Report Number : ICRR13393

IEG ICR Review
Independent Evaluation Group

1. Project Data:		Date Posted : 06/15/2010		
PROJ ID :	P071023		Appraisal	Actual
Project Name :	Financial Capacity Development Project	Project Costs (US$M):	5	4.94
Country:	Mongolia	Loan/Credit (US$M):	5.0	4.87
Sector Board :	FPD	Cofinancing (US$M):		
Sector(s):	Payment systems securities clearance and settlement (70%) Banking (30%)			
Theme(s):	State enterprise/bank restructuring and privatization (34% - P) Other financial and private sector development (33% - P) Standards and financial reporting (33% - P)			
L/C Number:	C3659			
		Board Approval Date :		06/11/2002
Partners involved :		Closing Date :	03/31/2006	06/30/2009

Evaluator :	Panel Reviewer :	Group Manager :	Group:
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2. Project Objectives and Components:

a. Objectives:

The main development objectives of the project were to support institutional capacity building of the Mongolian banking sector to reduce systemic risk and enhance financial intermediation through :

(i) improved commercial bank risk management.
(ii) modernization of payment systems and instruments.
(iii) controlled process of Saving Bank resolution.

b.Were the project objectives/key associated outcome targets revised during implementation?

No

c. Components (or Key Conditions in the case of DPLs, as appropriate):

The project had three components:

(a) Commercial Banking Risk Management
(b) Modernization of Payments Systems and Instruments

(c) Saving Bank Resolution

A. Commercial Bank Risk Management (appraisal US$1.30 million; actual US$ 0.69 million) This component was to assist participating banks in re-engineering their lending processes and creating a strong credit culture. It aimed to enhance the effectiveness of commercial banks' credit risk management and compliance with the regulations of the Bank of Mongolia (BOM) and international banking practices. Three commercial banks (Anod Bank, Mongol Post Bank and Zoos Bank) were assessed for eligibility (prior to project approval) as participating banks, and final selection was made before credit effectiveness.

B. Payment Systems Modernization (appraisal US$3.35 million, actual US$3.9 million.)

This component was to assure the availability of an appropriate set of cost-effective payment systems and payment instruments that satisfy the evolving needs of all sectors of the economy with particular emphasis on the needs of government, business, and individual consumers to make and receive non-cash payments. The component aimed to assist the Bank of Mongolia to:

(a) acquire and install a Switch Clearing House processor and software, and adopt related procedures and operating rules.
(b) develop new payment instruments and the legal and regulatory framework to support their use.
(c) establish a Shared Financial Network with multiple functions for the banking sector.

C Savings Bank Resolution (appraisal US$ 0.9 million; actual US$ 0.9 million.) This component would assist the Government to develop and implement a carefully managed divestiture process of the Savings Bank, to diversify systemic risk, and to reduce government subsidies. Under this component the Ministry of Finance and Economy would engage international advisors to develop and implement:

(a) a workable BR-Bonds redemption/replacement plan.
(b) a divestiture program to auction packaged assets and liabilities. The credit also included a small allowance for a study tour to selected countries with rich experiences in bank restructuring/resolution.

d. Comments on Project Cost, Financing, Borrower Contribution, and Dates:

In the first two year of the project the Bank of Mongolia successfully launched the National Clearing House (in 2006) which included the Switch Clearing Center (SCC.) The installment of this system was the major activity funded under the project and it was a milestone in the development of the country's financial infrastructure. Following SCC installation the government requested the development of a Real Time Gross Settlement System. This system was beyond the original expectations but in line with the project objectives. The project closed 39 months later than scheduled, in June 30 2009. The main reasons were the borrower request to add to the project a Real Time Gross Settlement component and its request for a direct contract of the firm that would implement it. This request brought to the fore procurement issues that took time to resolve. The extension of the original project objective coupled to delays in procurement lead to substantial project extension and related higher supervision.

3. Relevance of Objectives & Design:

The objectives of the loan were very relevant to reinforce a weak and crisis prone financial sector. Despite initiatives to strengthen and liberalize the sector, the banking system had experienced recurring crises and failures, most notably in 1994, 1996, 1998/99. The Bank Country Assistance Strategy (CAS) had supported the Government of Mongolia in completing the economic transition, improving living standards and reducing poverty through capacity building. In this context, a relevant objective was to improve capacity in its financial sector. This sector was evolving to support the development of a market-based economy. The 1999 Financial Sector Review and the 2000 Financial Sector Adjustment Credit (FSAC) identified among the policy distortions and structural weaknesses the following issues: eroded public confidence in the financial sector and low level of monetization; crowding out of private sector development; high non-performing loans; slow assets recovery; and weak financial sector infrastructure.Moreover, the whole financial sector infrastructure was very weak.

The project design was relevant for the most important component (Payment System Modernization.) but this was not the case for the "Saving Bank resolution" component. In the particular case of Mongolia the step-by-step approach design for the more technical (and least politically controversial component: payment system modernization) was indeed appropriate and may explain its success. On the other hand, the other two components (in particular the resolution of the Savings Bank) might have benefited from a more aggressive and up-front –less time-intensive- design. When the political environment is volatile and the risk of loosing commitment by the borrower is high a project design that is not time-intensive might take better advantage of an existing window of opportunity for change.

4. Achievement of Objectives (Efficacy):

Objective 1. Improve Commercial Bank Risk Management

The risk management framework in Mongolia was very weak. Reported non performing loans (NPL) reached about 20 percent of the total, and there was evidence of hidden NPL hinting of corruption. Also, the value of loan collateral was questionable. The project objective was to improve this dismal situation by introducing modern risk management techniques. The project originally envisioned that it would support at least three major banks, but at approval only two banks, Zoos and Mongol Post Bank, met the selection criteria. Once the new risk-management framework was put in place the expected result was an improvement in the participating banks financial position and general performance.

To achieve this objective the following actions were required:

(i) Ratio of nonperforming loans (NPL) to loans of participating banks not to exceed 10 percent through project implementation period. Both banks, Zoos and Mongol Post, fulfilled the Bank of Mongolia (BOM) prudential requirements imposed by the project and the Ministry of Finance and Economy (MOFE) (and both banks did not overshoot the target ratios during the duration of the project.) This action was completed and its result was to increment the profitability of participating banks and to make them more efficient when intermediating savings across investment. The objective was achieved

(ii) Credit/portfolio risk function reorganized within six months after Credit effectiveness. This reorganization allowed the banks to better assess risk and determine which credit applications to process -within acceptable risk brackets and which credit applications were not acceptable under the same criteria. This action was completed and the result was a reduced risk of default/delays. With the help of the technical assistance of advisors this action was taken and the objective achieved.

(iii) All credit officers of participating banks to have completed at least one training course in Mongolia within the first 12 months after Credit effectiveness. To match the improved risk-management infrastructure the project sought to upgrade the human capital in charge of it. All credit officers of both targeted banks, Zoos and Mongol Post, completed the training plan. This action was completed and the result was that adequate manpower would manage the new risk-management framework. The objective was achieved.

Objective 2: Modernization of Payment Systems and Instruments

The Mongolian banking system did not have and integrated solution for the transfer of funds by non-cash payments. By reducing the economy's dependence on cash and seeking a cost-effective use of IT, the project expected to fill the void on this matter. This component was necessary for increasing efficiency and confidence in the banking sector.

To achieve these objectives the following actions were required:

(i) Decision to be taken by the Bank of Mongolia (BOM) regarding the threshold value of transactions to be processed in the existing BOM system, The BOM put a cap on value or "urgency" qualifications for payments in the Real Time Goss Settlement system. This action was necessary for the smooth operation of the system. The result was a more efficient processing of transaction by the BOM. The objective was achieved.

(ii) Adopt an electronic transactions legislation. Interbank low and high value transaction related regulation were adopted and upgraded at different points in time to ensure successful operations of the Switch Clearing Center and Real Time Gross Settlement. This action was necessary in order to have a legal frame for the new system to be efficient. The action was completed and the result was the establishment of a sound legal back-up to address any problem related to the new system. The objective was achieved.

(iii) Value of commercial and government transactions processed through the new payments to increase by at least 20 percent per annum, respectively, after the system becomes operational. A step-wise increment in its input/output was part of the process of implementing the new payment infrastructure. The goal of this action was to develop a more efficient new payment system. The objective was achieved.

(iv) Alleviated overload of the existing Bank of Mongolia (BOM) payment system. This occurred immediately after the Switch Clearing Center (SCC) began operations by (a) moving all interbank payments out of the BOM General Ledger, and (b) moving all treasury accounting out of multiple BOM accounts and into the electronic payment details passed through a Single Treasury Account at BOM. This resulted in a significant reduction in overload permitting the BOM to stop all manual paper processing associated with the previous Treasury payment instruments. The evidence indicates that the objective was achieved.

The component achieved all its objectives by significantly improving and modernizing the payment system infrastructure of the BOM.

Objective 3: Savings Bank Resolution

The government was at the time committed to privatize it, realizing it was a drain on the budget. The Bank and the Mongolian government agreed on "controlled divestiture" of a large portion of the bank's assets and liabilities to make it fit for suitable private investor. The strategy implied the following requirements:

(i) A time-bound resolution plan for Saving Bank to be submitted to IDA for its review and comment within four months after Credit effectiveness. The Savings Bank was a burden to the fiscal accounts and the prospects were that the burden would increase over time. The action required a specific time-frame for resolving the Saving bank (by privatizing it.) The evidence suggests that this action was achieved.

(ii) Implementation of the resolution plan to be initiated within six months after Credit effectiveness. After the action plan it was necessary its implementation. However, implementation was initiated but never followed. The action was not carried out.

The government met all the previous steps. It submitted a resolution plan based on the advice of an international banking specialist. The specialist prepared an action plan and a set of technical evaluation criteria and scoring system for the privatization process and also advised on implementation. However, though initiated, the implementation never took off and during 2006 the government followed an alternative route privatizing the bank in the same year. Shortly after the sale a major fraud was discovered indicating a significant failure in due diligence by the government. The evidence suggests that this component was partially achieved.

This review concludes that because the participating banks complied with BOM prudential regulations and with the sound prudential and productivity ratios demanded by the project component; they were better prepared to face risk related to the ordinary course of business. This was the intended objective of the component.

5. Efficiency (not applicable to DPLs):

This type of project is not apt for calculating specific numbers in relation to ERRs or FRR. However on a qualitative basis the project was efficient because two of its three objectives were achieved and the third was partially achieved.

a. If available, enter the Economic Rate of Return (ERR)/Financial Rate of Return (FRR) at appraisal and the re-estimated value at evaluation :

	Rate Available?	Point Value	Coverage/Scope*
Appraisal		%	%
ICR estimate		%	%

* Refers to percent of total project cost for which ERR/FRR was calculated.

6. Outcome:

The project sought limited but relevant objectives and its efficacy was moderately satisfactory.

a. Outcome Rating : Moderately Satisfactory

7. Rationale for Risk to Development Outcome Rating:

The type of objectives achieved-payment system modernization, privatization of Saving Bank and improvement in risk management in two targeted banks, indicate low risk of backtracking. The Bank of Mongolia (BOM) is already using the new Real Time Gross Settlement System and implemented new processes associated with it. Also, BOM staff has been trained, and they are competent to identify technical policy challenges and further develop the system. The main risk is related to future lack of resources to maintain the system infrastructure and the backup center to date. Regarding the other two components the Privatization of Saving bank involves a moderate risk of backtracking (taken over by the government) as it may not have fully recovered from the post-privatization fraud. Zoos bank is under receivership of the BOM and its future is uncertain. Mongol Post Bank has applied to BOM for a merger with Saving Bank and the situation is fluid. The benefits of the TA assisting Zoos and Mongol Post banks in re-engineering their lending processes, credit risk management and compliance with the regulations of the Bank of Mongolia (BOM) may be diluted.

a. Risk to Development Outcome Rating : Moderate

8. Assessment of Bank Performance:

Regarding quality at entry and design, it was satisfactory for the most important component - the modernization of the payment system and instruments. However for the other two components quality at entry and design was unsatisfactory. It was satisfactory for "modernization of payment system and instruments" because it was a component with little "political" content and no controversial elements. For that reason the component could withstand, without major risk of the borrower changing its commitments, a rather long implementation process. At the end its success exceeded expectations. Regarding the quality at entry and design for the "Resolution of the Saving Bank" its weakness was the long implementation process and the lack of incentives to induce the borrower to implement the action plan that it had successfully elaborated and submitted to the Bank. In effect, the Saving Bank resolution component did not proceed as planned: the process by which it was privatized had not been envisaged by the Bank and for this reason it stopped disbursement in March 2007. The Saving Bank was indeed privatized. This is the reason why this objective was "partially achieved". Very shortly after the sale a fraud was uncovered and resulted in a major loss to the Government (almost half the sale price.)

The design for the commercial risk management component did not appear to have been fully prepared regarding a "demonstration effect" to the rest of the banking system. The idea that a risk management tool adopted by two banks would have this type of effect on the rest of the banking system does not seem to have been fully worked-out.

Supervision was satisfactory. Staff continuity was excellent during implementation and were able to keep key activities on track at time when implementing agencies faced implementation problems. The Bank appears to have adequately supervised fiduciary and safeguards policies according to the project audits and supervision reports as no major issues arose during implementation.

This Review concludes that the Bank performance was Moderately Satisfactory.

a. Ensuring Quality -at-Entry: Moderately Satisfactory

b. Quality of Supervision : Satisfactory

c. Overall Bank Performance : Moderately Satisfactory

9. Assessment of Borrower Performance:

During preparation government commitment was high. The government staff involved in this project was high level personnel from the Central Bank of Mongolia (BOM) and the Ministry of Finance and Economy (MOFE.) In particular key staff from the BOM was competent, committed and proactive in managing the project. In addition they produced fine financial reports and maintained good relationship with Bank staff and other partners. However, the MOFE did not match the performance of the Central Bank. Despite the fact that it also showed commitment its performance was, at best, uneven. For example, the failure to implement the action plans for the Savings Bank component. Another problem was that during implementation there were frequent changes in some Government counterparts, delays in decision making, procurement, and general implementation. Because the implementing agencies were both the BOM and the MOFE and his review concludes that the borrower performance was moderately satisfactory.

a. Government Performance : Moderately Satisfactory

b. Implementing Agency Performance : Moderately Satisfactory

c. Overall Borrower Performance : Moderately Satisfactory

10. M&E Design, Implementation, & Utilization:

The M&E design was sound but not without some reservations. The indicators were not carefully chosen. This was the case because in many instances the indicator was achieved while the PDO was not. This is symptomatic that a different or more detailed indicator should have been chosen, for example in the case of Saving Bank resolution the design failed to induce the government implement the last stage.

Regarding implementation, all the components were closely monitored. The project implementation unit and Bank staff regularly monitored progress and lack of it. Regarding utilization Bank staff collected data and obtained information that was used in their dialog with the government and implementing agencies. The Bank team used project progress in achieving the PDO as the key criteria to determine whether to extend various project components. For example, the Bank agreed to extend the payment system component but closed the Saving Bank components when became aware that the borrower was following a detour, inconsistent with the project design, to privatize the said bank.

a. M&E Quality Rating : Modest

11. Other Issues (Safeguards, Fiduciary, Unintended Positive and Negative Impacts):

12. Ratings:	ICR	IEG Review	Reason for Disagreement /Comments
Outcome:	Moderately Satisfactory	Moderately Satisfactory	
Risk to Development Outcome:	Moderate	Moderate	
Bank Performance :	Moderately Satisfactory	Moderately Satisfactory	
Borrower Performance :	Moderately Satisfactory	Moderately Satisfactory	
Quality of ICR :		Satisfactory	

NOTES:
- When insufficient information is provided by the Bank for IEG to arrive at a clear rating, IEG will downgrade the relevant ratings as warranted beginning July 1, 2006.
- The "Reason for Disagreement/Comments" column could cross-reference other sections of the ICR Review, as appropriate.

13. Lessons:

The most important lesson is that when the borrower has commitment, the components that are controversial or politically sensitive should be incorporated in a project design that addresses and resolve the issue in the shortest possible time-frame. The least satisfactory components, in particular Saving Bank resolution, would surely have benefited from this type of approach. Another lesson, from the Saving Bank resolution component, is that it is very important to focus more on implementation than on the promises or “action plans”. A government can present an “action plan” that is bold and satisfactory to the Bank but the real proof of commitment is its implementation.

14. Assessment Recommended? ○ Yes ● No

15. Comments on Quality of ICR:

The ICR showed consistency and good analysis. It focused on the evidence and succinctly pinpointed the main achievements and shortcomings of the project extracting appropriate lessons from the evidence.

a.Quality of ICR Rating : Satisfactory