

## **Diagnosis of Corporate Governance for Banking Sector in Mongolia**

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*Even though defining and measuring the sustainability status of a country is rather difficult issue, it is not significant when there has been no crises and whereas as financial system is unsustainable, it is quite critical problem. Generally it can be said that sustainability of financial system positively influences on real section. As well, government, real and external sectors have direct impact on financial system sustainability, in opposition to this; financial system sustainability causes these sections development. For the last 20 years, learners and researchers from central banks have been doing analyze and making conclusion on financial system by developing system representing indicators in order to evaluate financial system sustainability, but it is unnecessary to completely do evaluation work through developed indicators and it is considered too that financial system sustainability is dependable to the governance of financial institutions. Bank system governance index needs to be learned to the greater extend taking interconnections among banking system regulation and monitoring practice, banking system development, effectiveness as well as weakness into essential consideration and these factors are regarded as having capability to correspond to the system enlargement. Banks play significant role as a financial system in economic growth. Governance shall aim its focus on board of directors, shareholders, executive director, employees, and protection of clientele interests. Within my research work, I intended to study the governance in the banking sector, and if such governance is required, then how to form it.*

**Field of research:** Corporate governance and bank management, governance index

**JEL codes:** G21, G34

### **1. Introduction**

Aggravation of global financial and economic crisis is caused by economic globalization which is far-reaching most countries and affecting one another. Due to financial and economic crisis, global financial sector is in deep trouble. Especially the developing countries that is new on the market. Commercial banks are playing dominant role in Mongolian financial system because commercial bank crisis is followed by financial system crisis and as well as market crisis. This became the primary cause of economic crisis.

During global economic crisis, corporate governance is becoming important more than anything and it improves productivity, broadens the future possibility of the company, and provides equal rights to shareholders. (Taniel, 2008) Therefore, there are many questions such as how do the global financial and economic crisis have an effect on Mongolian financial market, financial system, and banking sector, what kind of resolution will reduce these effects, how are the frequencies, and last how to protect

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our financial system; crisis in Mongolian banking sector can surely be seen related to management of the bank, including corporate governance matter. Therefore, it became necessary to study and examines this critical subject. Urgent matter in banking system after drifting to two-scale banking system would be definitely bank management concern without a doubt. It is connected to the banking failure, and main reason of such failure is caused by loan portfolio quality which the main cause could be management operation or governance matter. Corporate governance has carried out internationally since 2003, and it is becoming brand new concept in circumstances of Mongolia specifically in banking sector.

## 2. Literature Review

During my research on analysis of foreign scholars, it was clear that the studies were examined on many levels. In the 20<sup>th</sup> century, after Wall Street crises happened in 1929, such legal sector scientists as Adolf Augustus Berle, Edwin Dodd, and Gardiner C.Means developed new conception on the contemporary corporate management role in society and the developed concepts became fundamental of corporate governance. A Research work with theme "The modern Corporation and private property", by Berle, Means in 1932 remarkably influenced on current conception of corporate governance and its future prospects. In addition to this, a paper work "The Nature of the Firm", done by Ronald Coase from the Chicago university, deepened understanding of transaction cost and got it linked with motivation for firm establishment and act. 50 years later since that time Eugene Fama, Michael Jensen conducted a research work named "The Separation of Ownership and Control", which could formulate organization theory and accurately developed corporate governance conception. From the view of them, organization is carrying out its activity on the basis of continuously made plural agreements. Moreover, a work "Agency theory" done in 1989 by Kathleen Eisenhardt is considered to have made sensible contribution to corporate governance development.

### 2.1 OECD

Corporate good governance has unarguable positive influence to the acceleration of economic growth and poverty reduction. As corporate good governance system is set up, it is easy to attract foreign investment, one of the important factors for insuring sustainable economic growth and employment rate. Theoretically, OECD defines that corporate governance clarifies allocation of rights and duties of such ultimate participants, of company, as board committee members, managers, stock holders and instructs decision making related rules, procedures. Therefore it can be said with the help of corporate governance, ways to achieve main goal and organizational chart to take control over the performance would be acknowledged.

### 2.2 International Bank Settlement (Basle III)

Currently banks financial intermediary role in economy must be considered to a great extent. Sensitivity rate is becoming higher due to their corporate weak governance and increased critical issues in public and market. Corporate governance is directly dependable to commercial banks and international financial system and auditing targeted at the company's activity is very important. Basle committee becomes introductory bridge to corporate governance experiences for bank organizations. For instance, regarding corporate governance, improved recommendations of were

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published in 2006, 2010. Those recommendations are designed for banks inspectors to introduce corporate governance experience through banking organizations in member country of Basle committee. As well principle concepts are supportive for bank's its own proper governance. In 2006 Basle committee developed its recommendation on the basis of corporate governance conceptions delivered by OECD in 2004.

Conceptions delivered by OECD are advises for participants in financial market, its regulatory officers and assistances to improve and evaluate corporate governance system too. Above conceptions consider relationships among company's executive officers, board members, shareholders, other participants and corporate governance coordinates issues related to company's goal, ways to achieve designed goal, to control over the company's performance. Corporate good governance needs to provide appropriate assistance and promotion for board members and executive officers to carry out activity, aimed at approaching company's goal, in conformity with shareholder's interests.

Vital issue was reflected in the recommendation developed in 2006 and main goal of the recommendations, provided in 2010 was targeted at the implementation of suitable bank governance.

### **2.3 Mongolian Corporate Governance Codex (FRC, 2007)**

For Mongolia, corporate governance was firstly discussed from the beginning of 2000 and developing corporate governance in Mongolia will be creating favorable environment for ensuring sustainable and suitable activity of supervisory officers of stock companies, securities of which are sold freely, and keeping mutual beliefs between shareholders and company as well as strengthening capacity to attract more investment. These are basics for macroeconomic sustainability, growth. Moreover corporate governance codex identifies proper ratio of interest between investors, business partnerships, employees and administrative officers by creating internal and external favorable environment and setting apposite activity procedures of board members, executive officers.

As what mentioned above, corporate governance development, effectiveness are dependable to many factors including legal regulation, formation of corporate good governance in a society, popular customs, participants knowledge, experience, awareness level. Mongolian governance codex is developed by having taken corporate governance principles followed by OECD, advises and recommendations provided with Asian development bank, European renovation and development bank and experiences from the world other countries, its own particularities into essential considerations.

This codex was designed for stock company, stock of which is publicly sold and Limited Liability Company and other legal entrepreneurs are possible to apply it in accordance with their specificities. Corporate governance principles define main conceptions for conducting company's activity and they must be developed in adaptation with concerns to respect participant's legal interest and to increase company's equity, to expand the framework of activity, to create new workplaces, to ensure financial sustainability, to get profitability rate into upper level.

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## 2.4 Bank's Good Governance Principle

Bank's good governance legal act was developed with the resolution of President of Mongolian central bank for the purpose to get the activity of bank board member, supervisory officers consistent with interest of shareholders and others, to change bank good governance into more developed one. (BoM, 2010). Establishment of good governance in bank sector can make reasonable contribution to ensure financial sector and national economic growth.

## 3. The Methodology

### 3.1 Banking System Development Index

How would international advisors say and conclude last 20 years findings of Mongolian financial and economy if I ask them what advantageous management of bank activity in developing country is? Interestingly their answer can be imagined. Until now countries have no information base on how to manage bank system and then it is impossible to surely tell which managing system is more effective. Therefore the World Bank did a policy research work within the framework of countries bank regulatory and auditing acts in order to help bank administrative officers have better knowledge of bank system. This research was made on the basis of questionnaire result from bank management and system and appeared quantitative data can supply knowledge on the current status of bank management of about 107 countries and show the World Bank system development rate. In this research as much information on bank management system as possible was included and 12 chapters and 175 questions were contained. Included in these:

- Bank system entrance
- Bank ownership
- Bank equity
- Bank activity
- External auditing requirements
- Internal management, organizational necessities
- Liquidity and development modification requirements
- Saving protective system
- Risk fund requirements
- Accounting transparency requirement
- Rules, bank disbandment
- Bank auditing

Above 12 questions are represented with 9 variables to define development index. Included in these:

1. Regulative variables of bank activity
2. Bank commercial regulatory variables
3. Bank competition regulatory variables
4. Bank equity regulatory variables
5. Processing variables of coordinating organization of bank
6. Reserve variables of coordinating organization of bank
7. Private inspectional variables
8. Saving insurance variables

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## 9. Market indicators

### 3.2 S&P GAMMA

Gamma evaluation method developed by Standard and Poor's is a product of newly growing market and it would be model for asset of investors and helpful to assess non financial risks. Corporate good governance increases wealth of shareholders and decreases investment risk. Private company management, responsibility, corporate governance related independent suggestions create value in growing market. Corporate governance services of Standard and Poor's entitles such participants as executive managers, investors, others to assess experiences from corporate governance and to make effective business and investment decision. Standard and Poor's designed criteria and methods to appraise corporate governance since 1998 and has been doing work of evaluating corporate governance experiences since 2000.

### 3.3 Sustainable Governance Indicators (SGI)

Governance sustainability indicator is estimated each two years with the Bertelsmann Stiftung Institution of Germany. Main purpose of this institution is defined to make research for sustainability of government strategy and principle policies and evaluate research output. SGI has purpose to develop corporate good governance, improve stable policy output, process of active collaborations. As well SGI provides proof based information, which allows having mutually effective work. Industrialized countries faced with several critical issues with characteristics of change in the beginning of twenty first centuries. In critical issues, globalization process, democratic change, resource scarcity, human resource, international safety. Generally within the framework of sustainability conception SGI makes conclusion on political plan, and its accomplishment, related to above mentioned critical issues but for governance conception, major participants in political effective management and their acts are mostly considered. From this a question "at which level serious problems generated from collaboration of OECD countries and globalization" can be emerged. SGI governance sustainability criteria includes status index, management index and using these indexes, above question can be answered.

## 4. The Findings

Operational stability of participants largely depends on Sustainability and development of market economy system. Even though there are many types of organizations, goes on for profit, of those the most popular one is corporate structure. (Blaise Gadanez, 2008). Corporate structure is not only dependable to legal acts but also company's strategic management. It has become popular that these are seen as one standard.

### 4.1 Questionnaire For Defining Financial Sector Governance Index

In order to define financial sector governance index, data applied for my research work was picked up on the basis of questionnaires filled with senior officer of inspectional department of bank of Mongolia in the framework of 88 questions with 12 chapters and 109 questions made against unified statement of commercial banks, monthly bulletin of bank of Mongolia as well as 153 questions asked against, legal acts, rules, enacted since 1992. Research consists of 12 chapters and 282 questions and in each chapter demonstrations to represent bank system governance with many sides included.

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### 4.2 Methodology For Estimating Governance Index Of Financial Sector

While estimating financial system governance index, bank section, which accounts for 95, 86 percent of total asset of financial system at the end of 2010 was considered as main representative. The main significance of calculating the index of banking section governance is to give an answer to illustrate where the development of our banking system is, how is the base in the financial sector and when calculating those indexes we could identify our branches development and it can explain how the consistency of economics rate and financial gestural indicators related to each other. While calculating Mongolian bank's branching governance index as a system, I used the rate of "the index of the development of banking system".

This research used the data from 107 countries' private banks as a collection from the world's bank and executed relations between the bank's systematic coordination, controlling practice and the development of bank's sector, its effectiveness, and its weakness after examining it with the Office of the Comptroller of the Currency (OCC), Institute of International Bankers. Result of this research is index and the calculated index is used for demonstration which is "possession of bank and the competition between foreign banks" in sub group, "Loan, labor, business" in Indexes of economics freedom approved by the Frazer institute.

Therefore, calculation of banking system governance index in this way can entitle somebody to compare it with the other countries and show the development of banking system. The World's Bank, International monetary fund, Basel's committee use of banking system development index is aimed at the illustration of bank regulatory and inspectional work rate and influence of well surveillance and accommodation to its stabilization of the bank's branching and its development. Questions of the research are divided as a below and each of them is computed as an independent. To affiliate these groups, we created the general index of bank governance. Included in these

1. Regulatory variables of bank's activity
2. Regulatory variables of bank's ownership
3. Regulatory variables of bank's competition
4. Regulatory variables of bank's capital
5. Variables of inspector action of regulatory organization
6. Variables of bank's organization of resource
7. Variables of private surveillance
8. Variables of savings insurance
9. Indicators of market structure

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**Table 1: General governance index**

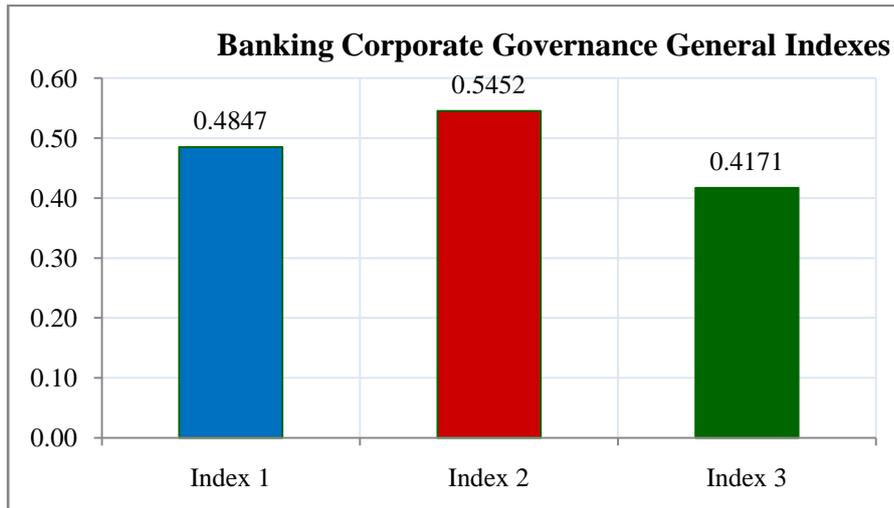
No	Variables	Average Index estimated from subsequent indexes
1	Regulatory variables of bank's activity	0.4444
2	Regulatory variables for bank ownership	0.5000
3	Regulatory variables of bank's competition	0.6250
4	Regulatory variables of bank's capital	0.3333
5	Variables of inspector action of regulatory organization	0.6533
6	Variables of bank's organization of resource	0.6000
7	Variables of private surveillance	0.7933
8	Variables of savings insurance	0.0000
9	Variables of market structure	0.4124
<b>General governance index</b>		<b>0.4847</b>

For the calculation of indexes of bank's system governance, firstly we used common average method setting all the sub groups and questions as an equal weight and compared them with each other without consideration of sub group of savings insurance. At last, to give more weight to calculate those indexes we made a list arranging subgroups in order of importance by how they affect to governance index, shown in Table 1.

See the result of bank section governance index from Table 1. From the view of index of each variable, 5 variables are greater than 0.5, 4 variables are less than 0.5, the general variables of governance index is 0.4847, shows that the governance of bank section is in the middle level which is not so bad result that I did not intend to make accurate conclusion yet. The reason is because we have made it for the first time and there is no answer for how it was, now where it is or what comparative index with the similar countries is too. Therefore, we only concluded those 9 variables that are showing the general index. To general governance index is estimated less than 0.5 is appreciably influenced savings insurance system and government only pays back for saving holders once there is no saving insurance special exchequer and there is no activity of financial agencies supportive for bank system. In other words, currently financial sub structure has been less developed. Also regulatory variables of bank's activity are estimated lower than average meaning in regard to the weak financial sub structure. Reasons for the origination of index which is lower than 0.5 and the weak financial sub structure are the market with lot of small banks, and existence of only one bank that is 100% state owned.

When subtracting the index of savings insurance system from the general index, the index will increase to 0.5452 and we can see that our savings insurance system is not developed well and it makes our index of banking system down. However, as given weights arranging sub groups in order of importance on governance index, the general index of bank governance is 0.4174. This shows that our countries bank section governance has not reached the average level. The reason is that variables, high in effectiveness, have a low weight and the sub group has low scores.

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In picture 1, the general index of banking governance is considered in 3 different conditions. The general index 1 is output of score distribution of 9 variables and index 2 is difference between savings insurance and 9 variables, index 3 is scored index on the basis of arranging 9 variables in order of importance.

### 4.3 General Group's Indexes

1. Regulatory index of commercial bank activity 0.44 shows that the bank has limitation to carry out such activities as real estate, insurance, bonding and so on. In our banking system, non banking institute has right to own some percentage of the banks ownership, but the bank has the right to own only non banking institute's 10 percent which leads and shows regulatory index to 0.5 and ownership regulation is in the middle.
2. Regulatory index of bank's competition is 0.62 says that our banking system of competition is high and there is high threshold to involve into the banking system.
3. The elaboration of bank's own capital amounting 0.33 is saying that competitive regulation is high, elaboration of its capital is bad and there is no function of market risk.
4. The index of the royalty of the official surveillance amounting 0.65 shows that the royalty of controlling is more than what is needed.
5. But, the variables of the official surveillance is 0.6 shows that however it is less in comparison with the activity of trading surveillance, regulatory rate of supervisory officer's such responsibilities as to be chosen, resonated.
6. Our bank's system's private surveillance index 0.79 which is high and shows we do not have any savings insurance system and it has high expectation for bank's registration, and for the surveillance .
7. In our country, we do not have any special savings insurance exchequer or any activities of agency and when bank is bankrupted the government only pays for the savings holders, which leads the index to 0.
8. The market structure index is estimated as 0.41 because of lack of the information on foreign industries. 0.41 also shows that we have very small information of the market structure and the structure has not reached appropriate standard.

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## 4.4 Sub group's indexes

1. A. Activities of bonding: Trading banks can have the activity of bonding when they only get permission. This is stated in the 2.1th section of rules, of “the procedure of the agreement of having an activity of bonding in market”, enacted with the 29<sup>th</sup> resolution of Financial regulatory committee in 2006 and as well bank can have the goings-on of underwriting. In the 2.5.2, 2.5.3 section about brokering activity conductance is reflected. Therefore, the regulatory index of this activity is 0.67.

B. Insurance activity: To have insurance activity, requirement, stated in the 2.17-2.23th sections of rules of “regular insurance, double insurance and insurance's vocational implication”, should have been met ". Therefore, the regulatory index of activity of insurance is 0.67.

C. Real estate related activity: In our country, it is illegal to have the activity regarding real estate in banking system. Therefore, we do not have any regulation of this kind of activity and then index is measured as 0.

2. A. Ownership of bank to nonbank financial institution: That commercial can have up to 10 percent of non bank financial institution in legal act shows there is limitation for bank ownership. So index is estimated at 0.33.

B. Ownership of nonbank financial institution to bank: There is no limitation of ownership percentage of nonbank financial institution to bank and as opposed to what mentioned prior to this, ownership can be comparatively flexibly defined. Index is 0.67

3. A. Limitation of foreign bank: Demonstration illustrative for foreign bank ownership and involvement chance to domestic bank amounts to 1 shows foreign bank ownership is lawfully unrestricted

B. In order to get the permission of bank establishment, following requirements should have been met: According to specific requirements stated in the question, 0.75 percent of all documents must be gathered and it's more than 0.5 describes requirement for the involvement threshold of bank market is rather high.

C. Application for the establishment of new bank and its invalidity. It shows what percentage of applications made for the bank establishment is abandoned and for our country only one application for the bank establishment was made invalid last 5 years and that restriction is high for the market involvement was confirmed.

4. A. Requirement for the total own capital: Requirement for the total capital influences to risk elements and market value is getting lower. Index equals to 0.5 shows requirement to own capital is in the middle.

B. Requirement to initial own capital: There is no need to create a fund for the formulation of initial own capital for the banking system of our country and own capital insufficiency can be made better through way of attracting loan from third parts is confirming requirement to initial own capital is not strict.

C. Own capital regulatory index: In spite of fact that requirement to initial own capital is not strict, prerequisite to total asset is rather high which is why own capital regulatory index is 0.5, amounting nearly average.

5. A. Official right of inspectional specialist: Index of this subgroup expresses opportunity to take measure with the purpose to solve issues faced with bank where inspectional officer works and for Mongolian banking system this index is calculated as 0,75.

A.1. Right for adjustment: As bank faces with unliquidity measurement taking right index is 0.67. In other words this index is high.

A.2. Right to renovation for bank activity: This right index is 0, 67 and high.

A.3. Right to announce unliquidity: When bank faces with unliquidity, inspectional officers announces about it and index equals to 1 is high.

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B. Difficulty with Inspector: Because of being statement, about regulation for bank illiquidity and responsibility to be taken for supervisory officer, reflected in law of bank index was measured as 1.

C. Requirement to loan classification: The longer term required to changing performing loan into nonperforming loan, the more prerequisite be. That 360 days are spent on change of performing loan into nonperforming loan for our country's banking system is the same as other countries. So loan classification is considered as good and took score 1.

### 5. Summary and Conclusions

I did do this research work with the purpose to do analyze Mongolian financial system sustainability through the way of getting financial system sustainability indicator and financial system index interconnected and I have tight belief that by doing analyze Mongolian financial system sustainability, financial system current circumstance can be made clearer and we would be provided with an opportunity to estimate and forecast sudden changes to be happened for the future prospect. Financial sustainability indicator from the first quarter to the fourth quarter of 2010 was estimated and as banking system is 95, 89 percent of financial systems of our country, main output of sustainability analysis have been accurately done on the basis of capital adequacy, asset quality, profitability and liquidity estimation. For the assessment of financial system governance index, I took banking system, which is 95,89 percent of financial system, as research object and banking system governance index is estimated with the purpose to show connection between financial system development, sustainability and economic variables and signaling indicators. From the view of each variable index, it was appeared that 5 of 9 variables are more than 0.5 and other four are less than 0.4 as well as governance general index is 0.4847.

As well difference between saving insurance system sub index and general index is 0.5452, which increased in comparison with that of earlier period. In other words less developed saving insurance system makes banking system index of our country down. However general governance index becomes 0.4174 as allocates weights on the basis of arranged orders of sub groups index of their importance and it shows banking section governance index of our country can not reach at least other country's average meaning. Because more significant variables for governance are small percentage of total variables and scores gathered from subgroups are undersized.

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