Mongolian Economy

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Inclusive sector

Goal to diversify

Foreign bank

Is the entry of foreign banks good for Mongolia

REVOLUTIONARY REFORM

Banking sector reform program

Strategy for reducing lending rate


TAG HEUER
DON'T CRACK UNDER PRESSURE
AUTAVIA
FOR THOSE WHO SEEK ADVENTURE-READY DESIGN
AND HIGH-PRECISION TIMEKEEPING.
TAG HEUER БУТИК
ШАНГРИ-ЛА ХУДАЛДААНЫ ТӨВ, 1-Р ДАВХАР

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FOUNDER, EDITOR-IN-CHIEF:
BEKHBAYAR Damdindorj (9999 4248)

EDITOR:
ENKHBAYAR Narantuya
(9916 1303)

EDITOR OF MONGOLIA "THE WORLD IN" MAGAZINE:
ENKHTSETSEG Boldbaatar
(9009 9880)

ENGLISH EDITOR:
JACQUELINE YVETTE EASTRIDGE

JOURNALIST:
DAVAADORJ Ganbaatar
ORKHON Gankhuyag
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MISHEEL Badral
SARANGUA Tumur (China correspondent)

ENGLISH TRANSLATOR
ARIUNZAYA Munkhbat

DESIGNER:
OYUNDARI Shirmen

MARKETING:
AMARSAIKHAN Gonchigdorj (9499 2389)

Address:
Chingeltei district, 1st khoroo
Peace Avenue, Express Tower 1101
Ulaanbaatar, Mongolia

Central Post Office, P.O. Box 2762,
15160 Ulaanbaatar, Mongolia
URL: www.mongolianeconomy.mn
E-mail: info@mongolianeconomy.mn
FACEBOOK: Mongolian Economy
TWITTER: EconomyMongolia

Tel/Fax: 976 - 7011 5476, 7011 5477

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At the dawn of the reform

The current issue of Mongolian Economy magazine can be regarded as one of the most important issues of 2020. This issue is brought to our readers by the Bank of Mongolia and Mongolian Economy Magazine to provide details about the reform in the banking sector that plays a crucial role in the economy as it accounts for 90 percent of the financial market. Furthermore, it gives an overview of the "Strategy for reducing lending rate" which has become the center of public attention recently.

The banking sector has gone through a tough journey to reach the current level, or so to speak "maturity", since the adoption of a two-tier banking system thirty years ago. In terms of technology, know-how, accessibility, simplicity and use of online banking, Mongolia's banking sector is ranked higher than most developing countries. However, it does not mean there is no room for improvement in the sector.

Hence, the Bank of Mongolia began implementation of the mid-term "Banking Sector Reform Program for 2020-2023." This issue contains extensive information on each of the five goals outlined in the program, especially, on the changes that are about to take place in the financial sector. Furthermore, we tried to provide a clear picture of how the reform will affect ordinary citizens, businesses and Mongolia's economy.

Another topic, covered in this issue, is the interest rate which has become a major social issue in Mongolia. However, special attention must be paid in determining a strategy and timeline for reducing lending rates.

In this issue, Members of Parliament and representatives of Bank of Mongolia, Mongolian Stock Exchange, Financial Regulatory Commission, commercial banks and economists shared their viewpoints on the aforementioned two challenges.

It is important to note that the English version of the magazine contains only unofficial translations and summaries of articles in the Mongolian version.

To ensure successful implementation of the "Banking Sector Reform Program" and "Strategy for reducing lending rate", regulatory reform and amendments will play key roles. Thus, the choice and decision of legislators will determine the trajectory of the current reform. ■

Policy

Reform that will put banking sector in shape

T. SARANGUA

The banking sector with a 30 year history is about to undergo a major regulatory reform under the Banking Sector Reform Program. This program is designed to diversify the financial market and ensure a stable financial system.

At the midst of the COVID-19 pandemic, the Parliamentary Resolution No.32 was approved in April 2020. This Resolution was with regard to measures of financial and economic stability, risk prevention and digital transition in the public sector. Within the scope of the Resolution, the Bank of Mongolia (BoM) approved "Banking sector reform program to build a healthy, reliable, transparent, open, publicly monitored, inclusive and digital banking system" in September 2020. This reform is about to be one of the largest scale regulatory reforms proposed by the BoM in the financial sector and can be counted as the continuation of structural reform started under the IMF's Extended Fund Facility (EFF) Program.

Selection continues ...

The history of modern banking in Mongolia has begun from the time when Mongolia transitioned from a centrally planned economy to a free market economy in 1990. The Bank of the Mongolian People's Republic was the only bank operating in Mongolia until the introduction of a two-tier banking system in 1991. By the end of 1994, the number of banks registered in Mongolia reached fifteen.

Over the course of history, the financial crises have tested the resilience of the commercial banks in Mongolia. The first financial crisis since the transition to a market economy led to bank mergers of Mongol Khorshoo Bank with Ard Bank and Selenge Bank with KHOTSH Bank. Furthermore, MM Invest Bank went bankrupt and the license of Ikh Zam Bank was terminated during the financial crisis of 1996-1999.

Mongolia's banking sector substantially strengthened following the implementation of the IMF's Enhanced Structural Adjustment Facility to support the government's economic program between 1997-2000. During 2001-2008, the price of gold and copper went up, the stability of government policy was ensured, the banking sector recovered and service and manufacturing industries bounced back, all of which played an important role in maintaining steady economic growth.

However, due to the global financial crisis of 2008, the economy and retail sales started slowing down and domestic currency began depreciating. As a result, the banking sector incurred large losses due to higher non-performing loans. To address these challenges, in late 2012, an unconventional monetary policy was implemented to offer loans with interest rates lower than market rates to economically important sectors through commercial banks. In 2017, when Mongolia was on the verge of sovereign default, the IMF approved the Extended Fund Facility (EFF) Program.

Unfortunately, since then, Capital Bank dissolved in 2019 and the Ulaanbaatar City Bank merged with Trade Development Bank in 2020.

In the past 30 years, the banking sector underwent natural selection. Currently, 12 commercial banks are operating in Mongolia. Under the IMF's EFF Program, the BoM conducted the Asset Quality Review on commercial banks and identified the banks' risk tolerance levels. However, structural reform, in the banking sector, has not been achieved by the end of the EFF Program. Therefore, BoM is working on achieving these goals which have been set out under the EFF Program. They also plan to increase the capital and risk tolerance of commercial banks in Mongolia.

GOALS OF THE MEDIUM-TERM BANKING SECTOR REFORM PROGRAM:

GOAL 1. Modernizing the regulatory environment to reduce bank ownership concentration, improve corporate governance and ensure an open and publicly monitored banking system.

GOAL 2. Ensuring a healthy and reliable banking system by aligning banking supervision and regulation with international standards.

GOAL 3. Maintaining cooperation with international organizations and making preparations for the next program.

GOAL 4. Enhancing the effectiveness of the framework to combat money laundering and terrorist financing, cooperating with the authorities, getting off the FATF's grey list and preparing for upcoming mutual evaluations.

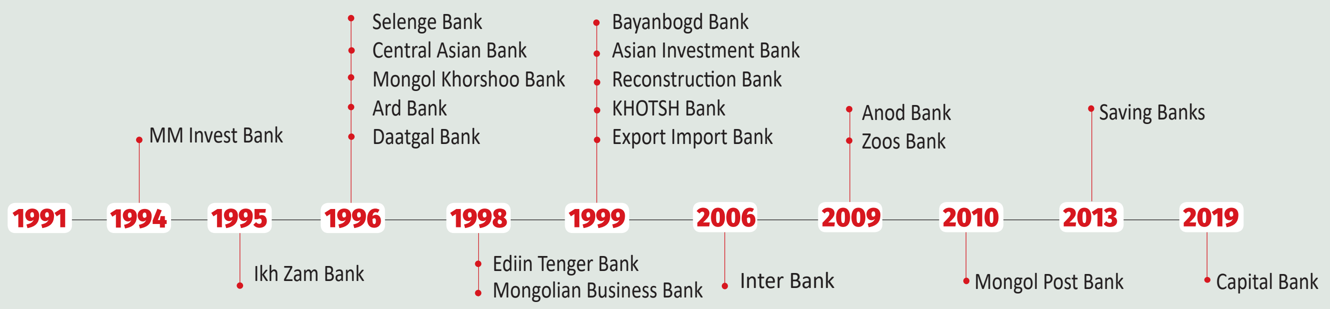
GOAL 5. Creating an inclusive and digital banking system by diversifying requirements and banking licenses based on bank operations, business models and other specific characteristics.

The BoM is cooperating with international organizations to overcome impacts of COVID-19 on the banking sector and aiming to ensure an effective framework for combating money laundering and terrorist financing. They are also making a substantial effort to be removed from the FATF's grey list and are preparing for upcoming mutual evaluations.

The Banking Sector Reform Program is not only designed to address the aforementioned challenges, but to also carry a structural reform that will create a healthy and reliable banking system by changing bank ownership and listing the bank shares on the stock exchange. Moreover, the program will enhance the development of the stock exchange market that is currently missing in Mongolian financial system.

List of failed banks (from 1991)

Source: Bank of Mongolia



Missing policy

The Mongolian Stock Exchange was established in 1991 by the decree of the Government of Mongolia to privatize state-owned assets. During the transition to a market economy, we have successfully laid the ground rules for stock market.

Unfortunately, the stock exchange is lagging behind the banking sector. Experts say that the underlying reason is a lack of public policy, favorable regulatory environment, tax support and financial literacy.

> The Bank of Mongolia approved "Banking sector reform program to build a healthy, reliable, transparent, open, publicly monitored, inclusive and digital banking system" in September 2020

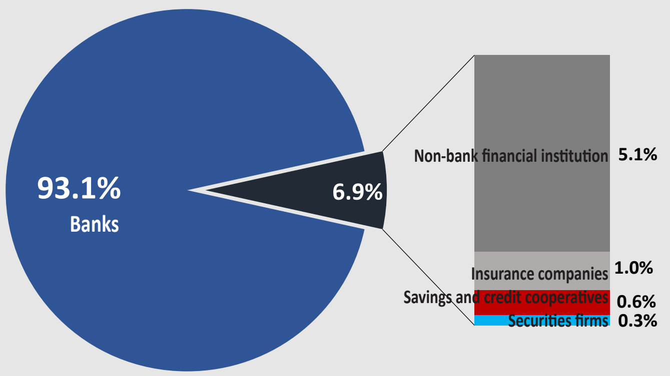
Between 2015 and 2017, when the Government started trading their securities through the Mongolian Stock Exchange, public participation in stock markets improved considerably. Furthermore, domestic companies which took an innovative approach to their operations, management and governance, have begun raising capital in the stock market. For the first time, in 2017, the trading volume reached 860 billion MNT. The Top 20 Index and market capitalization went up by 68.9 and 67.4 percent respectively. In 2018, the Mongolian Stock Exchange introduced the first dual listing and the number of listed companies reached a record high. The volume of securities traded in the primary market reached its peak in 2019.

Under the Banking Sector Reform Program, the BoM intends to diversify the shareholder base of commercial banks, enable public monitoring, expand funding sources and improve governance in the banking sector. These measures are expected to increase the investor's trust and encourage public participation in the equity market. In the scope of the "Strategy for reducing lending rate", the authorities are looking deeper into opportunities for trading new types of investment products such as guaranteed securities and certificates of deposit in the stock market and enabling banks to invest in businesses.

The first step of the Banking Sector Reform Program, which will be implemented from 2020 until 2023, is to make amendments to law, regulation and procedures. During the Parliamentary autumn session, amendments to the Banking Law are being reviewed and discussed.

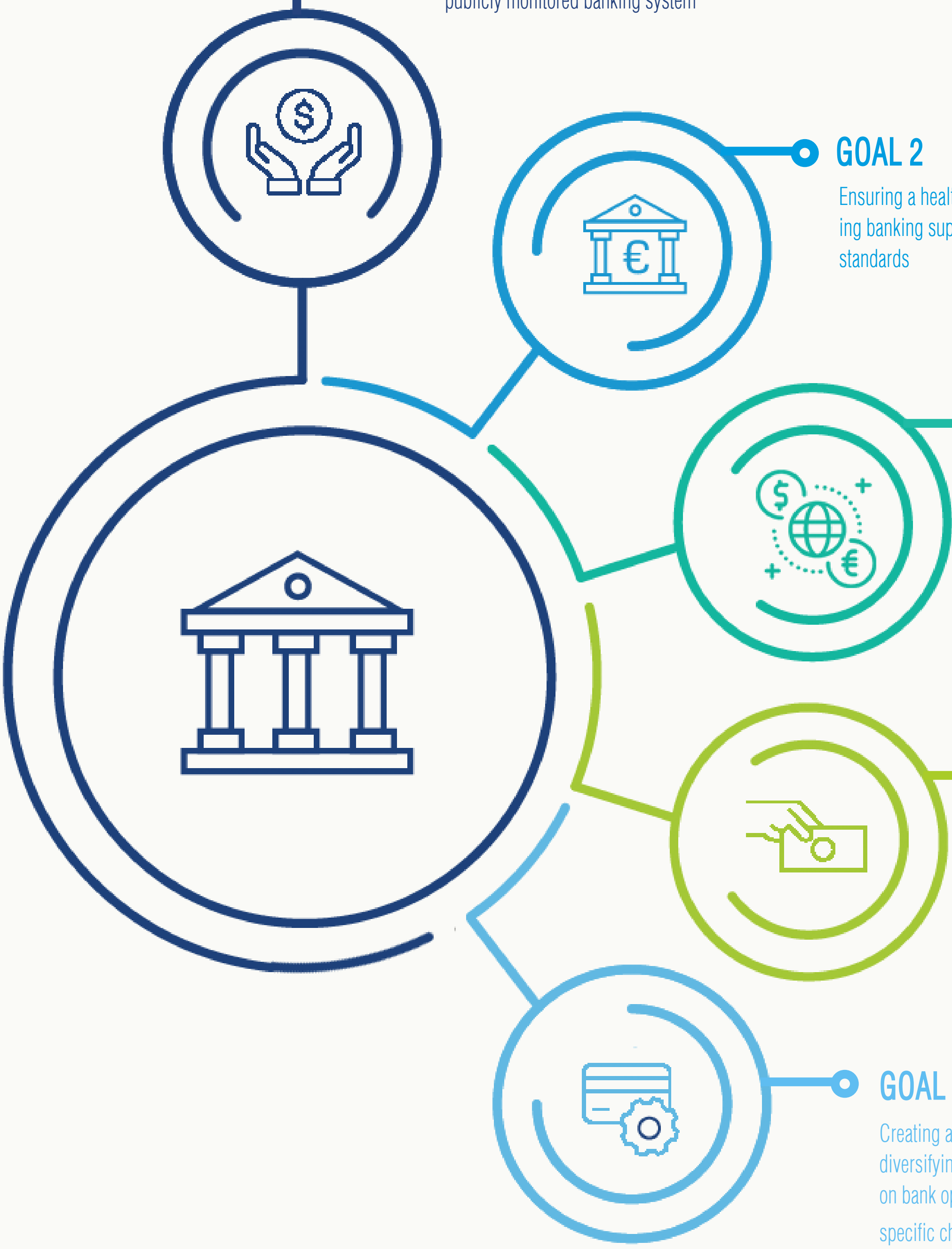
It is a pleasure to say that the reform that will take the banking sector to the next level has commenced. ■

Market share of key institutions in the financial sector
(as of the second quarter of 2020)



Source: Bank of Mongolia

BANKING SECTOR REFORM PROGRAM



GOAL 1

Modernizing the regulatory environment to reduce bank ownership concentration, improve corporate governance and ensure an open and publicly monitored banking system

GOAL 2

Ensuring a healthy and reliable banking system by aligning banking supervision and regulation with international standards

GOAL 3

Maintaining cooperation with international organizations and making preparations for the next program

GOAL 4

Enhancing the effectiveness of the framework to combat money laundering and terrorist financing, cooperating with the authorities, getting off the FATF's grey list and preparing for upcoming mutual evaluations

GOAL 5

Creating an inclusive and digital banking system by diversifying requirements and banking licenses based on bank operations, business models and other specific characteristics

Banking sector reform

B. Lhagvasuren: Taking the financial market to the next level by strengthening banks

Mongolian Economy Magazine spoke with B. Lhagvasuren, Governor of Bank of Mongolia.

-Several banking reforms were carried out in the past. What are the specific measures that make the current reform distinctive?

-The Bank of Mongolia (BoM) has been actively taking measures to advance the banking sector in the last few years. In 2016, Mongolia experienced economic contraction, lower foreign exchange reserves, exhausted domestic resources and limited lending. Therefore, between 2017 and 2018, in the scope of the IMF's Extended Fund Facility Program, we conducted an asset quality review in accordance with European Central Bank's standards. Mongolia became the first Asian country to review all of its commercial banks based on asset quality, credit risk and collateral valuation.

The current reform is aimed at boosting the risk tolerance of Mongolia's banking sector, increasing public participation, improving the governance of banks and adapting to international standards in supervisory functions. First and foremost, we need to strengthen the commercial banks by increasing their capital requirements. Based on careful evaluations, banks in Mongolia had to raise their capital by around 500 billion MNT in total. As it is a considerable amount, the authorities have decided to extend the compliance deadline.

It is becoming evident that having few shareholders is risky and makes it difficult to obtain additional financing. Hence, Mongolia needs to adopt international best standards in form of listing banks and expanding their shareholder bases. Within that framework, the BoM has started making necessary amendments to corresponding regulations.

Another distinctive measure is the creation of a digitalized and smarter banking sector. Since the beginning of banking history in the country, the banks have been offering similar products and services directed to the general public. We see that in other countries, however, banks tend to specialize in one area such as investments, trade, finance and retail. Thus, it is important that we diversify banks in Mongolia. Offering various terms and conditions with the purpose of establishing dominance in the market or poaching the biggest clients is an unacceptable practice. Hence, the reform will be aimed at strengthening banks, increasing capital, diversifying operations, enhancing digital transformation and expanding shareholder bases of domestic banks. ▶

Large and small commercial banks should not be subject to the identical requirements. For instance, we cannot urge small banks to raise their capital by the amount we demand from the large banks. That means the prudential ratios should vary depending on the size of our commercial banks.

Within the scope of this banking reform, requirements and criteria for acquiring banking licenses will differ based on the operational direction, scope, business model and impact on the financial market. This will open up opportunities for diversifying and enhancing the development of the banking sector as a whole.

-Is it truly possible to create a diversified banking sector?

-In order to diversify banks into an investment, retail, wholesale, trade, digital and online banking sectors, the authorities will have to set up an appropriate regulatory framework.

Competition between small and large banks pose several issues. For instance, large banks offer higher deposit rates or offer special terms to attract wealthy companies or clients to gain a market power. However, it tends to lead to higher financial risks in the banking system. There are quite a number of cases where high deposit rates led to higher cost burden, impeded operations of the bank itself and became a reason for insolvency in extreme cases.

-What solutions does the new mid-term Banking Sector Reform Program offer to address such issues?

-Economic growth heavily relies on loans and financing offered by the banks. Thus, the limited availability of loans and financing amid the COVID-19 restrictions became the center of public attention. It is indisputable that Mongolia needs to improve, strengthen and reform the banking sector. As the banking sector has a significant impact on the development strategy and security of the country, it must be capable of overcoming risks independently.

It is possible to reduce the pressure on the economy caused by the COVID-19 pandemic by strengthening our banking system. In other words, we could take forbearance measures, share the risk burden and resolve customer's requests for temporary relief on a payment deadline, interest rate and penalties. The BoM also decided to eliminate interest charges from the late fees on consumer loans and defer the mortgage payments for six months.

-How would you evaluate the risk tolerance of commercial banks?

-The BoM conducts banking supervision pursuant to international standards. The capital adequacy ratio for banks operating in Mongolia is 12 percent whereas in other countries it is around eight percent. The BoM set a relatively high ratio to increase the risk tolerance of commercial banks. Additionally, the liquidity ratio is set to be 25 percent whereas in other countries it is set around 20 percent. A country with a small economy like Mongolia tend to be vulnerable to wide-range of risks thus setting higher prudential ratios provides risk reserves in the financial market.

The most influential banks have been in compliance with international requirements. In regard to other banks, there are a few banks that have not met with capital adequacy and liquidity ratios.

-The BoM is taking a leading role in banking reform. What are your top priorities?

-One of the lessons learned from previous mistakes is that it is important to prohibit attempts to attract customers with unstandardized promises and special terms. As it is one of the key issues to be addressed under the reform, we are working to make necessary amendments to corresponding laws. Also, our policy is directed at excluding current and deposit accounts nominated in USD from deposit insurance. These are activities designed to halt competition under non-market conditions.

The next priority is to increase the banks' capital. We have drafted a law to create conditions for banks to attract new investors. This draft law was included on the list of laws to be discussed at the Parliamentary session this autumn. Furthermore, a provision to reduce the ownership concentration will be included in the "Banking Law". It also has an indirect effect on the development of the stock exchange when banks go public. Our goal is simple which is to improve banking supervision, achieve good governance and ensure transparency of banks by increasing public participation.

-How are the executives and owners of commercial banks responding to this change?

-Our experience and past lessons show that it is difficult to expand bank operations if it is owned by one person or a few. As financial products and services largely depend on banks' capital, it is not possible for banks to issue new loans without increasing their capital. Having only a few bank owners cannot keep up with rapid change and competition. Due to this reason, the bank's shareholders are eager to bring in new investors in form of shareholders.

-I understand that the loan interest rates will gradually decrease in association with the reform of the banking sector. How can we reduce interest rates?

-Without a doubt, we need to reduce loan interest rates. Our interest rates are relatively high compared to other countries. Though interest rates have been continuously decreasing in recent years, it is not at the desired level yet. This is largely related to our economic stability. The BoM is seeking the most optimal solution to create conditions necessary for lowering interest rates.

A commercial bank is a private business. A borrower is also running a private business. This raises the following concern, "Whether the government should intervene between two private parties negotiating on their business terms?" That's why we have been exploring possibilities of lowering interest rates under market principles and providing support through policy instead of demanding to cut interest rates to certain levels.

Today, the average loan interest rate is 15.8 percent. Almost 60 percent of interest rates depend on the cost of fundings, 20 percent on the loan-loss provisioning costs and the remainder on the bank's operational expenses. More than ten percent of loans worth 17 trillion MNT are classified as non-performing loans. Thus due to borrower's failure to repay the debt and debt-related disputes, the commercial banks have no choice but to incur additional costs by creating and increasing loan loss provision.

The loan loss provision amounting to 1.7 trillion MNT and higher operational costs are in turn, putting pressure on interest rates. This is an underlying reason for limited loans that is an obstacle in supporting businesses. To turn the current situation into an opportunity, we need to create a regulatory framework critical for resolving disputes without legal risks and in a timely manner. By doing so, Mongolia will have a higher chance of reducing interest rates to single-digit numbers.

-If I am not wrong, loan interest rates can certainly be lowered?

- When we started discussing a Program to reduce loan interest rates, the average interest rate was 16.6 percent. By the time of approval, it dropped to 15.8 percent. Between 2016 and 2020, interest rates fell by four percentage points from 20 percent to 16 percent, the fastest decline in history. If we can keep up the pace, the interest rates can be reduced to 12 percent by 2023 or 2024.

-Public opinion is divided on the entry of foreign banks in Mongolian market. What is the position of the BoM in that regard?

-The public has misconceptions about foreign bank entry. Some say that the BoM does not approve or that local banks are lobbying the authorities to block the entry of foreign banks to Mongolia. In reality, there are no such things. Issues concerning foreign bank and its entry are already regulated by the current "Banking Law" which means Mongolia do not restrict entry of foreign banks. Even, there are several foreign banks that have actually set up their representative offices in Mongolia.

As of today, there are four representative offices of foreign banks, two from China and two from Japan. Previously, banks from England and the Netherlands had their representative offices in Mongolia for three or more years.

-How do you see the banking sector in the next 30 years?

-Following the transition to a market economy, Mongolia adopted a two-tier banking system. In terms of the development, products and services, Mongolia's banking sector is ranked high in Asia. Moreover, Mongolia is at a similar level with advanced economies in terms of banking card technologies, the number of commercial bank branches and automated teller machines per 100,000 adults. According to estimates, there are around 3.4 million cardholders in Mongolia which shows the accessibility of financial services. The BoM will keep carrying banking reform to make financial services even more accessible, easier and cheaper.

In the future, the coordination between the Stock Exchange and the banking sector needs to be improved. In addition to loans, banks should be able to increasingly buy corporate bonds. In Europe and the United States, a corporate bond is commonly traded form of debt financing compared to government bonds. Furthermore, the Central Bank is required by the law to involve when the bonds are issued in the secondary market. We need to look deeper into this matter in the future.

In addition to traditional monetary policies, it is necessary to address the issue concerning unconventional policies. Also, it is important to learn and adapt to not only products and services created in the global financial market but also new technologies and advancements. ■

STRATEGY FOR REDUCING LENDING RATE

GOAL 1

Ensuring macroeconomic stability necessary for interest rate reduction

1. Maintaining low and stable inflation rate to reduce cost of funding
2. Increasing foreign exchange reserves to cut cost of foreign financing
3. Improving coordination between macroeconomic policies and enhancing export diversification.

GOAL 2

Introducing new types of financial instruments and products

4. Changing and improving monetary policy instruments
5. Lowering cost of funding by introducing new products and services to the financial market
6. Reducing dollarization of liablibilities in the financial sector

GOAL 3

Improving risk management, efficiency and governance of commercial banks

7. Expanding the scope of Credit Information Database
8. Reducing credit risks by modernizing regulatory environment
9. Increasing efficiency of commercial banks and reducing operational costs
10. Improving governance of banks and financial institutions and protecting customer's rights

Governance

Publicly monitored bank with balanced control, management and supervision is an example of prudent governance

Z. TSELMEG

Since Mongolia adopted a two-tier banking system, a total of 35 commercial banks had been established, out of which 20 became insolvent in the past. Underlying reasons for insolvency were high ownership concentration, imbalance in bank control and conflict of interests in the decision-making process.

In the last 30 years, the Bank of Mongolia (BoM) has been taking measures to continuously improve the banking sector. Currently, the BoM is about to take the most controversial yet critical measures under the Banking System Reform Program. The measures include diversifying shareholder base, reducing ownership concentration and ensuring open and transparent governance of Mongolia's commercial banks.

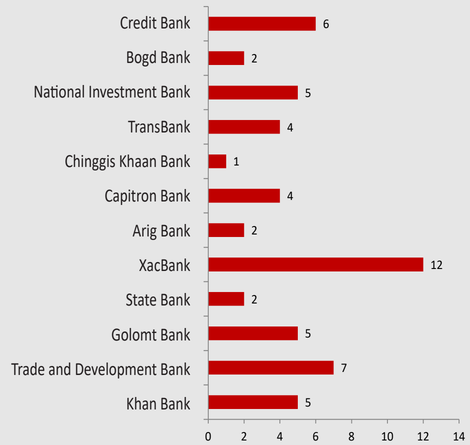
We need an answer to the following question: "Will we ever address the relatively loose governance and lack of competitiveness in the banking sector?" The upcoming reform in the banking sector might not be favorable to shareholders or executives but they are crucial for the well-being of citizens, businesses, financial intermediaries, financial sector and economy. In the last 29 years, the authorities have been taking a relatively liberal approach in regulating the financial sector. For instance, legal entities had the right to decide the bank's ownership type and shareholder structure.

A bank is a business that earns revenues and profits from managing financial risks. On the contrary, in Mongolia, a bank became a financial intermediary for implementing public monetary policies and enhancing economic growth. In order to have a financial intermediary that could promote economic growth, Mongolia needs to create a stronger and healthier banking system. At the same time, cooperation from the bank owners' side is necessary for ensuring the stability of the banking system and reducing interest rates. In particular, relationships between the board of directors and executive directors should continually practice prudent governance.

As of August 2020, total assets of the banking sector were at 34.5 trillion MNT which is equivalent to Mongolia's 2019 GDP. The current account and deposits reached 20 trillion MNT making up 60 percent of the total assets, whereas shareholder investments are equal to three trillion MNT. In other words, people who infused less than nine percent of the banks' total assets are making asset management decisions.

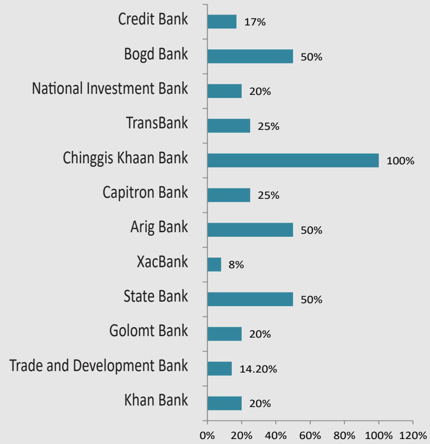
Studies show that ownership concentration is negatively correlated with financial stability and credit risk. Thereby, action plans to strengthen governance and change the form to public companies were included in the "Strategy for reducing lending

Number of shareholders



Source: Bank of Mongolia

Avereage shareholding



Source: Bank of Mongolia

rates" and the "Banking System Reform Program for 2020-2023." The latter was approved by the Governor of BoM on September 12, 2020.

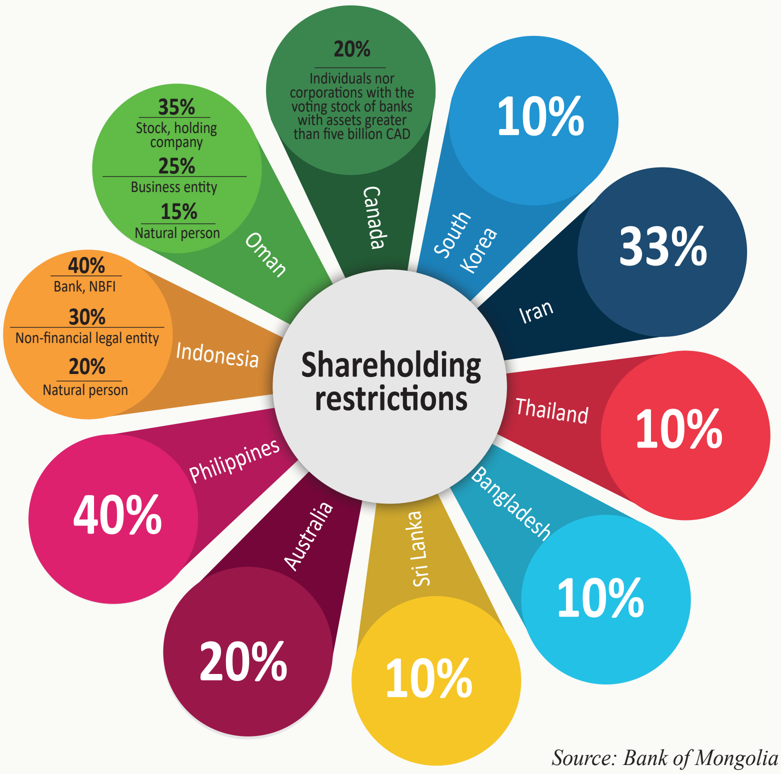
In the scope of banking reform, law and regulations such as the "Banking Law" and "Law on Central Bank" are expected to be amended. However, commercial banks will certainly need time before all the amendments come into effect. Furthermore, the representatives of the commercial banks agree that to avoid strangling the existing banks and to successfully carry the banking reform, the authorities need to enhance the domestic stock exchange market, improve financial literacy, create investment funds and activate the secondary market. Commercial banks will require time, plan and an in-depth research directed at diluting the current, highly concentrated three trillion MNT ownership concentration.

B.ERDENEKHUYAG
Director of the Legal Department's Legal Policy Division at the BOM.

"In international jurisdictions, if a bank does not comply with new requirements before the deadline, shares that exceed the regulatory limits will not have the right to vote and to receive dividends. Furthermore, a bank will not be allowed to open a new branch or unit, get the licenses on certain banking operations revoked and be forced to liquidate the bank shares."

The BoM intends to review stabilization and business plans submitted by the commercial banks and to formulate new rules, procedures, guidelines and methodologies in accordance with amendments to the laws. Therefore, the authorities are discussing about urging the banks to change the ownership to a joint-stock company and list their shares before a specified deadline. Further details regarding the amendments and enforcement of the law will be determined and drafted by the Parliamentary working group and standing committees.

One of the factors that spurred the global financial crisis of 2008 were serious deficiencies in the risk management and corporate governance of banks around the world. In response, international regulatory frameworks on banking supervision were revised. Prudent governance can be achieved only through a balanced management structure of the bank shareholders, board of directors and executive directors. However, when the economy expands, banks usually extend large amounts of loans to mining and construction sectors which tend to default



Source: Bank of Mongolia

> We need an answer to the following question: "Will we ever address the relatively loose governance and lack of competitiveness in the banking sector?"

in the face of macroeconomic turbulence. On top of that, executives tend to strive to get higher yields and bonuses in the short run, leading to operational instabilities in the long run. It can be said that with the current governance practices, our commercial banks have exhausted all possibilities of raising capital to comply with prudential ratios set out by BoM.

When it comes to raising capital, commercial banks have limited options such as raising capital by attracting foreign investors or splitting their shares. What is more, according to international standards, the banks must give utmost importance to the quality of Tier 1 capital, also known as common shares, in order to be listed on the stock market. By becoming a publicly listed company, opportunities to raise capital that meets the requirements set out by regulators will open up for commercial banks. For instance, a publicly listed bank can issue and trade bonds and certificates of deposit in the primary or secondary markets. That way the commercial banks will not face the sudden risk of losing customers and depositors, said B.Erdenekhuyag, Director of the Legal Policy Division at BoM.

Briefly put, the current reform in the banking sector is directed at diversifying bank ownership through public listing, ensuring prudent governance and facilitating long-term economic growth. ■

STOCK TRADING CONDITIONS

INDONESIA

40%

A shareholder with more than 40 percent shares in (local) banks' capital is obligated to list their shares till 20 percent within five years

CANADA

1-5

Thirty-five percent of the shares of banks with 1-5 billion CAD equity capital must be listed in any stock exchange registered in Canada

BANGLADESH

3 YEARS

Within three years after acquiring a banking license, a bank must issue public shares. The amount of public shares must be at least the same as investors' shares.

Supervision

Creating a preventive system to avoid wreaking havoc on banks

B.MISHEEL

Foundation for a healthy system

Banking is a business. A unique one, a vulnerable one. A bank's failure does not only put shareholders and investors, but also ordinary people's assets at risk and hamper the economy. Hence, the "health" of the banking sector needs to be ensured at all times. The Bank of Mongolia (BoM) has been gradually adopting an international risk-based and forward-looking supervision process and regulation in the banking sector.

The BoM's banking supervision is aimed at protecting the public interest, reducing risks and maximizing the benefits to the economy. Within that framework, the BoM has been gradually introducing the Basel Committee on Banking Supervision's Basel regulatory frameworks. The Basel framework plays an important role in ensuring good governance, effective supervision, capital and liquidity requirements.

Basel framework in Mongolia

Mongolia adopted the Basel I, requirements on capital adequacy, in 1996. The supervisory framework remained largely unchanged until the structural reform started under the IMF's Extended Fund Facility (EFF) in 2017.

Under the EFF Program, the BoM conducted an independent Asset Quality Review (AQR) in 2017. According to the results of AQR, seven commercial banks were below the capital requirements by 511 billion MNT. Even though the banks raised their capital the BoM announced that the recent capital injections were not permissible under the Law of Mongolia on Promotion of Economic Transparency. The AQR also revealed the bank's weak risk management system. The commercial banks mainly dispersed collateral loans but their collateral valuation did not meet international standards.

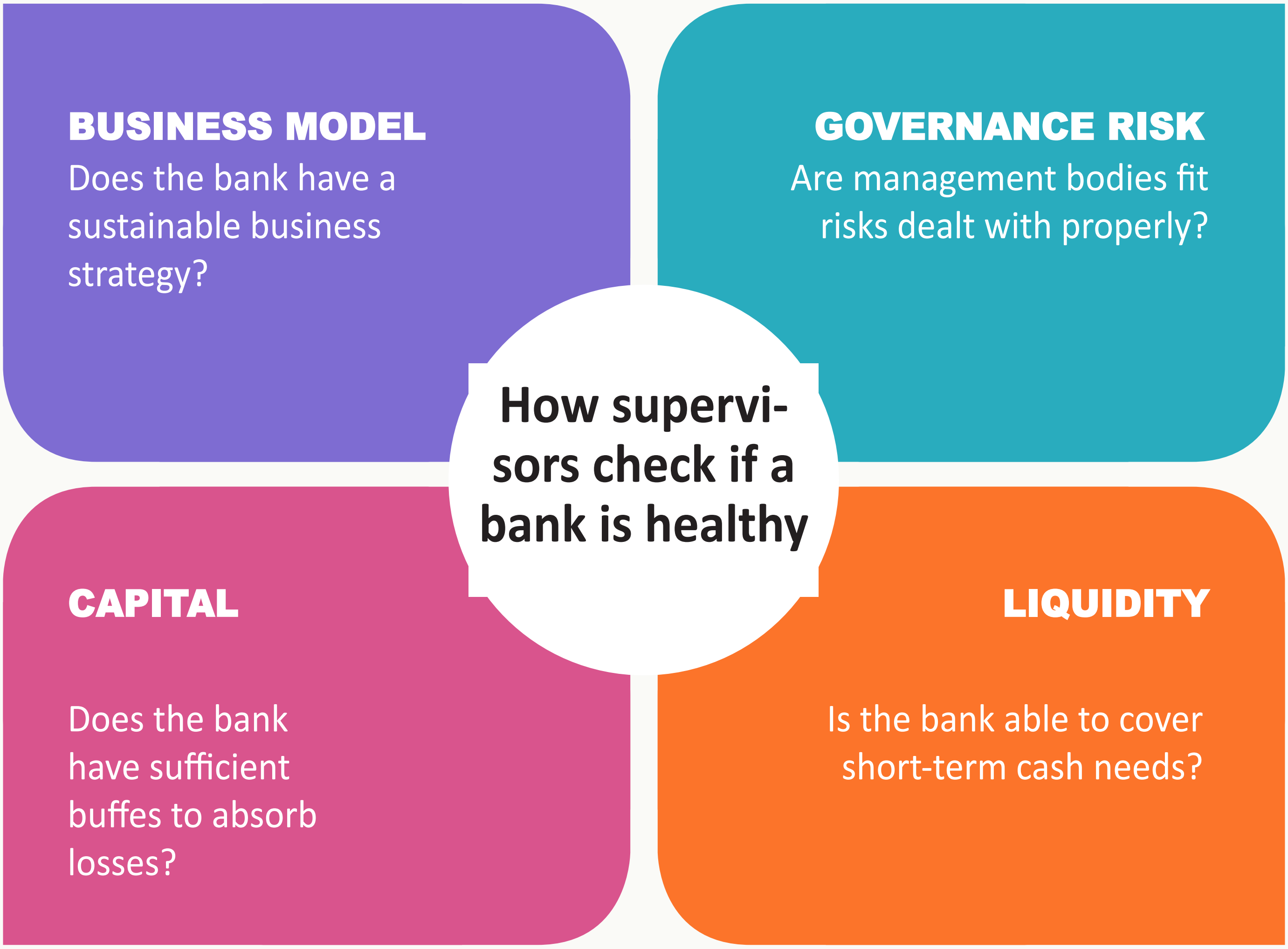
To address these issues in the banking sector, the BoM introduced a supervisory review process set out under Basel II framerok in 2017. In addition to the capital adequacy ratio, the BoM began requiring commercial banks to have a three-year plan and capital reserves which helped to ensure more appropriate capital to risk-weighted asset ratios. In terms of transparency, the BoM has made the bank's financial statements and other relevant information publicly available.

In the scope of the Basel III framework, the BoM has revised the "Regulation on setting and monitoring prudential ratios to banking operation". However, the commercial banks have not complied with the prudential requirements.

> The BoM's banking supervision is aimed at protecting the public interest, reducing risks and maximizing the benefits to the economy

Moreover, due to the COVID-19 pandemic, the deadline to meet the prudential ratios has been postponed. In order to shift to a risk-based and forward-looking supervision, the Banking Law and other related procedures were amended accordingly. That means the BoM has began shifting from compliance-based to a risk-based approach in supervisory functions.

The weak compliance with the measures to build a healthy and reliable banking system is holding the banking reform back. The Policy Notes for the Government of Mongolia prepared by the World Bank indeed pointed out that "Certain aspects of the legal framework undermine the independence of the BoM, thus weakening supervision." Furthermore, the World Bank stressed that "The general legal framework should be reviewed to ensure there is no interference while exercising regulatory and supervisory functions. BoM should be allowed to impose supervisory requirements and all enforcement measures directly. ▶



Source: Basel Committee

In addition, registration of the BoM's regulations by the Ministry of Justice should be strictly limited to ensuring conformity with higher laws, without allowing banks to lobby for changes. Finally, legal protection for supervisors should be significantly strengthened to prevent any potential intimidation of supervisory staff by banks."

It is important to stress that participation of public authorities, banks, professional associations and citizens are critical in strengthening the banking supervision. On one hand, the BoM needs to be careful in conducting subjective reviews in accordance with new requirements and frameworks. On the other hand, the banks must comply with their obligations and take the right measures based on risk assessment. Furthermore, public participation is one of the important components of the banking supervision. For instance, citizens should make their risk assessment based on available information before investing in commercial banks.

In short, all participants of the financial sector including the central bank, commercial banks and customers need to take responsibility in ensureing successful implementation of the banking reform. ■

First Deputy Governor

G. Dulguun: Healthy and reliable banking system is critical for financial stability

Mongolian Economy Magazine spoke with G. Dulguun, First Deputy Governor of the Bank of Mongolia

-In terms of shifting to risk-based banking supervision, what is the Bank of Mongolia mainly focusing on?

-One of the pillars of a healthy and reliable banking sector is the policy tools of the regulatory bodies. Following the international standards and global trends, the Bank of Mongolia (BoM) has been focusing on the following goals in order to shift to risk-based supervision:

1) *Improving regulatory environment;*

2) *Adopting international best standards on banking supervision while reflecting the country's distinctive characteristics and ensuring conformity with domestic laws;*

3) *Capacity building for supervisors and specialists.*

The macroeconomic and monetary policies outlined in the Monetary Policy Guidelines for 2021 are designed to ease the negative impact of COVID-19 on the economy and financial sector, to reduce the risks in the banking system and to ensure the continuity of financial intermediation. To provide financial stability, the BoM decided to adopt countercyclical instruments, maintain an adequate level of risk tolerance, strengthen supervisory and regulatory environment and modernize the legislations.

Regulatory amendments play a crucial role in shifting from performance-based supervision to a risk-based system. This shift did not only allow the banks to avoid risks and take preventative measures but also set the conditions for protecting the rights and interests of customers in the financial sector.

Moreover, the BoM will gradually keep introducing international standards such as the standards set out by the Basel Committee on Banking Supervision, International Financial Reporting Standards, International Valuation Standards, IT Audit Standards.

-How are you collaborating with the commercial banks in terms of improving their internal control, assessment and management?

-In the scope of risk-based supervision, the BoM is collaborating with international organizations and advisors to explore prospects of introducing the ICAAP (Internal Capital Adequacy Assessment Process) and ILAAP (Internal Liquidity Adequacy Assessment Process) which will be used in reviewing the internal assessment submitted by commercial banks. As a matter of fact, the internal control of banks has substantially improved in recent years.

The board committees of banks carry out auditing and supervisory activities through related departments and units. Thus, the BoM began adopting international principles of good governance in operational standards and requirements for both board committees and executive boards. Within this framework, we have started looking deeper into international standards and regulations intended to ensure good governance.

-How do you plan to ensure the implementation of the "Strategy for reducing lending rate"?

-The BoM alone cannot achieve the goals set out under the "Strategy for reducing lending rate." It is important to note that the multilateral cooperation of legislators, enforcement agencies, financial regulatory bodies, commercial banks and financial institutions is inevitable for achieving the desired results. Therefore, the BoM has been taking measures under the following policy guidelines:

- *Achieving macroeconomic stability, ensuring fiscal discipline and improving the coordination of macroeconomic policies;*
- *Reducing the cost of credit risks;*
- *Reducing the bank's operational costs;*
- *Developing stock exchange market and reducing the cost of funding through stronger competition;*
- *Modernizing the regulations related to the terms of contracts that alliviate the cost of fundings and effective enforcement of collateralized debt obligations through judicial and non-judicial proceedings.*

The regulatory framework for protecting customer's rights should not be left behind. Thereby, to protect the rights of customers in the financial sector, the BoM is working on the formulation of the draft law for introducing faster and effective non-judicial dispute resolution which will be discussed at the Parliamentary session. ■

International cooperation

Extended Fund Facility and future cooperation

Photo from the meeting between the representatives of the IMF and Mongolian authorities held on February 19, 2017, in Ulaanbaatar (Source: AFP)

T.SARANGUA

On February 14, 1991, Mongolia joined the International Monetary Fund (IMF), an organization that has been pulling Mongolia from the edge of economic downturn. In the past 20 years, the IMF has provided a total of six financial arrangements to Mongolia. The last financial arrangement was the Extended Fund Facility (EFF) designed to provide assistance to countries experiencing serious payment imbalances because of structural impediments or slow growth and weak balance of payment positions. The three-year EFF program that disbursed 434 million USD, expired on May 23, 2020. In the context of the EFF, Mongolia made considerable progress in terms of macroeconomic goals and overachieved goals for foreign exchange reserves.

Results of the Extended Fund Facility

At the time of approval of financial assistance under the EFF, Mongolia was on the verge of economic downturn and sovereign default.

From 2015 to 2016, Mongolia experienced a sharp decline in commodity prices and foreign direct investments. Thus, the Government of Mongolia had to cover the budget deficit through domestic and external financing arrangements. Furthermore, the debts amounting to 2.5 billion USD were due in 2016. By the end of 2016, Mongolia had a large fiscal balance of payment deficit, high public debt burden and weak financial sector.

Under the EFF, the Government achieved fiscal consolidation by taking a series of measures to reduce the fiscal deficit and restore short and long-term debt

Cooperation between the International Monetary Fund and Mongolia

1	1991.10.04.	To resolve the weak balance of its payment position, the IMF approved a Standby Arrangement with 13.75 million Special Drawing Rights (SDR). Between 1991-1992 Mongolia received loans amounting to 20 million USD with a 6.5 percent interest rate.
2	1993.06.25.	To resolve the weak balance of its payment position, the IMF approved an Enhanced Structural Adjustment Facility with 40.8 million SDR which is equivalent to 59 million USD with an interest rate of 0.5 percent . From 1993 to 1996, Mongolia has drawn 44.8 million USD.
3	1997.07.30	To correct macroeconomic imbalances and support structural reform, for the second time, the IMF approved the Enhanced Structural Adjustment Facility with 33.4 million SDR, a lending amount equivalent to 48 million USD with an interest rate of 0.5 percent. Between 1997-2000 Mongolia received loans amounting to 23.7 million USD.
4	2001.09.28.	The IMF approved a new financial arrangement, Poverty Reduction and Growth Facility, with 28.49 million SDR and a lending quota of around 36.9 million USD.
5	2009.04.01.	With an aim to ensure economic stability, the IMF approved a Standby Arrangement allocating 153.3 million SDR equivalent to a lending quota of 229.2 million USD.
6	2017.05.24	The IMF approved the Extended Fund Facility which was established to provide assistance in overcoming economic problems and ensuring macroeconomic stability. Under the Extended Fund Facility, the IMF allocated 314.505 million SDR equivalent to a lending quota of 440 million USD.

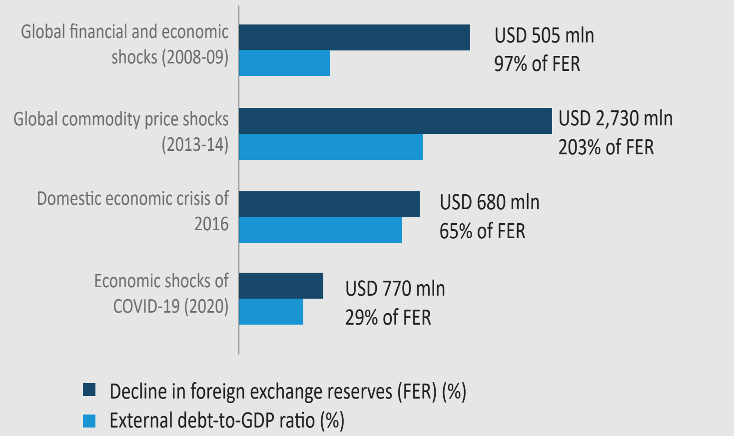
sustainability. For instance, the fiscal deficit dropped to 6.4 percent of GDP in 2017 and the fiscal balance was restored by 2018.

During the implementation of the project, Mongolia received financial assistance of 217 million USD from IMF and 1.4 billion USD from other donor organizations. The financial arrangements provided by international organizations enabled Mongolia to resolve economic difficulties within a short period. Eventually, it led to macroeconomic stability and helped to restore the confidence of both investors and businesses in the domestic market.

In 2017, the Government of Mongolia issued the "Khuraldai" bond worth 600 million USD with a rate of 8.8 percent and a "Gerege" bond worth 800 million USD with a rate of 5.6 percent in the international market to refinance the "Chinggis", "Dim Sum" and Development Bank of Mongolia's bonds which total 1.2 billion USD.

Furthermore, to ensure the stability of the financial sector, (i) the Law on Central Bank, (ii) Banking Law, (iii) Law on Deposits, Loans and Banking Transactions, (iv) Law on Combating Money Laundering and Terrorism Financing have been amended accordingly. The BoM selected the

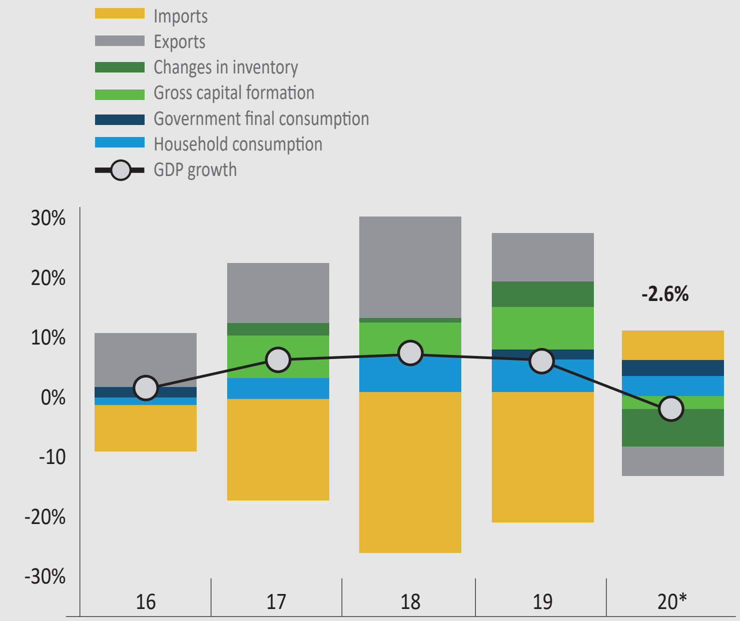
External sector statistics during the past crisis



Source: Bank of Mongolia

**Due to the past economic shocks, the foreign exchange reserves dropped by 39-67 percent whereas the external debt-to-GDP ratio expanded by 19-38 percent.*

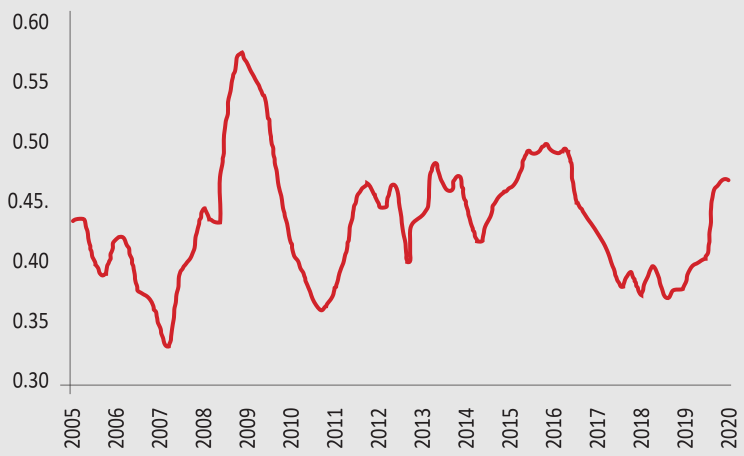
Economic forecast



Source: Bank of Mongolia

PwC Czech Republic to conduct the Asset Quality Review (AQR) on commercial banks in Mongolia. Following the AQR, the BoM called on commercial banks to comply with capital requirements within the allocated time frame. To verify the appropriateness of

Financial risk indicator



Source: Bank of Mongolia, Financial Regulatory Commission

Note: Larger numbers indicate higher risk in the financial system

recent capital injections, the Duff and Phelps Singapore PTE LTD conducted an independent forensic audit on six commercial banks.

The aforementioned measures, taken in the scope of the EFF program, carried significant importance to Mongolia as it improved the credit risk management of commercial banks. Despite the fact that fiscal policy measures set out in the EFF were successfully carried out, the measures to achieve financial stability have not been completed yet.

After the Extended Fund Facility

The IMF expects the current economic downturn caused by the COVID-19 to be deeper and longer-lasting than the global financial crisis of 2007-2009. Compared to advanced economies, emerging markets and developing economies, excluding China, are projected to experience even deeper economic contraction. In addition, the IMF expects Mongolia's GDP to contract by two percent in 2020.

After the COVID-19 outbreak, the economic growth slowed down and all sectors except agriculture, IT, communications and mining sectors have been hit hard. Furthermore, due to the lower production of raw materials, except for gold and iron ore, the mining sector shrunk by 29.4 percent. The coal exports which started recovering from the second half of 2020 and higher grade golds exploited at Oyu Tolgoi Mine are likely to boost the economy. Nevertheless, the economy is highly likely to contract because of extended border restrictions and uncertainty over the COVID-19 pandemic.

On top of the gloomy economic forecast, the COVID-19 pandemic has placed the financial system under a strain. As of June 2020, the banking sector which holds around 90% of the total financial sector assets incurred a total loss of 61.3 billion MNT.

The BoM and Government of Mongolia were tasked to continue measures to overcome the COVID-19 crisis, ensure compliance with the prudential requirements that started under the IMF program and reduce systematic risks. Therefore, our policymakers have begun implementing the "Banking Sector Reform Program". Even though the deficiencies in fiscal and financial systems were improved in the past three years, Mongolia would still require support from international financial institutions. ■

N. ARIUNBAT
Director General of Banking Resolution and Policy Department at Bank of Mongolia

Amid the COVID-19 restrictions and border closures around the world, the IMF approved 99 million USD disbursement under the Rapid Financing Instrument to Mongolia to address economic downturn, finance the fiscal gap and cover the balance of a payment deficit in May 2020. This emergency financial assistance is expected to catalyze further donor supports.

The policy reforms initiated during the implementation of the EFF program will be continued once the economy begins to recover from the impacts of the COVID-19 pandemic. Furthermore, Mongolia could extensively cooperate with international organizations in increasing foreign exchange reserves, improving supervision and monitoring of commercial banks and strengthening enforcement mechanisms to ensure banks have sufficient capital."

Grey list

Cure for the grey list is a cooperation

N.ENKHBAYAR

The Financial Action Task Force (FATF) was established by the G-7 Summit which was held in Paris in 1989. The Recommendations issued by the FATF are regarded as international common standards for combating money laundering and financing of terrorism and proliferation. The FATF places jurisdictions that are not effectively implementing the FATF Recommendations on the grey list and calls on these countries to complete their agreed action plans to improve their anti-money laundering and combatting financing of terrorism (AML/CFT) regimes. Mongolia joined the Asia/Pacific Group on Money Laundering (APG) in July 2004. The Financial Information Unit at the Central Bank of Mongolia (BoM) represents Mongolia in all activities related to the APG.

Building up our immunity

To implement the FATF Recommendations and to be in compliance with the standards issued, Mongolia utilized the efforts of competent authorities. Mongolia has fulfilled all the requirements to be removed from the grey list by addressing the technical deficiencies and creating an effective regime to combat money laundering and financing of terrorism. Thus, the decision to remove Mongolia from the grey list was officially made at the virtual meeting of the FATF Plenary on October 23, 2020.

Mr. B.Batbaatar, Head of the Financial Information Unit at the BoM, stated "After placing Mongolia on the grey list in October 2019, Mongolian authorities have demonstrated significant progress and as a result, the FATF announced that Mongolia has completed its action plan on June 30, 2020. The International Co-operation Review Group (ICRG) highly recognized Mongolia's efforts for successfully addressing its action plan items within only eight months. The key to this success was the importance given by the high-level authorities to the implementation of the action plan and active cooperation among government institutions. Also, of course, professional associations and private institutions have made their valuable contribution to the progress made."

Money laundering and financing of terrorism imposed a threat to the stability and reliability of Mongolia's financial system. The sectors that have been identified as being the most vulnerable to money laundering were the banking and real estate sectors. In addition, the sources of funding and assets for banks and non-banking financial institutions were subject to a money laundering risk.

The financial services and products that are most vulnerable to money laundering and financing of terrorism are cash transfers and cash transactions. Therefore, the BoM addressed those risks in the fourth goal of the "Banking Sector Reform Program". This fourth goal also includes other measures such as (i) supporting the correspondent banking relationship of commercial banks, (ii) establishing a regulatory framework for adopting new technologies in the financial sector in accordance with FATF's Forty Recommendations, (iii) strengthening control and monitoring over sources of funds and assets, (iv) facilitating international cooperation and information exchange with foreign counterparts and (v) ensuring a healthy, stable and reliable financial system. ▶

Prevention from falling into the grey pit

Since included in the list of jurisdictions having strategic AML/CFT deficiencies or so called grey list, Mongolia was given with six action plan items under four immediate outcomes set out by the FATF.

Within the framework of implementing the action plan, the BoM has jointly conducted research, training, discussions over the proliferation of mass-destruction weapons with commercial banks in Mongolia. Furthermore, the collaboration between BoM and law enforcement authorities in combating money laundering was strengthened through measures based on collective risk assessments and information exchange. Owing to the training and workshops provided by the BoM, the commercial banks gained an in-depth understanding of international standards, the main focus of the international review groups and requirements on correspondent banking.

"In order to move forward, not only the government authorities but also the private sector institutions should be aware of the changes in the FATF standards and everyone should understand their importance. Only such a system will have progress. Through our achievement, we have successfully demonstrated that public and private sectors can effectively work together and exchange information. Further continuing this progress will help prevent us from being grey listed again." said Mr. B. Batbaatar, Head of the Financial Information Unit at the BoM.

The unprecedented cooperation between public and private parties was one of the significant achievements in the banking and financial sector. Following the FATF's decision to place Mongolia on the grey list, some foreign banks and financial institutions suspended their relationship with Mongolian counterparts. These foreign banks refused to provide their services and increased and delayed the cost of international money transfers. Moreover, it had a negative impact on trade finance and foreign investment in the private sector.

Since the FATF has officially removed Mongolia from the list of jurisdictions with strategic AML/CFT deficiencies, our banks will inform other foreign banks and financial institutions that there is no risk in resuming business with Mongolia. Upon request, the foreign banks will make their own assessments. All the negative impacts of being listed on the grey list are expected to be offset by the end of this year. ■

Interview

G. Enkhtaivan: Mongolia will not fall into the grey list again if we fix the flaws

Mongolian Economy Magazine spoke with G. Enkhtaivan, Deputy Governor of the Bank of Mongolia, about measures taken to remove Mongolia from the FATF's list of jurisdictions with strategic anti-money laundering and combatting financing of terrorism (AML/CFT) deficiencies.

-What measures set out under the FATF Recommendations have been implemented?

-Mongolia was added to the list of jurisdictions with strategic AML/CFT deficiencies, so to speak "grey list," by the Financial Action Task Force

(FATF) in October 2019. The FATF set out 40 recommendations to combat money laundering and terrorist financing and 11 immediate outcomes to assess their effectiveness. Whereas, Mongolia was tasked to prioritize six action plan items for four Immediate Outcomes.

It is an honor to say that the FATF Recommendations have been implemented successfully with the close collaboration of the Government, Bank of Mongolia, Financial Regulatory Commission, private institutions, professional associations and other public authorities. The working group which was established under the Prime Minister's order submitted their report on the considerable progress made by Mongolia in April 2020. The report was presented at a virtual meeting with the FATF experts in May 2020. Based on the significant progress we have made, the FATF concluded that Mongolia has completed its action plan and warranted an on-site visit assessment as part of the exit process from the grey list.

The restrictions imposed during the pandemic had heavily impacted the scheduled on-site visits of FATF's assessment team to Mongolia. Therefore, upon the request submitted to the President of the FATF by the Finance Minister and Governor of the Bank of Mongolia, the assessment team managed to conduct their assessment in Mongolia between October 1st to 2nd of 2020.

-Could you elaborate on action plan items on four immediate outcomes given by the FATF?

-At first, two action items on Immediate Outcome 3 are on the licensing, regulating, and supervising designated non-financial businesses and professions. The Financial Regulatory Commission of Mongolia was the main responsible body in charge of implementing this action item. The second one is the detection of the physical cross-border transportation of falsely/non-declared currency by improving the declaration system at border crossings. Thereby, the Minister of Finance and Customs General Administration of Mongolia have successfully addressed this action item by revising the related policies and procedures to improve the declaration system. The next action item is to conduct money-laundering investigations and prosecutions in a timely and transparent manner. The law enforcement authorities and judicial bodies have made significant progress in that regard. The action items on fourth recommendation is to adopt related laws and procedures to implement targeted financial sanctions pursuant to the United Nations Security Council's Resolution.

Owing to collaborative efforts, Mongolia has addressed all the action plan items to be removed from the grey list. On October 13, 2020, during the virtual meeting of International Co-operation Review Group (ICRG), the all FATF member jurisdictions and organizations have agreed to remove Mongolia from the list of jurisdictions with strategic AML/CFT deficiencies and Mongolia was officially removed from the grey list at the virtual meeting of the FATF Plenary held on October 23, 2020.

-To avoid falling into the grey list again, what measures must be taken?

-Mongolia was added to the grey list, not because of one organization or individual. Combating money laundering and financing of terrorism is indeed a systematic problem. The system will work only if both public and private sectors and professional associations cooperate together to address the flaws. All transactions of a financial nature in Mongolia must be recorded.

Legal entities such as banks, non-banking financial institutions, security traders, real estate agents, insurance companies, lawyers, notaries, accounting and financial advisory service providers are required by the law to undertake customer due diligence and report promptly any suspicious transactions that might be related to money laundering and financing of terrorism and proliferation to the Financial Information Unit at the BoM.

In short, to protect the integrity of our financial and economic systems, the financial and non-financial business activities should be properly regulated and monitored. Furthermore, a record of all transactions must be kept and records must be available to domestic competent authorities upon request. So that, we can build a robust national system against money laundering and financing of terrorism by identifying and assessing the sectoral risks and taking appropriate measures. ■

Inclusive sector

Goal to diversify

T.SARANGUA

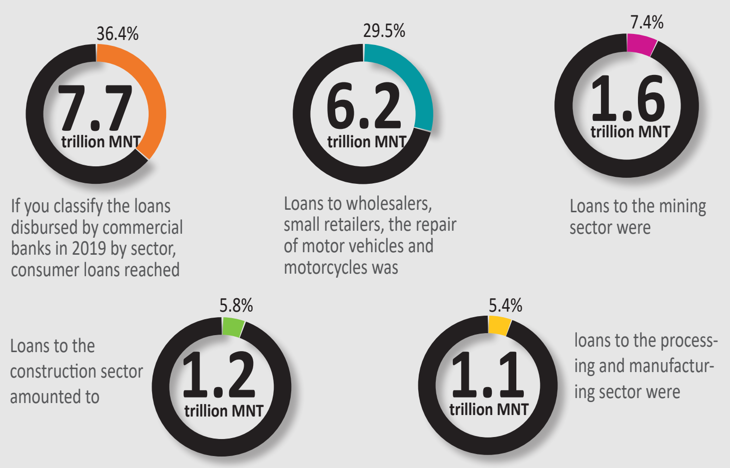
Commercial banks in Mongolia compete with each other with their services and products that meet customer needs.

In 2019, the consumer loans provided to wholesalers reached 7.7 trillion MNT (36.4%) to wholesale. Loans to small retail businesses and for the repair of motor vehicles and motorcycles were 6.2 trillion (29.5%). Loans issued to the mining sector was 1.6 trillion MNT (7.4%), loans to the construction sector amounted to 1.2 trillion MNT (5.8%) and loans to the processing sector were 1.1 trillion MNT (5.4%). The above loan portfolio shows the commercial banks' failure to contribute and drive the economic growth and development of the country. Moreover, it also reveals the fact that banks might be at risk of insolvency due to large income losses and economic contraction caused by the COVID-19 crisis.

Transforming our business model

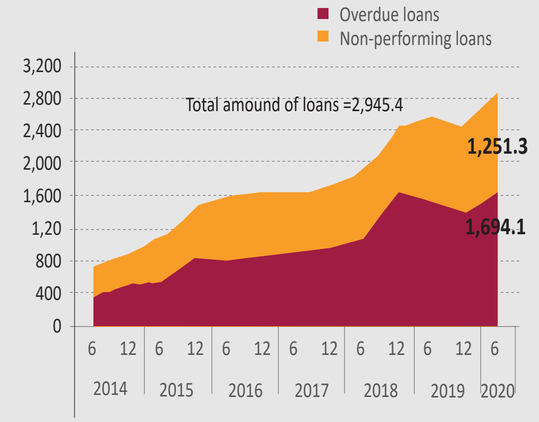
N.Enkhbayar, economist and former advisor to the Prime Minister of Mongolia, emphasized the fact that Mongolia will have an opportunity to expand the economy, support businesses and increase bank capital only after diversifying banking services and products and directing bank loans to large scale development projects.

Bank loan portfolio by sector (2019)



Source: National Statistics Office

Outstanding amount of overdue and non-performing loans (billion MNT)



Source: Bank of Mongolia

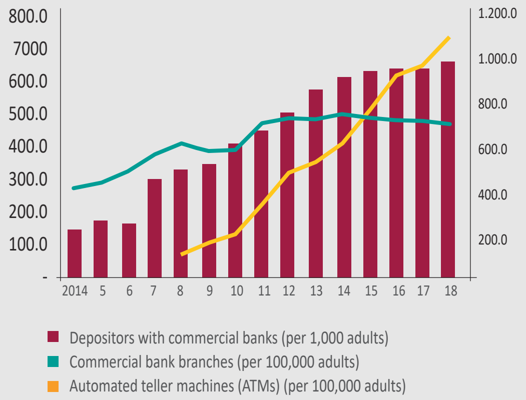
Today in Mongolia, there are twelve commercial banks that are operating under similar business models and offering almost identical products and services. Whereas, in other countries, not only banks but also investment funds and financial institutions offer a wide range of financial services. Therefore, the Bank of Mongolia (BoM) is considering the possibility of specializing or diversifying the operations of banks in Mongolia. For instance, the banks could start financing large projects, supporting small and medium enterprises, or offering mortgage loans. In some countries, there are banks that provide their financial services to citizens, small and medium enterprises at specific geographic locations, regions, provinces and even in isolated areas with the purpose of improving their access to financial services and accelerating economic growth.

Under the upcoming banking reform, the authorities are aiming to (i) ensure the adequacy of the regulatory framework and (ii) create a digital and inclusive banking system. Furthermore, legislators are planning to diversify the requirements for banking licenses based on their business models and areas of specialization.

Digitalization

One way to diversify the banking and financial sector is the adoption of financial technology or so-called ▶

Financial inclusion indicators



Source: Bank of Mongolia

Fintech. The fourth industrial revolution is accelerating the introduction of Fintech in Mongolia and around the world. To illustrate, LendMN NBFI's LendMN, Ard Credit NBFI's Ard and Mobifinance NBFI's Monpay apps offer digital financial services in Mongolia.

In order to increase financial services based on Fintech, the BoM has designed a policy and regulation necessary to create core infrastructure for Fintech companies. Adoption of the Law on National Payment System can be given as an example of BoM's past efforts to ensure the stability, reliability and efficiency of the non-cash payment.

In terms of digital transformation, commercial banks are taking a leading role in the private sector. In Mongolia, 90 percent of payments and transactions are made through payment cards, mobile apps, digital and internet banking.

The only outdated aspect of the banking sector is being physically present at a branch to sign documents. With the support of the Asian Development Bank, BoM is implementing the "Payment System Modernization Project" for the purpose of replacing physical signatures with electronic ones. BoM has already purchased and installed a digital signature system. The system will be put in use after connecting with the National Data Center's digital signature system and getting authorizations.

Under the banking sector reform program, the authorities plan to introduce RegTech, a technology for regulatory monitoring, reporting, and compliance. Within this framework, the BoM began receiving bank reports and information online through the Financial Auditing System. The largest banks in the world are putting together an IT team to adopt the RegTech. As a matter of fact, these software systems can be modified so as to make them suitable for that specific organization or country. ■

TS. NARANDALAI
Acting Director of the Supervision Department at Bank of Mongolia

To grant more diversified banking licenses, we need to determine ownership types and operational scope of banks by conducting research on possibilities of setting up different types of banks while taking our distinctive economic and financial characteristics into account. Furthermore, we need a policy and plan to ensure a regulatory environment for different types of banks, formulate the new requirements for banking licenses, set up suitable prudential ratios and supervisory standards."

A. BATSAIKHAN
Director of Payment Systems Department's Policy and Operation Division at BoM

The most important article on security and secrecy of personal data is an article that prohibits the disclosure of any information which is considered by its customers as "confidential" in the Banking Law. Furthermore, the Law on National Payment System contains an article prohibiting disclosure of a customer's name, account number, transaction and payment amount by all parties in the payment system. A natural person that violates the law by disclosing a customer's information, will be subject to a fine under the Law on Infringement whereas legal entities will be subject to large fines and executives will face criminal charges. Banks are not allowed to disclose information on transactions made through one of the financial institutions to a third party. Also, banks are banned from using any information from customer transactions for the purpose of advertising and marketing. These regulations apply to Fintech companies that are newly entering the financial market as well."

Interview

A. Enkhjin: Providing long-term financing to enhance export diversification

Mongolian Economy Magazine spoke with A. Enkhjin, Director of the Reserve Management and Financial Markets Department at the Bank of Mongolia

-To what extent is the Bank of Mongolia cooperating with the Government to increase foreign exchange reserves which play an important role in reducing the cost of funding?

-Since 2014, the Bank of Mongolia (BoM) started offering long-term swap agreements to banks. This was done so as to increase foreign exchange inflows, reduce interest rates, slow the growth of foreign currency loans and manage foreign exchange risks. Until the first half of 2020, the BoM has signed long-term swap agreements worth 3,279.3 million USD.

Following the COVID-19 outbreak, the BoM and the Government of Mongolia adopted soft monetary and fiscal policies and have been taking a series of measures to support economic growth. Within this framework, the Bank of Mongolia reduced its policy interest rate by three percentage points to eight percent and took the necessary macroeconomic policy measures.

In addition, the BoM has been independently and continuously ensuring the purchase of gold. For instance, the BoM is aiming to purchase 20 tons of precious metals in 2020 and to break the record of 22 tons. Furthermore, in order to increase gold production, we started providing preferential financing to local gold mining companies through commercial banks with the cooperation of the Ministry of Mining and Heavy Industry. At the end of August 2020, the gold purchased and exported by the BoM reached 1,147 million USD which is 802 million USD or a 233 percent increase compared to the same period the last year.

The BoM set out an aim to diversify the economy by supporting non-mining exports and small and medium enterprises, enhance economic growth, improve financial markets, increase loan disbursement during the COVID-19 pandemic and reduce interest rates. To achieve this goal, the BoM is planning to provide long-term financing to commercial banks through the purchase of loan-backed securities.

In September 2020, the Monetary Policy Committee set the fund rate to be 8.5 percent with a term of up to two years. This means that commercial banks will have an opportunity to borrow from the central bank at 8.5 percent and lend at 11-12 percent. This measure is expected to provide considerable support to companies that create new jobs and earn in foreign currency.

-Mongolia's external debt has reached 30.8 billion USD. With a debt of this size, it is doubtful whether the costs of funding can be reduced and credit ratings can be improved. What will be the role of the BoM in ensuring proper debt management?

-As of May 2020, the rating agencies namely Fitch, Moody's and S&P's credit ratings for Mongolia stand at "B", "B3" and "B" respectively. Except for Fitch and S&P credit ratings, Moody's downgraded its rating to "B3" and the outlook to "negative".

The fact that Mongolia's credit rating remained unchanged when rating agencies have been downgrading most country's credit ratings shows the effectiveness and adequacy of macroeconomic policies. Not only is the shock on Mongolia's economy temporary, but also the economic recovery is expected to be sharp and the debt to GDP ratio is projected to decline in 2021. Moreover, with the purpose of financing bond repayments, the Government decided to issue new government bonds amounting to 600 million USD at a 5.1 percent rate which is a relatively low rate in the international market. This will not only reduce Mongolia's short-term debt burden and have a positive impact on the flow of foreign currency but also improve the credit rating agency and investor's expectations.

-Exchange rate expectations affect dollarization. Higher expectations on dollarization might pose a major challenge in achieving monetary policy objectives. In that case, what measures and regulations are you planning to take?

-Dollarization occurs in relatively stable economies when there is an expectation for higher use of foreign currency or inflation and weaker national currency. Therefore, in addition to taking measures in order to stabilize the macroeconomy and keep inflation low, the BoM will ensure the enforcement of the "Law on Payments in National Currencies" and increase foreign exchange earnings from the activities of state and state-owned legal entities. Furthermore, the BoM has set varying purchase and reserve requirements based on the currency type, reduced MNT reserve requirements based on foreign currency current accounts and deposits and concluded long-term swap agreements with commercial banks. ■

Interview

B. Bayardavaa: Investment returns can be improved through lower interest rates

Mongolian Economy Magazine spoke with B. Bayardavaa, Director of the Monetary Policy Department at the Bank of Mongolia.

-Strategy and plans to reduce lending rate have been approved. The implementation of the strategy is attracting public attention. Would you mind explaining the upcoming reform in the banking sector?

-It is not possible to reduce interest rates by merely passing a law. In order to ensure macroeconomic stability, the fiscal, monetary and financial regulatory policies and measures should be aimed at ensuring the medium and long-term stability of the economy and financial system. Economic stability plays a critical role in reducing the cost of funding, base interest rate and improving credit ratings.

On the one hand, economic stability will allow Mongolia to increase the flow of foreign investments and financing. This will lead to lower external benchmark rates. Therefore, Mongolia should focus on improving the credit rating from its current "B" level. On the other hand, it is important to work with factors that are absorbed into the interest rate as a cost. The strategy to reduce interest rates includes proposals to amend 17-18 laws on banking and finance. We are working to submit the draft laws to Parliament this autumn.

-How to reduce the base interest rate and what are the main interest expenses?

-Base rate is determined by internal and external factors. Domestic base rate can be lowered by reducing and keeping inflation rates, which determines the purchasing power of the national currency, at low levels. Therefore, the monetary policy target has been redefined to keep the inflation rate at 6 percent with a fluctuation of +/- 2 percent. External base rate is the cost of raising funds from the international financial markets which largely depends on our country's credit rating. Mongolia has issued Nomad Bond with 5.125 percent annual rate of return to refinance the previous high-yield bonds.The rate of return can be lowered only by upgrading the credit ratings.

In order to continue the financial intermediation of banking and financial institutions, the banking system needs to be strengthened and needs to be more resilient. In terms of the budget, stability of the country's external and domestic debt must be ensured. This will restore investor confidence and lower external cost of funding. Moreover, it leads to less policy adjustment from monetary side and provide more room for expansion in private sector.

-How was the risk of external factors affecting the macroeconomy calculated?

-The year of 2020 was a challenging year with global economic contraction, financial hardships, falling export revenue and lower flow of foreign currency. These challenges are likely to remain in some part of the next year. Even though we do not have a favorable external environment to reduce interest rates in 2020-2021, we must turn this into our advantage. In other words, we are working to expand the scope of financial intermediation, strengthen the banking and financial sector, and speed up litigation procedures related to non-performing loans. That will enable us to lower interest rates or at least avoid interest rate hikes during unfavorable time period.

-What will be the challenges of implementing a strategy for reduceing lending rates when the economy starts recovering and growing rapidly after the pandemic?

-According to the Bank of Mongolia, the macroeconomic stability is attainable if the economic growth is around five percent in the medium run. Furthermore, businesses will have a relatively favorable macroeconomic environment when inflation and real growth reach six and five percent respectively. This will help to reduce interest rates or the cost of private and domestic financial intermediation.

To achieve macroeconomic stability in Mongolia, a country whose economy is highly dependent on the external environment, we must ensure coordination between fiscal and monetary policies and financial regulations.

-Some economists say that measures to reduce interest rates including the reduction of bank ownership concentration may have a negative effect on the banking sector which is a critical sector for the post-pandemic recovery. What are your expectations?

-I do not think that the measures will have a negative impact. Lower interest rates will certainly lead to higher investment flow and returns. Not only will the bank's businesses expand and financial deepening increase, but also the quality of loans will improve. Lower ownership concentration has a positive effect on the relationship between shareholders and executives and creates good governance. ■

Foreign bank

Is the entry of foreign banks good for Mongolia

G. BORKHUU

Foreign banks, financial institutions, or legal entities that complied with the requirements set forth by domestic rules, procedures and laws can submit their application to set up a bank in Mongolia to the Central Bank (Thereafter "Bank of Mongolia").

Generally, the same requirements are applied to both foreign and domestic legal entities. However, there are a few additional requirements for legal entities with foreign investments under the "Law on Foreign Investment of Mongolia" and "Regulation on Authorization for Incorporation of the Bank and Its Unit". For instance:

- A prior approval for a foreign state-owned bank to establish its subsidiary in the territory of Mongolia has been granted by the Government and Bank of Mongolia;
- a foreign bank must be rated as one of the safest banks in the world in terms of its assets and credit ratings;
- a foreign bank must not have engaged in any prior criminal records or have incurred financial or payment difficulties in the past;
- a foreign bank must open a representative office in Mongolia at least one year in advance of submitting an application to set up a bank with the Bank of Mongolia;
- a foreign bank must cooperate with the home supervisory authority of the Bank of Mongolia.

So far, the Bank of Mongolia has granted a permission to open a representative office in Mongolia to six foreign banks: (i) the Standard Chartered PLC, (ii) ING Group, (iii) Bank of China, (iv) Industrial and Commercial Bank of China, (v) Mitsubishi UFJ Financial Group and (vi) Sumitomo Mitsui Banking Corporation. All the aforementioned banks' representative offices are still open except for Standard Chartered PLC and ING Group.

Opportunities and risks

The impact of foreign banks on the domestic financial system depends on a wide range of factors such as (i) the host country's development of banking and financial sectors (ii) the effectiveness of the regulatory framework (iii) the foreign bank's business line (iv) the corporate structure and (v) capacity of supervisory authorities of their home country. People are generally divided into two camps on foreign bank entry, financial deregulation and financial regulation. The former is in support of ensuring sustainable economic and financial growth by restricting state regulation over foreign bank operations. The latter suggests that emerging countries with financial systems not yet capable of dealing with risks, should avoid granting a license to foreign banks or impose restrictions and requirements to maintain their financial stability. Both concepts offer opportunities and risks which can be outlined as follows. ▶

Opportunities

1. *Increase in a long-term investment flow;*
2. *Higher chances of obtaining long-term investments for projects that cannot be financed through domestic banks or financial institutions;*
3. *Incentivizes banks and financial institutions to cut costs in response to fierce competition with foreign banks;*
4. *Increase in loan disbursements and low-cost financing options for businesses;*
5. *Improves productivity through the introduction of new technologies, products and services;*
6. *Higher availability of funding to foreign banks from their head offices or other branches.*

Risks

1. *The domestic financial market becomes more vulnerable to global financial shocks;*
2. *Lower availability of financial services such as loans and financing options due to sudden closure of foreign banks;*
3. *Higher systematic risk due to the foreign bank's cyclical behavior;*
4. *Domestic banks and financial institutions are pushed out of the market due to relatively cheaper financing options, advanced services and products offered by foreign banks;*
5. *Impairs bank liquidity if foreign bank transfers assets to their head office or other branches.*

Compared to advanced nations, developing countries with financial sectors that are not mature enough or competitively weak in the financial market tend to be significantly affected by foreign bank entry. Hence, policy, regulations, medium-term strategy on a license to set up a bank with foreign investments all should be directed in maximizing the above-mentioned opportunities yet mitigating the possible risks.

BoM policy

With an aim to mitigate the impact of the COVID-19 pandemic, improve governance and the operational transparency of the banking sector, enable faster, cheaper and more efficient financial services, the Bank of Mongolia has been drawing up a complete set of policies such as "Strategy for reducing lending rate" and "Banking sector reform program to build a healthy, reliable, transparent, open, publicly monitored, inclusive and digital banking system".

These programs will lead to the creation of publicly listed banks with diverse financial products and services which is a prerequisite in reducing interest rates. Furthermore, the programs are designed to increase the number of branches and subsidiaries of foreign banks in Mongolia.

To avoid any threats to the financial stability imposed by foreign banks, the following measures must be taken into consideration:

- *Granting a license to foreign banks that would not jeopardize or put domestic banks at risk;*
- *Putting certain restrictions on foreign banks in attracting new depositors from the domestic market or limiting direct loans and financing to specific sectors;*
- *Putting necessary regulations in place to mitigate any risks from the head office or other branches of foreign banks;*
- *Adopting a law and agreements on cooperating and exchanging information with foreign monitoring and supervisory authorities;*
- *Protecting the rights of foreign bank customers and setting a separate prudential ratio and requirements for subsidiaries and branches of foreign banks;*
- *If a foreign bank imposes a threat to national security, a decision on the license to set up a bank in Mongolia must be taken in accordance with the applicable law, resolution and guidance of competent authorities.*

A decision to regulate or deregulate the financial sector is up to Mongolian authorities. However, the authorities must take the potential risks and opportunities into account in resolving the existing challenges through regulatory instruments. ■

View point

B. Javkhlan: Interest rate reduction should be placed at the center of our policy

(Member of Parliament and Head of the Standing Committee on State Budget)

Not only the public is rooting for interest rate reduction but also it has become the main goal of our commercial banks. Coopera-tion and efforts from both sides are inevitable in reducing interest rates. Fortunately, due to relatively stable macroeconomic conditions in the past four years, the interest rate has been reduced.

To lower interest rates, we need to ensure macroeconomic stability. Even though administrative measures in the banking sector will play a role in reducing interest rates, the Government and Parliament of Mongolia must place interest rate reduction at the center of their policy. Having said that, it is somewhat doubtful if Mongolia could ensure macroeconomic stability when we have a soaring fiscal deficit. Actually, as long as it is effective, fiscal expansion is not a bad thing. Roughly 60 percent of work done, in terms of lowering interest rates, depends on macroeconomic stability. The unstable and uncoordinated fiscal and monetary policies are the underlying reasons for turbulent inflation which further causes instability in the macroeconomy. Furthermore, we need to ensure macroeconomic stability through our public policy and give special importance to government spending and operational efficiency. ■

Kh. Bulgantuya: The second phase of banking sector re-form

(Member of Parliament and Vice Minister of Finance)

The interest rate reduction is not the sole responsibility of the Bank of Mongo-lia. The Government of Mongolia, also, must safeguard macroeconomic stability. Therefore, the strategy for reducing lending rates which was approved by the Parliament reflects the Government hearings. At the same time, we are urging the private sector to reduce their cost of borrowing.

I would say that the banking sector reform has already started in Mongolia. In the past, an asset quality review was conducted to improve the asset quality of commercial banks operating in Mongolia. Within that framework, the Law on Central Banks and the Law on the National Payment System were amended as well. So as not to wreak havoc on our financial sector, we must take further steps in listing commercial banks in the stock exchange market and ensuring the operational transparency of our banks.

Now, we are moving to the second phase of banking reform. The interest rates ▶

dropped by four percent in the last four years as a result of measures taken under the banking sector reform program. If we keep up the current work, the interest rates can be cut by another four percent. On the other hand, not only the public but also the Parliament holds doubts on the effectiveness of measures to reduce the interest rate during economic hardships and under a high fiscal deficit. Despite all of the setbacks, we must keep striving to lower the interest rates and fiscal deficit with or without the IMF's assistance. It is important to note that owing to the IMF's Extended Fund Facility Program, the Budget Law and Fiscal Stability Law were tightened.

In the past three years, the banks were under pressure to implement the Extended Fund Facility Program and to improve their financial ratings. This time, as the private sector is awaiting to participate in and successfully carry out banking reform, the strategy approved by the Parliament is highly likely to bring a positive impact on the financial sector. The Bank of Mongolia, Financial Stability Council, Ministry of Finance and Financial Regulatory Commission have all previously implemented a strategy for reducing lending rate which were reported to the Parliamentary Standing Committees. Now, however, the Parliament is about to take a leading role in the current strategy and make necessary amendments to the law.

Cutting interest rates by four percent within four years is tremendous work. If the poverty or interest rates shoot up, it would be even harder to reduce the interest rates once again. It indeed requires a long term effort. Therefore, if we want to see tangible results, we must encourage each other to take action as early as possible. ■

G. Amartuvshin: One way to diversify funding sources is to expand the stock market

(Member of Parliament)

The strategy for reducing lending rate is a four-year multi-stage program hence we should not expect interest rates to drop anytime soon. Interest rates largely depend on not only financial and equity markets but also on macroeconomic conditions. Economic growth is projected to be positive in 2021. In the next few years, countries with advanced economies are highly likely to experience a V-shaped growth. The GDP of China, a southern neighbor, grew by 4.9 percent in the third quarter of 2020. Around 80-90 of Mongolia's exports are positively correlated with China's economy. Thus, I am confident that the growth of our economy will be V-shaped.

The GDP of Mongolia is expected to grow by 7.2 percent which might seem an overly optimistic projection but it is possible. Export, mining and tax revenues are projected to increase in the next year. China's coal consumption is unlikely to decrease in near future and China has banned the coal imports from Australia. In addition, the global outlook on the prices of copper and coal is quite optimistic. In other words, Mongolia has a tremendous opportunity. Furthermore, we are already resolving the repayment of the external debts due in the next few years. This means there will not be a high debt burden in the upcoming 18 months.

We are making progress on the short and mid-term projects intended to facilitate exports and improve the macroeconomic environment. For instance, investments in the power plant with a capacity to meet domestic demand are included in the government budget with an aim to reduce electricity imports. The railway that will increase the coal transportation capacity is currently under construction.

In terms of measures to reduce interest rates, the mortgage interest rate was cut to six percent. Furthermore, we plan to disburse loans worth 230 billion MNT to small and medium-sized businesses through commercial banks. To lower deposit interest rates and the cost of funding, we will need a funding source that could come close to deposits. In other words, the banks need to raise capital and expand their shareholder base by issuing bonds in the equity market. Therefore, several measures to enhance the development of our stock market were included in the strategy for reducing lending rate.

Under the banking reform, we plan to ensure good governance in the banking sector by reducing bank ownership concentration. In fact, there is no country that has high bank ownership concentration like Mongolia. Fourteen bank failures in the past 30 years were due to the heavy influence of shareholders on decision making which resulted in the deterioration of loan quality and insolvency. To ensure transparency and independence of banking operations, we must put the necessary regulatory framework in place. ■

View point

G. Tsevegjav: Reducing ownership concentration under the principles of free-market iseffective in the long run

Mongolian Economy Magazine spoke with G. Tsevegjav, CEO of XacBank, about the implementation of the Banking Sector Reform Program.

-What is your position on the goals set out in the Banking Sector Reform Program?

-The "Banking Sector Reform Program" which was approved by the Bank of Mongolia (BoM) and the "Strategy for reducing lending rate" address the key issues in the macroeconomy and banking sector. I support virtually all goals including upcoming amendments to the law to ensure macroeconomic stability, reduce the fiscal deficit, diversify export products, strengthen corporate governance in the banking sector and accelerate digital transformation.

However, I do not think that it is appropriate to forcefully reduce the bank's ownership concentration. The concentration should be reduced naturally under the principles of the free market instead of forcing banks to limit shareholding to 20 percent. The value of commercial banks will certainly fall if they are forced to trade their shares. In fact, expanding the shareholder base does not necessarily lead to good governance, an increase in bank capital, or a higher risk tolerance. I believe that the most important thing is not quantity but the quality of shareholders.

Furthermore, I respectfully disagree with the measure to limit the bank ownership type to joint-stock companies. As it is risky for countries like Mongolia to require commercial banks to publicly trade 25-30 percent of their shares, the banks should set trading plans at their own convenience. The reason is simple. Our stock exchange market is not mature enough and lacks the necessary assets. On top of that, the economy at the moment is not doing well. Therefore, it is uncertain if share prices will stabilize when the banks start listing themselves on the stock market. This means that the banks may not be able to benefit from these investments. Also, the level of financial literacy has not reached a satisfactory level yet. We should therefore start talking about the bank ownership type only after resolving the aforementioned shortcomings.

-In the scope of reform, what measures have been taken by XacBank?

-One critical piece of work, that needs to be done, is to cut cost of fundings. In the last two to three years, XacBank offered the lowest interest rates on deposit accounts compared to other commercial banks. It became possible by diversifying our funding sources. In addition to term deposits in domestic currency and dollars, XacBank received a syndicated loan from international financial institutions and financing from Green Climate Fund.

When the benchmark interest rate was cut to eight percent, we lowered our deposit interest rates as well. To support exports, XacBank decided to focus on providing loans to domestic businesses, especially to small and medium businesses that manufacture products that could replace imports.

In terms of the goals set out in relation to Fintech, we are working on accelerating our digital transformation. Within this framework, we have started replacing the core banking system with more advanced systems. This project will take approximately 18 months.

XacBank does not need to take any action with regard to corporate governance as each of our shareholders owns less than 20 percent of the total shares. Becoming a publicly listed company is a matter of strategic importance, the executives, shareholders and board of directors will need to identify our strengths and weaknesses and take a more in-depth look. Listing our shares publicly will require at least 2-3 years of preparation.

-What would be necessary to enhance the digital transformation in the financial sector?

-In my opinion, instead of electronic signatures, we should be promoting electronic contracts. In the same vein as mobile transactions, we should enable customers to receive small non-collateral loans through our mobile phones. It can be simple. For example, reading the terms of a contract on mobile phones and verifying the loan with a transaction password. If lenders decide that they need additional verification, they could send a text message code to the customer's mobile phone. XacBank uses the Khur system in our daily operations, meaning we are able to conduct an online identity verification.

Even though Mongolia already has the necessary technology, we still demand our customers to sign on paper contracts. Fortunately, as the BoM addressed these issues in their strategy, we are expecting progress in that area.

I would like to stress the fact that a number of praiseworthy measures to cut costs were included in the program. For instance, banks will be allowed to utilize systems based on cloud computing which will bring many advantages to our operations. That means, rather than taking a risk of adopting new technology and wasting time, the banks can outsource. This will reduce server, security and human resource costs.

-What is your view on the strategy for reducing lending rate?

-Every banker would be in support of reducing interest rates. To cut interest rates, we must begin by strengthening our macroeconomic environment. It is quite challenging to reduce interest rates within a short time when the fiscal deficit is rising and the economy is slowing down due to the COVID-19. For sure, the interest rates will decrease to a certain extent following the implementation of this strategy. But, I think there is a 50/50 chance that interest rates will drop to 12 percent. Even if we successfully reach the target, we should keep aiming for single-digit interest rates.

To achieve that goal, we need to ensure responsible fiscal policy and stability of the macroeconomy. In order to lower the interest rates, reform in the financial market should be carried out in parallel. It is critical that the key players in the financial market are regulated under the unified policy and that regulations to protect customer's rights and interests are put in place.

For example, the rules on the protection of financial customers from the debt burden and KYC/AML (know your customer and anti-money laundering) procedures should apply to commercial banks, non-banking financial institutions and savings and credit cooperatives in the same manner. Only in that way, citizens and businesses can get rid of their debt burden and have higher access to finance.

-What policy changes have been made due to the COVID-19? For instance, taking a risk-based approach in policy-making?

-XacBank has been taking a risk-based approach in all our policies from the beginning. Thus, we did not have to make changes but a few adjustments reflecting the current situation. We specify the acceptable risk levels in our risk management policy and our Board of Directors sets the limits. Then, our executives have the full rights to make operational decisions within those limits. This structure has been in place for more than 15 years. The last change was made four years ago and that change was only with regard to specific details. In fact, the Board of Directors reviews the structure each year and makes amendments if it necessary.

- What goals are going to be at the center of XacBank's focus in the near term?

-Currently, we are working on our post-COVID-19 operational plan. Moreover, we intend on making changes in our service standards reflecting our customers' needs and demands. Also, we are considering training our staff to keep up with the digitalization of banking services. We look at our digital transformation in two ways, customer and employee directed. The core banking system must be reliable and efficient so as to speed up employee directed digitalization. We have already started taking action in that regard.

We are paying special attention to being compliant with new regulations. For instance, if we have to publicly trade our shares, we will need to discuss preparation for that at the strategic level. Also, XacBank recognizes the importance of diversifying our funding sources. Today, XacBank connects Fintech companies such as LendMN, Mobicom, Ard Financial Group, MOST Fintech, 360 Finance and Qpay with the Mongolian payment system. We intend to further expand our partnership with Fintech companies in the future. ■

View point

Jean-Pascal Nganou: Independence of the Central Bank of Mongolia is crucial for an effective banking reform

(Senior Economist at World Bank)

-Economists are warning to pay careful attention to the implementation of structural reforms as the banking sector plays an important role in past-covid economic growth. How can we carry the banking sector reform program without impeding the financial system? Where should we focus our attention?

-The new administration has indicated a sense of urgency to accelerate the reform of the banking sector. In fact, pre-existing problems of the banking sector are further complicated by a COVID-19 triggered economic contraction, resulting in the rise in NPLs.

The reform should pay attention to a series of interrelated issues. These include: (i) addressing the implementation capacity of BoM to carry these reforms successfully; Relatedly, eliminating supervisory forbearance will require revisiting the law on banking and the law on the central bank to ensure independence, protect supervisors and strengthen BoM governance and decision-making processes; (ii) assessing the current business model of the Mongolian banks is critical as some banks are in a loss-making stance; (iii) strengthening the corporate governance in the banking sector through more transparency (e.g., disclosure of the Ultimate Beneficial Owner of banks, enforcement on restrictions on related-party lending) is also warranted; and (iv) abiding by the principles of the central bank law by not re-engaging in quasi-fiscal activities.

-To increase the shareholder base, the authorities are amending the law whereby individual shareholding can be no greater than 20 percent of the total shares outstanding. Additionally, banks must publicly trade their shares. Could you share with us the best practices of countries that have successfully carried such reform?

-It is crucial that the effort by the authorities to diversify ownership of banks is accompanied by an improvement in corporate governance in the banking sector. In fact, the most recent World Bank's economic report, "Mongolia: Mines and Minds"v, indicates that high levels of concentration in bank ownership exacerbate governance weaknesses and reduce market pressures to change existing practices.

The 3M Report also argues that the main areas for improvement in the corporate governance of Mongolia's commercial banks include, business policies and procedures, the professional qualification of directors, the involvement of committees in technical matters, the role of independent directors and internal reporting lines. Moreover, improving governance in the stock exchange is also warranted. ■