



# A review of the Mongolian Primary Mortgage Market

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## **ABBREVIATIONS AND ACRONYMS**

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ADB	Asian Development Bank
BoM	Bank of Mongolia
FHA	Federal Housing Administration
HFC	Housing Finance Corporation
LTV	Loan to Value Ratio
MBS	Mortgage Backed Security
MCUD	Ministry of Construction and Urban Development
MIK	Mongolian Mortgage Corporation
NSO	National Statistics Office
PFI	Participating Financial Institution
SWG	Standardization Working Group



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## **SECTION I: INTRODUCTION**

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The Mongolian Mortgage Corporation (MIK) Mortgage Market Review consultancy was completed in tandem with the Bank of Mongolia (BoM) Securitization Advisor consultancy. The purpose of the MIK Mortgage Market Review was to identify what, if any, standardization exists within the Mongolian mortgage market regarding policies and procedures relating to mortgage loan origination, underwriting, collateral appraisal, pricing, servicing, and reporting and subsequently to identify what mortgage loan products are generated as a result of the existing market policies and procedures. The BoM Securitization Advisor consultancy was intended to assist the BoM in defining its role at different stages of the secondary mortgage market development by providing recommendations and guidance on potential areas of policy, institutional development, and regulatory interventions. Given the importance of primary market prerequisites and market infrastructure requirements underlying the development of a secondary mortgage securities' market, another significant purpose of the MIK Mortgage Market Review was to provide a preliminary analysis of existing primary mortgage market prerequisites to the BoM Securitization Advisor as a basis for recommendations to the BoM on its potential role and possible interventions in enhancing primary market infrastructure, standardization, and thus, attractiveness for eventual securitization.

Activities completed include:

- Met with Bank of Mongolia (BoM) officials along with the BoM Securitization Advisor to explain the purposes of the consultancies
- Met with some of the Mongolian Mortgage Corporation (MIK) Board members for introductory meetings to explain the purposes of the consultancy and to plan working meeting with mortgage loan officers
- Prepared lender due diligence, loan file, and mortgage portfolio statistics and policy and procedure checklists / survey forms
- Met with MIK shareholder banks to complete mortgage portfolio statistics checklist, lender due diligence checklists, and to perform loan file reviews
- Met with the Housing Finance Corporation (HFC) to discuss the 40,000 housing units Government of Mongolia (GoM) initiative
- Met with the Ministry of Construction and Urban Development (MCUD) to discuss housing demand projections and the 40,000 housing units initiative
- Reviewed draft laws on Securitization, Mortgages, and Credit Bureaus
- Reviewed the 2006 Mongolian statistical yearbook
- Reviewed MIK Business Plan
- Reviewed the Asset Classification Regulation

One of the recommendations from the final “Report on assistance to the Bank of Mongolia with the development of polices and regulations to support secondary mortgage market development,” from the BoM Securitization Advisor consultancy, proposed that the BoM Bank Supervision Department in coordination with MIK and commercial bank representatives constitute a “Standardization Working Group” (SWG) to promote the adoption of industry standards on mortgage loan structures and documentation and to review and discuss the 3 draft laws, being 1. the Mortgage Law, 2. the Securitization Law, and 3. the Credit Bureau Law, which will significantly impact the mortgage market infrastructure and legal and regulatory environment.

The ensuing mortgage market review includes an assessment of the existing mortgage market standards and thus preconditions for securitization and provides recommendations for enhancing standardization based on the assumption that the SWG or a similar group will be created to champion the necessary market reforms to prepare for eventual securitization.

## **SECTION II: BACKGROUND**

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### **A. Mortgage Market Background**

Prior to the Asian Development Bank's (ADB) Housing Finance Sector Project (2002-2007), only a few banks in Mongolia had experimented with very limited mortgage lending programs. The ADB project started working with 5 commercial banks in 2002 and supported the large scale origination of mortgage loans in Mongolia. ADB sponsored loans were first disbursed in 2003 and laid the foundation for today's Mongolian mortgage market, valued at MNT 72 billion as of March 31, 2007.

The ADB program required participant banks to use standardized forms and documents and to follow specific policies and procedures based on international best practices. As the 5 participant banks drew upon the technical assistance from the ADB program and developed independent mortgage loan portfolios funded by internal bank capital, they deviated from the standardization precedents set forth under the ADB program. As the mortgage market experiences continuous growth, competing commercial banks have entered the market, resulting in each bank developing their own approach to and standards for mortgage lending.

### **B. Market Demand Background**

Currently there is a lack of solid demand studies providing in depth and accurate information on population income levels, which is necessary information for predicting demand for mortgage financing as it indicates how much of the population in need of financing can actually afford the financing available on the market. According to some studies on income levels, it would appear that only a very small portion of the residents of Mongolia can actually afford mortgage loans, which is clearly not the case. Despite the limited data available, there are still some preliminary demand estimates that can be made.

According to Mongolia's National Statistics Office (NSO) 2006 Bulletin, Mongolia's total population as of year end 2006 was 2.594 million, which represented a 1.2% increase since 2005. Mongolia's population has maintained steady growth between 1.1-1.5% per year over the past few years and this level of growth is expected to continue in the near term.

Of the 2.594 million people in Mongolia, 2005 estimates indicate that approximately 520,000 or 20% of the population inhabit structures meeting standard hygiene and sanitary requirements and connected to basic infrastructure, such as water, sanitation, and heating. This figure implies that approximately 2 million reside in dwellings that do not meet modern living standards. According to the Ministry of Construction and Urban Development (MCUD), urban households (55% of all households in Mongolia are urban) have an average of 4 people per household. If it is given that 2 million people live in substandard structures and there is an average of 4 people per household, it can be inferred that the present approximate need for housing units meeting standard hygiene and sanitary requirements is 500,000 units. Based on this basic demand approximation there remains a significant unmet demand for housing in Mongolia. However, demand in this sense is more representative of need and does not take into consideration what portion of the population can actually afford housing at market interest rates, which is questionable and remains undefined.

MIK's business plan used the historic growth rate of the mortgage market to make projections for mortgage originations for the next 5 years. Based on these projections, mortgage originations are estimated to reach MNT 230 billion by 2011. The 9 MIK shareholder banks have a total of MNT 68,495,488,467.16, which represents a total number of 13,378 mortgage loans. Using the existing MIK shareholder bank portfolio as a basis for projections, a 235.79% growth in the value of mortgage loans would represent approximately 31,543 additional

mortgage loans on the market. This is obviously a very basic projection, but gives an idea of the potential for growth.

MCUD in cooperation with the Government of Mongolia (GoM) has resolved to provide the construction and financing for 40,000 homes by 2009. MCUD created the Housing Finance Corporation (HFC) approximately 6 months ago to manage the implementation of the 40,000 Housing Units Master Plan. Though still in preliminary design stages, the HFC intends to make mortgage loans under the program available for a maximum of 10 years with an annual interest rate ceiling of 10%, which is approximately 9.8% less than the current market average interest rate, as displayed in Annex 1 Table 4. Properties under the program will sell for USD 350 per square meter while the going UB market price is USD 500 per square meter.

The HFC explained they were not concerned about potentially “crowding out” private sector mortgage loan originators by offering subsidized interest rates and prices because they will be targeting the lower to medium income population and government employees while the private sector serves the mortgage financing needs of the medium to higher income population. HFC requires borrowers to submit an application for a loan under the 40,000 units program. The application requires borrowers to report their household income and only incomes falling below a certain level will qualify for mortgages under the program. As discussed below in Section III B Underwriting, verifying income is extremely difficult in Mongolia due to the rapidly expanding informal sector providing more and more families with unregistered income. In order to qualify for a loan under the 40,000 units program it would be very easy for a borrower to leave out some of the informal income the family generates in order to qualify for a subsidized loan. As a control to avoid potential abuse of the program, HFC could define the low to middle income supply of homes such that if someone could afford a market based mortgage loan, they would prefer to pursue market financing as the market housing supply options are not limited to the program-defined low to middle income design. The 40,000 units Master Plan did not indicate specifically how the demand for and thus the design of the mortgage loan product was derived. The plan does not identify the actual income, expected growth, savings information, or other relevant demographic and financial information of the lower to medium income population that the program intends to target. The HFC already reported that higher income families have tried to apply for units to buy and then re-sell the property for profit at market rates. By mandating that the borrower must be purchasing the home as a first residence, the HFC might avoid similar issues.

The HFC recently conducted a survey of 1,522 families living in UB and nearly 100% of the families displayed qualified income levels and reported they could afford mortgage loans at the interest rates to be offered under the HFC program. Reports on income and other borrower profile information reported by the HFC survey participants should be closely examined. The results should be compared to the existing borrower profiles in Annex 1 Table 7 to see if the HFC is actually targeting a currently underserved population or if the HFC will be tapping into borrowers that would have otherwise turned to the private sector for mortgage financing. There is a large need for affordable housing that the private sector is not capable of providing. This portion of the population will certainly benefit from the 40,000 units program, but the program implementation should take measures to avoid undeserving applicants receiving subsidized loans as this could potentially be an issue.

More specific demographic information on savings levels, income levels and growth of population disaggregated by savings and income levels needs to be accumulated in order to make more accurate demand projections for mortgage loans at market rates. This information should also be disaggregated by people living in formal housing structures and those living in sub standard conditions. Population growth estimates must be linked with real income levels. Another linkage should be created to the information provided in the borrower profiles in

Annex 1 Table 7 and to Annex 1 Tables 3-5 describing the available market tenors, interest rates, and values to determine how much of the population (living in substandard housing) is actually capable of affording homes at market prices. Without the necessary demographical indicator information, it is hard to predict actual demand and it appears that right now the only concrete information is on actual need for formal housing structures as opposed to realistic demand for mortgage financing at market prices.



## **SECTION III: CURRENT STATUS OF MORTGAGE LENDING**

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In some developed mortgage markets, the functions of origination, servicing, risk management, and funding tend to be managed by different institutional entities. The portfolio lending system, that is characteristic of Mongolia's mortgage market today, allows for the possibility that mispriced loans with incomplete documentation and/or weak underwriting are hidden or "buried" within a portfolio because there is no separation or check when the loan completes one stage and is passed along to the next institutional entity. Regardless of whether functional separation exists in a market, the effective management and standardization of the basic functions and risks involved in primary market mortgage lending lays the framework for a successful secondary market. Although Mongolia's market practices the portfolio lending system, which presents some risk, there are many changes that, if implemented, will allow for more effective primary market management to lay a strong foundation for secondary market development.

The 9 MIK member banks participated in a survey from May 14, 2007 through June 7, 2007 to identify what, if any, market standardization exists among mortgage loan policies and procedures with respect to origination, underwriting, property appraisal, servicing, and loan documentation. An additional analysis of mortgage portfolios sought to identify the presence of product uniformity. An individual lender due diligence review for each bank is attached in Annex 3. The 9 MIK member banks represent approximately MNT 68,495,488,467.16 of the mortgages in the market. Please see Annex 1 Table 1 (Note all currency conversions are calculated using the exchange rate of 1 USD = 1165 MNT) for a mortgage market summary and a breakdown of mortgage lending by commercial bank. As of the end of Quarter 1 2007, the total value of outstanding mortgage loans in Mongolia was reported as MNT 72 billion, of which MIK shareholders represent approximately 95%. Therefore, the market assumptions made based upon the MIK shareholders mortgage portfolios and mortgage lending policies and procedures are considered to provide a relatively accurate representation of the entire mortgage market.

### **A. Origination**

Mortgage loan origination refers to the various functions required to generate a mortgage loan, including sourcing customers, underwriting loans, appraising the value of property to be mortgaged, collecting all necessary loan file documentation and borrower information, reviewing applications and providing approval or disapproval decisions, closing approved loans, and completing necessary loan closing documentation. Originators may be traditional commercial banks, mortgage companies or mortgage brokers. In the presence of a secondary mortgage market, the origination functions are completed with the understanding that the mortgage loans generated must be attractive investments on the secondary market. As previously mentioned, typically in a developed mortgage market, origination functions are managed by separate institutional entities. Separating or outsourcing functions can lead to lower costs, ultimately delivered to the borrower in the form of lower interest rates or origination fees due to decreased operational costs.

In Mongolia commercial banks serve as mortgage loan originators and the prevailing market practice is for commercial banks to complete all origination functions internally. Individual loan officers are responsible for every step of origination and beyond from sourcing customers to compiling loan and borrower information to underwriting to servicing a mortgage loan.

Originators decide whether or not to charge an origination fee to cover the costs of generating a mortgage loan. The majority of originating commercial banks interviewed indicated that they

charged an origination fee, however the policy for charging origination fees in Mongolia varies from bank to bank and as a matter of competition, banks prefer to keep the fee as low as possible. Current fees range from 0.05% to 0.50% of loan principal. Origination fees are intended to cover the operational costs of originating a mortgage loan and contribute to the overall calculation of the expected return on a loan. Given the concentration of origination functions being performed internally at each bank, it is likely in the bank's best interest, if not financially required, to charge an origination fee in order to realize the necessary returns. Higher origination fees tend to preclude potential borrowers from qualifying for mortgage loans, however, a low fee or no fee at all will demand higher ongoing interest rates to compensate for costs incurred throughout origination.

## **B. Underwriting**

Quality and consistent underwriting is crucial for originating primary mortgage loans that will be suitable and desirable for subsequent sale in a secondary market. The objective of underwriting is to control the probability and cost of defaulted loans by assessing three general qualities; the value of the collateral being used to secure the loan, the creditworthiness of the potential borrower, and the capacity of a borrower to repay the loan. As part of the collateral assessment, the underwriter must ensure all legal and financial requirements are completed satisfactorily on collateralized property to protect interests of the mortgage holder. Michael J. Lea's paper, *The Role of the Primary Mortgage Market in the Development of a Successful Secondary Mortgage Market* provides a thorough explanation of the "three Cs" being collateral, credit reputation, and capacity upon which all mortgage underwriting is generally based.

In Mongolia's emerging mortgage market, today virtually none of the internationally recognized underwriting best practices are followed either due to market nascence or lack of supporting legal and regulatory infrastructure. Underwriting guidelines are subjective and vary from bank to bank, sometimes varying within banks depending on the level of decentralization. In order to achieve a more consistent market approach to underwriting, there are a number of issues the SWG can address to move towards market standardization. SWG interventions should also serve to mitigate potential risks and increase commercial banks' portfolio quality, augmenting attractiveness for secondary market investors.

### **B.1 Collateral**

#### **A. Appraisals**

An accurate and quality appraisal of the collateral for a loan is a critically important underwriting function and should ideally be performed by an experienced appraiser using a market standardized set of criteria upon which to evaluate a property. In the U.S. there is an Appraisers Qualification Board of the Appraisal Foundation, which establishes certification requirements to guide states in the development of their own requirements for certifying appraisers and administering certification exams. Collateral evaluation criteria generally consists of information such as the location, size, number of rooms, quality of construction material, quality of construction structure, and other related information. The proper evaluation of such criteria is of course contingent upon good quality house price data as a basis for judgment. In the U.S. house price data is obtained from government title registration offices and multiple listing services run by real estate brokers.

In order to assign an appropriate appraised value to a property, appraisers generally use a combination of the 3 primary valuation methods or cost approaches:

1. Cost approach: includes an estimate of the value of the land as vacant, the cost of replacing the improvement and an adjustment for estimated depreciation due to physical deterioration and functional and economic obsolescence of the property
2. Market approach: estimates the value of property based on sales prices of similar properties (comparables) in the neighborhood. 3 general comparables are used & adjustments are made to the comparables for differences in physical characteristics and conditions of properties
3. Income approach: values property based on the potential rent that could accrue to it. Appraiser will capitalize the potential rent of the property using an income multiplier or capitalization rate.

The accuracy of such approaches is completely dependent upon the competence of appraiser, the quality of market data, and the access all appraisers working with mortgage originators have to the same standardized market data set.

Collateral appraisals are entirely subjective in Mongolia today. Most banks use market value or sales comparison methods for evaluating property, however, each bank is responsible for obtaining the market data to apply such methods. Banks often obtain market data from real estate developers, but each bank deals with different developers and therefore different data. No uniform set of criteria against which properties are evaluated exists (i.e. neighborhood, size, number of rooms, amenities, etc.) so it is at the bank's discretion to create such measures. Banks rely upon individual credit loan officers to appraise the value of property, exposing appraisals to further subjectivity according to the competence of each loan officer.

Some banks reported having an appraisal unit within the bank, which is a good starting point for internal bank standardization but certainly does not address the more systemic market problem of potentially distorted and variable property appraisal practices upon which lending is based.

For secondary market investors, the appraisal value of a property serves as an indicator of whether the property will be sufficient security for the mortgage in the event that the borrower defaults on the loan and thus is weighted heavily when considering investing in a portfolio of loans with property as collateral.

### **B. Loan to value ratios**

Loan to value ratios are generally calculated by dividing the proposed size of the mortgage by the purchase price or the appraised value of the property. Of the 9 MIK shareholder banks interviewed, maximum allowable loan to value ratios ranged from 70% - 80% while real the portfolio market average is approximately 63.4%. Please see Annex 1 Table 2 for an overview of market LTVs. Research has proven that the lower the loan to value ratio, i.e. the more equity the borrower has invested in the property, the less likely the borrower is to default. The fact that borrowers in Mongolia tend to make larger downpayments than banks require and have more equity invested in properties might contribute to the low rate of default in today's market. Annex 1 Table 6 provides a breakdown of loan quality classifications by portfolio. However, as explained above, the quality of appraisals is highly questionable and there is direct dependence of loan to value ratio calculation on the appraised value of a property.

### **B.2 Creditworthiness**

Research indicates that a borrower's credit history is highly indicative of likely performance on any given loan. Therefore, a borrower's credit record or score, if the infrastructure is available to provide such information, is heavily weighed in the loan approval decision as it

significantly enhances a lender's ability to accurately predict loan performance and potential for default or loss.

Currently the BoM has a loan information fund, which maintains records of all historical and current loans outstanding for each borrower. However, the information provided through the loan information fund was reported as unreliable and often outdated or inaccurate and on a regular basis the information is at least a month old. This allows for a situation where a borrower could take out multiple loans at once without lenders being aware of other currently outstanding debt obligations, which naturally impairs the ability of a lender to properly assess borrower capacity.

The loan information fund only provides the current status of a loan. Loans that have been prepaid are reported as closed with no indication of loan performance over its life. Defaulted loans are reported as cancelled, however, the reason for cancellation is not available which engenders asymmetrical information. Lenders are not aware of the reason for cancellation, which may be interpreted as unwarranted blemishes on a borrower's credit record even if a loan was cancelled for reasons other than default. In the same right, borrowers may be approved for loans which they are really not worthy of receiving based on historical performance.

The BoM's current loan information fund only includes information from banks and is not inclusive of other relevant credit history from non-banking financial institutions, consumer credit companies and public utilities companies such as telecommunications and electric utilities, which all provide extremely relevant information regarding a borrower's credit history. Mongolia's mortgage originating banks make significant efforts to accurately assess a borrower's creditworthiness despite lacking infrastructure to support a thorough and sophisticated credit bureau. Despite these efforts, mortgage originators really do not have the ability to properly and accurately assess creditworthiness. If enacted, the current Credit Bureau Draft Law that is being reviewed and discussed will address the need for a more comprehensive alternative to the current BoM loan information fund.

### **B.3 Capacity**

In order to assess a borrower's capacity to repay a mortgage loan, general practices require the loan officer who builds the loan file and processes the application to collect documentation to verify an applicant's income and financial status. Such documentation may include bank statements, business financial statements, income and employment verification from employer, copies of pay stubs and tax returns, asset/liability information, and other information available depending on the market context. The availability of funds for down-payment, closing costs, and any other associated fees, such as origination fees, insurance premiums, or escrow account fees should also be included when evaluating a borrower's financial capacity.

In Michael J. Lea's paper cited above, two possible ratios expressing the percentage of an applicant's income needed to cover monthly debt obligations, including the mortgage payment, are recommended as measures for assessing borrower capacity to repay a loan. The ratio that is used by mortgage originators in Mongolia is the debt-to-income ratio, which focuses on housing-related payments and is calculated as the ratio between monthly mortgage payments (including taxes and insurance) and gross monthly income. Acceptable debt-to-income ratios range from 25-80% depending on the lender and the calculations vary widely, for example some lenders calculate the ratio using after tax income and account for all other household expenses. However, not all of the lenders required proof or documentation of other household expenses (car payments, tuition fees, etc.), which affects the ability to properly assess capacity.

In the current case of Mongolia, in many instances the ability of a loan officer to accurately assess a borrower's capacity to repay a loan is limited at best. Another primary limitation is inherent in the rapidly expanding informal sector, which generates a significant amount of unregistered household income. During loan file reviews at 9 MIK shareholder banks, well over half of the loan files included borrower's personal "black book" or hand-written financial statements, which were used to display historical income information for self-employed borrowers. If available, bank statements or loan information from other banks or previous loans were provided in an attempt to substantiate previous cashflows. The risk banks face by making financial capacity assessments based on such potentially unreliable information is evident. A growing informal sector does not indicate that these limitations on accurate income assessments will be lessened in the near future.

Despite this obstacle for self-employed borrowers, a number of formally employed borrowers were capable of providing an appropriate level of quality information allowing lenders to perform adequate financial capacity assessments. Such documentation includes income verification from an employer, social insurance books, copies of payments, employment verification. However, the presence of all the necessary income information was not consistent throughout the files and appeared to be included on an as available basis not necessarily as a requirement for approval.

### **C. Underwriting legal requirements and loan file documentation**

In a developed mortgage market, there are a number of legal requirements for a mortgage loan application to be approved. A key legal prerequisite is the timely and cost effective registration of the land title. In Mongolia it takes anywhere from 2 to 3 weeks for the Real Estate Registration Department to process land titles, but it takes anywhere from 2-10 business days to process loan file applications. Banks indicated that a lengthier approval process makes them less competitive. However, the implication that banks are approving mortgage loan applications prior to securing a clean title from the Real Estate Registration Department exposes banks to significant risk and not every loan file reviewed included the required documentation from the Real Estate Registration Department. In order to avoid the potential situation of a property not having clean title, some banks are only willing to make mortgage loans on newly constructed properties. Developed markets often require a title report or title insurance policy, which verifies that the mortgagee owns the property being pledged as security while also insuring against the risk that the mortgagee may not have clear title or may have pledged the property as collateral for another loan. There is no title insurance existing in Mongolia today and there was no evidence of anything akin to a title report in any of the loan files. Most banks only keep a copy of the certificate of title in the loan file and house all of the certificates of title for mortgage loans together in a vault for security purposes. However, some of the loan files lacked even a copy of the certificate of title.

Another given requirement in a developed mortgage market is insurance coverage. The insurance required by banks may vary, but there is a minimum level of insurance required for all mortgage loans. In Mongolia, some banks require mortgage borrowers to have both property and credit life or hazard insurance, while some banks require only certain borrowers to have such insurance, such as borrowers purchasing a new apartment or borrowers over a certain age. Other banks do not require any insurance in any case. One of the largest mortgage originators in the country does not require borrowers to have property or hazard insurance, which will likely have a significant impact on the perceived risk for an investor on the secondary market.

The language included in the loan and collateral agreements in Mongolia has made foreclosure difficult. A clear loan and collateral agreement is important to insure and formalize the

responsibilities of both parties and is also critical for the purpose of enforcing the lender's right to foreclose on a property in the case of default. The problem lies not solely within the loan and collateral agreement but is inherent within the interpretation by courts of the civil law, which does not specifically define when a loan is considered in default and therefore when a property can be legally foreclosed. This interpretation of the civil law puts lenders at a disadvantage and many banks reported that the court is subjective when processing claims of default and when judging mortgage collateral contractual obligations. The existing draft Law on Collateralized Mortgage Bonds, if enacted, will impact the existing infrastructure requirements and enabling environment regarding the collateralization of real estate as a security to fulfill obligations.

Loan documentation is far from standardized within the market and even individual banks lack internal standardization and order of documentation in loan files. A formal loan file should include standardized forms in a specified order or format. The majority of the loan files reviewed used standardized forms, however, the order in which the forms were presented in the loan file was generally random and not in any intuitive order, which makes a review process more cumbersome and time consuming.

#### **D. Underwriting summary and loan approval**

Once the underwriter has taken into consideration the capacity of a borrower to repay, a borrower's creditworthiness, and the value of the collateral used to secure the loan, a recommendation to either approve or disapprove a loan should be made. As a best practice, any mortgage originator should establish a set of guidelines that are used to judge whether or not a loan will be approved, which contributes to both portfolio uniformity and quality. Another recommended best practice is to use an internal classification or rating system based on a loan's level of risk to make sure that the portfolio is balanced regarding the level of risk embedded in individual loans.

Of all the 9 banks interviewed, none of the banks indicated that there was a standard internal set of criteria upon which mortgage loans are judged. Additionally, none of the banks use any internal rating or classification of loans to differentiate the varying levels of risk that each approved loan represents within the portfolio. All of the banks indicated there was some set of internal procedures a mortgage loan must go through to be approved, however each bank's level of decentralization varied tremendously. Large scale mortgage loan originating banks allow their branches and headcounts a great deal of autonomy in approving mortgage loans, which contributes to a heterogeneous portfolio and diverse quality of underwriting and loan documentation. Each bank follows the practice of requiring a loan approval committee of sorts to make the ultimate decision on a loan. The approval committee members and level of experience is greatly different at each bank and the process is relatively informal depending on the bank. One bank described the approval committee process as an informal discussion about a loan's potential risks, which are individually identified by various committee members after an initial review of the underwriting summary and application. The risks an individual loan presents are subjectively discussed and weighed and the committee makes a decision based on this informal discussion. When loan approvals are made using a consistent evaluation process, this naturally contributes to portfolio uniformity. In Mongolia today there are some best practices in place in terms of evaluating loan applications, but the fundamental problem is the level of decentralization and lack of enforcement of consistent standards.

#### **E. Pricing and mortgage product uniformity**

Investors and rating agencies must be able to perform due diligence with reasonable cost. The more heterogeneous the terms and documentation is of a portfolio of loans, the greater the cost

of due diligence and the less competitive is sale through securitization. In order to reduce the transaction costs of evaluating mortgage loans and the processing costs of issuing and administering mortgage-backed securities (MBS), the characteristics (rate adjustment, amortization schedule, term) of individual loan products within a pool should be uniform. A portfolio seeking securitization may exhibit an allowed range of loan maturities and interest rates. These limits and pool requirements allow investors to more accurately predict cash flows. However, in smaller markets, such as Mongolia, in order to pool a critical mass of mortgage loans for securitization it is necessary to bundle loan products with relatively diverse terms. The risks associated with pooling diverse loan products can be mitigated through overcollateralization on the side of the security issuer.

Regarding the uniformity of existing Mongolian mortgage loan products, terms range from 1 month to 10 years. Annex 1 Table 3 provides an overview of existing mortgage terms. Some interest rates are fixed for the life of a mortgage loan, but most are adjusted anywhere from twice per year to once after three years of payment and thereafter, fixed for the life of the loan. Some banks have a standard interest rate, applied to all mortgage loans over a certain period of time, while others apply risk-based interest rates applying a range of rates depending on specific borrower profiles. Current interest rates available on the market for MNT loans range from 1.4083% per month to 2.5% per month and for USD denominated loans the range is from .9917% per month – 2.5% per month. Annex 1 Table 4 provides a list of mortgage loan interest rates.

Most banks do not have policies restricting or charging fees on prepayments, which weakens the ability to accurately estimate returns and would expose originating banks to significant risk in a securitized market. Annex 1 Table 8 displays the current market information available regarding prepayments.

As mentioned above, none of the banks use an internal rating system to classify or pool individual mortgage loans together based on level of risk. On the same note, none of the banks indicated that they internally pooled mortgage loans together based on product characteristic in order to streamline the process of reporting on and servicing similarly structured loans. All of the banks do use the BoM's loan performance classification for their portfolios, which allows for systematic identification and classification of non-performing loans, however, a more sophisticated mechanism to classify performing loans according to level of potential risk and product characteristics could mitigate risk and decrease servicing and reporting costs.

## **F. Servicing and reporting**

A critical function of a viable secondary mortgage market is the reporting and servicing of outstanding mortgage loans. Reporting involves the monitoring of all outstanding loans. All of the 9 banks interviewed use a different type of computer software to track the status of payments. The frequency of running such reports varied with each bank ranging anywhere from a daily to a monthly report. The capability of the software to manipulate the mortgage data also varied from bank to bank, but it appeared that most banks were able to run reports on the current status of all loans and to run a report to specifically identify loans by asset classification, per the BoM's asset classification regulation. Reporting on prepayment rates was not standardized throughout the market. Some banks were able to provide statistics on the frequency of prepayments along with the total number of loans, currency value and percent of the total portfolio that was prepaid, while other banks were incapable of producing a statistic to represent the percentage of the mortgage portfolio that was prepaid. This information is of particular interest to secondary market investors as it will affect cash flows and should also be of interest to originating banks as it also affects how much of their anticipated returns on a fully amortizing loan are actually realized.

The servicing function entails the collection and / or processing of mortgage payments and in a secondary market, servicers periodically remit payments to the investor. It is the responsibility of the servicer to maintain accurate and up to date information on mortgage balances, current status, all financial transactions, and historical performance in order to report to the originating bank and / or investor. Default management and if necessary, foreclosure, are also servicing functions. Servicers are expected to collect past due accounts and dispose of foreclosed properties. In many developed markets, separate servicing entities or private businesses exist to service mortgage loans for an originator and processing payments either back to the originator or to an investor in a securitized market.

In Mongolia today, all reporting and servicing functions are performed at the originating bank. Some banks use a foreclosure management company when a loan is in serious default and the collateral property needs to be sold. The general practice for originating commercial banks in Mongolia is to have the originating loan officer also report and service all loans he or she originates, underwrites, and closes. Default management is the loan officer's duty, requiring follow up with the borrower to determine the reason for default and assess whether the inability to repay will be consistent or if it is an isolated event. Most banks indicated that they require the loan officer to monitor the collateral for defaulted loans. A loan restructuring or special assets department existed at a lot of the banks. In cases when a loan is repeatedly delinquent, the payment schedule originally set forth may require restructuring to accommodate potential changes in a borrower's income or ability to repay on a previously established schedule. The ability to restructure delinquent loans greatly increases a bank's chance of recovering losses and the borrower's ability to repay the loan in full. Restructuring also helps banks avoid foreclosure, which is not a process banks enjoy as the disposal of collateral properties is difficult and costly, especially in the case of Mongolia. Unfortunately, some banks have been disallowed by the BoM to restructure loans due to the language in clause 2.9 of the BoM's Asset classification regulation, which states "If a loan is classified as non-performing, it is prohibited to issue more loans [to this borrower – tr.]" Banks indicated that in some cases, the attempt to restructure a loan for a borrower has been disallowed by the BoM as a violation of the above mentioned clause arguing that by restructuring the loan the borrower is actually receiving more money, which is prohibited. This lack of flexibility for a bank of respond to a change in a borrower's financial situation decreases the bank's possibility of recovering losses and avoiding foreclosure. In a secondary market, investors require servicers to be proactive in default management and this restriction seriously inhibits the ability of a servicer to avoid recurring default and eventual foreclosure.

When a mortgage must be foreclosed and the collateral property repossessed, banks in Mongolia face a multitude of obstacles to completing this process. There are two options for foreclosure that commercial banks can pursue, one being the judicial process and the other being the non-judicial process. In the non-judicial process, the borrower or a third party has the right to delay the auction of the property if there is not agreement on the terms of sale. For example, if the borrower thinks the property should be sold for more money than the bank arranges, then they can object to the sale and delay the whole process. When pursuing the judicial process of foreclosure, there can be up to 5 courts the bank has to go through before the process is complete and banks reported that the whole judicial process takes 2-3 years on average. In the judicial process, banks also expose themselves to the possibility that the court will deem the portion of the loan that has not been repaid as irrelevant or not enough to foreclose on the whole property. In Mongolia, courts maintain the discretion to determine if the value left to repay a mortgage is relevant or irrelevant and therefore worthy of foreclosure. This legal environment enables irresponsible borrower behavior and further contributes to the possibility that losses will not be recovered.

## **SECTION IV: RECOMMENDATIONS FOR STANDARDIZATION WORKING GROUP INTERVENTIONS**

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Mongolia's mortgage market has developed rapidly over the past five years and there remains huge potential for further development. In order to sustain the success the mortgage market has realized to date, now is an ideal time to address existing market imperfections to foster a sustainable, viable, and properly functioning mortgage market.

One of the current obstacles to maintaining growth is the lack of long term funds available for on-lending and the asset / liability mismatch banks face as a result. The market is currently exploring a solution to this problem in the form of securitizing a portfolio of existing mortgage loans for sale on the secondary market. In order to attract investors for such a sale, there are a number of primary market preconditions that must be in place to create a portfolio of uniform loans exhibiting a level of standardization. Based on the above review, there are a number of areas that the SWG can target to achieve meaningful results in the form of preparing the market for securitization.

### ***Recommendation 1: SWG Leadership***

The SWG must have strong leadership in order to mobilize the commercial banks and other counterparts to create an environment for change. An invested group of the involved stakeholder needs to take ownership to create a unified vision for the market. These leaders must also advocate and ensure there is buy-in from all concerned stakeholders. The SWG leaders must then identify specific actions and interventions that will strategically move towards attaining the market vision. Without clear and definitive leadership, it will be much more difficult for the entire group of stakeholders to come to a consensus and take collaborative actions to achieve results and affect widespread change. The leadership for the working group should be established as soon as possible. Potential leaders identified in the BoM Securitization Advisor's report include the BoM's Bank Supervision Department in coordination with MIK, which would ensure that both the government and private sector interests are represented. The Bank Supervision Department and MIK should work together to identify leaders or "champions for change" who will drive the SWG process. The HFC should also be an active participant in the SWG. Given the large volume of mortgage loans that will be originated under the 40,000 units program it is imperative that the loan originators for the program apply the same standards as the rest of the market. After an initial discussion with the HFC they expressed interest in participating. Additionally, participating financial institutions (PFIs) in the proposed KfW project with MIK should be involved in the SWG so that the Minimum Quality Standards (MQS) required for KfW project loan eligibility are driven by the SWG standards to encourage a cohesive market approach to standardization.

### ***Recommendation 2: Underwriting standardization interventions***

Investors must have confidence that lenders are properly judging risk and using a consistent set of criteria in evaluating loans. A degree of standardization is necessary to lower costs of due diligence and allow investors, rating agencies and guarantors to quantify credit risk. In order to prepare the market for securitization, the SWG should make strategic interventions to reduce the diversity of underwriting procedures existing today. The following are recommendations for intervention:

- a. Build upon the market standards that have already been set. Gather all of the paperwork and documentation (i.e. borrower profile forms, applications, employment verification, income verification, loan and collateral agreements, etc.) used for the

ADB Housing Sector Finance project as that project laid the foundation for the mortgage market that exists today and the ADB participant banks indicated that they modeled their internal procedures and forms after the ADB model to some extent. Make necessary modifications to the forms to update and tailor more specifically to the Mongolian context if necessary. Given the prevalence of informal or unregistered income on the market, the SWG will need to come up with creative ways to standardize the collection and analysis of informal income reports. Circulate the forms to all stakeholders for review, comment, and consensus building. Finalize all forms and required loan file documentation. Require these documentation standards to be followed for legal mortgage lending.

- b. Create a standardized loan file checklist to ensure all mortgage loan files include the same set of standardized forms in the same intuitive order to make loan file or due diligence reviews more transparent, straightforward, and less costly.
- c. The SWG should collect and systematically disburse house price data on a monthly basis. Require all banks to use the same house price data for performing appraisals so as to decrease the potential for appraisals being based on diverse market information creating a distorted perception of property value.
- d. Create a standardized set of criteria against which properties are evaluated for appraisals. Disseminate the list to originating banks for review, comment, and consensus building and require all banks to use the same agreed upon criteria to decrease the level of subjectivity that is currently inherent in the appraisal process. If there is technical assistance available to the SWG, an appraisal training course specific to appraising property that will serve as mortgage collateral would be extremely beneficial for loan officers, most of whom have not been formally trained to perform appraisals.
- e. Work with commercial banks to encourage them to create internal loan approval criteria and use this to systematically evaluate each loan. Once a loan is evaluated using this standardized approval criteria, it should be classified internally at a bank according to its level of risk (for example, High Quality, Intermediate Risk, High Risk, etc.), which might determine some product characteristics, such as interest rate, required LTV, term of loan, contributing to a more uniform pool of products.

### ***Recommendation 3: Legal and regulatory infrastructure standardization interventions***

- a. Create a public dialogue to advocate for the enactment of the new Credit Information Bureau law and require banks to use the newly available credit history information in the evaluation of a mortgage loan application.
- b. Create a public dialogue to advocate for the enactment of the Law on Mortgages to address the existing obstacles to a streamlined and cost-effective property foreclosure process. Consider instituting a loan disclosure form for all mortgage loans to spell out loan payment obligations (dates, amounts, adjustment terms, etc.) and procedures to be followed in the event of default, specifically defining a date after which a loan is considered a loss and can be foreclosed.
- c. Create a public dialogue to advocate for the enactment of the Law on securitization and make sure the commercial banks are aware of the requirements and expectations of the law.
- d. Create a dialogue to either change the language of the Asset Classification Regulation or to change the interpretation of the regulation so as to allow banks to restructure loans as a tool to mitigate potential losses. The BoM may consider building some

flexibility into the clause to allow a one time only restructuring of mortgage loans, for a period of maybe 6-12 months. The one time restructuring option would not require specific consultation with the BoM and would not trigger a reclassification of the loan's quality based on the regulation.

***Recommendation 4: Product uniformity SWG interventions***

This is an area where the SWG may only be able to make limited interventions because the terms and interest rates available at each bank depend on the availability of internal term resources capable of funding long-term mortgage loans and interest rates are driven by internal capital and operational costs. The SWG could work to begin establishing a framework for loan risk classification that could be used internally at all banks, as mentioned above. The SWG could also work with banks to advise on how to internally pool similarly priced mortgage products together for purposes of servicing and reporting on a pool of similarly structured loans, which could serve to not only decrease bank servicing costs, but also train banks on the process of generating a uniform pool of loans to prepare for securitization. Given that a certain level of heterogeneity will likely persist within the pool due to the issue of generating a critical mass of loans in a small market, the SWG could help banks explore the practice of overcollateralization to offset the risks inherent in securitizing a diverse pool of loans.



## **SECTION V: NEXT STEPS**

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In order to realize results quickly and respond to the rapidly growing mortgage market demands, the SWG should be fully constituted by August or September of 2007. Between now and August 2007, EPRC consultants will gather standardized documents and best practices from international organizations such as Fannie Mae and the ADB (which has already performed a similar standardization effort on a smaller project scale). The documents should be modified to appropriately reflect the Mongolian context. After the SWG is fully constituted, EPRC consultants will lead working sessions with the SWG on actionable next steps to pursue comprehensive market standardization.



## **SECTION VI: CONCLUSION**

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There is an evident want of standardization of critical primary mortgage market functions in Mongolia today. In Michael J. Lea's paper, *The Role of the Primary Mortgage Market in the Development of a Successful Secondary Mortgage Market*, it states that "true and sustainable secondary market development cannot proceed unless and until the primary market is able to produce a sufficient volume of high quality mortgages that meet the servicing and performance requirements of investors." Despite the current lack of market standardization in Mongolia, individual banks have already been making efforts to standardize procedures and mitigate risks in the face of numerous market constraints. As a result, all banks currently maintain portfolios with high rates of performance. Banks recognize the need to pursue a more inclusive level of standardization in the market as a whole and based on the interviews from this consultancy originating commercial banks appear more than prepared to cooperate to achieve this objective. The ADB program has already made efforts to standardize functions, which should lay the groundwork for further and more comprehensive market standardization, assuming all of the necessary support from the BoM and the government is present to enforce and uphold proposed market standards. Should the SWG be established, it will create a platform for the BoM, mortgage loan originators, potential investors, and other stakeholders to collaborate to create a cohesive and sustainable approach to achieving market standardization.



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