

Importance of Financial Sector Reform in Mongolia

Brief presentation plan

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1. Current banking sector situation:
 - 1.1. Banking sector liquidity and credit crunch
 - 1.2. Principals in arrears and loan quality, banks' equity shortage, profitability

2. Main features of current difficulties:
 - 2.1. Related party credit ceiling/exposure
 - 2.2. Credit exposure per borrower
 - 2.3. LCs
 - 2.4. Highly centralized loans outstanding in some sectors, for instance, construction sector
 - 2.5. Substantial deterioration in loan quality is likely to happen due to unrealistic classification of bank loans and low profitability in real economy

3. Facing objectives:
 - 3.1. Overcoming current financial crisis
 - 3.1.1. Conduct bank portfolio audit
 - 3.1.2. Develop a detailed plan for each bank
 - 3.1.3. Consolidation, merging and re-capitalisation
 - 3.1.4. Encourage foreign investment

 - 3.2. Going forward, implement banking sector restructuring
 - 3.2.1. The need to implement restructuring:
 - Implementation of OT and TT projects
 - Credit exposure limit per borrower is too low per bank
 - Take corrective action over currently revealed constraints
 - Reduce operational and service cost of the banks

 - 3.2.2. Restructuring options:
 - Increase paid-in-capital of the banks
 - Disclose bank operations and financial statements to the public
 - Strengthen central bank supervision and enhance financial discipline of the banks
 - Improve bank management and staff capacity through introducing good governance in the banks
 - Establish and develop classic structure of deposit insurance
 - Improve loan portfolio database

Starting from around mid 2007 we have started to feel strongly effects of the global crisis. As a result of this crisis, major industries have gone through downfall and people around the world have suffered losses mounting to billions and billions of dollars. The International Monetary Fund estimates that the cumulative impact on the global economy will be losses equivalent to 4 trillion USD.

There seems to be a consensus in tracing the origins of this crisis to the subprime mortgage crisis in the USA. Prior to this crisis, significant amounts of investments were directed from dynamically developing Asian economies to the US economy. That contributed to funds channeled toward mortgage lending in that country. As the housing market was expanding rapidly, lending institutions took more liberal approach to their lending practices and adopted loose credit regime, thus creating risk management loopholes. The debt-to-income ratio in the US has reached an unprecedented level of 2. Banks' profit driven initiatives unleashed a thriving secondary mortgage market attracting huge amounts of investments. That precipitated high leverage. As the housing bubble burst, banks and other institutions that have made large investments into those derivatives have suffered huge losses. Consequently, insolvencies of seemingly most invincible institutions have been witnessed. As the crisis has spread from the financial sector to other sectors of economy, it created a vicious circle by undercutting social wealth and increasing bad debts in the banking sector and undermining its risk bearing capabilities. Surge in credit risks was in some ways an implication of long going economic stagnation in the developed world. In era of globalization, it was evident that a banking institution in one country is irreversibly connected to the rest of the world.

In Mongolia's case, unlike the USA or other developed economies, housing market or financial market crises were not the culprit. Instead, it was the sudden drop in the prices of copper, main contributor to the country's budget revenues, on the world market and shrinking investment inflows that were the key factors. As the effects of the crisis were felt strongly by the real sector, business and individual incomes have fallen significantly. Simultaneously, the period from the fourth quarter of 2008 to the first quarter of 2009 has seen such predicaments as the sharp decline of the tugrug, delinquencies of foreign currency denominated credits and foreign exchange adjustment losses by our banks. The sudden devaluation of the tugrug has placed considerable burden on individuals holding foreign exchange

denominated loans, and the amount of foreign currency denominated bad debt increased 2.6 times or 42 billion tugrug. Whereas, most mining resource-driven economies were adhering to more relaxed monetary policies whereby weakening their national currencies during that time, the Bank of Mongolia has set on stabilizing the tugrug in order to lessen currency risk burdens for its people. There were registered big discrepancies between official and unofficial exchange rates on the market, which played negatively on the foreign trade balance. Consequently, foreign currency formal reserves of the country have decreased by 60%.

Certain adverse information spread in the society concerning the banking sector, as well as some banks' inefficiencies have led to a certain loss of confidence in the banking system. As of the end of 2008, withdrawal amounts increased dramatically, reaching 123.8 billion tugrug in October, 2008 and 109.3 billion in November. As a counter measure to this phenomenon, the Parliament of Mongolia has passed the Law on State Guarantees on Bank Savings on November 25, 2008. As a result of this action, withdrawal rates have gradually decreased and the deposit amounts have reached pre-crisis levels of 2.5 trillion tugrug in June, 2009. This has alleviated some of solvency related problems faced the banks. For the purpose of promoting banks' liquidity, the Bank of Mongolia has introduced such services on the interbank market as reverse repo, collateralized loans and foreign exchange swaps.

As the economic growth has slowed down and the real sector has suffered blows, creditworthiness and payment power of borrowers diminished significantly and credit risk increased accordingly. Therefore, we see a considerable deterioration of banks' portfolio. For example, the amount of bad credit in the mining sector reached 19.9% of credits, 17.3% in construction sector, 11.7% in processing sector, 10.9% in retail sector. Cumulatively, the percentage of bad credit to total outstanding credits increased by 13.4 points and reached 15.2%. As the overall level of credit risk increased throughout the country, the bank were scaling back on lending, taking more stringent lending practices and watching closely repayments on previously issued credits. USA along with other developed nations have coordinated efforts to overcome the global crisis, to improve liquidity and provide economic growth. Within the framework of these efforts measures were taken toward financing of insolvent and systemically important financial institutions, as well as strategically important business entities capable of making big inputs to the

state budget and bad asset write-offs. Upon that, some positive signs started showing on international economic and financial markets. In most developing countries, it is possible for banks to attract sufficient amounts of funding for short-term liquidity replenishments. There are signs of revival of derivatives market.

As for the Mongol Bank, it has brought up the equity level to 12% for banks and, in conjunction with the Ministry of Finance, introduced changes in asset classification rules geared toward alleviating risk fund burden on banks. The fact that the foreign trade deficits are starting to decline from the third quarter of 2009 and the foreign currency auctions introduced by Bank of Mongolia have contributed to stabilizing the national currency. Once stagnant banks are showing signs of revival by exhibiting slight increases in lending activity.

Most importantly, the positive outcome of the latest crisis is a determination of flaws in legal regulations governing financial relations and recognition of the need for change by policy makers worldwide.

Mongolia has derived its lesson and will try to use the dollar prudently and stabilize its own currency. We are working on introducing best international experience in Mongolia in order to enhance risk management within its system. We can never be complacent, instead we should strive to accomplish many things such improving regulation and supervision, introducing international accounting and monitoring standards. The Bank of Mongolia, the Ministry of Finance, the Government of Mongolia will implement policies promoting export development, in particular provide policy support for domestic manufacturing.