the sound and orderly development of NBFIs. To this end, the TA will focus on strengthening the regulatory and supervisory framework for NBFIs and addressing remaining impediments to the development of the sector. Outputs will include (i) a long-term strategy to regulate and develop NBFIs; (ii) governance, regulatory, and supervisory standards for NBFIs in line with international standards, and further development of NBFIs; (iii) improved efficiency of the NBFI regulatory and supervisory framework by harmonizing regulatory and supervisory practices, possibly in the form of NBFSA; and (iv) a medium-term road map for the development of NBFIs.

B. Methodology and Key Activities

9. The TA will undertake the following:

1. Develop a Long-term Strategy for the Regulation and Development of the Nonbank Financial Institutions

10. This activity will entail the following:

(i) Review the development stage of banks and NBFIs to develop a broad perspective on the financial sector as a whole. Assess the medium- to long-term potential for development of the individual subsectors of the NBFS.

(ii) Review the scope, functions, and institutional arrangements of financial regulators.

(iii) Based on (i) and (ii), and incorporating the evolving interlinkages between banks and NBFIs, develop a perspective of a long-term strategy to develop NBFIs, with a primary focus on identifying a cost-effective and viable regulatory framework.

2. Strengthen Governance, Regulatory, and Supervisory Standards for Nonbank Financial Institutions, and Other Measures

11. This activity will entail the following:

(i) Improve licensing, financial reporting, and fiduciary standards; improve corporate governance of NBFIs; and strengthen governance and oversight of self-regulatory organizations such as the stock exchange and others (associations of intermediaries or market professionals) that might perform self-regulatory functions.

(ii) Harmonize prudential and regulatory standards to reduce opportunities for regulatory arbitrage and conflicts of interest inherent in related-party transactions.

(iii) Review tax treatment of financial services and related corporate income, and recommend measures to address tax-related distortions.

(iv) Make specific recommendations for expanding the range of financial instruments available for investment, bond and equity markets, collective investment schemes, and private pension funds.

(v) Recommend policy actions and regulatory reforms to develop NBFIs.

3. Harmonize Regulatory and Supervisory Practices of Nonbank Financial Institutions

12. This activity will entail the following:

(i) Create a regulatory council or high-level working group to implement a memorandum of understanding among financial regulators to facilitate the harmonization of regulatory and supervisory practices with respect to banks and NBFIs.

(ii) Explore the feasibility of, and potential benefits from, creating a unified NBFI regulator in light of the existing regulatory framework and long-term development goals for the sector.

(iii) Streamline the financial and operational regulatory reporting system, and develop an integrated on-site and off-site supervision program for nonbank financial subsidiaries or affiliates of commercial banks, and for nonbank financial services groups.

(iv) Prepare guidelines for NBFIs and self-regulatory organizations to facilitate regulatory compliance and reporting requirements of financial regulators.

(v) Develop an Information Technology-Management Information System (IT-MIS) strategy, with recommended systems and software to be employed under the harmonized regulatory framework/NBFSA.

4. Develop Medium-Term Reform Agenda for the Nonbank Financial Sector

13. This activity will entail formulating a reform agenda, with specific recommendations, conditions, and benchmarks to guide sector reform in 2004–2007.

C. Cost and Financing

14. The total TA cost is estimated at $589,000 equivalent, comprising $451,000 in foreign currency and $138,000 equivalent in local currency costs. The TA will be financed on a grant basis by the Japan Special Fund, funded by the Government of Japan, and will cover the entire foreign exchange cost of $451,000, and $49,000 equivalent of the local currency costs. The Government will finance the remaining local currency costs of $89,000 equivalent by providing counterpart staff, domestic transportation, workshop facilities, and office and logistical support. Detailed cost estimates are in Appendix 1.

D. Implementation Arrangements

15. The TA will be implemented over a period of 8 months, commencing February 2004. The TA will require 12 person-months of international, and 12 person-months of domestic consulting services. The international consultants will include a financial services regulatory and policy expert (5 person-months), a regulatory expert on pension plans (2 person-months), a legal and enforcement expert (3 person-months), and an IT-MIS expert (2 person-months). The four domestic consultants will also have expertise in the above areas and will be engaged for the same length of time. The consultants will be selected and engaged as individual consultants in accordance with ADB's *Guidelines on Use of Consultants* and other arrangements acceptable to ADB for the selection and engagement of domestic consultants. The terms of reference for consultants are in Appendix 2.

16. The team leader will coordinate all other consultants' inputs. The consultants will submit (i) an inception report 3 weeks after start of services,[6] (ii) interim progress reports at appropriate stages of TA implementation, (iii) a draft final report before the TA ends, and (iv) a final TA report 2 weeks after receiving comments from the Ministry of Finance and Economy (the Executing Agency) and ADB. Seminars and workshops will be organized intermittently to invite comments from international and domestic experts in the field, and to disseminate the TA findings. BoM and MSEC will be implementing agencies.

IV. THE PRESIDENT'S DECISION

17. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of $500,000 on a grant basis to the Government of Mongolia for preparing the Third Financial Sector Program, and hereby reports this action to the Board.

[6] The inception report should include the timetable for training, ensuring that training is not the last activity involving the consultants.

COST ESTIMATES AND FINANCING PLAN
($000)

Item	Foreign Currency	Local Currency	Total Cost
A. Japan Special Fund Financing			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants	336	0	336
ii. Domestic Consultants	0	24	24
b. International and Local Travel	40	0	40
2. Representative for Contract Negotiations	6	0	6
3. Reports, Translation, and Communication	5	5	10
4. Workshops	0	15	15
5. Contingencies	64	5	69
Subtotal (A)	**451**	**49**	**500**
B. Government Financing			
1. Office Accommodation and Transport	0	30	30
2. Counterpart Staff	0	30	30
3. Training, Seminar, and Workshop	0	20	20
4. Others	0	9	9
Subtotal (B)	**0**	**89**	**89**
Total	**451**	**138**	**589**

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. International Consultants

1. International Financial Services Regulatory and Policy Expert–Team Leader
(5 person-months)

1. The consultant will be a financial sector expert, with extensive advisory experience in financial sector reform in transitional economies. The consultant will serve as a team leader and coordinate the overall activities of the Technical Assistance (TA). The consultant will work closely with the Government, employing a participatory approach to ensure strong government ownership of the project. The consultant will also coordinate closely with other donor agencies with related activities in Mongolia. The terms of reference (TOR) for the consultant will include, but not be limited to the following:

(i) Review the development stage of the financial sector and assess the long-term potential for the development of nonbank financial institutions (NBFIs).

(ii) Recommend a model/framework for the regulation of NBFIs, taking into account the interlinkages between banks and NBFIs.

(iii) Conduct policy audit of regulatory practices and procedures of the Mongolian Stock Exchange Commission (MSEC), using the International Organization of Securities Commission's best practices.

(iv) Review the adequacy of corporate governance and self-regulatory functions of the stock exchange, and MSEC oversight, and recommend changes in line with international best practices.

(v) Provide policy guidance to the Government in meeting international norms in the governance, regulation, and supervision of NBFIs.

(vi) Review tax treatment of financial services and related corporate income (particularly that of NBFIs), and recommend measures to ensure that tax policies are not biased against NBFI development.

(vii) Develop a strategy to improve public awareness of capital markets.

(viii) Prepare a strategy to develop the nonbank financial sector, including bond and equity markets, collective investment schemes such as investment funds, non-state voluntary private pension plans, and other nonbank financial services.

(ix) Investigate the feasibility of, and the potential benefits from, creating a unified NBFI regulator, as part of the medium-term strategy to develop the sector.

(x) Prepare policy recommendations in the form of a policy matrix and propose future TA, as necessary, to achieve the policy and regulatory reform objectives for NBFIs.

(xi) Supervise and coordinate the activities of other team members.

(xii) Conduct training on NBFI regulation and supervision, with the assistance of other team members.

(xiii) Help recruit the local consultant in his/her area of expertise by drafting TOR, and identifying and short-listing potential candidates.

2. International Regulatory Expert on Private Pension Plans (2 person-months)

2. The expert will have extensive experience in pension plan design and regulation in transition economies. The expert will be responsible for leading the work of domestic pension consultant, as well as helping the team leader prepare a strategy to develop voluntary private pensions. The TOR for the international consultant will include, but not be limited to the following:

(i) Develop a legal and regulatory framework for voluntary employer-sponsored private pension plans to supplement the state pension.

(ii) Prepare an action plan evaluating capacity, and steps needed to develop necessary complementary financial services and facilities to support private pension plans, such as corporate governance practices and fiduciary standards, investment advisors, fund plan administrators, national register, safekeeping of assets, investment opportunities, tax code and potential institutional impediments, public education and awareness of potential participants, and training of market professionals. Emphasis is to be placed on the infrastructure needed to support a voluntary employer-sponsored, defined-contribution pension scheme to supplement mandatory state-sponsored social security.

(iii) Help the team leader prepare a strategy to develop voluntary private pensions.

(iv) Prepare training materials and help the team leader conduct training.

(v) Help recruit the local consultant in his/her area of expertise by drafting TOR, and identifying and short-listing potential candidates.

3. International Legal and Enforcement Expert (3 person-months)

3. The expert will be a lawyer specializing in financial sector law and regulation. The expert will have extensive experience in the analysis and drafting of laws and regulations in transition economies. The expert will lead the work of the domestic legal expert, and help the team leader formulate long- and medium-term road maps. The TOR for the international consultant will include, but not be limited to the following:

(i) Review the legal framework, identifying legal impediments, if any, to harmonization of regulatory practices and the creation of nonbank financial services authority (NBFSA).

(ii) Recommend draft amendments to substantive acts as necessary on regulation of NBFIs (i.e., Law on Nonbank Activity, Insurance Law, Securities Law etc.) under the harmonized framework/NBFSA.

(iii) Help MSEC draft rules, guidelines, or procedures of immediate need to facilitate implementation of key provisions of the Securities Law of 2002.

(iv) Review the adequacy of the legal framework in enforcement of laws and regulations applicable to NBFIs, including provisions for anti-money laundering.

(v) Develop an action plan to enhance regulatory enforcement and compliance.

(vi) Prepare training material and conduct training on legal and enforcement matters.

(vii) Help recruit the local consultant in his/her area of expertise by drafting TOR and identifying and short-listing potential candidates.

4. International Information Technology-Management Information System (IT-MIS) Expert (2 person-months)

4. The expert will have relevant qualifications, and expertise in developing IT-MIS. Relevant experience in financial regulation will be highly desirable. The TOR for the IT-MIS expert will include, but not be limited to the following:

(i) Review IT-MIS systems, software, and procedures employed by the nonbank financial regulators.

(ii) Develop an IT-MIS strategy and action plan, with recommended systems and software to be employed under the harmonized regulatory framework/NBFSA, taking into account systems used by financial regulators, and international best practices.

(iii) Prepare guidelines for NBFIs and self-regulatory organizations to facilitate regulatory compliance and to meet the informational needs of financial regulators.

(iv) Help recruit the local consultant in his/her area of expertise by drafting TOR and identifying and short-listing potential candidates.

B. Domestic Consultants (12 person-months)

5. Four domestic consultants—one each for nonbank financial services regulation and policy, pension system, financial law and enforcement, and IT-MIS–will be recruited. Domestic consultants will have strong expertise in their areas of expertise, and will help the international consultants by (i) providing background information, (ii) translating documents into English, (iii) helping draft laws and regulations, and (iv) helping prepare and conduct training and workshops. Detailed TORs for domestic consultants will be prepared by the international consultants.