KhanLexPartners

Amended Banking Act and Recapitalization Act seek to strengthen the regulatory and supervisory regime of Mongolian commercial banks

The amended Banking Act and the Recapitalization Act strengthen the regulatory and supervisory regime of Mongolian commercial banks

The Mongolian legislature has adopted the amended Banking Act on 18 Jan 2018. The amended **Banking Act** has become effective from 1 Apr 2018 (the "**Amendments**").

The Amendments introduce several important new rules such as:

1. **Requirements applicable to shareholders, board directors, CEO and related parties,**
2. **Resolution of troubled banks,**
3. **Prohibition of subsidiaries.**

This advisory covers some of the more salient aspects of these new rules.

In addition to the Amendments, on 22 June 2018, the Mongolian legislature passed the **Recapitalization Act**. The Recapitalization Act outlines when and how public-sector funds can be used to support systemic banks in the event of a capital shortfall. This advisory also contains a short note on this Act.

The amended Banking Act

1. Requirements for shareholders, Board directors, executive management and related parties

1.1. Requirements applicable to shareholders

The Amendments introduce further criteria for a bank's "*influential shareholder*". An influential shareholder of a commercial bank is defined as (i) a person who owns 5 (five) or higher percent of the bank's total shares (whether directly or together with a related party) or (ii) a shareholder who is able to exert "*influence over the bank's policies, decisions or management*".

According to the Amendments, a bank's influential shareholder must now meet the following statutory criteria:

- the shareholder has not been subjected to insolvency proceedings or if the shareholder is an individual, he/she is not a "governing official" of a legal entity that has been subjected to insolvency proceedings[1];
- the shareholder has not been convicted of economic crimes, crimes against rights of ownership, public safety, national security, security of humanity or crimes of corruption or security;
- the shareholder has financial capacity and will not give rise to conditions which may affect the operations of the bank adversely;
- if the shareholder is a legal entity, then the relevant banking group is of a structure which allows for inspections by the Bank of Mongolia ("BoM"); and
- the shareholder has presented sufficient evidence of its ultimate beneficiary.

Also, an influential shareholder is subject to a prior review and consent of the BoM. In particular, if (i) any person becomes an influential shareholder of a commercial bank, or (ii) size or structure of the existing shareholding of an influential shareholder changes, then these changes are subject to the prior review and consent of the BoM. Furthermore, an influential shareholder of a commercial bank or any of its related parties may not be an influential shareholder in another commercial bank in Mongolia.

[1] A "governing official" means any person who participates in decision-making process of a company or who participates, directly or indirectly, in entering into agreements of a company. Specifically, an "authorised official" covers Board directors, CEO, other senior executives (e.g., CFO, VP, general accountant), or Board secretary etc. (Art. 84.1, Company Act of Mongolia).

Finally, under the Amendments the voting rights of shareholders, including influential shareholders, may be suspended if the bank has been placed under any enforcement program, including early intervention (preventative) measures.

1.2. Disclosure of beneficial ownership

The Amendments introduce the concept of ultimate beneficial ownership of commercial banks. Banks have now an obligation to disclose the identity of their beneficial owners to the BoM. According to the Amendments, a beneficial owner is an entity who (i) directs the operations of the bank, or (ii) exercises such powers through a delegate, or (iii) indirectly holds shares in the bank (i.e., through one or more related entities) with rights to benefit from the shares or operations of the bank.

Banks must now inform the BoM if there has been any change in its beneficial ownership.

1.3. Requirements applicable to board directors

The Amendments introduce new fit-and-proper criteria for a commercial bank's board directors. For instance, a candidate for directorship must be trained in banking, finance, economics, law, IT or corporate governance. He/she must have at least ten years of professional experience, including five years of experience as a "governing official" in a bank. Also, a board candidate must be clear of any past criminal record or conflict of interests.

A candidate for a bank director is subject to review and pre-approval by the BoM against the fit-and-proper criteria (based on the information presented by the bank to the BoM prior to the appointment).

Banks are also required to have at least 1 independent director. In addition to general fit-and-proper qualifications applicable to a board director, an independent director cannot be an influential shareholder, or a related party of an influential shareholder, of the bank or a member of its banking group. Such person must serve, and vote, on the audit and risk committees of the Board as well as on any matters involving conflict of interest.

1.4. Requirements applicable to CEO

The Amendments introduce an extensive set of qualifications for the CEO, too.

For instance, a CEO must have at least ten years of professional work experience, including five years of experience as a "governing official" in a bank. In addition, a CEO must not have been a "governing official" of the BoM in the last two years. Moreover, a CEO cannot be a member of the Audit, Remuneration or Nomination Committees of the Board.

1.5. Related Party

The definition of a "related party" has been clarified and expanded as follows:

- a member of the banking group;
- an individual, legal entity, its governing official, or the spouse, parent, sibling or child thereof who owns 5% or more of the shares of a bank or any member of a banking group;
- a legal entity in which 5% or more of the shares thereof are owned by a bank;
- a legal entity in which 5% or more of the shares thereof are owned by a governing official of a bank or the spouse, parent, sibling or child thereof;
- the governing official of a bank or a member of a banking group or the spouse, parent, sibling or child thereof;
- an affiliated entity with an apparent influence on the operations of a bank;
- a legal entity where the role of a governing official is exercised concurrently by one individual who is a governing official of a bank;
- a legal entity whose governing official owns 10% or more of the shares with voting rights of a bank;
- any other individual or legal entity that is an affiliated party of any of the foregoing; or
- any other entity the BoM determines as a related party.

1.6. Banking group

The Amendments further clarify the concept of a "banking group" as well as legal treatment of the banking group. A "banking group" is defined as where a legal entity is a related party of another legal entity and one of these legal entities is a bank.

Participants (members) of a banking group may be subject - whether individually or collectively - to a "consolidated supervision" by the BoM of their finances. Each member

of a banking group, including the influential shareholder of the bank, have the obligation under the Amendments to permit the BoM to exercise such consolidated supervision, including the obligation to allow the BoM's authorized personnel to access any data, equipment, passwords etc. as well as to provide any additional evidence that the BoM may request. Further according to the Amendments, the banking group must report, on a consolidated basis, its finances to the BoM. The regulation of such consolidated reporting is to be jointly published by the BoM, the Financial Regulatory Commission (Mongolia's regulator of capital markets) ("FRC") and the Ministry of Finance of Mongolia. Similarly, the BoM and the FRC are due to establish prudential and other requirements in respect of management, finances and solvency of a banking group.

The Amendments also introduce the concept of a "parent of the banking group". According to the definition in the Amendments, a parent of the banking group is a company who manages (directs) the banking group and its members. One key consequence of qualifying as a parent of the banking group is the BoM (through its authorized receiver) may require the parent to inject funds into the bank which has been placed under receivership (termed as "restructuring" in the Amendments).

It is not exactly clear from the Amendments what other specific consequences the qualification as a parent of the banking group would entail.

Overall, the definitions of "related party", "banking group", and "parent of the banking group" above suggest expanded scope for supervision and access by the BoM and other government agencies of Mongolia. The administrative regulations to be issued by the BoM, FRC and the Ministry of Finance are expected to offer more clarity.

2. Resolution and restructuring of banks

The Amendments introduce a set of measures aiming at prevention, early intervention, resolution and liquidation of failed banks.

2.1. Prevention: stabilization plan and restructuring plan

Commercial banks will be required, based on risk assessment, to submit to the BoM "stabilization plans". A stabilization plan must set out measures to retain and maintain the bank's solvency and liquidity. If, upon review, the BoM finds the stabilization plan as not feasible to implement, the BoM may require the bank to:

- reduce its general risk (exposure) levels;
- refinance the bank through issue of new shares or take other measures to improve the liquidity of the bank, including but not limited to revisions of business plans;
- change the management or organizational structure of the bank; or
- take such other measures that the BoM may deem appropriate.

In addition to the stabilization plan, there is a restructuring plan. In contrast to the stabilization plan, the restructuring plan appears to apply to troubled banks who are set for restructuring. According to the Amendments, it is the obligation of the BoM to prepare a restructuring plan for a troubled bank.

Further clarity on stabilization and restructuring plans is expected once the BoM publishes administrative regulations, covering, among others, requirements and deadlines of stabilization plans as well as preparation of restructuring plans.

2.2. Early intervention

The Amendments now permit the BoM to deploy preventive measures intervening in a bank's operations in a timely manner if there is a sign of distress or non-compliance. In particular, the Amendments permit the BoM to do so if the bank (1) breaches, or is likely to breach, banking laws and regulations, including decisions of the BoM, (2) fails to comply with terms and conditions of its banking license, or (3) engages in "unreliable, abnormal activities".

Examples of preventative measures by the BoM include, among others, a warning to the bank to rectify the breach; imposition of a deadline to rectify the breach; implementation of the stabilization plan; requirement to increase the bank's capital; suspension or termination of the powers of the Board or the executive management;

requirement that a consent be sought from the BoM prior to engaging in certain activities or transactions; requirement that the average of the total assets of the bank for the given quarter does not exceed the average of the total assets for the preceding quarter or to require the bank to diversify its assets; full or partial restriction of certain operations of the bank; commence provisional administration etc.

If the BoM-imposed preventative measure(s) above has not been complied with by the bank, the BoM may further suspend the voting rights of the influential shareholder(s) of that bank.

2.3. Bank resolution: provisional administration and restructuring

2.3.1. Provisional administration

If the BoM deems that (i) preventative measures are not sufficient in improving the operation of the bank or in reviving the reliable and stable management of the bank, or (ii) if through inspections, it is deemed that the financial capacity of the bank is deteriorating, the BoM may decide to appoint an administrator. According to the Amendment, the administration is provisional and may last for up to one year.

During the provisional administration, the BoM may temporarily transfer the powers of the executive management of the bank to the provisional administrator. Examples of the powers that the provisional administrator may exercise include:

- independently make any necessary decisions in respect to the operations of the bank;
- suspend, during the provisional administration, any obligations in relation to any financing procured from others;
- void or terminate any deposit agreements and other agreements entered into on different terms from those applicable at the time and affecting the bank adversely;
- enter into any agreements on behalf of the bank;
- file with court claims on behalf of the bank;
- terminate employees or employ new employees;
- change the structure and size of the capital of the bank (in order to satisfy capital adequacy requirements).

2.3.2. Restructuring (receivership)

The BoM may also take measures to restructure the bank if (i) the bank has a loss of financial capacity or the conditions have arisen which will inevitably lead to the loss financial capacity, or (ii) supervision by the BoM has determined that the bank is no longer able to undertake normal operations, or (iii) if the restructuring of the bank is necessary to protect the interests of the public.

The following tools may be used to restructure a commercial bank:

- transfer assets and liabilities of the bank;
- establish a special purpose bank;
- change the structure and size of the bank's capital;
- convert debt into shares.

A receiver appointed by the BoM carries out the restructuring. Restructuring must be conducted over a period of 90 days which period may be renewed twice for the same 90 days period. The Amendments provide detailed regulations for the restructuring procedure.

Finally, the Amendments make it clear that the restructuring of a bank does not require consent of the shareholders or creditors of the bank.

2.4. Liquidation

The BoM may decide to liquidate a failed bank and appoint a liquidator following:

- Termination of the banking license under the Banking Act, including following bank resolution measures, or
- The BoM's determination that it is not feasible to undertake any restructuring measure under the Banking Act.

It is the BoM who has the sole authority to commence liquidation proceeding of a commercial bank. The BoM-appointed liquidator may exercise broad statutory powers in respect to the bank's assets, transaction, and operations. The Amendments provide detailed regulations on the liquidation procedure, the order of payments to be made from the liquidated bank's assets, and criteria for voiding transactions etc.

2.5. Stabilization Fund

The Amendments introduce the concept of the Stabilization Fund. The Stabilization Fund would be established and administered by the BoM and used for the purpose of stabilizing financial conditions of a bank and implementing restructuring. Funds of the

Stabilization Fund are to consist of fees payable by commercial banks and will be equal to 1,3% of the total deposits of the banking system as a whole.

The BoM will determine the amount of fees payable and deadlines for payment.

The lawmaker's intention behind creation of the Stabilization Fund appears to be an effort to implement restructuring of commercial banks without having to resort to taxpayer money.

2.6. Limitations on remedies available for shareholders

According to the Amendments, those affected by bank resolution measures taken by the BoM, including the bank's shareholders, file claims to a court. However, unlike under the prior Banking Act, the submission of claims will not serve as a ground for the court to suspend the bank resolution actions taken by the BoM. If the court finds in favor of the claim, it may only award compensation for actual damages suffered – i.e., the court decision will not affect any decisions or actions taken by the BoM under the Banking Act.

3. Prohibition of subsidiaries

Previously, Mongolian commercial banks were able to, and did, establish subsidiary companies to engage in certain financial service activities.

With the Amendments, however, they can no longer establish subsidiaries to engage in certain financial service activities. The existing subsidiaries established under the previous Banking Act must be brought in compliance with the Amendments by 1 January 2019.

Accordingly, if a bank wishes to engage in financial service activities (e.g., underwriting, brokerage or securities custodian), it must apply to the FRC to obtain the license in its own name to do so.

However, the Amendments do not affect the banks' right (existing under the previous Banking Act) to acquires company shares, if the total amount acquired does not exceed 20% of the bank's total capital and is limited to 10% of the total amount of the shares issued by any one legal entity.

In summary, the Amendments prepared with the help of, and as part of the bailout program by, the International Monetary Fund, have been adopted by the Mongolian legislature. They were also written with the concerns in mind that the overall NPL rate of Mongolian commercial banks may be going up. We believe the Amendments are a big step forward for the Mongolian bank sector and should strengthen it. The fit-and-proper requirements applicable to the bank's shareholders and board directors, disclosure of ultimate beneficiaries are expected to result in better transparency and accountability of Mongolian banks. More importantly, in our view, the Amendments introduce an extensive set of preventative and as well as enforcement measures to prevent bank failures and to resolve failed banks

Recapitalization Act

In addition to the amended Banking Act, on 22 June 2018, the Mongolian legislature passed the **Recapitalization Act** (full name - the "Law of Mongolia on Supporting Stability of the Banking Sector").

Like the Amendments (to the Banking Act), the Recapitalization Act was part of the reform package brought by the IMF and directly followed the results of the asset quality review of all Mongolian commercial banks, completed by an independent auditor earlier in 2018 ("**AQR**"). The AQR reviewed more than 90% of all corporate loans in the banking system and subsequently rated them in accordance with relevant classifications (such as enterprise size and loan type), according to the BoM's report in February 2018.

The AQR revealed that fourteen (14) of fifteen (15) Mongolian commercial banks needed to raise a total of MNT 511 billion (approx. USD 200m) of new capital to satisfy the capital adequacy ratio requirements.

The applications of Recapitalization Act is limited to those commercial banks who are (i) regarded as systemically important (i.e., accounting for five percent or more of the total assets of the Mongolian banking system) and (ii) who do not meet relevant capital adequacy requirements (determined as a result of the AQR). These banks must secure additional capital to meet the requirements by the end of 2018.

The Act lays out requirements and eligibility criteria for the affected banks to receive government-funded bailout.

Prior to injection of public funds, however, the existing shareholders must bear the first loss. If they cannot inject additional capital or inject insufficient capital, the government will recapitalize the bank, but remain at arm's length with no influence on day-to-day management. Also, the Recapitalization Act requires that the government exit its shareholding in a timely fashion and in accordance with pre-approved exit strategy.

If the government has injected financing into the recipient bank, the Recapitalization Act goes on to outline governance of the recapitalization process, burden sharing principles, supervision of the supported banks, management of public equity holdings in banks, and the need for privatization in due time.

Finally, the Act sets the deadline for the government to exit the bank. Specifically, the government must recall the public funds from the banks within 5 (five) years since the date of the Act, i.e. by June 2023.

Non-systemic and non-viable banks unable to raise adequate capital will not be eligible for recapitalization under the Recapitalization Act and will subsequently be resolved. The resolution would be carried out by the BoM in the form of measures (provided

under the Banking Act and discussed above in this advisory) and/or in the form of the deposit insurance program (provided under the Deposit Insurance Corporation Act).

The BoM will publish administrative regulations under the Recapitalization Act.

In summary, the Recapitalization Act effectively introduces conditions and requirements of potential government bailout of commercial banks. Also, the Act is limited in scope (applicable to systemically important banks) and term (the government must exit the recipient bank before June 2023).

The total capital shortfall identified by the AQR (i.e., MNT 511 billion or approx. USD 200 million) constitutes equivalent to 1.9 percent of Mongolia's GDP of 2017. According to the industry commentators, Mongolian banking sector, with total of MNT 28.8 trillion (or approx. USD 13 billion) of assets, should be able to raise the required funding without the need to resort the government recapitalization - i.e., existing or new investors, including foreign investors.

IF YOU WISH TO RECEIVE FURTHER INFORMATION ABOUT NEW BANKING LAWS OF MONGOLIA, PLEASE CONTACT MR. ENKHBAT BATSUKH (PARTNER). TEL: (+976) 9911-1061 (M), (+976) 7747-1122 (O), EMAIL: EnkhbatB@ KhanLex.mn.

OUR CONTACT DETAILS:

KHANLEX PARTNERS LLP LAW FIRM
SUITE 1404, LEVEL 14, AYUD TOWER
OLYMPIC STR 5, SUKHBAATAR DISTRICT
ULAANBAATAR 14240, MONGOLIA
TEL: (+976) 7747-1122
INFO@KHANLEX.MN
WEB: WWW.KHANLEX.MN (*UNDER CONSTRUCTION*)