OPERATION EVALUATION SUMMARY

Mongolia Financial Sector Framework

Mongolia

European Bank
for Reconstruction and Development

June 2013

EBRD EVALUATION DEPARTMENT

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Industry:	Depository Credit (Banks)	Portfolio:	Private
Disbursement:	19 December 2006 and 29 October 2007	Project risk rating:	Various
Investment type:	Debt/Equity	Environmental category:	FI
Total amount:	€7.8 million (debt)/€13.6 million (equity)	Board approval:	18 September 2007
EBRD amount:	€7.8 million (debt)/€13.6 million (equity)		

1. Executive summary

This is an evaluation of the Mongolia Financial Sector Framework (MFSF), an administrative umbrella for implementing investment projects and the accompanying framework for technical cooperation (TC) operations with a view to:

- Improve financial intermediation
- Increase access to longer term finance for micro, small and medium-sized business (MSMEs), including through non-bank financial institutions (NBFI)
- Enhance the regulatory framework
- Promote transparency and corporate governance.

It was the first such operation to be approved following the inclusion of Mongolia as an EBRD country of operations in 2006. Over the implementation period a number of loans and two equity investments amounting to €46.5 million were provided to three leading Mongolian commercial banks. TC projects provided the banks with support for institution building, primarily through advice and training on lending and leasing procedures, as well as trade facilitation.

The different activities under this framework have had varied results. Whilst the investments with two of the banks did well and led to large successor operations outside this framework, the engagement with the other was short, turbulent and unsuccessful.

An important role was played by policy dialogue with domestic regulators and financial authorities, which was provided alongside that of numerous other international agents. In addition, other EBRD units undertook technical cooperation projects and legal advisory work outside of this framework but in pursuit of the same overall objectives.

1.1. Achievements and lessons identified

The rating of a framework is typically challenging, given the need to develop and consolidate ratings across different but interlinked areas of effort. For reasons explained in the main text, it proved to be particularly difficult to assign a meaningful overall rating and summarise average ratings for each category in the context of the MFSF. Consequently, this report focuses on the “design aspects” of the framework and practical recommendations for the future. The latter is of particular relevance as the operation team is now in the process of elaborating the next phase of the framework.

The financial sector in Mongolia has developed dynamically in recent years. The EBRD, along with other IFIs, appears to have contributed appropriately by providing longer term credit lines, ensuring liquidity during the financial crisis and supporting the capitalisation and corporate governance of local banks through equity investments. On the other hand, there is little evidence that the EBRD was able to support the intended development of the NBFI market segment. While some of the clients interviewed expect to start activities in this segment soon, it is less clear how the EBRD might help to trigger this more effectively in Phase II. Given the prominence of the MSME target group, it would have been beneficial to see a clear definition of what exactly is included in this group and what kind of barriers they are facing in their access to finance.

Supplementary policy dialogue and TC projects were intended to strengthen the business practices of EBRD clients. Important outcomes have been evidenced on site, mostly with two of the banks. Even in the unforeseen and unfortunate case of the failure of the other bank, strong positive effects were noted through a sector-wide demonstration of the need for corporate transparency and good governance. Unfortunately, there is little documentation of the non-transactional TC and policy dialogue activities in pursuit of wider sector reform and related results. Valuable institutional knowledge and transition capital is therefore at real risk of getting lost and a concerted effort for its recovery will be needed in the context of Phase II development.

1.2. Findings and recommendations for the next phase of the MFSF

The MFSF has certain features of the EBRD’s **integrated approach;** application of this tool or a variant might usefully be considered for Phase II as a means to more comprehensive planning and monitoring of achievements at different levels.

Improved transition impact (TI) benchmarks and other metrics for measuring progress at framework and sector-level need to be identified, integrated and resourced if the team is to be able to tell a more effective story from the next Phase or to better understand how further improvements might be obtained. Important advances now underway with respect to a strengthened results system for country strategies and TC will need to be integrated fully.

The second phase of the framework should be straightforward to define cost-sharing schemes for repeated TC projects with the same client. Good examples are available from other similar framework programmes implemented by the EBRD.

2. The scope of this evaluation

As an operation evaluation, this report would usually validate the ratings assigned by the operation team in its self-assessment of the project and supplement them with information and evidence collected in the field. In this case though, the subject is not a stand-alone investment but a framework using a combination of different instruments, such as investments, technical cooperation projects (TC) and policy dialogue measures (PD). Moreover, the MFSF was supplemented by other activities in pursuit of similar objectives including policy dialogue and legal advice, some of which were delivered by the same team and some by other EBRD units.

The linkages between the framework and other activities are especially interesting if they affect a higher (sector) level and therefore contribute (or not) to the framework’s transition impact. In order to comprehensively address these individual elements, the evaluation mission assembled a small team for the site visit, including a TC specialist and an analyst from the Office of the Chief Economist (OCE).

Because of the diversity of the measures undertaken, as well as the blurred borders between the framework and other activities, EvD decided that there would be no benefit in concluding on overall ratings and that it would be much more relevant to focus on the design of the framework and its position in the overall transition context instead. Still, the report does discuss results in all main evaluation categories, from additionality to transition impact.

In the EBRD's special context, it is sometimes challenging to separate the operational objectives of a project from its expected transition impact. The evaluation team addressed this by separating the anticipated results between 'outputs' on one hand, and 'outcome/ impact' on the other.

The unfortunate operation with the bank that failed has some exceptional features. The assessment therefore concentrates on the two other clients in the framework. As the operation team is presently preparing the second phase of this framework, the evaluation team paid particular attention to drawing practical findings and recommendations that could be helpful in this process.

3. Project relevance to the EBRD's mandate

3.1. What was the rationale behind this project?

The main rationale for this framework can be interpreted as ensuring access to finance for small and medium-sized enterprises (SMEs) because "commercial lending, in particular for SMEs, is troubled by high interest rates, lack of long term lending and an unsatisfactory institutional environment" (extracted from Board document).

3.2. Is additionality confirmed?

International donors were active in the Mongolian Financial Sector prior to the EBRD's involvement, with many engaged in very similar activities and often targeting the same institutions. While this confirms the relevance of a framework approach, it also raises the bar significantly with respect to making a persuasive case for additionality. The EBRD's focus was primarily on private sector clients but it proved difficult to identify sound financial institutions that met the strict integrity criteria. As a result, participating banks (PBs) received support from several IFIs.

The operation team's self-assessment stressed that the EBRD project was additional by design, considering the transition impact expectations based on the Bank's knowledge of and previous experience in the Mongolian financial sector. This refers mainly to the TC projects[1] implemented at a number of Mongolian commercial banks. Commendable though these activities are, the Bank was again far from being the only institution active in this sector.

In summary, it is not easy to fully verify the additionality for the framework or to specifically attribute positive developments from previous years to the EBRD, although it may be said with some confidence that it has made a positive contribution.

[1] Funded by the Mongolia Cooperation Fund (MCF) which is evaluated in parallel.

4. Project objectives

- **Increased lending activities to MSMEs**

Increased lending activities to MSME are at the core of the MFSF and this was an expectation at approval. The gross loan portfolios (GLP) of the two PBs remaining in the framework have increased substantially. The GLP of one of the banks more than doubled and that of another more than quadrupled. The GLP include MSME lending activities (in terms of volumes) accounting for approximately 35 per cent to 60 per cent. The extension of PB branch networks serves as a proxy indicator for increased lending provided to rural MSME. One of the banks has increased its branch network overall and set up four SME Business Centres. Another has steeply increased its regional branches and sales points from 68 to 100.

By partnering with the two main players in the Mongolian MSME market, the EBRD has achieved the financial intermediation objective on the whole. However, the interpretation and attribution of results requires caution. Any effect has to be seen against the backdrop of the extremely dynamic overall financial sector development in the period in question.

- **Supporting the capital base and funding of local banks**

One of the explicit objectives of this framework was to support the capital base of the participating financial intermediaries (PFIs). The debt operations aimed at ensuring liquidity whereas the equity investments were to help with the capitalisation and consolidation of the banking sector.

The first equity investment within this framework (for US$ 12 million) was completed in 2007 with the holding company of one of the banks and other subsidiaries. The Bank also invested in a 25 per cent +1 shareholding in another in 2008. This bank went into receivership in November 2009 and was delisted. The EBRD equity investment is unlikely to be recovered.

The assets of both remaining PBs grew by an extraordinary amount. It should be noted that one of the banks has also received equity investments (from other IFIs) and the contribution of the MFSF would be more accurately viewed in the provision of liquidity and advice during the crisis period 2008-09.

- **Development of the NBFI segment**

Firstly, the MFSF appraisal document stresses the need to develop the non-bank financial sub-sector through the support of related institutions and accordingly built this into the design of the accompanying TC framework. Secondly, assistance in developing innovative products and services was to be given to clients (bank and non-bank). There were two TIMS benchmarks set in this area for the two remaining PBs in the MFSF, both requesting the introduction of new products such as in the area of micro-leasing.

Results have fallen short of expectations. At framework level, the operation team's self-assessment report states that no suitable MFI or NBFI client institution could be identified due to issues with either integrity or creditworthiness. No PB has been able to introduce new insurance, mortgage or leasing products on a greater scale either. The experience of a TC project addressing one of the regulatory gaps in the NBFI segment in 2008 was informative. An attempt was made to help implement the primary insurance law enacted in 2005 by advising on related regulations. The consultant was to work closely with the Financial Regulatory Commission (FRC). After a productive inception phase in the consultant's view[2], the FRC was

[2] As can be taken from the Consultant's Final Report.

not satisfied with the advice and no tangible result emerged from the activities. Instead, the FRC renewed its request for the Bank's assistance in this area during the evaluation mission.

Overall, little was achieved in this segment. Two of the banks stated that it was just a question of time until NBFI products such as saving/insurance/mortgage would be offered. The choice for the operation team is whether to take an active approach in defining current bottlenecks and trying to address them with TC and policy dialogue or – as with the last phase – waiting for an opportunity to unfold. Based on this review, the latter course is unlikely to find persuasive argumentation in its favour.

5. Project handling efficiency

Bank handling is judged to be very efficient and praise was heard from clients on site for the successful building and maintenance of good relationships. A number of succeeding investments with two of the three PBs in this framework also suggests this. The Resident Office (RO) in Ulan Batar is able to effectively coordinate activities where they fit. Some lessons were identified in relation to the engagement with the bank that did not perform and the handling of the TC framework. With regard to the latter, it was noted that the PBs had been multi-year recipients of a range of different technical assistance and cooperation projects from multiple sources. That bears the risk of duplicating individual efforts, diminishing the effective coordination and efficiency of activities and eventually leading to client "saturation".

6. Contribution to longer term impact

6.1. Improved financial intermediation and access to long-term funding

6.1.1. *Improved financial intermediation*

This framework has to be seen in light of the very dynamic development of the Mongolian banking sector as well as the harsh effects of the global financial crisis during the lifetime of the MFSF. Since 2010 a steep increase in domestic credit provision is apparent, which was also experienced by the PBs and described by interviewees as a rise in credit volumes of 70 per cent in 2011. The Bank of Mongolia (BoM) took action to prevent the financial markets from overheating with the result that banks are once again reporting problems with liquidity.

Again, it is not possible to attribute the overall sector development directly to the activities of this framework. On the other hand, leverage for demonstration effects is certainly there, given that two of the banks together constitute some 33 per cent of the Mongolian market by bank assets. A number of interview partners pointed to important demonstration effects from the Bank's engagement with the two market leaders of MSME financing, in terms of the general promotion of this customer segment in Mongolia.

6.1.2. *Increased access to longer-term finance*

One of the principal expectations in terms of the MFS's transition impact was enhanced access to medium and long-term finance for MSME borrowers. One of the banks has successfully increased its average tenor and provides loans with a medium-term maturity of just over three years (37 months on average) compared to 33 months at project appraisal. The information provided by different sources for another also confirms longer-term maturities.

There is a more general question as to whether the term of a loan is not purely a technical (output) matter rather than signalling an outcome or impact. By its very nature, the PB's ability to provide long-term funding depends on its ability to access it. In view of double-digit inflation rates, domestic financing institutions face the problem that customer deposits tend to be short-term whereas borrowers require longer-term loans for their investment programmes.

6.1.3. *MSME development and remaining issues*

It appears that the number of MSMEs (as per the definition of the Mongolian SME law) has almost doubled between 2007 and 2012 and currently stands at about 57,000.[3] This translates into a ratio of 49 people per business or 20 enterprises per 1,000 inhabitants. Positive as the development is, there is likely to be room and a need for this business segment to increase further.

The interviews on site[4] confirmed that there are still a number of obstacles for MSMEs accessing financing, the most difficult being the collateral requirements that companies without real property are unable to fulfil. High borrowing costs and general caution towards banking institutions were also cited.

6.2. Strengthened business practices and corporate governance

6.2.1. Outcomes of TC provided to framework clients

Most of the expected impact from this framework is rooted in the accompanying TC programme and projects funded from other sources between 2008 and 2010. A comprehensive range of advisory and training activities was implemented and the available reporting, especially the field visit, confirmed some important achievements (outcome-results).

As noted before, both PBs had benefited from various TC and technical assistance programmes from other institutions. This is a positive thing in general but there is the danger of encouraging client institutions to "pick and choose". It appears to be time to graduate the PBs from TC or to request a considerable amount from them towards cost sharing for future assignments but recent loan operations with two of the banks (outside this framework) include TC support.

6.2.2. Strengthening corporate governance as shareholder

Both the first Mongolia country strategy and the main framework Board document emphasised the need to enhance corporate governance through the provision of equity investments. Support would primarily be provided through the nomination of an EBRD representative on the board of the PB. The EBRD's board nominee at one of the banks is reported to have been vital for the introduction of good practices, such as the consolidated IFRS-based reporting at group level.

The other equity investment made with the bank that failed experienced the full range of possible corporate governance issues, from simple weak standards to fraudulent behaviour. It was due to the TC consultants engaged with an institution building plan and the EBRD's nominee director on the bank's Board that the EBRD became aware of these substantial violations of good corporate governance practice. Management, including the corporate recovery unit, acted swiftly and effectively in flagging and tackling these issues in a transparent manner and in advising and encouraging the BoM in dividing the bank's business into a "good" and a "bad" bank. As the evaluation team repeatedly heard, this event had a strong and important demonstration effect regarding the need for transparent corporate governance rules across the domestic banking sector.

[3] Information sources provided in the OE.
[4] Which, due to the parallel evaluation of the MCF, included a number of former BAS clients who were all asked about their experience and expectations in accessing credit from banks.

7. Findings and recommendations for the next phase

7.1. A framework in integrated approach clothing

As an administrative envelope, the framework was primarily designed as the Bank's operational response to lending constraints at the time and not as an instrument for sector-wide transition. With the benefit of hindsight, EvD believes that the MFSF is very reminiscent of particular features of the integrated approach, given that:

- similar projects with overarching policy reform objectives are aggregated (which affords the Bank leverage to deliver demonstration effects)
- investment projects are rated on their own TI merits and combined with policy dialogue and technical cooperation activities to deliver broader sector reform.

The field visit confirmed the impression gained from the operation team's self-assessment – that a number of transition challenges persist in the Mongolian financial sector that would be worth addressing, such as advice on the "secured transaction/ pledge law", on further regulations for applying the deposit insurance scheme and other bottlenecks in the banking and especially non-banking segment. The framework extension is a good opportunity for the Bank to address these challenges in a sustainable manner. From a monitoring and evaluation point of view, an integrated approach would ideally be applied for this second phase.

Recommendation:

→ The opportunity should be taken to develop the next framework as an integrated approach rather than a mere administrative envelope.

7.2. Project design and monitoring require improvements

A lot of questions arose in the process of this evaluation that have not as yet received firm answers but hopefully are helpful in inspiring the design of the next phase. Among the many considerations that the operation team has to juggle at the project design phase, EvD would be particularly interested to see the following topics discussed:

- How to reasonably refine the MSME target group in Mongolia?
- Which of the business segments faces particular constraints in accessing finance?
- What needs to be done to unlock the NBFI sub-sector?
- What are suitable indicators for such principal objectives as "financial intermediation"?

The core question is,how to link results expected from individual transactions to developments seen at a higher sector or country level. A more explicit description of the baseline situation would be crucially important for the next phase, along with a clearer definition of the objectives. In the absence of a neat and coherent definition of objectives and success indicators, valuable "transition capital" gets lost or at least is invisible. It is fair to say that the MFSF was one of the first framework operations of its kind and improvements are already visible in similar operations that were approved more recently.

Still more needs to be done by the operation team and OCE if the EBRD wants to be able to tell a more powerful story for an instrument that is indeed potentially powerful. The utilisation of more innovative design concepts such as a 'theory of change' and a results framework would be advisable.

Recommendations:

- → Make more efforts to analyse and describe the *ex-ante* situation, with baseline indicators to allow solid judgements to be made on the subsequent achievements. Ensure that current deficiencies in the sector as well as the framework's specific target groups are clearly described.
- → More suitable TI benchmarks and other metrics for measuring progress at framework and sector-level should be identified and their aggregation facilitated. In this regard, the current practice of monitoring TI benchmarks of debt and equity investments with the same client does not appear helpful.
- → Either the operation team or OCE to monitor the results of all instruments, including TC and policy dialogue, more coherently, including relevant activities that are implemented by other Bank units.