



**Amendments to Banking Act of Mongolia
adopted by the Parliament
on January 29, 2021**

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Amendments to Banking Act of Mongolia adopted by the Parliament on January 29, 2021

On January 29, 2021, amendments to the 2010 Banking Act of Mongolia have been approved by the Parliament of Mongolia (the "**Amended Act**"). Together with the Amended Act, the Parliament adopted "*the Law on Procedures for Implementing the Amended Act*" (the "**Implementation Act**", collectively with the Amended Act - the "**Amendments**"). The Amendments introduce potentially sweeping reforms not only to the banking industry, but also to the Mongolia's stock market.

This summary highlights some of the key features of the Amendments.¹

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

Until the Amendments, a "*systemically important bank*" ("**systemic bank**") was 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. The Amendments have removed this definition. Instead, the Bank of Mongolia ("**BoM**") will determine if a bank constitutes a "systemic bank" pursuant to "*international practices*" 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.

¹ FYI – our client advisory of the previous round of substantial amendments to the Banking Act of Mongolia in 2018 can be accessed at www.khanlex.mn/wp-content/uploads/2020/12/Banking-Law-Aug-2018.pdf.

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

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

1.1. Core 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 means 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, a non-systemic bank may choose to become an open JSC, similar to its “systemic” peers.²

1.2. Core 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

² 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.

such, starting from January 1, 2024, any bank operating in Mongolia is to have minimum of five (5) shareholders.³

The Core Requirement #1 and the Core Requirement #2 are at the core of the Amendments and the Implementation Act (collectively, the “**Core Requirements**”).

According to the Implementation Act, by June 30, 2021 a systemic bank is to submit to both BOM and the Financial Regulatory Commission of Mongolia (“**FRC**”)⁴ a plan of how the bank intends to achieve the Core Requirements (the “**Plan**”) (please see “**III. Banks must submit a Plan**” below).

Failure to fulfil the Core Requirements may result in the BoM applying enforcement measures against the bank - such as early intervention, provisional administration, restructuring or “any other sanctions available under Mongolian law”.

Overall, the Amendments lack details of implementation of the above requirements. According to the Implementation Act, the BoM and the FRC are to publish joint regulations, including a “provisional regulation” setting out guidelines and procedures for developing and reviewing the Plan (“**Provisional Regulation**”) (please see “**III. Banks must submit a Plan**” below).

III. Banks must submit a Plan

A systemic bank must develop a Plan of how it intends to achieve the Core Requirements.

³ FYI - this Core Requirement does not apply to Development Bank of Mongolia, or a bank under restructuring (enforcement), or a bank recapitalized by the government under the 2018 Bank Recapitalization Act of Mongolia (please see our advisory on the Bank Recapitalization Act at www.khanlex.mn/wp-content/uploads/2020/12/Banking-Law-Aug-2018.pdf).

⁴ The FRC is the regulator of the Mongolian capital markets.

As mentioned above, pursuant to the Amendments, one of the enabling regulations to be adopted by the BOM and the FRC is a Provisional Regulation. The Provisional Regulation is expected to set out guidelines and procedures for developing and reviewing the Plan.

As at the time of this advisory, the Provisional Regulation is yet to be adopted.

FYI - a draft of the Provisional Regulation was published online by the BOM in February 2021 seeking public comments⁵. According to this draft Provisional Regulation, the Plan must provide for phased-in implementation of the Core Requirement #1 as follows: (i) IPO of at least 10% of total shares and achieving status of open JSC by June 30, 2022, and (ii) FPO (follow-on public offering) of at least 10% of total shares by Dec 31, 2023. The foregoing appears to be an option only, which means a bank *may* choose to sell 20% of its shares to the public in one offering, instead of two offerings. On the other hand, it is unclear to us if this minimum 20% offering (10+10) must be offered strictly to the public or whether a “strategic investor(s)” may acquire these shares (subject to the other Core Requirement – the maximum share ownership of 20%). In addition, the Plan must contain, among others, the following details applicable to IPO/FPO – timelines, projected share price, EOI of prospective investors, total amount of investment to be raised, shares allocated to minority shareholders.

With respect to the Core Requirement #2, the draft Provisional Regulation requires the Plan to spell out actions to achieve the Core Requirement #2 (which must similarly be met by Dec 31, 2023) - such as timelines and details of prospective investors.

The Plan should also describe structure and size of capital of the bank following implementation of the Core Requirements (i.e., post-Jan 1, 2024).⁶

⁵ <https://www.mongolbank.mn/documents/Reg%20draft.pdf>.

⁶ The draft Provisional Regulation accessed by KhanLex on Feb 24, 2021.

The Plan must be submitted to the BoM and the FRC for review by July 1, 2021. 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.

As described above, the Plan appears to constitute a major milestone for implementation of the Amendments. For instance, according to the draft Provisional Regulation, the Plan should comprehensively cover both Core Requirements – (i) Core Requirement #1: reorganization of banks into open JSCs (with minimum 20% public float per the current draft of the Provisional Regulation) and (ii) Core Requirement #2: bringing the presently high levels of ownership concentration down to 20% of the total issued shares of the bank. As such, the Plan will likely go a long way toward shaping a strategy of the banks for the next several years - once approved by the BOM and the FRC, the Plan will, for instance, serve as a basis for the IPO/FPO prospectus (Core Requirement #1) as well as the divestment/capital raising efforts of the banks (Core Requirement #2).

As mentioned above, a failure to fulfil the Core Requirements may result in the BoM and the FRC applying enforcement measures against the bank - such as early intervention, provisional administration, restructuring or “any other sanctions available under Mongolian law”.

In addition to the Provisional Regulation, it is understood that the BOM and the FRC will publish a bank listing regulation which will likely introduce listing requirements and procedures appropriate for banks under Core Requirement #1 (compared to the existing regulations which are not suitable for banks).

The Regulations should be adopted (and published) by the authorities asap in order to enable the Mongolian banks to develop and submit a bankable Plan by the deadline of June 30, 2021.

IV. Approval by BoM of changes in shareholdings

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

- (i) 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),
- (ii) changes to the holdings of an incumbent "influential shareholder",
- (iii) changes in the amount or structure of the bank's capital,
- (iv) 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 bank must be pre-approved by the BoM.⁷

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

Prior to the Amendments, the above regulation was adopted by the BOM only. However, more important change is how this review and approval process will play out now that the banks will become open JSCs and shares will be publicly traded. While the joint regulation to be issued by the BOM and the FRC will possibly bring clarity to the BoM's review process, the scope of the BoM's review and approval appears broad-ranging. For example,

⁷ 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.

due to the public trading of the bank's shares, some of the transactions 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.

Also, Article 36.11 of the Amended Act appears to require a regulatory (BOM) approval for any share transfer or sale irrespective of the size. If our construction is correct, such requirement would apply to daily exchange trading and would appear excessive – it would likely be inconsistent with the intended objective of Amendments for banks as open JSCs and possibly difficult to implement, too.

Failure of securing an approval of the BOM will leave the relevant shares of the influential shareholders with no voting rights or dividend rights. Moreover, such shares will be deducted by the BOM for the purpose of regulatory and prudential requirements – these shares will be deducted from the bank's equity. Finally, such influential shareholder will have an obligation to sell or transfer such shares within 30 days of acquitting the same.

Overall, the mechanics of how the BoM will exactly administer its regulatory function of review and approval awaits further clarity.

V. Board

- Boards to consist of at least 9 directors

Under the previous regulations, non-systemic banks could have at least 5 directors. Under the Amendments, all banks, irrespective of size, must have at least 9 directors on their boards.

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

Also, under the previous regulations, non-systemic banks could appoint only one independent director to their boards. Now pursuant to the Amendments, at least 1/3 of the board in all banks, irrespective of size, must consist of qualified independent directors. Also, according to the Amendments, the term of office of a new director will kick in only after the review and approval by the BoM of that director's qualifications (vs. upon election by the shareholders as in the past).

As mentioned, up to date, the requirement of minimum 3 independent directors has applied to "systemic banks" only - the non-systemic banks were allowed to have only one independent director on their boards or less than 9 directors on the board. Thus, with the Amendments passed, the non-systemic banks in Mongolia now each need to elect at least 2 more independent directors to their boards.

VI. Capital requirements for a "systemic bank"

The Amendments are likely to 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 is flat MNT 50,0 billion for all banks in Mongolia (approx. USD 17,5m), whether "systemic" or not. According to the existing directive of the BOM, the foregoing requirement is slated to increase to MNT 100,0 billion (approx. USD 35,0m) starting from Jan 1, 2022.

In the light of the Core Requirements, the Amendments may lead the BoM to implement 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, 2022).

VII. Order of creditors in liquidation

The Amendments have re-arranged 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; and
- 16) subordinated debt.

One of the key changes resulting from the above re-arrangement is higher ranking of customers (such as individual depositors), ahead of the bank's shareholders.

VIII. Requirements applicable to influential shareholders

Prior to the Amendments, an “*influential shareholder*” was defined as a person holding 5 or more percent of the bank shares (solely or together with a related person), or a shareholder that can influence the policy, decisions and management of the bank.

The Amendments have expanded this definition to include the “ultimate *individual* beneficial holder” of such persons or shareholders. This appears to be an attempt to bring the concept of “ultimate beneficial holder” in conformity with the existing definition of the same in another Mongolian law – the Law on Combating Money Laundering and Terrorism Financing (2013). Questions will remain as to how enforce this concept in respect of influential shareholders who are listed companies or investment funds, let alone mechanics of review and enforcement.

Finally, the Amendments have introduced a new requirement applicable to an influential shareholder - an influential shareholder and its ultimate beneficial owner must not be a “high-ranking government official”. “High-ranking government officials” are the President of Mongolia, MPs, the Prime Minister, Ministers, vice ministers, Supreme Court and Constitutional Court justices, senior prosecutors, governors of aimags and Ulaanbaatar, chairpersons of aimag and Ulaanbaatar citizen khurals, top leadership of the BOM and the FRC etc (Parliament Decree No.2019/19).

IX. Prohibition of ownership of shares using another person's name

The Amendments ban indirect ownership of shares in a bank using another person's name. Our interpretation is that this ban intends to cover the following situations - a new shareholder wishing to acquire more than 20% of the total shares in the bank (in breach of the Core Requirement #2) or an existing shareholder in excess of the Core Requirement #2 wishing to transfer its excess shares to its associates. In our view, this restriction does not apply to trust or similar arrangements (e.g., nominee or depository).

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

The Amendments ban creation of security over shares in (e.g., to secure a shareholder's debt).

Takeaways

- The Amendments 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 an open JSC (Core Requirement #1), Mongolian commercial banks will arguably benefit most from better corporate governance and transparency. At present, all 12 commercial banks in Mongolia are limited liability companies, i.e., closely-held companies. Their ownership and, by extension, management are largely dominated by few shareholders.⁸ The Amendments should lead to reduction of bank ownership concentration (Core Requirement #2), on top of legal form of open JSC for some of the banks (Core Requirement #1). 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 will be required, too. In addition to the BoM, commercial banks operating in Mongolia will be supervised by the FRC and the MSE.
- Next, the Amendments may promote acceleration of consolidation in the banking sector over the next several years⁹.
- If duly implemented, the Core Requirement #1 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 will drive further legal and regulatory reform of the stock markets in Mongolia

⁸ 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).

⁹ 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.

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 Amendments. In our view, it will be challenging to fully implement the Core Requirements, especially Core Requirement #1, within the intended timelines. Also, it remains to be seen what would happen if genuine commercial disagreements over the share valuation make implementation of either or both of the Core Requirements unfeasible.
- 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, scheduled repayments of Mongolia’s sovereign bonds throughout 2021-2024 - may force delays or, at best, phased-in approach of full and timely implementation of the Core Requirements. These delays will 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 Requirement #2 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 the courts of Mongolia.
- Therefore, the Amendments’ 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.¹⁰

- Neither prohibition of large shareholdings (Core Requirement #2) nor legal form of open JSC (Core Requirement #1) in and of itself are not a guarantee of good governance of banks, competitive banking sector or vibrant stock markets.¹¹
- We believe a proper implementation of the Amendments, including the Core Requirements, will largely depend in equal measure on the capacity of the BoM and the FRC. In addition to additional personnel, the BoM, the FRC, and others will need to strengthen their capacity in order to be able to create, and administer, a legal and regulatory framework necessary for implementation of the Core Requirements.
- Equally, if not more, important is the political will of the BoM and the FRC to enforce the Core Requirements given the past enforcement track record of these regulators.
- The existing stock exchange rules in Mongolia are not exactly suitable for public listing of the banks. It is hoped that the regulations of the BOM and the FRC, which are yet to be adopted, will address, in a clear and reasonable manner, the following legal and regulatory aspects in order to implement the Core Requirements:
 - bank-specific listing rules (e.g., minimum shareholder spread, methods of offering – whether private placement will be permitted etc.),
 - trading rules of the bank shares in the secondary market,
 - rules for bank M&As (e.g., review and approval of new shareholders, substantial and ultimate ownership, changes in control, rules for

¹⁰ FYI – our client advisory on the Bank Recapitalization Act of Mongolia can be accessed at www.khanlex.mn/wp-content/uploads/2020/12/Banking-Law-Aug-2018.pdf.

¹¹ FYI, currently, out of the 12 commercial banks in Mongolia only XacBank, via its 100% holding parent, already meets the 20% single shareholder cap. It is assumed the Core Requirement #2 will not apply to XacBank’s holding parent.

- divestments of existing shares to meet the Core Requirement #2, taxation, accounting etc.),
- rights of minority shareholders,
 - reporting and disclosure requirements,
 - requirements for investors and investments,
 - capital and other prudential criteria of banks as open JSCs etc.¹²
- One other thing that the Regulations should address with regard to the Core Requirement #1 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 Amendments do not contain an express language requiring the banks to list on the MSE only. Thus, we are of the view 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 bank to list on the MSE as a primary stock exchange and then a foreign stock exchange as a secondary listing.¹³

¹² 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,
- 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.

¹³ FYI - 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 (subject to the requirements of the foreign exchange), thus, ensuring fungibility of its shares between the MSE and the foreign stock exchange. The foregoing said, we are not aware of any practical case of a Mongolian issuer cross-listing on a non-Mongolian stock exchange so far.



- 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, Amendments' 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 Amendments.

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