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FOR AGENDA

SM/08/151
Correction 1

June 3, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Mongolia—Financial System Stability Assessment**

The attached correction to SM/08/151 (5/14/08) has been provided by the staff.

Typographical Error

Page 30, para. 53, line 10: for “2005” read “2006”

Questions may be referred to Mr. O’Brien (ext. 34319) and Ms. Loukoianova (ext. 35916) in MCM.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

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Department Heads

Table 4. Mongolia: Summary Results of the Stress Tests [1/]

(based on the data of June 30, 2007)

Test	Regulatory Capital (in percent of risk weighted assets)			
	Group 1	Group 2	Group 3	Total
Baseline capital adequacy ratio	12.3	40.4	13.1	15.2
A. Sensitivity analisys				
Exchange Rate Risk				
Depreciation by 15 percent	13.0	42.1	13.1	15.8
Appreciation by 20 percent	11.4	38.2	13.0	14.3
Appreciation of CNY by 10 percent	12.3	40.4	13.0	15.2
Interest Rate Risk				
Increase in interest rates by 10 percentage points	10.1	38.2	11.1	13.0
Steepening in the yield curve	11.6	39.7	12.5	14.5
Flattening in the yield curve	12.3	40.5	13.0	15.2
Credit Risk				
Shock to the agriculture sector	8.6	40.0	11.6	12.3
Increase in the NPL ratio by 10 percentage points	6.7	36.8	7.7	9.8
Downgrading of classified loans by one category	11.1	38.4	11.8	13.8
B. Scenario Analysis				
Scenario 1	7.1	37.8	7.0	10.1
Scenario 2	9.5	36.9	11.2	12.5

1/ Group 1 includes five largest banks, accounting for almost three quarters of the total market share in terms of assets; Group 2 includes six small banks, with a combined market share of 7.3 percent, which all perform more investment banking-type of activities; and Group 3 includes the remaining five small- and medium-sized banks.

Appendix 2. Mongolia: Supervision of Savings and Credit Cooperatives

53. **The SCC sector has grown rapidly, without a clear formal regulatory and supervisory framework that would ensure financial discipline and protect member savings**. Prior to the creation of the FRC in early 2006, SCCs were not under the purview of a government entity and were governed by the law on cooperatives which does not adequately distinguish between the financial intermediation role of SCCs and those cooperatives which offer non-financial services to their member base. A consequence was the proliferation of financially weak SCCs. The imposition of the oversight of SCCs led to the failure of 32 SCCs accounting for more than half the assets of the sector in 2006.[17] The reputation of the SCCs sector has suffered as a result and it has yet to recover. A law specific to SCCs was drafted in 2006 but has not been passed yet. The FRC has gained some initial experience since 2006 in supervising SCCs, and portions of the draft law may need to be revisited to ensure proper implementation. It is also critical that prior to the passage of this law, the SCC industry's views are sought.

54. **In the absence of appropriate legislation for SCCs and in light of a large number of member complaints, the FRC issued in 2006 a temporary regulation on licensing SCC activities**. Out of 955 registered SCCs in 2006, around 500 applied for a license before October 1, 2007 (the deadline for applying for licensing), and many have been subsequently licensed. These newly licensed SCCs are located mainly in the capital city and competing directly with the banking sector by offering higher deposit rates.

55. **The FRC's capacity to supervise SCCs is constrained by limited skilled and experienced staff as well an appropriate complement of number of staff to conduct the inspections**. Since June 2006, the FRC has conducted 50 on-site supervisions of SCCs and its mandate is to conduct these regardless of the size of the SCC. As the licensing process could result in over 200 SCCs, it is critical that FRC collect data on the key characteristics of the newly licensed ones and categorize them as large, medium and small (based on asset size, number of members, etc.) and consider using a tiered model to supervise them on-site. Prudentially regulating all SCCs may not be either necessary or feasible in light of FRC's limited staff capacity. As the draft law is still being discussed, it would be useful for FRC to examine the experience of some other countries using the tiered approach and revise the supervisory aspects in the law accordingly

[17] Around half of the total loss of the failed SCCs (TOG 33 billion) is supposed to be paid out by the state budget. As of April 2008, TOG 19 billion has already been paid.