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In August 2020 a bill proposing amendments to the 2010 Banking Act of Mongolia has been presented to the Parliament of Mongolia (the "**Bill**"). If adopted, the Bill, which is sponsored by several MPs, would introduce some sweeping reforms not only to the banking industry, but also to the Mongolia's stock markets.

This summary highlights some of the key features of the Bill dated 26 January 2021.

I. New criteria for defining a "**systemically important bank**"

Until today, a "*systemically important bank*" ("**systemic bank**") has been defined as a bank which has accounted for five (5) or more percent of the total assets of the Mongolian banking system in the most recent six months. Under the Bill, however, this definition would be removed. Instead, the Bank of Mongolia ("**BoM**") would determine if a bank constitutes a "systemic bank" pursuant to "*international practices*" and based on criteria such as the bank's total capital, total liabilities, volume share of banking transactions within the overall payments system, core operations, number of customers as well as market share.

II. A "**systemic bank**": requirements of change in legal form and a cap on single shareholding

According to the Bill, all commercial banks in Mongolia will need to comply with the following two requirements:

1.1. Requirement 1 - change in the legal form of banks:

By June 30, 2022, the banks determined by the BoM as "systemic" must become "open joint-stock companies" ("**open JSC**"). This appears to mean that the systemic banks must conduct an initial public offering of its shares by June 30, 2022.

As for the remaining, “non-systemic” banks, they must become, at least, “*closed joint stock companies*”. If it wishes, though, a non-systemic bank may choose to become an open JSC, similar to its “systemic” peers.¹

1.2. Requirement 2 - reduce bank ownership concentration:

By December 31, 2023, any shareholder must not hold more than 20% of the total issued shares of any bank (whether alone or together with its/his/her related persons, if any). As such, starting from January 1, 2024, any bank operating in Mongolia is to have minimum of five (5) shareholders.

The above two requirements are at the core of the Bill (the “**Core Requirements**”).

The Bill lacks details of implementation of the above requirements. It is unclear how banks should achieve the Core Requirements.

The existing stock exchange rules in Mongolia are not exactly suitable for the public listing of the banks. In our view, legal and regulatory clarity is required in order to implement the Core Requirements, such as:

- Bank-specific listing rules (e.g., minimum shareholder spread, methods of offering – whether private placement would be permitted, whether the banks can choose to trade on a foreign stock exchange etc.),
- trading rules of the bank shares in the secondary market,

¹ *Note 1:* At present, all 12 commercial banks in Mongolia, including “systemic” ones, are set up as “limited liability companies”, i.e., closely-held companies. Ownership of most of them is concentrated in a few influential shareholders.

Note 2: Key difference between a “closed joint stock company” and an “open joint-stock company” is the following:

- shares in an “open joint-stock company” are listed on a stock exchange and are freely traded by the public,
- shares in a “closed public company” are not listed or traded on a stock exchange, but are instead registered with a securities depository and traded in the closed market.

- rules for bank M&As (e.g., review and approval of new shareholders, substantial and ultimate ownership, changes in control, rules for divestments of existing shares to meet the 20% threshold, taxation, accounting etc.),
- rights of minority shareholders,
- reporting and disclosure requirements,
- requirements for investors and investments,
- capital and other prudential criteria of public banks etc.²

The Bill mandates both the BoM and the Financial Regulatory Commission of Mongolia (“**FRC**”)³ to publish joint regulations, including a “*provisional regulation*”, setting out in detail procedures and requirements for implementing the Core Requirements (“**Regulations**”).

We expect the Regulations will address, among others, the issues above.

One other thing that the Regulations should address is whether a bank operating in Mongolia can list on a foreign stock exchange. While the intention of the lawmaker may be to limit the bank’s listing to the domestic stock market, the Bill does not contain an express language requiring the banks to list on the Mongolian Stock Exchange (“**MSE**”) only. One can, thus, technically argue that a bank may choose to go public on an overseas stock exchange. Even if limited to the MSE, in our view, it would still be possible for a

² According to the listing rules of the Mongolian Stock Exchange in effect, an issuing company must meet certain requirements for an IPO such as:

- achieve a minimum free float of 25% to be maintained at all times. It is possible the issuer to offer up to 50% of the free float to so-called “strategic investors” during the IPO. Thus, effectively, the minimum free float for an IPO under the current Mongolian regulations is approx. 12,5%.
- alternatively, a listed company’s semi-annual trading value must be more than 5% of the total trading value of the MSE during the same period,
- minimum number of shareholders must be 100,
- the shares must be free of any encumbrance, lien, pledge etc at the time of listing,²
- the market cap of the issuer must be more than MNT 10 billion (approx. USD 3,5m).
- also, requirements of minimum revenue and profit apply.

An issuing company apply to the MSE for waivers from any or all of the above requirements if certain conditions are met.

³ The FRC is the regulator of the Mongolian capital markets.

bank to cross-list on the MSE *and* a foreign stock exchange. Mongolia recently adopted regulations which enable dual listing of the Mongolian issuer's shares on both the MSE and a foreign bourse. This, for example, would be achieved by the issuer launching a secondary listing abroad. Furthermore, such cross-listing could be achieved without the Mongolian issuer setting up a legal presence in the foreign country, thus, ensuring fungibility of its shares between the MSE and the foreign stock exchange.

The above said, we are not aware of any practical case of a Mongolian issuer cross-listing on a non-Mongolian stock exchange so far.

Failure to fulfil the Core Requirements may result in the BoM applying enforcement measures against the bank - such as early intervention, provisional administration, restructuring etc. However, we would expect to review the final text of the Bill before evaluating legal consequences for failing to comply with the Core Requirements.

III. Enabling regulations to be adopted by the authorities

As mentioned above, pursuant to the Bill, the BOM and the FRC are to jointly adopt regulations, including a “provisional regulation”, setting out in detail, among others, procedures and requirements for implementing the Core Requirements (“**Regulations**”).

Draft of the Regulations is not available to us – we understand these are yet to be developed. Not it is clear when the BoM and the FRC will adopt the Regulations and whether its draft text will be open to the stakeholders for commenting. Among these Regulations, the BOM and the FRC are to publish a “provisional regulation” setting out procedures and requirements for developing and reviewing the Plan (please see “**IV. Banks must submit a plan of action**” below). It is hoped that the Regulations will be published asap in order to enable the banks to develop and submit the Plan by June

30, 2021– the Regulations will spell out guidelines for preparing, implementing, reporting and monitoring the Plan.

One of the key features of the future Regulations to watch is what minimum public float requirements and what timelines, if any, the Regulations will introduce. It is possible that the Regulations introduce a phased-in approach to the public float for the banks who should become publicly listed within June 30, 2021. It is also possible the authorities set thresholds lower than the currently required freefloat of 25%.⁴ Gradual implementation of the 20% single shareholder cap may be a consideration, too.⁵

IV. Banks must submit a plan of action

A systemic bank must develop a plan of how it intends to achieve the Core Requirements (“**Plan**”). In particular, according to the Bill, the Plan must be comprehensive – it must, among others, describe the bank’s plans as to its proposed methods of share offerings (public offering, private offering, divestments of portion of existing shares to meet the 20% threshold), share valuation, potential investors, timelines, step-by-step implementation of the Core Requirements etc.

The BOM and the FRC are to publish a “provisional regulation” setting out procedures and requirements for developing and reviewing the Plan. By July 1, 2021 the Plan must be submitted to the BoM and the FRC for review. Upon their review, the BoM and the FRC may require the bank to improve the submitted Plan if they deem the Plan to be “*impossible to implement or unfounded*”. The BoM and the FRC may similarly demand improvements if they consider the Plan “*non-compliant*” with the Regulations.

V. Approval by BoM of changes in shareholdings

The BoM’s prior review and approval are required for the following transactions of a bank related to shares:

⁴ Please see FN2.

⁵ FYI, currently, out of the 12 commercial banks in Mongolia only XacBank, via its 100% holding parent, already meets the 20% single shareholder cap.

- (i) any share transfers,
- (ii) acquisitions by a new “influential” shareholder of a bank (i.e., a shareholder holding more than 5% shares in a bank or a shareholder which can influence the bank’s management or operations),
- (iii) changes to the holdings of an incumbent “influential shareholder”,
- (iv) changes in the amount or structure of the bank’s overall capital,
- (v) issues of new shares or securities convertible to shares.

In addition, in case of a foreign-invested bank, any potential buyer of shares in such must be pre-approved by the BoM.⁶

According to the Bill, the BoM and the FRC are to jointly adopt a separate regulation setting out procedures of the BoM’s review and approval.

While the foregoing regulation will possibly bring clarity to the BoM’s review process, the scope of the BoM’s review and approval appears broad-ranging. For instance, the regulatory approval for (i) above suggests to include daily trading in and appears excessive – it would likely be inconsistent with the Bill’s intended objective of publicly traded banks and possibly difficult to implement, too. Another example is due to the public trading of the bank’s shares, the transaction in (iii) above may have to be conducted as an OTC transaction given the requirement of prior regulatory approval. Neither it is unclear whether an “influential” shareholder may sell its shares back to the bank - i.e., whether the bank may redeem or repurchase shares of an influential shareholder wanting to divest or exit. Overall, the mechanics of how the BoM would exactly administer its regulatory function of review and approval awaits further clarity.

VI. Board

- Boards to consist of at least 9 directors

⁶ A foreign-invested bank in Mongolia is a bank with a foreign investor(s) holding 25% or higher of the total shares in that bank.

Under the incumbent regulations, some banks can have at least 5 directors. If the Bill is adopted, all banks must have at least 9 directors on their boards.

- At least one-third of the Board to consist of independent directors

Under the incumbent regulations, some banks can have only one independent director on their boards. If the Bill is adopted, at least 1/3 of the board in all banks must consist of independents. Also, according to the Bill, the term of office of a new director elected by the shareholders will kick in only after the review and approval by the BoM of the director's qualifications.

Up to date, the requirement of minimum 3 independent directors has applied to “systemic banks” only - the non-systemic banks are thus allowed to have only one independent director on their boards. Thus, if the Bill is passed, the non-systemic banks in Mongolia would each need to elect at least 2 more independent directors to their boards.

VII. Capital requirements for a “systemic bank”

If adopted, the Bill may result in a requirement of higher minimum paid-in capital for a “systemic bank” than other banks. Amount of minimum paid-in capital of a “*systemic bank*” will be set by the BoM.

FYI – currently, minimum paid-in capital of all banks in Mongolia is flat MNT 50,0 billion (approx. USD 17,5m), i.e., applicable to all banks, whether “systemic” or not. According to the existing regulations, the foregoing requirement is slated to increase to MNT 100,0 billion (approx. USD 35,0m) starting from Jan 1, 2022. Therefore, if and when enacted, the Bill may result in the BoM setting a new minimum paid-in capital requirement for “systemic banks”, higher than MNT 50,0 billion (currently in effect) or MNT 100 billion (as anticipated from Jan 1, 2020).

VIII. Order of creditors liquidation

The Bill re-arranges the order in which the bank's creditors will be paid in liquidation as follows:

- 1) completion of court ordered payments to be made by the bank to others for damage caused to their life or health;
- 2) payment of wages of bank's employees (other than directors and executives) subject to a cap of 5x the minimum wage;
- 3) payment of expenses incurred by the liquidator;
- 4) payment of deposits of individuals and households not covered by the deposit insurance of the Deposit Insurance Corporation of Mongolia;
- 5) payment of funds in current accounts of individuals and households;
- 6) payment of deposits of legal entities not covered by the deposit insurance of the Deposit Insurance Corporation;
- 7) payment of funds in current accounts of legal entities;
- 8) payment of claims by the Deposit Insurance Corporation arising from subrogation in the rights of insured depositors;
- 9) payment of claims by the following depositors – banks, government agencies, government-run social insurance funds;
- 10) payment of claims by the Deposit insurance fund (government special fund);
- 11) payment of taxes, other payments to the Government;
- 12) payment of claims by the BoM;
- 13) payment of claims by the following depositors (e.g., related parties, auditor who audited the bank's financials in the most recent 3 years preceding the insurance event, depositors who, based on the BoM's supervision, adversely affected the bank's financial health or who enjoyed more favourable financial services from the bank etc.);
- 14) senior debt;
- 15) debt;
- 16) subordinated debt.

One of the key changes resulting from the re-arrangement of the order is higher ranking of depositors, in particular individuals.

IX. Prohibition of creation of security over shares in a bank

The Bill appears to contain a ban on a shareholder of a bank to pledge its shares (e.g., to secure debt).

KEY TAKEAWAYS OF THE BILL:

- The Bill, if adopted as-is, will likely usher in changes which will shape the Mongolian banking industry and stock markets in particular, and the Mongolia's economy, in general for years to come.
- Of all the benefits of a public company, Mongolian commercial banks will benefit from better corporate governance and transparency most. At present, all 12 commercial banks in Mongolia are limited liability companies, i.e., closely-held companies. Their ownership and, by extension, management are dominated by few shareholders.⁷ The Bill, if enacted, will lead to reduction of bank ownership concentration, on top of public listing of some of the banks. For example, influx of new shareholders from the public should, at least in theory, lead to decoupling ownership and management. Better transparency and disclosures under the stock market regulations would be required, too. In addition to the BoM, commercial banks operating in Mongolia will be supervised by the FRC and the MSE, which will require additional and better skilled staff in these organizations.

⁷ FYI - as at the end of Nov 2020, total assets of the banking sector is MNT 35.8 trillion, of which only approx. 10 percent is considered owners' equity (source: BoM).

- Next, the Bill may promote acceleration of consolidation in the banking sector over the next several years⁸.
- Duly implemented, the Bill should lead to almost doubling the size of the Mongolia's existing total market cap and attracting new investors. Thus, the Mongolia's small-size stock markets may get an important boost, too. This in turn would drive further legal and regulatory reform of the stock markets in Mongolia as well as more competition and better capacity of both the market players and the market regulators.
- However, concerns remain as to proper and timely implementation of the Bill. In our view, it would be challenging to fully implement the Core Requirements within the intended timelines. In addition to extremely tight timetable, external factors – e.g., lack of established investment funds and other professional players on the Mongolian stock market, investor depth as well as technical capacity of the existing stock market, political and regulatory uncertainties in Mongolia, prolonged impact of the pandemic - may force delays or, at best, phased-in approach of full and timely implementation of the Core Requirements. These delays would likely cause the banks to fail the regulatory prudential ratios, too.
- Caution should be exercised in order to avoid the Core Requirements backfiring – due to weak profile of the potential domestic investors, the Core Requirements may lead to unintended consequences of the (portion of) freefloat being acquired by foreigners;
- In addition, the Core Requirements could be prone to legal challenges in Mongolia. In particular, the Core Requirements may be viewed as infringing on constitutional rights of the existing bank shareholders by forcing them to divest of their ownership rights, and, as such, challenged in in the courts of Mongolia.

⁸ FYI - as of January 2021, there exist 12 commercial banks. In 2020, two of the Mongolia's six largest banks - Trade and Development Bank and Ulaanbaatar City Bank – have merged. The merger was the result of enforcing the Mongolian regulations which restrict a shareholder having control in two or more banks simultaneously. In addition, some of the smaller banks have been in negotiations to merge.

- Therefore, the Bill’s implementation may well be delayed or even share the fate of another recent banking regulation of Mongolia – “Bank Recapitalization Act of Mongolia” adopted in 2018 in order to require some commercial banks, including “systemic” ones, to recapitalize following the IMF-mandated “asset quality review” of the Mongolian banking industry. “Bank Recapitalization Act of Mongolia” is yet to be operationalized.
- Neither prohibition of large shareholdings (more than 20%) nor public listing in and of itself are not a guarantee of good governance of banks, competitive banking sector or vibrant stock markets.
- We believe a proper implementation of the Bill, including the Core Requirements, will largely depend in equal measure on both (i) the capacity and (ii) the political will of the BoM and the FRC. Capacity of the BoM, the FRC, and others should be strengthened in order for them to create, and administer, a legal and regulatory framework necessary for implementation of the Core Requirements.
- We expect the Regulations to be jointly developed by the BoM and the FRC will go a long way toward clarifying many of the issues identified in this paper.
- Finally, except for the Core Requirements, any change to the Banking Act that is eventually adopted by the legislature should not apply retroactively. In our view, a Bill’s ban on pledging shares in a bank to a third party (e.g., lender) should not affect validity and enforceability of the stock pledges created before the effective date of the Bill. The above said, we would withhold the definitive advice until if and when the Bill’s final text is adopted.

Finally, KhanLex Partners understand the Bill is to be adopted in the next few weeks before the Mongolian legislature recesses.

IMPORTANT NOTICE:

Please note the above overview of the Bill has been prepared by our office based on the most recent text of the Bill (dated January 26, 2021). The Bill will likely have been

modified before its final adoption by the parliament. We have not been able to access official text of these modifications. As such, the above summary **cannot constitute legal or definitive advice** – it has been prepared only with intention to provide information only about a draft legislation. If and when the Bill is adopted, based on its official text the above summary will be expanded.

If you wish to receive further information about the proposed banking regulations in Mongolia, please contact Mr. Enkhbat Batsukh (Partner) or Ms. Khulan Bayarsaikhan (Associate), tel: (976) 7747 1122 (o), email: EnkhbatB@khanlex.mn, Khulan@khanlex.mn .

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