



Draft Law on Non-Banking Financial Activities needs further refining

The draft Law of Mongolia on Non-Banking Financial Activities needs further improvement

In July 2018, the Financial Regulatory Commission of Mongolia (“FRC”), regulator of NBFIs, published a text of the draft Law of Mongolia on Non-Banking Financial Activities (“Draft Law”). The Draft Law is dated 13 June 2018 and posted on the FRC’s website (www.frc.mn). If and when adopted, the Draft Law is meant, to replace the 2002 Law on Non-Banking Financial Activities (“Current Law”).

This advisory focuses on some of the key new provisions of the Draft Law.

1. Power of FRC to conduct “consolidated supervision” over “non-banking financial conglomerates”

The Draft Law introduces the concept of a “non-banking financial conglomerate” (“NBFC”). Per the definition contained in the Draft Law, a “non-banking financial conglomerate” is “*separate entities which are related parties to each other and one of which is an NBF*” (Art. 4.1.11).

Under the Draft Law, FRC is vested with a statutory power to conduct “*consolidated supervision*” over NBFCs (Art.33.1). Further per the Draft Law, “*consolidated supervision*” of FRC means “*assessment [by FRC] of financial position of a member of an NBFC on a stand-alone and consolidated basis*” (Art. 4.1.13).

FRC may conduct consolidated supervision by itself or jointly with Ministry of Finance and/or Central Bank of Mongolia, as necessary (Art.33.1). A consolidated supervision of an NBFC comprises assessment of financial capacity and solvency of members of the NBFC, flow of funds between them (NBFC members), investments, payments, liabilities, receivables, and loans between them, relationship of their other financial obligations and transactions, and exposure at the NBFC level. Assessment is based on operational reports, financial statements and other information of members of an NBFC (Art.33.3).

If necessary, FRC may request from the NBFC’s parent and/or the parent’s subsidiaries additional information and the NBFC’s parent or its subsidiaries must comply with such request (Art.24.2).

Overall, in our view, this is a positive proposal to enable FRC to exercise supervisory powers over a “non-banking financial conglomerate”, including an NBF’s parent. Oftentimes in Mongolian practice, an NBF’s parent (shareholder) is a large, if not the

largest, borrower of the same NBFIs or a counterparty in other conflict-of-interest transactions with that NBFIs.

2. NBFIs licenses are categorized into four types depending on product

According to the Draft Law, non-banking financial activities that an NBFIs may engage in are expanded.

The following table summarizes the range of products that NBFIs in Mongolia can offer now (under the current 2002 NBFIs Law) vs. under the Draft Law:

NBFIs Product	Under the current NBFIs Law (2002)	Under the Draft Law
Loan	✓	✓
Payment guarantee	✓	✓
Factoring	✓	✓
Financial intermediation related to collateral	✓	✓
Financial advisory and consultancy	✓	✓
Trust	✓	✓
Issue, buy, sell financial instruments	✓*	✓
Issue negotiable instruments	✓	✓
Electronic payments, remittances	✓	✓
Currency trading and exchange	✓	✓
Credit guarantee		✓
Financial leasing		✓
Insurance intermediation (bancassurance)		✓
Underwriting		✓
Assessment of loss in insurance		✓
Receiving valuables into custody		✓

* limited to investments into short-term instruments (i.e., up to one year) only.

Licenses to be issued by FRC to NBFIs are classified into four categories depending on the NBFIs Products (above). Specifically, the following categories of NBFIs licenses are provided for by the Draft Law:

NBFIs Product	NBFIs license category			
	1 Financial NBFIs	2 Lending NBFIs	3 Payment & Settlement NBFIs	4 Currency Exchange NBFIs
Loan	✓	✓		
Payment and/or credit guarantee	✓	✓		
Factoring	✓	✓		

Financial leasing	✓	✓		
Financial advisory and consultancy	✓	✓		
Trust	✓			
Issue, buy, sell financial instruments	✓			
Issue negotiable instruments	✓*	✓*	✓	
Electronic payments, remittances	✓*	✓*	✓	
Currency trading and exchange	✓*	✓*	✓*	✓
Insurance intermediation (bancassurance)	✓*			
Underwriting	✓*			
Receiving valuables into custody	✓*			
Financial intermediation related to collateral	✓*			

* requires separate licensing from FRC (in addition to primary license).

It, thus, appears that the Draft Law requires a license for any activity by an NBF, irrespective of the NBF's size capital, product range, geographic location, or business nature.

The Draft Law does not contain any further indication as to the procedure for applying for the various licenses above or criteria and requirements an applicant must meet in order to be successful in applying. The Draft Law does seem to suggest that each of the above license categories is subject to different requirements and qualifications of FRC. This further suggests that FRC will publish the requirements and qualifications separately for each of the four license categories in the above table (Art.7.4, Art.7.5). In addition, FRC will issue detailed procedures for issuing, revoking, renewing etc. of the licenses (Art.7.6).

3. A new type of NBF - "Mutual NBF"

The Draft Law introduces a concept of a "*mutual non-banking financial institution*" ("**Mutual NBF**"). A Mutual NBF is defined as "*a for-profit legal entity whose capital consists of equity contributions in cash by an NBF(s) which NBF(s)'s liability is limited to the extent of the value of its (their) shares in such mutual NBF*" (Art.4.1.21).

Further, a Mutual NBF may be established by several NBFs with "*the objectives to expand their operations, to ensure financial stability and to provide onlending services under donor programs*" (Art.30.1).

As for its activities, a Mutual NBF may (i) engage in any or all NBF Products (*please see the table in 2 above*) and (ii) take deposits from third parties (Art. 30.2).

Similar to a NBF, a Mutual NBF must apply for and procure a license from FRC. Overall, requirements and procedures of licensing, lending restrictions (e.g., single borrower cap), incorporation, dissolution, state registration, corporate governance, fit-and-proper requirements for certain shareholders and board directors, financial reporting applicable to a (regular) NBF equally apply to a Mutual NBF. (Art.30.7).

The rationale for an NBF which is “mutual” (i.e., incorporated by fellow NBFs) appears to be the objective to support ability of NBFs to grow their business by pooling their assets. However, the Draft Law is not clear as to the rationale for ability of such Mutual NBFs to accept deposits. It would appear to us that deposit-taking would be contrary to the nature of NBFs and lead to further discussion such as whether it should be FRC or Central Bank of Mongolia (as a regulator of deposit-taking commercial banks in Mongolia) to regulate and supervise Mutual NBFs, if the Draft Law is adopted as-is.

4. Association of Mongolian Non-Banking Financial Institutions NGO is vested certain regulatory powers

The Draft Law has several provisions related to establishment of an Association of Mongolian NBFs and/or of professional associations of NBFs (“**NBF Association**”). This Association is defined as an NGO whose membership includes both individual NBFs and (smaller) professional association (Art.26.1).

The Draft Law, thus, intends to designate the NBF Association as the major industry trade group to represent interests, and conducts advocacy on behalf, of its members – NBFs.

The Draft Law goes on to set out organization, structure, and powers of the NBF Association. For instance, the NBF Association is to have a Board of Directors, and Oversight Committee, both to be elected by its members. The Board elects the President of the NBF Association who runs it for three years. The NBF Association’s powers, among others, include adoption of code of conduct of NBFs and training/retraining programs for NBF staff (Art.28.1.3, Art.28.2.2). One notable provision in the Draft Law is that FRC may delegate regulatory powers to the NBF Association (Art.28.2.1).

Our interpretation of the above provisions of the Draft Law is to lay the foundation for the existing Association of Mongolian NBFs to become a self-regulating industry trade group. Such transformation would, in our view, require strong cooperation between the

regulator and the industry association as well as significant capacity-building of the latter.

5. Substantial secondary legislation to be issued by FRC

Per the Draft Law, FRC is to issue several new or amended secondary legislative regulations such as:

- 1) Prudential ratios and other financial performance requirements for an NBFIs (Art.7.4),
- 2) Liquidity, capital adequacy, foreign currency position, minimum capital and other prudential ratios and requirements for a Mutual NBFIs (Art.7.7),
- 3) Requirements and qualifications for each of the four license categories for the NBFIs Products (Art.7.5),
- 4) Procedures for issuing, revoking, suspending or renewing the NBFIs licenses (Art.7.6),
- 5) Registration procedure of NBFIs and their licenses (Art.7.6),
- 6) Regulation on asset classification and loss provisioning (Art.7.8) (jointly with Ministry of Finance),
- 7) Various supervisory and regulatory rules and procedures related to financial solvency, service types, financial technology, consumer protection, disclosure and transparency,
- 8) Regulation for NBFIs to become open (public) companies (Art.7.11),
- 9) Accounting rules and regulations (Art.22.1, Art.23.2) (jointly with Ministry of Finance),
- 10) Rules and procedures for offsite supervision and onsite inspection of NBFIs, including Mutual NBFIs.

While most of the subject matters may be issued by FRC in the form of secondary legislation, some subject matters in our view are important enough so as to consider them including the primary legislation, i.e., the NBFIs law itself. For instance, we believe that the matters set out in 3) and 4) should be set out in the primary legislation, at least key requirements and procedures related thereto.

How the secondary legislation above is written will go a long way toward determining adequacy and efficiency of the NBFIs law itself and its objectives. Without the benefit of reviewing some of the most critical of the draft secondary legislation above, any assessment of the NBFIs law is incomplete.

We finally note that the Draft Law appears to be not accompanied by its concept paper.

Without the concept paper, it is difficult to understand and discuss objectives of the Draft Law, rationale behind the legislative provisions (.e.g., those introducing new concepts and regulations), intended impact, benchmarks used, roles of various stakeholders etc.

Thus, in the absence of a concept paper, it is not easy to properly analyse and assess the new concepts that the Draft Law appears to be introducing. In particular, without the concept paper, “big picture” aspects of the Draft Law, such as its background, objectives and rationale behind its new provisions (e.g., related to Mutual NBFIs or separate legal regime for each type of an NBFIs license) are not exactly clear.

FYI, a concept paper in any legislative initiative is a mandatory requirement under Mongolian law. Moreover, the concept paper must be reviewed and reviewed by a designated authority, usually by the Ministry of Justice of Mongolia. With an approved concept paper, a draft law cannot and should not be developed.

Overall, we conclude that the Draft Law is a **rough preliminary draft** produced by the FRC. It is our understanding that no input has been sought by the FRC on the Draft Law from various stakeholders, such as government agencies (e.g., Ministry of Finance, Ministry of Justice, or Central Bank of Mongolia) or non-government parties (e.g., trade associations, legal academics, or practitioners). In addition, the text currently drafted is not exactly professional containing several omissions, misspelling, mis-references, or terms which are defined in the definitions part, but unused throughout the text etc.

Our view is the Draft Law requires significant work in terms of both substance and form.

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