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Implementation Completion Report on a credit in the amount of SDR 24M (US$ 32M equivalent) to Mongolia for a financial sector adjustment credit

World Bank/World Bank Group

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IMPLEMENTATION COMPLETION REPORT
(IDA-33340)

ON A

CREDIT

IN THE AMOUNT OF SDR 24 MILLION
(US$32 MILLION EQUIVALENT)

TO

MONGOLIA

FOR A

FINANCIAL SECTOR ADJUSTMENT CREDIT

March 31, 2005

China and Mongolia Country Unit
Poverty Reduction and Economic Management Unit
East Asia and Pacific Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of March 2005)

Currency Unit = Togrog
1.00 Togrog = US$ 0.0008292
US$ 1.00 = 1,206 Togrogs

FISCAL YEAR
January 1 December 31

ABBREVIATIONS AND ACRONYMS

AgBank		Agricultural Bank
ADB		Asian Development Bank
BELTAC		Banking, Enterprise, and Legal TA Credit
BESAC		Banking and Enterprise Sector Adjustment Credit
BOM		Bank of Mongolia (Mongolia Central Bank)
BR Bonds		Bank Restructuring Bonds
CAR		Capital Adequacy Ratio
CAS		Country Assistance Strategy
CIB		Credit Information Bureau
CMEA		Council for Mutual Economic Assistance
EGSPRS		Economic Growth Support and Poverty Reduction Strategy
FSAC		Financial Sector Adjustment Credit
FSRP		Financial Sector Reform Program Loan (ADB)
MARA		Mongolian Assets Recovery Agency
MOF		Ministry of Finance
MOFE		Ministry of Finance and Economy
NPL		Non-Performing Loan
PRGF		Poverty Reduction and Growth Facility
PRSC		Poverty Reduction Support Credit
PRSP		Poverty Reduction Strategy Paper
PSDC		Private Sector Development Credit
QAG		Quality Assurance Group
RB		Reconstruction Bank
SB		Savings Bank
SOEs		State-Owned Enterprises
TDB		Trade and Development Bank

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MONGOLIA
Mongolia Financial Sector Adjustment Credit

CONTENTS

Project ID: P068071	*Project Name:* Mongolia Financial Sector Adjustment Credit
Team Leader: Xiaofeng Hua	*TL Unit:* EASFP
ICR Type: Core ICR	*Report Date: March 31, 2005*

1. Project Data

Name:	Mongolia Financial Sector Adjustment Credit	*L/C/TF Number:*	IDA-33340
Country/Department:	MONGOLIA	*Region:*	East Asia and Pacific Region

Sector/subsector: Banking (68%); General industry and trade sector (16%); Capital markets (8%); Payment systems, securities clearance and settlement (8%)

Theme: Legal institutions for a market economy (P); State enterprise/bank restructuring and privatization (P); Standards and financial reporting (S); Infrastructure services for private sector development (S); Export development and competitiveness (S)

KEY DATES			*Original*	*Revised/Actual*
PCD:	01/24/2000	*Effective:*	07/26/2000	09/26/2001
Appraisal:	01/28/2000	*MTR:*		
Approval:	04/20/2000	*Closing:*	06/30/2003	09/30/2004

Borrower/Implementing Agency: GOVERNMENT OF MONGOLIA/BANK OF MONGOLIA/ MINISTRY OF FINANCE

Other Partners:

STAFF	Current	At Appraisal
Vice President:	Jemal-ud-din Kassum	Jemal-ud-din Kassum
Country Director:	David R. Dollar	Julian F. Schweitzer
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2. Principal Performance Ratings

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HL=Highly Likely, L=Likely, UN=Unlikely, HUN=Highly Unlikely, HU=Highly Unsatisfactory, H=High, SU=Substantial, M=Modest, N=Negligible)

Outcome:	S
Sustainability:	L
Institutional Development Impact:	SU
Bank Performance:	S
Borrower Performance:	S

	QAG (if available)	ICR
Quality at Entry:	S	S
Project at Risk at Any Time:	Yes	

Note: The outcome of the operation is rated by the ICR as "moderately satisfactory," balancing the achievements *with the challenges in fulfilling the tranche release conditions with two waivers and delays. It is currently rated "S" because the PDS system does not have a MS or similar rating category.*

3. Assessment of Development Objective and Design, and of Quality at Entry

3.1 Original Objective:

3.1.1 *Background.* Since 1990, following the establishment of the newly democratic Mongolia, the country opted for a market-led system through a rapid transition. Mongolia stabilized its economy through the implementation of a range of reforms including currency reform, price and wage liberalization, privatization of small and medium industries, and changes in laws and regulations to enable private sector activities. The program of reforms and the agenda for transition to a market-based economy would, however, need to be supported by sound financial and banking sectors.

3.1.2 The still evolving financial system in Mongolia is small and fragile with recurring insolvencies in the banking system and high vulnerability to shocks and crises. The banking sector was seriously dysfunctional with a severe shortage of banking skills and a need for improvements in the legal and institutional framework. These weaknesses and the narrow range of available financial services acted as a constraint on the private sector development and economic growth.

3.1.3 Over the past decade, successive governments have undertaken important measures to restructure, develop and stabilize the financial system during the transition. Initial government efforts included putting in place the legal infrastructure for a commercial banking system. These included, among important actions, the splitting up of the state mono-bank into a central bank, the Bank of Mongolia (BOM) and five commercial banks; the BOM began licensing private banks in 1991; interest rates were liberalized; the Banking Law was approved in May 1991.

3.1.4 These efforts and initiatives notwithstanding, the framework for an efficient and stable banking sector was still developing, especially concerning the basic gaps in the legal, regulatory, supervisory, and regulatory and contract enforcement infrastructure. The sector experienced serious weaknesses and faced formidable challenges as reflected in a series of crises and bank failures in the 1990s – most notably in 1994, 1996, and 1998/99.

3.1.5 The seed for the *1994 banking crisis* was planted when the five commercial banks inherited loans from state-owned enterprises (SOEs) which quickly became nonperforming as the SOEs lost their market overnight with the collapse of the CMEA trading system.[1] The legal and judicial system and the regulatory/supervisory and enforcement framework were yet to be properly established, compounded by the weak technical financial and administrative capacity of the banks. The application of the new financial laws and regulations and their interpretation by the courts encountered considerable struggle, largely because of inadequate institutional capacity and corruption. The commercial banks lacked basic skills of credit analysis among their staff and had not developed proper credit policies and procedures, although they were engaged in rudimentary banking services comprised of simple deposits and loans. A substantial portion of the loans were based on personal connections. By mid-1993, Mongolia's scarce human and capital resources were stretched even thinner with the licensing of ten additional small private commercial banks leveraging on the low legal requirements toward new entrants. In these circumstances, the banking system quickly became unstable, with many banks failing to meet BOM prudential requirements. BOM had to place some banks under conservatorship and/or financed mergers for troubled banks. It also provided emergency liquidity support to these institutions amounting to about two percent of GDP.

Note: 1. Council for Mutual Economic Assistance.

3.1.6 *The 1996 banking crisis.* Public confidence in the banking system continued to erode. By 1995, the non-performing loans accounted for over 40 percent of total portfolio of banks.[2] The banking system as a whole was illiquid and had deteriorated to the point of insolvency. Four of the five large banks were deeply insolvent, and had no possibility to restore themselves to solvency without very large infusions of new capital. The BOM injected large volumes of liquidity to prevent further failures. In 1995-96, two small banks collapsed. By mid-1996 the banks virtually ceased to accept time deposits in the rate prescribed by the authorities as they increasingly became unable to afford high cost of funds. In late 1996, the BOM had to remove the floor rate on time deposits. Two large insolvent banks were liquidated. The largest of the remaining problem banks were placed under rehabilitation by the BOM.

Note: 2. Memorandum of the President of the IDA to the Executive Directors on a Country Assistance Strategy of the WB Group for Mongolia. June 2, 1995, Report No. 14565-MOG.

3.1.7 *The 1998/99 banking crisis.* The Asian financial crisis brought about an external shock to the Mongolian banking system. Its performance deteriorated sharply in 1998, triggered by the impact of the large external shock on the liquidity and profitability of major corporate clients. Three banks, which accounted for about 21 percent of total bank assets, became illiquid as well as insolvent. The restructuring plans for two of these banks did not materialize and the situation in other five small banks deteriorated further in 1998. Confidence in the banking system eroded further. These events led to a vote of no-confidence in the government, which remained in an acting capacity until end-1998. The banking crisis continued to deepen in 1999, partly as a result of the continuous deterioration in Mongolia's terms of trade, and partly as a result of poor governance and supervision of banks, and of decisions to delay liquidation of insolvent banks. Expectations of high inflation and togrog depreciation, recurrent disagreement on banking reform among political parties, and frequent investigation raids of politicians and government agencies of banks further induced capital flight. The share of total bank assets to GDP fell to 20.5 percent in 1998, compared to 26 percent in 1997, and about 30 percent in 1996. The banking system as a whole was barely solvent by the end of 1999: the capital for the whole industry equaled only 0.6 percent of total assets.

3.1.8 At the height of the 1998/99 crisis, the government began a new round of reforms in the financial sector with the support of donors. The World Bank and other international financial institutions, including the IMF and the Asian Development Bank (ADB), contributed funding and technical assistance to support the reforms. At the invitation of the government, the Bank carried out a review of the main issues confronting the financial sector in 1999 as part of the broader donor program to support the reform in this sector and to lay the ground work for the Financial Sector Adjustment Credit (FSAC). This project was part of a sequenced program of assistance to the financial and enterprise sectors, with the following operations:

(a) Banking and Enterprise Sector Adjustment Credit (BESAC), approved in FY1997, focused on enterprise sector reforms and addressed the issue of NPLs;
(b) Banking Enterprise and Legal Technical Assistance Credit (BELTAC), also approve in FY1997, provided assistance in banking, restructuring and the legal framework for insolvency; and
(c) Private Sector Development Credit (PSDC), approved in FY1999, consisted of a line of credit to support private enterprise development with a supporting technical assistance sub-component for participating intermediaries and the Credit Information Bureau and the Bank of Mongolia.
(d) Financial Sector Adjustment Project (FSAC), approved in FY2000.
(e) Financial Capacity Development Credit (FCDC). approved in FY2002, supported institutional capacity building of the banking sector to reduce systemic risks and to enhance financial intermediation;
(f) Financial Capacity Technical Assistance Project, approved in FY2002, provided technical assistance to support the above project.

3.1.9 *Objectives.* Overall, the project supported the implementation of the banking sector component of the government's medium-term strategy for financial sector reform and development needed to achieve and consolidate macroeconomic stability, accelerate private-sector-led growth and reduce poverty. Specifically, the objective of the project was to facilitate the development of a sound and efficient banking system through (a) the establishment of basic financial structure (i.e., banking skills, accounting standards, enforcement of financial contracts, and a clear exit policy framework for troubled banks); (b) the consolidation of the banking system; (c) the divestiture of the government's ownership in the Trade and Development Bank (TDB); (d) the development of more effective regulation and supervision of the financial system; (f) the improvement of the payment system in rural areas; (g) the confirmation of the government commitment to honor financial contracts by timely servicing government bonds including the payment of interest arrears; and (f) the replacement of existing government bonds held by banks with marketable securities.

3.1.10 The project also aimed to provide assistance to the government macroeconomic program which was designed to enable Mongolia to adjust to the severe terms of trade shock in 1998-99 with persistent adverse effects in 2000. Specifically, FSAC was expected to help close the financial gaps in the 2000-02 balance of payments, minimizing a costly adjustment to the large terms of trade shock. The credit would help finance the costs of bank restructuring and reduce the government's large stock of net credit from the domestic banking system, thus freeing –up bank credit for the private sector to accelerate its development and overall economic growth.

3.2 Revised Objective:

3.2.1 There was no revision in the objective of the project.

3.3 Original Components:

3.3.1 The components of the operation could be grouped into three main categories as follows

Financial Sector Infrastructure Development and Strengthening Program:
- Establishment of basic financial infrastructure (i.e., banking skills, accounting standards, enforcement of financial contracts, and a clear exit policy framework for troubled banks, credit information system);
- Consolidation of the banking system and banking supervision and prudential regulations;
- Development of effective regulation and supervision of the financial system;

Banking Restructuring and Privatization:
- Divestiture of the government's ownership in TDB;
- Agriculture Bank restructuring action plan
- Savings Bank privatization action plan

Improved government financial functions:
- Restoration of payment services in the rural areas;
- Confirmation of government's commitment to honor financial contracts by timely servicing government bonds.
- Standardizing Bank Restructuring Bonds (BR Bonds) and replace or redeem them by marketable instruments and servicing government debt on time.

3.4 Revised Components:

3.4.1 There was no revision in the components of the credit.

3.5 Quality at Entry:

3.5.1 The project was prepared during a difficult period in Mongolia, especially in the financial sector, due to the overall challenging macroeconomic situation as well as the fluid political environment. There were severe imbalances in the external sector due to the terms of trade shock and in the government budget, with resulting inflationary pressures and high interest rates. In this environment, the Bank team took the lead in designing an operation to help the government push ahead a reform agenda in the financial sector with multi-donor support. The FSAC incorporated a series of lessons learned from past experiences and underscored the close working relations between Bank staff, the government and other donors. FSAC reflected significant efforts to gain commitments and support from various stakeholders, notably the Financial Sector Development Performance Group which included high-level officials, parliament members from different parties, NGOs and private sector representatives and to build a broad consensus on reform and development in the financial sector. Potential risks to the operation were discussed in details by the task team, given the political situation in Mongolia, the macro-economic framework which could be adversely affected with policy slippages and unusually severe weather, the country's limited administrative capacity, and the different interests of various stakeholders. The task team made some wide-ranging efforts to mitigate these risks, including identifying an appropriate window of opportunity for the program's implementation, undertaking expeditious actions to broaden the consensus among a wide cross-section of the civil society, and enhancing the program sustainability through donor cooperation, notably with the ADB and the IMF, to address the issue of implementation capacity. The tranche release option was chosen in order to keep the active engagement and attention of the authorities in the financial sector reform agenda. The Bank team also pursued a strategy to ¨lock in¨ the actions and policy changes it considered needed for the sector by securing the political commitment of the then current government, with the rationale that this commitment would transcend whatever subsequent party and/or administration in power.

3.5.2 In retrospect, the designed strategy to lock in the political commitment proved to be less effective once the government changed hand as it required further time-consuming dialogue before FSAC could be implemented. The "window of opportunity" for the reform posed another challenge for the program, especially with the changing political situation (i.e., imminent elections and change in administration), making the identification of an opportune time for the implementation process more complex with costly delays. The time frame for the government to fulfill the conditionality of the program was ambitious, especially given the limited and weak institutional capacity and the fluid political situation of the country. The project's effectiveness and the implementation of the operation were further challenged by the overall deterioration in the macroeconomic framework and key indicators whose satisfactory maintenance was an effectiveness condition and turned out to be a key issue affecting the project's effectiveness and implementation.

3.5.3 Despite the team's great efforts in mitigating these risks as they were, the broad-stroke program as designed by FSAC, in hindsight, appeared to have underestimated the implementation challenges due to a) the weak institutional capacity of the government, b) the time needed for the government to reach consensus and adopted far reaching policy changes, and c) the status of the financial sector (which was very rudimentary with lack of basic infrastructure, paucity of banking skills, and weak institutional capacity). Further, FSAC could have been better supported by prior or parallel technical program to help address the rudimentary financial sector and the weak administrative capacity of the government in undertaking the envisaged broad changes. For these reasons that eventually affected adversely the implementation record (as discussed in Section 4), the ICR rated the quality at entry of the FSAC as moderately satisfactory.

3.5.4 *Results of the Quality Assurance Group (QAG) findings*.

3.5.5 The project was reviewed twice by the QAG in March 2001 and October 2002. The first one was the Quality at Entry Assessment[3] prepared on March 31, 2001. The QEA4 Panel rated the operation as satisfactory, with "some dimension rated as Highly Satisfactory." The Bank processes were rated "Highly Satisfactory." The panel noted that the Bank was "to be commended for assisting the Government in pushing ahead with an appropriate reform agenda with multidonor support" in a difficult country situation. The task team was commended in leading a multidonor coordination effort to provide assistance to the government, including coordinating effectively technical assistance from various donors to address the limited implementation capacity, adequately assessing and mitigating the operation's potential risks, obtaining commitment from various stakeholders for the program. The panel also noted the high value added by the management team through continuing involvement and through the regional management review process. The panel cautioned, however, on the long list of effectiveness conditions, many of which were not critical, but could potentially delay effectiveness.

Note: 3. QAG – QEA4, Quality at Entry Assessment – Mongolia – Financial Sector Adjustment Credit, March 29, 2001 and QAG – QSA5, Quality of Supervision Assessment – Mongolia – Financial Sector Adjustment Credit, October 31, 2002.

3.5.6 The project was also reviewed by the QAG during its implementation with the Quality of Supervision Assessment in October 2002. The Panel assessed the quality of supervision of the project as satisfactory; however it cautioned that the team on the realism and quality of the project performance monitoring in the Project Status Reports (PSRs) with a "marginal rating." The assessment also highlighted some notes of caution regarding the ambitious time frame of the various conditions of effectiveness for a country with limited capacity for implementation and the key problem in maintaining a satisfactory macro economic framework and satisfactory key economic indicators. The panel emphasizes the general need for donors to be more realistic in setting reform goals and proposing policies for the financial sector that are appropriate to the needs and capacity constraints of economies at the stage of development of Mongolia with rudimentary structure and only a fledging private sector.

4. Achievement of Objective and Outputs

4.1 Outcome/achievement of objective:

4.1.1 Overall, there was some notable progress over the past four years in the implementation of the government's mid-term policy reform actions toward the development of the financial sector as supported by FSAC, albeit with some long delays and difficult challenges in meeting tranche release conditions, requiring two waivers by the Bank's Board (discussed in details in Paras. 4.1.7 – 4.1.10). At its closure, FSAC helped facilitate the implementation of a series of policy reforms measures and put in place some necessary undertakings aimed toward the establishment of a sounder and more efficient banking sector to aid in macroeconomic stabilization. Balancing between what FSAC has helped to achieve with the difficult challenges for the authorities in fulfilling the conditions for tranche releases and some waivers, the outcome of the operation was rated by the ICR as "moderately satisfactory."

4.1.2 FSAC first helped to address the immediate consequences of the 1999 financial crisis with a series of actions on the three commercial banks. This included the selling of the government's 76 percent stake in the TDB, the country's largest commercial bank, to a strategic investor group in May 2002, which is carrying out a fundamental restructuring of TDB. The Agriculture Bank (AgBank), the fourth-ranked commercial bank with the largest branch network in rural Mongolia, was sold to a Japanese securities house in March 2003. [4] In April 2004, a time-bound action plan was adopted by the government for the privatization of Savings Bank who also confirmed its commitment to the principles of a transparent and competitive privatization process.

Note: 4. It was privatized further when the Japanese sold 40 percent of its stake in AgBank to a Mongolian private sector group.

4.1.3 Since 2000, the government has adopted several amendments to the banking and central bank laws, including among other things the amendment to the Banking Law to enhance prudential regulations and the amendment to the Central Bank Law to prohibit the central bank from issuing commercial guarantees and establish a framework for an independent oversight board of the central bank. Correspondingly, the regulations for the BOM have also been revised. These changes contributed to strengthening the current legal and regulatory framework for banking regulation and supervision. An assessment by the Fund on the supervisory and regulatory framework – using the internationally recognized Basel Core Principles (BCP) as benchmarks – showed that – in terms of compliance with BCP – the overall standard of banking supervision was reasonable." [5] These changes have also facilitated the enforcement of loan contracts. As the political and economic environment was stabilized, the banking regulatory framework was strengthened through improved asset classification criteria, and new regulations on prompt and effective central bank interventions in case of bank non-compliance and/or bank failure. Access to finance in the rural areas was improved following the successful restructuring of the AgBank.

Note 5. IMF, Mongolia – Improving Banking Supervision and Accounting Standards, November 2002.

4.1.4 The public confidence in the banking system was given a boost with the stabilization and restructuring of the financial sector, as reflected in the rapid growth of deposits which increased four times in real terms over the last four years. Loan portfolios at banks expanded at an average annual rate of over 80 percent in the last two years. The share of non-performing loans (NPLs) in loan portfolios (8.6 percent) was much lower than that before the FSAC program (60 percent). Financial intermediation has deepened, as reflected in the ratio of financial sector assets to GDP that increased from 21 percent in 2000 to 60 percent in 2004. This met the needs for the real sector and contributed to the recovery of economic growth and increased government revenue. Hence, the government managed to meet its obligations for salary, pension, and debt servicing.

4.1.5 While the progress made in the period covered by FSAC contributed to the strengthening of the financial sector, this would need to be sustained. The government would need to maintain the momentum and to continue with further reforms and capacity building and strengthening in this as challenges remained. The still fragile Mongolian financial sector was vulnerable to crises and fundamental weaknesses were yet to be overcome. Several indicators highlighted these challenges. The stress to the banking system came from a significant and rapid credit expansion in the last few years. The volume of NPLs increased more than three-folds in 2004 – though the ratio of NPLs as a share of total loans was lower when compared to the situation in 2000 as the total loan portfolio has increased. Competition for deposits and increasing operating expenses led to declines in banks' net interest margin to 15 percent at the end of 2003 from 24 percent in 2001 and the banking sector's average net interest income did not cover its average operating expenses. There were more risky loans made by banks, some of which were also entering new markets with minimal expertise. Some commercial banks' rapid growth without regard to proper risk management and prudent practice could also bring about a worsening performance and financial position, thus undermining the effort to maintain economic stability. These trends, if accelerated, could erase the hard-won progress in the stabilization and development of the financial sector, as supported by FSAC.

4.1.6 The new challenges are being addressed by the government, BOM and the Mongolian financial institutions with assistance from the World Bank, the IMF and the ADB, building on the gains from FSAC. Bank assistance is composed of on-going AAA and lending operation, including the mid-term sector review, the Financial Capacity Development Project, the second Private Sector Development Credit (being prepared for FY2005 delivery).

Summary of the tranche releases' conditions

4.1.7 As mentioned above, the implementation of the project experienced difficulties and delays in fulfilling the conditions for effectiveness and tranche releases. At the onset of the project, there were long delays in fulfilling the effectiveness conditions.[6] The effectiveness date, originally set for July 26, 2000, was extended three times to September 27, 2001 for a total of 18 months.[7] A number of factors contributed to this delay, including slippages caused by the general elections in June 2000 and the time elapsed during the transition between two administrations. While six of the seven effectiveness conditions were met by April 2001, the last condition which required the maintenance of a sound economic framework based on agreed indicators took a longer time due to the outstanding issues between the government and the IMF concerning its second PRGF program. These were finally resolved in September 2001 with the submission of the IMF's PRGF package to its Board. The program, as agreed with the IMF, clarified the questions on macroeconomic data and the government's commitment to macroeconomic stability and allowed the task team to recommend and the Board to declare the Credit's effectiveness as of September 26, 2001.

Note: 6. The task team considered the cancellation of the credit as one of the alternatives when the end of eighteen-month period approached – the maximum allowable period within which a credit must be made effective, according to Bank's Guidelines.
7. The effectiveness date was first extended to October 24, 2000, then to April 26, 2001, and lastly to September 26, 2001.

4.1.8 The delay in fulfilling the effectiveness conditions also led to a delay for the release of the floating tranche to September 2003, from the initial expected date of October 2002. The floating tranche itself experienced some delays as the specific condition concerning privatization of TDB took much longer that initially planned by the government, due to the lack of interest among international banking system and the lack of experience in the government to manage he privatization process. The two general conditions on the implementation of the program and the agreed macroeconomic were fulfilled.

4.1.9 The second tranche release was approved by the Board with waivers in two conditions in September 2004, after some delays due to the difficulties in meeting the conditions as specified in the Development Credit Agreement (DCA). The conditions covering the strengthening of the credit information system and the legal status of the assets recovery agency were fulfilled. Two specific conditions where actions had substantially achieved their objectives but they were not in complete compliance with the requirements of the conditions, thus necessitating waivers. The first waiver concerned the condition on the replacement of all BR Bonds with marketable securities. The government replaced a substantial amount of the BR-Bonds with marketable central bank bills and treasury bills, but a small portion of these bonds remained at Savings Bank.

Although the government was willing to redeem or replace all the BR-Bonds outstanding, it was concerned about the severe consequences for the financial health of Savings Bank. Given the government's action had substantially achieved the objectives of this condition – which is to support the gradual development of a capital market through increased supply of marketable government securities, the Bank Board approved the waiver for this condition.

4.1.10 The government undertook substantial actions to enhance the effective bank failure resolution mechanism, including the revision of the BOM regulations and the provision in the Banking Law for the prompt imposition of receivership with some specific triggers. However, there was a difference between the triggers specified in the BOM regulation and those in the DCA. As the government actions had substantially achieved this objective of developing an effective bank failure resolution mechanism, a second waiver was granted for this condition in the Second Tranche release.

4.2 Outputs by components:

Macro-economic framework

4.2.1 The achievements in the financial sector contributed to economic growth and improved macroeconomic conditions (Table 1). Under the FSAC program, Mongolia has maintained macroeconomic stability, and improved its fiscal and monetary policies. This is significant given the high inflation, huge trade deficits and stagnant economic growth the country suffered in the 1990s. The economy grew at 5.5 percent in 2003 and an estimated 5.6 percent in 2004 in real terms, thanks to improved terms of trade, and favorable weather conditions. The country exchange rate was stable and the inflation was within the range of the target projected by the IMF's PRGF program. The imbalance in the external sector became manageable with the deficit at about $100 million in the last two years. The recovery of the mining industry contributed to the export earnings, aided by the favorable commodity prices. Overall, the macroeconomic framework could be considered satisfactory during the FSAC implementation period, notwithstanding the difficulties experienced at the onset of the operation causing delays in its effectiveness (as discussed earlier)

Table 1. Mongolia – Key Indicators, 1999-2004 - FSAC Implementation Period

	2000	2001	2002	2003 Prel.	2004 *Prel. Est.*
Real GDP Growth (%)	1.1	1.0	4.0	5.6	*10.6*
Inflation (average, %)	8.1	8.0	1.6	4.7	*11.0*
External sector (US millions)					
Exports of goods	536	522	524	616	*853*
Imports of goods	-614	-638	-691	-801	*-1,012*
Current account balance 1/	-70	-62	-106	-99	*5.4*
Budget (fiscal year basis):					
Revenue (% of GDP)	34.5	39.4	38.4	37.9	*38.6-*
Expenditures (% of GDP)	41.5	43.9	44.4	42.1	*39.5-*
Current budget balance (% of GDP)	3.1	5.7	4.4	7.6	*9.1-*

Note: 1. Including official transfers.
Source: IMF and World Bank, derived from data provided by Mongolia.

4.2.2 To aid in the maintenance of a sound macroeconomic framework, the government adopted a time-bound action plan with a view to mitigate the external commodity risks and the terms of trade shocks. These included actions to support the development of non-traditional exports and the establishment of a contingency fund to help address the impact of volatile commodity prices on the fiscal position.

4.2.3 However, new issues emerged after the settlement of old Transferable Ruble debt at the end of 2003. While the settlement had a broadly positive effect on Mongolia's long-term debt sustainability, this was achieved through heavy borrowing from the Bank of Mongolia and added pressure on short to medium term macroeconomic management, especially in the areas of Government fiscal cost and Central Bank profitability. It has also highlighted the need for strengthened public sector governance. These new fiscal and monetary management issues would be addressed through a proposed First Poverty Reduction Support Credit being prepared for FY 2005 delivery

4.2.4 The macroeconomic and FSAC program performance indicators and the outcomes at the completion of the operation are presented in the tables in Annex 1.

Financial sector infrastructure development and strengthening

4.2.5 FSAC supported the government to establish a sound banking infrastructure though the implementation of the action plan to strengthen the financial sector, including the improvement in banking skills, accounting standards, enforcement of financial contracts, and a clear exit policy framework for troubled banks. In September 2001, the Financial Sector Strengthening Plan was adopted, covering actions on commercial bank corporate governance, legal and regulatory framework, risk management, human resource development and non-bank financial institutions. These changes have brought about a reasonable legal and regulatory framework for the banking sector. However, the government now faces the challenges to enforce, among other things, contract agreements, monitoring of compliance with prudential regulations, and implementation of risk management, given the lack of capacity for monitoring and supervision.

4.2.6 Progress has been made towards improving banking and supervision skills, which were supported by the Financial Capacity Development Project and the Private Sector Development Project and other donor programs. Mongolia adopted the International Accounting and Auditing Standard. Capacity building needs of the government's auditors and other financial institutions are being supported by a number of donor programs.

4.2.7 The Credit Information Bureau has been upgraded and strengthened. The upgraded system is operational with positive feedback from the commercial banks. Information on credit defaulters can now be shared among Mongolian banks and between banks and the BOM. This is, however, the first steps in a long road toward better credit information system as the effectiveness of the upgraded system would need to be enhanced, a continuing long-term task which depended very much on the improvement of banks' risk management capacity and credit culture in the Mongolian society.

4.2.8 The Mongolian Asset Recovery Agency (MARA) was converted into a state-owned enterprise and legally empowered to sell recovered assets at discount (including through auctions). However, the disposal of distressed assets proved to be a slow process and MARA would need continuous improvement and attention from the authority to be able to carry out its mandate effectively.

Banking restructuring and privatization

4.2.9 The government undertook several steps to consolidate the banking system through restructuring and privatization of some selected state-owned commercial banks. These actions were completed successfully by the end of FSAC, although the pace of the progress was uneven with considerable delays at the beginning stages, due to the unfamiliarity with what needed to be done. With the following activities, the government has shown and honored its commitment to banking privatization.

4.2.10 *Divestiture of the government's ownership in TDB.* The privatization of the TDB took much longer time than originally planned. Lack of interest from the recognized international banking community and inexperience on the part of the Mongolian government to manage the privatization process. The tender process for TDB privatization was concluded in May 2002. The government sold its 76 percent stake in the TDB to a strategic investor group (Gerald Metal of the US and Banka Lugano of Switzerland). Currently, the new management team from ING is implementing a fundamental restructuring of the bank. IFC and ADB have also invested in the bank.

4.2.11 *Agricultural Bank (AgBank) restructuring.* AgBank was under the receivership status in 1999. FSAC supported the restructuring of the AgBank to restore its financial soundness, provide financial services to the rural areas, and prepared the bank to operate independently.

According to the restructuring plan, the government proceeded to acquire 100 percent of AGBank ownership, hired an experienced external management team, appointed an independent board, and eventually to privatize the bank once it was turned around. The external management team, consisting of two expatriate managers as Chief Executive Officer and Chief Operations Officer and four Mongolian executives, began their task in 2000 and fulfilled the above objectives 18 months later in 2002. Total equity grew from a negative figure of US$620,000 to a positive $5.9 million; total assets reached over $60 million from a mere $9 million. The rural branches were restructured and expanded in numbers to 375 from 269 in July 2000. The number of new accounts has increased. The quality of the loan portfolio was solid with low NPL level. Upon the successful turnaround of the bank, the government sold its stake in the bank in March 2003 through competitive bidding. The IFC has also invested in AgBank.

4.2.12 *Savings Bank.* FSAC supported the adoption of a time-bound action plan to privatize the Savings Bank. Savings Bank is an important banking institution in Mongolia with over 200,000 customers and accounted for about 25 percent of household deposits. Up until early 2004, the government was still considering options for the resolution of the bank. The plan incorporated the lessons and the benefits from the privatization of TDB and AgBank. The government issued Resolution No. 120 in April 2004, adopting a time table of specific actions to proceed with selling the bank and confirmed its commitment to a transparent process of privatization of this bank.

Improvement of government financial functions

4.2.13 Access to finance in the rural areas was improved following the successful restructuring of the AB. More branches were opened in the rural areas and better services were provided. Payment services in the rural areas were restored with the restructuring of the AgBank.

4.2.14 The government has also substantially replaced the BR Bonds which were issued in large quantities in 1996-97 with no clear-set maturity and coupon rate. In addition, arrears accumulated as the government failed to service the debt on time. Supported by FSAC, the government reached an agreement with BOM on the interest rate determination of the BR-Bonds. Since 2001, the government has made interest payments on time, and redeemed the bonds held by financial institutions (other than those held by BOM and the Savings Bank). The government also issued marketable Treasury bills with similar yield to that of the BOM bills. The amount of BR-Bonds of 24.8 billion togrog in September 2001 at FSAC's effectiveness was reduced to 14,1 billion togrog in mid-2004. The Treasury intended to redeem the rest of the BR-Bonds within the next two years.[8] With the lesson from the BR-Bonds, the government will need to develop its strategy for debt management and debt market development.

Note. 8. The bulk of the outstanding BR-Bonds were held by the Savings Bank. A rapid replacement of these BR-Bonds may have severe consequence for the bank's financial health because Savings Bank developed a loan portfolio only about three years ago and the BR-Bonds were the largest higher earning assets. An international advisor is expected to help the Ministry of Finance and Economy to develop a workable BR-Bonds replacement plan under the on-going Financial Capacity Development Projects in coordination with the implementation of the government action plan on Savings Bank's privatization.

4.3 Net Present Value/Economic rate of return:

4.3.1. Not applicable.

4.4 Financial rate of return:

4.4.1. Not applicable.

4.5 Institutional development impact:

4.5.1. FSAC helped to establish some basic financial infrastructure, notably banking skills, accounting standards, and enforcement of financial contracts which contribute to the improvement of the sector with long lasting effect. The adoption of the International Accounting and Auditing Standards by the government constituted an important step in requiring quality performance and reporting from the financial sector.

4.5.2. Under FSAC, some financial institutions were restructured and privatized with positively lasting impact in the Mongolian banking sector [Paras. No. 4.2.10-4.2.11]. The TDB was successfully privatized in 2003, albeit with some delays. The Ag Bank was successfully turned around in its performance after being place under receivership in 2000 and was subsequently privatized in October 2002.

4.5.3. The Credit Information Bureau (CIB), which was not an effective institution previously, has been upgraded and made more operational and useful for the commercial banking sector. The development and upgrade of the credit information system software administered by the CIB was completed and made operational following the user acceptance testing by BOM. The CIB has come a long way since its establishment in the late 1990s when it was a one-person shop with little information to share. The upgraded system now operates as an on-line system which collects data from almost all Mongolian banks and non-bank financial institutions for all borrowers, both corporate and individual. Information on credit defaulters can be shared among Mongolian banks, and between the banks and BOM. Based on user feedback from commercial banks in Mongolia, the upgraded system provides a useful tool for the evaluation of potential borrowers. While the effectiveness of the upgraded system will need to be further enhanced, the initial beneficial beginning of the CIB has already made a good institutional impact in the sector.

4.5.4. There has been commendable progress to strengthen the banking supervision and prudential regulations under FSAC policy framework and the IMF assessment on compliance with the Basle Core Principles found that the Mongolian legal and regulatory framework for the banking system reasonable, albeit with the qualification that some gaps and non-compliances are still existing and there is need for further improvement, especially in the area of enforcement. The independence of the BOM has been enhanced after the 2003 amendment to the Central Bank Law which establishes a supervisory board and prohibits the BOM from providing commercial guarantees. However, enforcement of this amendment is still a challenge [9] and further amendment would be needed for provision on an improved decision-making process for the BOM.

Note: 9. The BOM management extended, without prior Board approval, a large loan to the government in apparent violation of the Central Bank Law, when the government needed the funding to finance the repayment of a portion of Mongolia's old Russian debt.

5. Major Factors Affecting Implementation and Outcome

5.1 Factors outside the control of government or implementing agency:

5.1.1. FSAC recognized that a satisfactory macroeconomic framework was one of the basic requirements of the program and could be affected by the unusually severe winter weather, policy slippages, in addition to the fluid political situation following the general elections in June 2000.

5.1.2. The difficulty for the government to build internal consensus with regards to policy actions and indicators as required in the IMF's PRGF among the stakeholders.

5.1.3. The weak government capacity in technical skills and experience in banking and financial sector was not immediately under the control of the government in the short term.

5.2 Factors generally subject to government control:

5.2.1. The preparation of the project benefited from a close working relationship between the government and the Bank.

Most of the regulatory requirements and preparation and approval of action plans were generally

5.3 Factors generally subject to implementing agency control:

5.3.1. During project preparation, the MOF and the BOM participated in the design of the project, despite changes in the government and administration. The two institutions continued to be actively involved in the implementation of the project despite difficulties and delays in meeting tranche releases conditions.

5.4 Costs and financing:

5.4.1. The FSAC was a three-tranche operation. The amount of the credit was approved by the Board at SDR 24 million (US$ 32 million equivalent). The first tranche of SDR9 million was disbursed in September 2001 when the project was declared effective. The Floating Tranche of SDR6 million was released two years later in September 2003. The Second Tranche of SDR9 million was disbursed in September 2004 (with two waivers) and the project was closed on September 30, 2004.

6. Sustainability

6.1 Rationale for sustainability rating:

6.1.1. FSAC supported the effort of the government to implement the mid-term strategy for the financial sector. The series of actions undertaken under FSAC contributed to the consolidation of the banking system and strengthened the institutional capacity of the financial sector with the establishment of basic financial infrastructure and improvement in the legal framework, especially for effective regulation and supervision. These also would put the reforms in the financial sector on an irreversible trend in Mongolia, albeit with some uneven paces. However, the achievements and experiences gained so far would help build a lasting basis for further enhancement toward a sound and efficient financial system. The overall project sustainability is rated "likely" by the ICR.

6.1.2. The stabilization and restructuring of the financial sector have helped to boost the public confidence in the banking system (Para No.4.1.4). There was also evidence of financial intermediation deepening, meeting the needs of the real sector and contributing to economic growth and increased government revenues. Technical knowledge for loan evaluation process along with the upgrade of the CIB at the BOM have contributed further to the improved capability of the sector, including effectiveness in credit and risk evaluation, MIS, and overall staff training in bank services, and business operations. The successful privatization of the two largest banks would also set the stage for further sustained private sector development in the banking sector, with better banking services. The improved banking regulation and supervision would help set the stage for better corporate governance within the banking system in Mongolia. These institutional strengthening and improvement of the legal framework would have a permanent and positive effect on the economy.

6.2 Transition arrangement to regular operations:

6.2.1. FSAC was followed by the Financial Capacity Technical Assistance Project which was approved in 2002 and the Private Sector Development Project 2 which is being prepared for submission to the Board in FY2005. Further policy-based lending operations would be made within the framework of the Poverty Reduction Support Credit (PRSC), the new lending instrument by the Bank. PRSCs are in turn based on Poverty Reduction Strategy Papers (PRSPs), a government document which outlines its strategy for economic development and poverty reduction. Mongolia has developed a satisfactory full PRSP, the Economic Growth Support and Poverty Reduction Strategy (EGSPRS), presented to the Bank's Board in September 2001, and the reform process will be supported through PRSCs in the future, thus ensuring sustainability of the reform efforts. PRSCs would be more tailored to Mongolia's needs and circumstances, as the development of the PRSC program is based on the country's initiative and ownership outlined in its EGSPRS.

7. Bank and Borrower Performance

Bank

7.1 Lending:

7.1.1. The Bank responded timely to the need of the Mongolian economy in general and appropriately to the financial sector with the preparation of this operation. The preparation for the lending activity was rated satisfactory.

7.2 Supervision:

7.2.1. The Bank has diligently carried its supervision activities throughout the life of the project and contributed to the successful completion of the project. Bank staff maintained a close working relationship with the government and their counterparts, contributing to an effective implementation of the project.

7.3 Overall Bank performance:

7.3.1. The overall Bank performance was rated satisfactory with timely response to the need of the client country and with quality supervision of the project.

Borrower

7.4 Preparation:

7.4.1. The government played an active role in the preparation of the project. But the change in administration affected the effectiveness declaration of the project with some delay.

7.5 Government implementation performance:

7.5.1. The government implementation performance was satisfactory during the preparation and supervision of the project. Efforts in monitoring the activities of the project and good coordination with Bank staff to address emerging issues effectively to carry out the project to its successful completion.

7.6 Implementing Agency:

7.6.1. The MOF's and the BOM's continuing efforts to prepare and implement the project despite many adverse events and their performance was satisfactory.

7.7 Overall Borrower performance:

7.7.1. The overall borrower performance is rated as satisfactory. The government has brought the project to a satisfactory closure in a challenging political and economic environment and with weak civil service.

8. Lessons Learned

8.1. The major lessons are:

- Continuing commitment, support and ownership from the senior leadership in the government were needed not only during project preparation but also during the crucial stage of implementation to ensure a timely and successful completion of the project. It is difficult to ensure the continuing support and commitments especially when there is a change in the administration.
- Conditionality in an adjustment operation: The large number of conditions for project effectiveness and second tranche release will need to be balanced with the implementing capacity of the borrower. In Mongolia, these presented a serious challenge to the government in fulfilling them and also in maintaining the momentum and the continuous attention required throughout the whole life of the credit, especially when there were changes in the administration.
- The weak capacity and lack of information among government agencies would necessitate more awareness-raising seminars and workshops for senior and middle-level officials for policy changes to increase ownership. This necessitates a technical assistance operation in

capacity building programs to prepare the ground for, or a technical assistance operation in parallel with, the adjustment operation.

- A key to ensure fulfillment of tranche release conditions is the Bank team/management's continuous dialogue with main stakeholders on longer-term benefits of difficult policy actions required by adjustment lending, and contribution to consensus making between different government agencies under broad adjustment programs that affect multiple agencies.
- Coordination among international donors was essential within the financial sector to minimize overlapping of assistance, especially technical assistance.
- An appropriate time frame is required for the institutional-building components, especially in countries with weak civil service such as Mongolia. The time actually taken to introduce fundamental changes in the financial and banking sectors as well as institutional building necessitate better programming and sequencing.
- New institutions, once established, would need continuing monitoring and improvement in order to be effective in fulfilling their role in the financial sector.

9. Partner Comments

(a) Borrower/implementing agency:

MONGOLIA
BORROWER'S ASSESSMENT ON THE FINANCIAL SECTOR ADJUSTMENT CREDIT (Loan No.3334-MOG)

I. General background conditions

The World Bank International Development Association had agreed to lend 24 million Special Drawing Rights (SDR) or 32 million USD to the Government of Mongolia for the Financial Sector Adjustment Credit and its Development Credit Agreement had been signed on April 27, 2000.

Approval date of the World Bank Board of Directors:	2000.04.20
Agreement date:	2000.04.27
Effective date:	2001.09.27
Closing date:	2003.06.30
Closed date:	2004.09.30

General conditions are the same as the other credits provided by the International Development Association for 40 years (grace period is 10 years) with interest rate of 0.75% per annum. First payment of the principal will be July 15, 2010 and the last will be July 15, 2040.

II. Purpose.

The purpose of the Financial Sector Adjustment Credit is to support the Government's medium term strategy for financial sector reform and development needed to achieve macroeconomic stability, accelerate private sector-led growth and reduce poverty.

The main components of this strategy, which will facilitate the development of a sound and efficient financial system include: a) the establishment of a basic financial infrastructure (banking liquidity, accounting standards,enforcement of financial contracts, and a clear exit policy framework for troubled banks, b) strengthening of the banking system, c) privatizing state share of the Trade and Development Bank, d) developing effective regulating and supervising framework of the financial system, e) improving payment system in rural areas, f) confirming Government's commitment to honor financial contracts by timely servicing Government Bonds.

III. Definition

The Financial Sector Adjustment Credit was used for filling the gap of the balance of payment financing for 2002-2003, creating sources for bank lending for private sector development and economic growth by reducing net borrowing of the Government of Mongolia from domestic banks, and financing the cost of bank restructuring.

IV. Outcome

The main outcome of the Financial Sector Adjustment Credit was directed to provide macroeconomic stability and faster economic growth, and improve overall living standards.

Also the proceeds from this credit, which was provided within the framework of the Mongolia Country Assistance Strategy for 1999-2001, had helped in avoiding the decline of consumption and investment of Mongolia during the transition of its economy, and overcoming the trade shocks, which started in 1998 and caused by the decline of export product prices, at lower cost.

The Financial Sector Adjustment Credit had helped the Government of Mongolia in meeting its medium term strategy for financial sector needed for implementation of a Long Term Financial Sector Concept. The implementation of this strategy gave certain benefits to the economy and the population in strengthening capacity of entities, neutralizing risks, increasing companies' and citizen's access to the banking service, creating and expanding financial intermediaries' sources.

V. Components of the Credit:

The Financial Sector Adjustment Credit was provided in 3 tranches by the International Development Association(from which 1 is with floating tranche conditions).

First tranche of 12 million USD supposed to be transferred if the Financial Sector Adjustment Credit conditions for the first phase was met by May 2000 and the Development Credit Agreement becomes effective. But Government had extended this period 3 times due to not being able to meet the conditions and finally 12 million USD was transferred to the

Government budget account based on the World Bank's official statement "First tranche conditions are met" made on September 26, 2001.

The first tranche was used for the payment of interests of the Bank Restructuring Bonds, Treasury Bills, and financing the balance of payment deficit and current expenditure of the budget.

Conditions for the first tranche.

a.(i) *Borrower shall provide macroeconomic indicators agreed between Borrower and the Association.*

Macroeconomic indicators had been met.

(ii) *Adapt a time-bound action plan to reduce the Terms of trade shocks and economic loss as its consequence.*

Action plan to reduce economic loss caused by the Terms of trade shock was approved by Resolution No 188 of the Government of Mongolia in 2000.

(iii) *Develop and implement a plan to establish payment service network in soums including KHAAN (AgBank) bank's branches, and sub-branches and other qualified entities.*

Incorporating IDA's experts' comments and proposals, the Action Plan to develop payment system network in rural area was approved by the Bank of Mongolia and the Ministry of Finance and Economy /by old name/ jointly on July 15, 2000. Implementation started in August. At present, 12 banks are serving in rural areas through its 500 branches.

(iv) *Submit evidence that bank restructuring bond interests were paid fully to the Association by the date of Development Credit Agreement.*

Accumulated 2.1 billion Tugrics of due interests of the Bank Restructuring Bond were paid completely by September 2001.

(v) *Pay interests of the Bank Restructuring Bonds and Central Bank bonds in time with no delay. Develop and implement procedures on correlation of interests of the Government Treasuries and Bank of Mongolia Bonds. .*

In order to prevent the accumulation of interest payment, a rule of paying due interests on Bank Restructuring Bonds placed in banks within 7 days of the following month has been introduced. By standardizing the interest payment on the Bank Restructuring Bonds in correlation with the Bank of Mongolia Bond rate, all banks are paid the same interest on this bond.

(vi) *Instruct Savings Bank to adopt an asset-liability management policy, including cash, funding needs, and competetive market interest rates for deposits.*

Asset-Liability management policy, approved by Resolution No 73 of the Minister for Finance and Economy in 2001, was delivered to the Savings Bank. Asset-Liability Management Steering Committee was estalished and is operating now. Worked together with the World Bank, JICA and other financial institutions on improving operation of Saving's Bank's Asset-Liability Management Steering Committee.

(vii) *Approve an action plan to develop financial sector strengthening program covering Banking and supervision skills, accounting and auditing standards, enforcement of financial contracts.*

"Long Term Financial Sector Development Concept and Medium Term Strategy" and "Short Term Guidance on Banking Sector Restructuring and Development" (Letter of Development Policy from the Minister of Finance and the Governor of the BOM dated March 29, 2000)

"Action Plan for Strengthening Financial Sector" adopted by the Minister of Finance and the Governor of the BOM in a Joint Order dated September 6, 2001.

(b) *Develop procedures on classifications of loans and other assets..*

Incorporating IMF, World Bank and ADB's comments, "Procedure on classifying the assets, and establishing and using the asset risk fund" was approved by joint Resolution No 614/125 of the Minister for Finance and Economy and the Governor of the Bank of Mongolia in 2000. Amendment was made in September 2004.

Experiences gained.

- Making the interest payment of the Bank Restructuring Bond in time and standardizing its level linked with the Bank of Mongolia Bond interest rate made the Government of Mongolia to be able to pay the same interest rate based on the market interest level and influenced the operations of the commercial banks,who hold the bonds, in a positive way.

- Establishment of payment system network in rural soums stimulated the delivery of banking service to the rural area and creation of favorable environment for the banking operation through local government and businessmen effort. This operation has been implemented through KHAAN (AgBank) bank's branches and as a result KHAAN bank became the leading bank in terms of branches with its 354 branches.

- Among the actions taken under the financial sector stabilization framework of the Financial Sector Adjustment Credit, "Asset and Liability Management Steering Committee" was established and operations of the bank was stabilized, consequently its solvency improved and Bank of Mongolia prudential ratios have been met constantly. As a result the Savings Bank became one of the largest commercial banks of Mongolia with a profit of 1.1 billion Tugrics by the end of 2004.

Conditions for the floating-tranche.
Meet macroeconomic indicators agreed with the International Development Association.

Macroeconomic indicators had been met.

Privatize Trade and Development Bank.

TDB was privatized in 2003 successfully.

Based on the successful fulfilment of the floating *tranche* conditions, 8.5million USD was transferred to the budget account on November 7, 2003.

At the time of recieving the floating *tranche*, financial sector of Mongolia had achieved certain progress due to the fulfilment of the most conditions of the I and II phases of the Financial Sector Adjustment Credit. For example, Mongolian Asset Recovery Agency had recieved legal status, and TDB and KHAAN banks were privatized successfully.

Conditions for the II tranche

Due to the necessity of meeting the conditions for the II *tranche* and agreeing on the final fulfilment of credit conditions the Government of Mongolia made a request for extention of closing date on June 4, 2004, although the FSAC proceeds supposed to be fully used by June 30, 2003. As a result it was extended until June 30, 2004.

According to the World Bank notification to transfer the II *tranche* of the Financial Sector Adjustment Credit before September 30, 2004 $13.2 million US was transferred to the budget account on October 4, 2004.

1. *·. Develop and implement an action plan to reduce the Terms of trade shocks and economic loss as its consequence.*

Action plan to reduce economic loss caused by the Terms of trade shock was approved by Resolution No 188 of the Government of Mongolia in 2000. Operational plan to implement the actions in the action plan was approved by the Decree of the Ministry for Finance and Economy and it is under implementation.

b. *Implement KHAAN (AgBank) bank's restructuring plan..*

As a result of the successful implementation of the KHAAN bank's restructuring plan, approved in June 2000, financial ability and solvency of the bank had been improved, and Bank of Mongolia prudential ratios had been met constantly. It was privatized in March 2003.

c. *Replace all outstanding Bank Restructuring Bonds with marketable and tradable securities.*

By December 31, 2003 the Savings Bank had a balance of 16.1 billion Tugrics worth of

Bonds (BRB), from which 6.1 billion Tugrics worth of bonds were monetized in 2004 and 10 billion Tugrics bonds remained by the end of 2004.

Interest rate of the Bank Restructuring Bond was between 14.25-18.00% in 2004 and interest payment of 2.4 billion tugrics were paid in time.

For this year 1.0 billion Tugrics worth of bonds were monetized, and currently Bank Restructuring bond balance is 9 billion Tugrics. This is planned to be replaced by the Government discounted Treasury Bills as part of the government's 2005 borowing program approved by the Parliament on February 21, 2005.

d. *Develop and implement a time-bound action plan for Savings bank privatization.*

A preparation plan for Savings bank privatization incorporating World Bank comments and advices was developed by a multi-agency government working group and approved by the Government Resolution 120, 2004. Within the Financial Capacity Development Project the implementation has been started with the international advisors.

e. *Implement (vii) of (a) of 5.01 of the Development Credit Agreement.*

Medium Term Financial Sector Reform Guidance was approved by the Government of Mongolia. Financial Sector Infrastructure Improvement Plan within the framework of this guidance was approved by joint resolution 128/235 of the Minister for Finance and Economy and Governor of the Bank of Mongolia in 2001 and is under implementation.

2. a. *Make the following amendments to the Banking Law. Make commercial banks to develop action plan to increase capital adequicy ratio, increase assets, limitate new activities, improve management etc., whenever the bank's Capital Adequicy Ratio falls below 75% and 50% of the minimum CAR required level as determined by the Bank of Mongolia.*

An amendment made in the Banking Law in February 2001 legalized the Bank of Mongolia's right to approve the prompt corrective actions for the commercial banks in trouble. Amendments were made by the Bank of Mongolia's Governor's Decree No 459 dated in October, 2001 to the related procedures by a list of corrective actions to be taken when the commercial banks are not meeting the capital adequicy ratio.

b. *Bank of Mongolia has to send a Reciever to the commercial bank when its CAR falls below 25% of the minimum CAR level determined by the Bank of Mongolia..*

By current regulation a receiver shall be send by the Bank of Mongolia when the CAR is zero or below zero, or its operation was not improved by special remedial action.

c. *Bank of Mongolia has to take urgent or prompt measures when occured conflict with the provisions of the Banking Law, particularly owners or the managers of the bank misused the bank asset, or did not meet legal requirements, or did not implement requirements of authorities.*

Main measures to be taken and requirements to the bank managers were clearly indicated in 31 and 6.25 of the Banking Law.

d. *Create liquidation system of the assets of the bankrupted bank.*

Amendments were made in the Chapter 6&7 of the Banking law in 1998 and 1999, and corrective actions to be taken to the insolvent banks and issues related to the rights of liquidating bank assets were included in these amendments more clearly. Also Regulation on Bank Liquidation Commission operation was approved on December 29, 2000.

3. *Develop a plan to improve the operations of the Bank of Mongolia's credit information data base, satisfactory to the IDA, and facilitate share of information on loan defaulters between Bank of Mongolia and commercial banks.*

In order to expand the operation of the credit information data base of the Bank of Mongolia related softwares were renewed by Grape City company, winner of the bid. Information is exchanged according to the agreements concluded with the banks and cooperation agreement with Stock Exchange, National Customs Authority, National Tax Office, Immovable Property Registration Office and MARA.

4*.To give legal status to the Mongolian Asset Recovery Agency.*

Loans with court decision were transferred to the Court Decision Enforcement Agency and the Mongolia Asset Recovery Agency status was changed into State owned enterprice (SOE) by Government Resolution No 109 on "Intensifying asset recovery actions" in 2002.

Experiences gained and outcome.

- As a result of approval and implementation of the "Long Term Financial Sector Development Concept and Medium Term Strategy" and "Short Term Guidance on Banking Sector Restructuring and Development" within the Financial Sector Adjustment Credit framework, banking sector has been stabilized through reduced financial system centralization risk. By improving related legal acts and regulations, loan repayment rate increased substantially for the recent years, bank managment skills improved, and managers gained experience. This was a very important policy measure in improving Bank of Mongolia's supervision and inspection of commercial banks, assessing risk in the operation of the commercial banks, and in managing bank in professional way.

- Introduction of an international banking management has started in the Mongolian banking sector as a result of the banking sector privatization, which was implemented within the Financial Sector Adjustment Credit. Bank privatizing experience was gained through the privatization of the TDB and the KHAAN bank. Based on this experience the Savings Bank shall be privatized in 2005.

- Activities of the agreement signed between the Bank's international consultant, the Ministry of Finance and Economy and the Consulting company were implemented successfully in time. Consultant's advices provided on privatization preparation plan were delivered to the Bank of Mongolia, The State Property Committee and the Savings Bank. Preparation activities of the plan for the privatization are under successful implementation.

- Extention of legal empowerment of the MARA in order to intensify the recovery of asset facilitated faster recovery of bad loans and organizing auctions by bad loan packaging. But we are seeking for more flexible and faster asset recovery ways, since the current recovery process is too lengthy.

- Government budget was not able to monetize the Bank Restructuring Bond. Therefore replacement of the Bank Restructuring Bonds (BRB) with the marketable securities, Treasury Bills, will enable the bank to pool funds through trading these securities on inter-bank market when the bank is needed. Introduction of the Single Treasury Account improved the treasury management, facilitated monetization of BRB linked with the Saving's Bank loan growth and trading of the BRB at the inter-bank market. But 9 billion Tugrics worth of BRB placed at the Savings Bank is planned to be replaced by Government discounted Treasury Bills at annual interest rate 12.5-17.0%.

- The implementation of the Financial Capacity Development Project has started by the World Bank and the Government of Mongolia in order to meet FSAC second tranche condition for providing preparation of the Savings Bank's privatization.

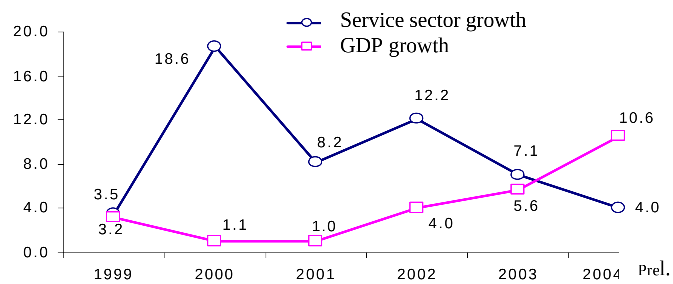
Conclusion.

The Financial Sector Adjustment Credit to support the Government's medium term strategy for financial sector reform and development needed to achieve macroeconomic stability, accelerate private sector-led growth and reduce poverty is implemented successfully.

During the implementation period of this program the Government has emphasized on the policy objectives of reducing unemployment and poverty through facilitating economic growth, declining budget deficit, stabilizing price and exchange rate depreciation in order to maintain macro economic stability.

Policies for intensifying banking sector restructuring, creating sound banking framework through attracting foreign investment, preparing and privatizing to the domestic and foreign strategic investors, converting the banking sector in to a private one through shrinking state ownership, improving commercial banks' competitiveness, management and internal control were put in place in order to create sound banking sector. As a result of these policies and their gradual and sophisticated implementation banking sector has been recovered and stabilized.

Picture 1. Economic Growth

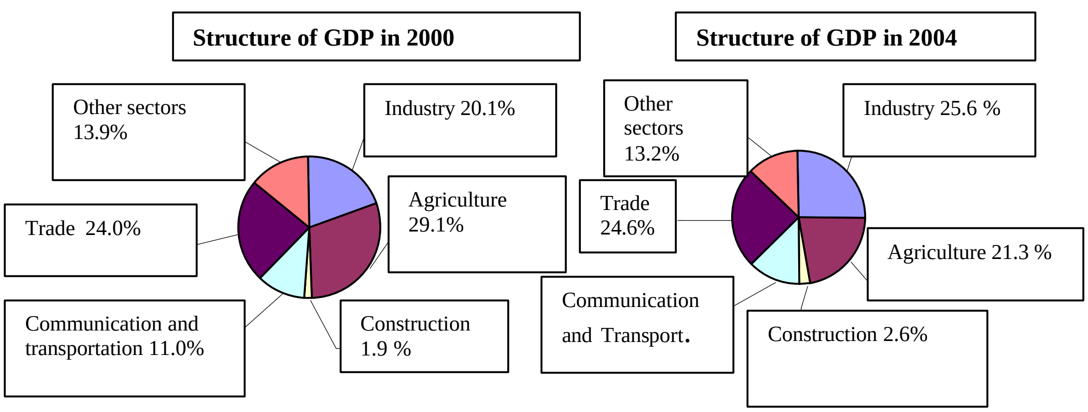


As a result of these policies and actions the economy has been rehabilitated, banking and financial indicators improved and growth in the economy has fastened. Economic growth in 2004 was 10.6%. An animal husbandry sector, the main sector of our economy, had considerable loss during 2000-2001 caused by natural disaster. But since 2002 situation has been improved and economy is growing faster.

Although the economy is growing faster for the recent years, the primary sector -agriculture and mining - production is making the most of the growth. Therefore it can not create sustainable growth and increase the employment to the substantial level.

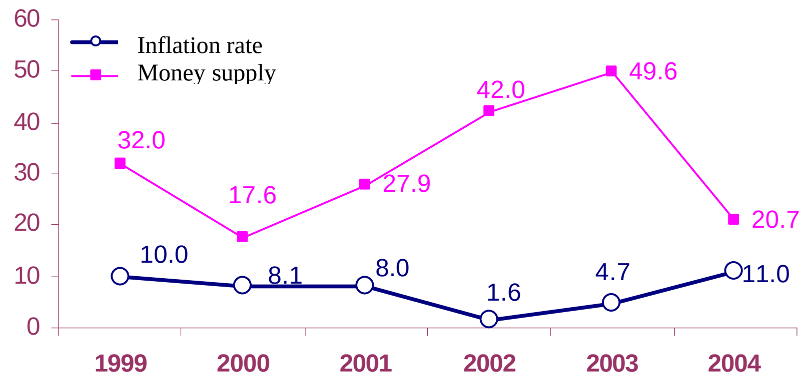
GDP per capita is expected to reach 600 USD for 2004, increase by 18.3% compare to the previous year. Real GDP per capita is expected to increase by 9.3% in 2004.

Picture 2. GDP



Increase of price of consumption goods and services was comparably low for the last 4 years. Inflation has comparably decreased since 2003 and in 2002 it went down to the minimum level of the transition period. In previous years money supply raised due to substantial increase of citizens' deposits, while money beyond the banking system was not increased to that level. Bank of Mongolia's policy on reserve money could maintain the money beyond the banking system below 10% and consequently the inflation was declined. Average growth of money beyond the banking system is 9.1% for 200-2004. Main portion of the money supply growth is the increase in deposits of the individuals and entities. Consequently the loan to the private sector has been increased faster. This has stimulated the economic growth and increased the supply.

Picture 3. Inflation, Money Supply, from the beginning of a year -%



(b) Cofinanciers:
None.

(c) Other partners (NGOs/private sector):
None.

10. Additional Information

Annex 1. Key Performance Indicators/Log Frame Matrix

Macroeconomic Performance Indicators and Outcome

Mongolia: Annual Macroeconomic Data
Table 1. National Accounts and Government Finance a/

	1998	1999	2000	2001	2002	2003	2004
National Accounts (Bil. Togrogs)							
GDP	817.4	925.3	1018.9	1115.6	1240.7	1362.5	1808.0
Industrial output	476.1	525.8	645.4	726.2	696.9	783.3	1164.5
CPI (%)	6.0	10.0	8.1	8.0	1.7	4.7	11.0
Registered unemployment rate (%)	5.8	4.6	5.0	4.6	3.6	3.5	3.6
Exports	345.2	454.2	535.8	521.5	524.0	615.9	853.3
Imports	-503.3	-512.8	-614.5	-637.7	-690.8	-801.0	-1011.6
Trade balance	-158.1	-58.6	-78.7	-116.2	-166.8	-185.1	-158.3
Net international reserves	80.3	116.9	140.7	160.1	225.9	129.1	163.6
Government Finance							
Revenues and grants	240.0	266.5	351.1	439.3	477.0	535.8	692.8
Expenditures and net lending	342.1	364.7	429.7	489.7	550.5	616.5	717.3
Total government wage bill	56.0	63.5	86.1	92.1	105.0	116.3	129.4
Fiscal balance	-102.1	-98.2	-78.6	-50.4	-73.4	-80.7	-24.5
Net borrowing from domestic financial institutions b/	41.5	34.5	17.1	-6.8	-32.4	96.7 d/	40.5
Net transfer to non-financial SOEs (% of GDP) c/	0.4	0.6	0.3	0.5	0.7	0.6	0.6

Note:

a. National account office data in current prices.

b. Net credit to government – IMF and BOM data

c. Subsidies to state-owned enterprises – IMF and BOM data.

d. Revised according to reclassification of loans to non-residents.

Mongolia: Annual Macroeconomic Data
Table 2. Money and Banking

	1998	1999	2000	2001	2002	2003	2004
Monetary Aggregates (bil Togrogs)							
Broad money (M2)	167.3	220.4	258.8	331.4	470.1	703.6	847.0
Reserve money	74.8	112.1	132.9	143.8	175.3	200.8	234.9
Cash outside bank	56.4	87.3	100.9	109.2	120.8	131.5	143.5
Net foreign assets	96.6	167.5	201.7	220.2	308.5	256.3	311.0
CB-bill rate (% - 91 days)	28.7	18.3	14.2	8.6	11.4	13.5	16.0
Exchange rate (MNT=1.00 USD)	891.9	1070.4	1097.0	1101.3	1124.1	1168.0	1209
Bank Performance Ratios (%)							
Capital adequacy	1.5	20.4	27.0	24.6	20.0	20.4	20.
Liquidity b/	32.1	56.4	55.4	48.4	48.8	41.0	Na
Non-performing loans	41.7	37.2	23.5	8.0	7.2	8.2	6.0
Return on assets	-6.4	-4.2	4.2	5.9	4.3	3.1	2.5
Return on equity	-55.4	-31.4	20.6	23.2	20.8	14.7	12.3

Source: BOM data.

Annex 2. Project Costs and Financing

Project Cost by Component (in US$ million equivalent)

Project Cost by Component	Appraisal Estimate	Actual/Latest Estimate	Percentage of Appraisal
IDA	32	32	100.0
Total Project Costs	32	32	100.0

Note:
1. Details may not add to total due to rounding.
2. Figures are amounts to be financed by IDA credit.

Annex 3. Economic Costs and Benefits

	Costs	Benefits	NPV	ERR (%)
Not Applicable	N/A			

Annex 4. Bank Inputs

(a) Missions:

Stage of Project Cycle	No. of Persons and Specialty (e.g. 2 Economists, 1 FMS, etc.)		Performance Rating	
Month/Year	Count	Specialty	Implementation Progress	Development Objective
Identification/Preparation				
Nov-Dec 1999	*6*	2 TTLs; 1 Financial expert; 2 banking expert, 1 legal expert	S	S
Appraisal/Negotiation				
Jan 2000	*8*	2 TTLs; 1 Financial expert; 2 banking expert, 1 legal expert, 1 economist	S	S
Supervision				
9/2000	*3*	2 TTLs, 1 Financial expert	S	S
06/09/2001	*3*	TTL (1); CMCIAL BNK RSIK MGNT (1); BNK RESTRUCTURING (1); OPER. ANALYST (1)	S	S
3/2002	*2*	TTL (1) FINANCIAL EXPERT (1)	S	S
10/01/2002	*2*	TASK TEAM LEADER (1); BANKING SPECIALIST (1)	S	S
06/28/2002	*4*	TTL (1); BNK SUPV (1); BNK RISK MGNT&RESTRCT (1); BANKING SPECIALIST (1)	S	S
Oct 2002	*2*	TTL (1); BANKING SPECIALIST (1)	S	S
Feb 2003	*1*	FINANCIAL EXPERT (1)	S	S
Jun 2003	*2*	TTL (1); FINANCIAL EXPERT (1)	S	S
Aug 2003	*1*	TTL (1)	S	S
Sep 2004	*1*	TTL (1)	S	S
ICR				
ICR	*2*	TTL (1); ECONOMIST (1)	S	S

(b) Staff:

Stage of Project Cycle	Actual/Latest Estimate	
	No. Staff weeks	US$ ('000)
Identification/Preparation	10.0	35.0
Appraisal/Negotiation	87.5	306.1
Supervision	74.3	334.3
ICR	12.0	42.0
Total	183.8	717.5

Note: 1. Figures do not include Trust Funds. SAP data only show a combined figure for Identification/Preparation and Appraisal/Negotiation.

Annex 5. Ratings for Achievement of Objectives/Outputs of Components

(H=High, SU=Substantial, M=Modest, N=Negligible, NA=Not Applicable)

	Rating				
	H	*SU*	*M*	*N*	*NA*
☐ *Macro policies*	○	○	●	○	○
☐ *Sector Policies*	○	●	○	○	○
☐ *Physical*	○	○	○	○	●
☐ *Financial*	○	○	○	○	●
☐ *Institutional Development*	○	●	○	○	○
☐ *Environmental*	○	○	○	○	●
Social					
☐ *Poverty Reduction*	○	○	○	○	●
☐ *Gender*	○	○	○	○	●
☐ *Other (Please specify)*	○	○	○	○	●
☐ *Private sector development*	○	●	○	○	○
☐ *Public sector management*	○	○	●	○	○
☐ *Other (Please specify)*	○	○	○	○	○

Annex 6. Ratings of Bank and Borrower Performance

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HU=Highly Unsatisfactory)

6.1 Bank performance	*Rating*
☐ *Lending*	○ *HS* ● *S* ○ *U* ○ *HU*
☐ *Supervision*	○ *HS* ● *S* ○ *U* ○ *HU*
☐ *Overall*	○ *HS* ● *S* ○ *U* ○ *HU*

6.2 Borrower performance	*Rating*
☐ *Preparation*	○ *HS* ● *S* ○ *U* ○ *HU*
☐ *Government implementation performance*	○ *HS* ● *S* ○ *U* ○ *HU*
☐ *Implementation agency performance*	○ *HS* ● *S* ○ *U* ○ *HU*
☐ *Overall*	○ *HS* ● *S* ○ *U* ○ *HU*

Annex 7. List of Supporting Documents

ANNEX 7 - Detailed Review of Board Effectiveness and Tranche Release Conditions.doc