

**The Development of a Mortgage-Backed Securities Market
in Mongolia**

Final Report

Short - Term Technical Assistance - Mortgage-Backed Securities Advisor

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PREFACE

Background and Justification

There is a great liquidity in most of the larger banks and outside of the banks in Mongolia. Most of the larger banks hold more liquidity today than can be invested in Bank of Mongolia bills or government bonds. There is a lack of significant domestic investment instruments. The following table shows the asset breakdown for the four largest Mongolian banks as of the end of June 2002.

Summary Balances for the 4 Largest Mongolian Banks (30 June 2002)

Assets (1,000 MNT)	<u>TD Bank</u>	<u>Golomt Bank</u>	<u>Savings Bank</u>	<u>Ag Bank</u>
Cash and Short Term Investments	33,980,558.70	9,891,830.70	42,687,003.40	18,836,466.00
Foreign Assets	29,528,920.10	14,614,554.60	427,179.90	503,532.00
Loans (net)	50,351,985.10	31,162,025.80	4,314,169.70	15,302,002.00
OREO	6,272.40	0.00	0.00	0.00
Fixed Assets	7,583,093.90	2,350,996.90	1,119,580.40	3,342,880.00
Other Assets (net)	<u>6,237,853.80</u>	<u>2,222,121.50</u>	<u>1,347,624.20</u>	<u>1,990,640.00</u>
Total Assets	127,688,684.00	60,241,529.50	49,895,557.60	39,975,520.00

Concurrently, there is a great demand for housing. Mongolia has urbanized rapidly in the last three decades. Until the early 1990s, the norm for new housing provision was public sector construction of prefabricated apartment buildings. With Mongolia's transition to a market economy, the construction industry has collapsed, and the public sector housing supply has ended. The total cessation of public housing construction coupled with high migration into the city has led to a rapid growth in ger housing areas in Ulaanbaatar. Most ground floor housing has been converted into cafes, bars, restaurants, shops, and offices. Such conversions have reduced apartment housing in Ulaanbaatar by approximately by 15 percent.

However, there is a lack of experience with housing finance in the country, and Mongolian banks today lack long-term deposits to make long-term housing loans. In addition, the interest rate market in Mongolia is substantially higher than the rate homeowners can afford. For instance, most alternative types of loans that are available to the banks at the moment are in the 2.5%-4% per month interest rate range. If housing loans are made at the same rates, it will require monthly payments significantly higher than most homeowners can pay.

Packaging individual housing loans into mortgage-backed securities, which would be available both to banks and other investors as a new investment alternative, could be optimal solution to providing affordable housing finance in Mongolia.

Although there has been external assistance to the housing finance sector from the Asian Development Bank, it has not addressed the securitization of the mortgage loans. It is in the form of direct loan of 11.817 million Special Drawing Rights (\$15

million equivalent), which is to be on-lent through participating commercial banks to private and public enterprises, and through them to their employees to finance their housing. Therefore, USAID was asked by the Bank of Mongolia to get involved in this area to develop mortgage-backed securities issuance, which is how this project was initiated.

Objective of Technical Assistance

The objective of this analysis is to fulfill the requirements of the STTA Scope of Work - Mortgage-backed securities advisor (*Appendix I*), the objective of which is the following: a) setting up an appropriate and sustainable mechanism for packaging mortgage loans and issuing mortgage-backed securities for providing housing finance at market rates, including origination, funding and servicing, and the participants' fee structure; b) establishing institutional framework for government backing of the securities (Bank of Mongolia or Government sponsorship); c) coordinate with the counterpart, Bank of Mongolia.

Issues Needing to be Considered

In the course of performing the analysis required to complete this project, it was necessary to take the following into consideration:

- 1) the size and nature of the Mongolian mortgage market and the characteristics of mortgage loans and their related cash flows;
- 2) legal, tax, and regulatory issues that could impact the development of a secondary mortgage market;
- 3) the state of the capital markets in Mongolia, including investor profiles, existing instruments, and the feasibility of developing an MBS market within the current framework;
- 4) the ability/willingness of the Bank of Mongolia and/or Government to provide support, including enacting necessary or desired regulatory changes, providing loan or bond guarantees, and acting as a market maker; and
- 5) operational issues including loan originators' ability to service transferred loans and provide the current and historical loan information necessary to understand the loans' credit quality and expected cash flow characteristics.

Achievement of Objectives

The following tasks have been completed as per the Scope of Work and are covered within the body of this report:

- design of an appropriate mechanism for the securitization of mortgage loans into asset-backed securities in Mongolia;
- identification of legal and institutional changes which will be required to implement such a mechanism;

- evaluation of the risks and recommended counter-measures to reduce such risks; and
- completion of a model for this type of long-term housing finance that can be implemented in Mongolia within the current market conditions.

In order to achieve these objectives, it was necessary to meet with several key Government and Bank of Mongolia officials and financial institution representatives in order to gain a full understanding of the current legal, regulatory, economic, institutional, and capital market environments in Mongolia and discuss various issues related to the implementation of a mortgage-backed securities market in Mongolia. It was also necessary to review several Mongolian laws to determine which would need to be changed or superceded by new legislation in order to allow the establishment of a Mongolian MBS market. Also, two introductory presentations were given to bank representatives and final recommendations were presented to interested parties, including several senior Government and Bank of Mongolia officials. Attached are a list of the laws and other documents which were reviewed (*Appendices II and III*), which includes comments on specific Articles that could affect the development of a Mongolian mortgage-backed securities market, and a list of the meetings held and presentations given (*Appendix IV*).

EXECUTIVE SUMMARY

Summary of Recommendations

- It is possible and advisable to establish a mortgage-backed securities (“MBS”) market in Mongolia.
- Since both the mortgage lending and debt capital markets are in their early stages in Mongolia, it is advisable to establish a new secondary market mortgage company (“SMMC”) supported by the Government to co-ordinate MBS-related activity.
- The ownership of the company could be structured to include both the Government and the private sector (possibly including the financial institutions, which will participate in the MBS market).
- The SMMC would acquire mortgage loans from lenders and issue MBS to investors. It would be responsible for establishing the criteria for the mortgage loans that it will acquire and that can be packaged into MBS.
- At the initial stages of the market, in order to encourage investors to buy MBS and accept a lower interest rate, the MBS should be issued with a guarantee that interest payments will be made on time and that any outstanding principal balance will be repaid on the maturity date.
- Either the Government or Bank of Mongolia should provide the guarantee directly or indirectly.
- The guarantee provider should be paid a guarantee fee and should expect to have any drawings on the guarantee repaid (with interest) from future mortgage loan collections and foreclosure proceeds.
- Over time, as historical mortgage loan data becomes available and investors become more comfortable with MBS and their underlying collateral, guarantees should be phased out. Increasing the guarantee fee and/or over time reducing the percentage of the MBS interest and principal payments that will be guaranteed can do this.
- For banks to be interested in investing in MBS with longer maturities, they will need to be convinced that there is sufficient liquidity in the market so that they can sell MBS if necessary. Either the Government or the Bank of Mongolia can provide market liquidity by either:
 - acting as an MBS market maker;
 - entering into reverse repurchase agreements with MBS investors in order to provide short-term liquidity; or
 - agreeing to exchange central bank bills or Government securities for MBS.
- For the securitization of mortgage loans to be efficient and cost-effective, legal and regulatory changes will be required. Mostly likely this will require amendments to the Civil Code and creation of new laws to regulate securitization and enable the establishment and operation of the SMMC.
- The SMMC’s responsibilities would include the following:
 - acquiring mortgage loans from financial institutions;

- issuing mortgage-backed securities collateralized by the mortgage loans it acquires;
 - establishing credit guidelines and eligibility criteria for loans it will acquire and for loans that can collateralize MBS;
 - establishing servicing guidelines and foreclosure procedures for the loans it will acquire;
 - acting as servicer (in exchange for a fee) of mortgage loan collateral for loan originators which prefer not to perform the servicing themselves or are unable to perform the servicing as required by the guidelines established by the SMMC;
 - if required by investors, providing or procuring MBS guarantees which would ensure that investors receive timely interest payments and full repayment of outstanding principal on or before the MBS maturity dates;
 - tracking collections received from mortgage loan collateral and ensuring that they are applied correctly to pay principal and interest to MBS investors and fees to third-party service providers;
 - maintaining a detailed historical database of information regarding loan performance, including delinquencies, defaults and recoveries, and prepayments;
 - engaging in risk management and funding strategies which ensure that it maintains the strongest credit quality possible; and
 - acting as a liaison with the Government and Bank of Mongolia to ensure that required legal and regulatory changes are implemented to support the development of the MBS market in Mongolia.
- Possibly, the new SMMC could also provide or procure loan guarantees for low-income and other priority borrowers in order to reduce the interest rates on those particular loans even further than the general rate reduction that should result from an efficient MBS market.
 - The development of an MBS market in Mongolia will require Government and Bank of Mongolia support, particularly in the following areas:
 - ensuring that necessary legal and regulatory changes are enacted,
 - establishing the new SMMC to regulate the market and act as MBS issuer,
 - providing necessary guarantees to attract investors, and
 - ensuring that there is liquidity in the MBS market.
 - Because of the number of laws that would need to be revised in order to facilitate the development of an efficient MBS market, it is recommend that new legislation be enacted that supercedes existing and future law for issues specific to the development of an MBS market.
 - A section should be added to the Civil Code that relates specifically to securitization and establishes procedures for loan and collateral registration, transfer, foreclosure, and auction that supercede the procedures described in other sections of the Civil Code.

- At least two new laws should be created: one to establish the mechanism for securitization in Mongolia and one to establish and regulate the newly established SMMC.

Possibly, the Civil Code amendments and new laws could be drafted to allow the future securitization of other types of collateralized loans and leases in addition to mortgage loans.

Key Issues to be Considered

In order for an MBS market to be established in Mongolia, the following must occur.

- Investors must be convinced that MBS have strong credit quality and liquidity. This will enable them to accept lower yields that can be passed along to mortgage borrowers in the form of lower mortgage loan rates.
- The Government and Bank of Mongolia must provide support to ensure that necessary legal and regulatory changes are implemented, that an SMMC can and will be established, and that MBS have strong credit quality and liquidity.
- Lending institutions need to understand that participating in an MBS issuance program is beneficial to them. In order to participate in the MBS market as loan originators, they will need to standardize their mortgage lending programs and develop the required credit policies, operational procedures, and systems.

Next Steps

- There needs to be an evaluation of these recommendations by Bank of Mongolia and Government officials. Then a decision needs to be made as to whether or not to proceed and, if so, how and when?
- If a decision is made to proceed with the recommendations, the following should occur:
 - further education of relevant Government and Bank of Mongolia officials and financial institution staffs regarding mortgage lending and MBS issuance in other countries and the application to the Mongolian market;
 - establishment of the framework for the SMMC, including the ownership structure, capitalization, required funding, form of guarantees to be provided, permitted activities, management structure and composition, and staffing requirements;
 - amendments to the Civil Code and creation of new laws and regulations required to facilitate the development of the market; and
 - provision of foreign technical assistance, where required, to facilitate the development of an MBS market and the establishment of the SMMC.

INTRODUCTION TO MORTGAGE-BACKED SECURITIES (“MBS”)

What are Mortgage-Backed Securities?

Mortgage-Backed Securities are debt securities collateralized by pools of mortgage loans.

- Mortgage loans that have been originated by lenders (“originators”) are packaged together into pools of loans.
- MBS are issued to investors. The MBS are secured by the mortgage loan pools.

The MBS investors are normally financial institutions, including banks, insurance companies, and pension funds. In the short-term in Mongolia, it is anticipated that banks will be the primary MBS investors.

Usually, in order to protect investors against the credit risk of an originator and to enable the originator to remove the pooled loans from its balance sheet, an intermediary acquires the mortgage loans from a lender and is the “issuer” of the MBS. The issuer is normally created specifically for this purpose, and depending on the particular market where MBS are issued and a particular originator’s objectives there can be:

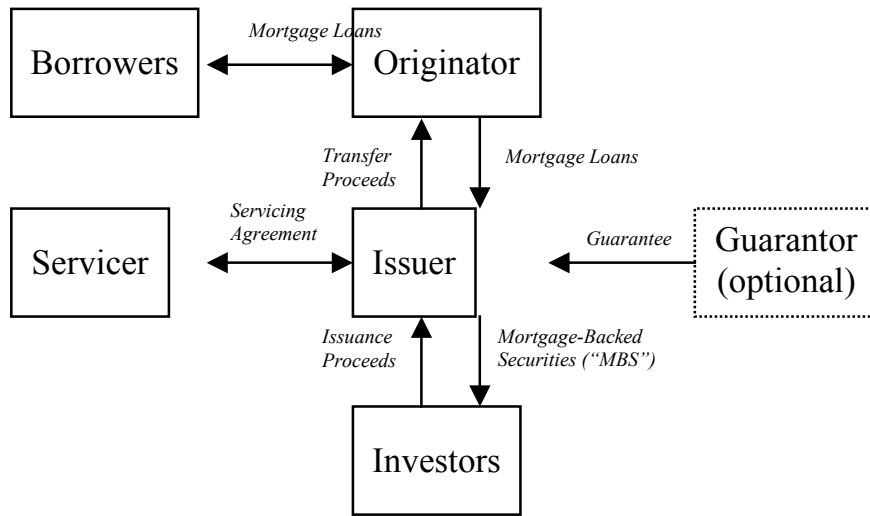
- an new issuer set-up every time MBS are issued,
- one issuer that acquires loans and issues MBS multiple times for a particular originator, or
- one issuer that acquires and issues MBS multiple times for multiple originators.

A “servicer” collects and tracks the payments received from the borrowers of the pooled mortgage loans securing the MBS and receives a fee for doing so. The collections are used to make interest and principal payments to the MBS investors and to pay on-going fees and expenses related to the MBS issuance. The servicer also is responsible for the collection of delinquent payments and initiating the foreclosure of loans in default.

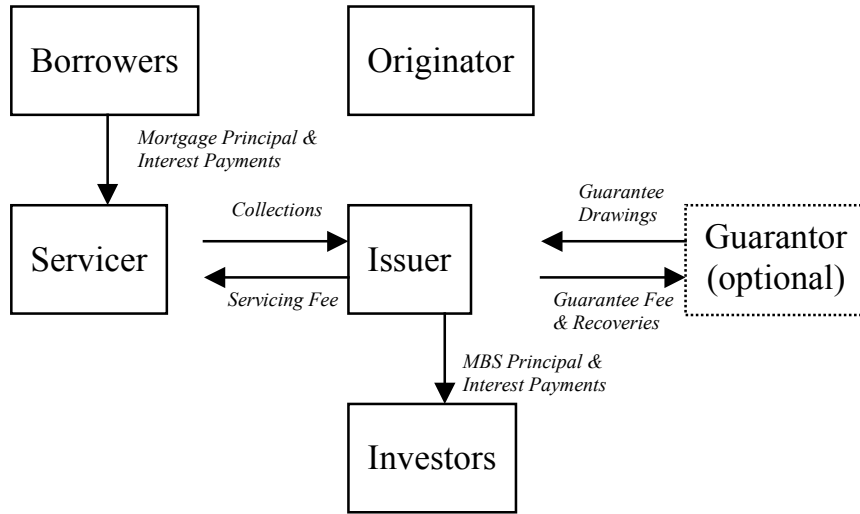
The servicer is normally a bank or non-bank financial institution, and the originator can act as the servicer if it has the operational and systems capabilities required. In some cases a third party other than the originator will service the loans on behalf of the MBS issuer since a large investment may be required to develop adequate servicing capabilities for an MBS issuance, and a large volume of business may be required to achieve the economies of scale necessary to cover the cost of that investment.

The credit quality of the MBS can be strengthened a number of ways. Typical forms of “credit enhancement” include guarantees of the MBS and/or their underlying loans by an entity with very strong credit quality or by MBS structuring techniques such as “over-collateralization”, which is when MBS are issued in an amount which is less than the total outstanding principal balance of their underlying loan pools, or by use of a reserve fund into which deposits are made when collections of mortgage loan payments are in excess of the interest and principal payments due to the MBS investors and the on-going fees and expenses related to the MBS issuance. In the case of a guarantee, the guarantor will ensure that MBS investors will receive the payments due to them even if the loan collateral does not fully perform. Typical guarantors include Governments, Government-sponsored companies or agencies, and highly rated banks or insurance companies. Normally, the guarantor receives a fee for providing the guarantee.

Example of MBS Structure - MBS Issuance



Example of MBS Structure - On-going Cash Flows



BENEFITS OF AN MBS PROGRAM TO THE MONGOLIAN ECONOMY AND CAPITAL MARKETS

Increased availability and lowered cost of housing finance

The development of a secondary mortgage market, such as the issuance of MBS, provides a new source of funding for mortgage lenders. Therefore the ability to securitize mortgages via an MBS market should make mortgage loan originators more willing to lend and increase the supply of housing finance.

Furthermore, this increased availability of funding will create a more competitive lending market. This should result in lowered mortgage rates, particularly as investors become comfortable with the strong credit quality and liquidity of MBS and are willing to accept lower interest rates than lenders would have to pay for their other borrowing sources.

Also, securitizing mortgages will reduce the capital requirements for mortgage lenders since the lenders will be able to remove the transferred loans from their balance sheets. This will reduce the real cost of mortgage lending.

U.S. experience shows that securitization has been responsible for lowering mortgage rates in the U.S.

Standardization of housing finance products

MBS can be structured a variety of ways, but normally, MBS investors receive principal and interest payments as they are received from the borrowers of the underlying mortgage loans. Therefore since the MBS cashflows will reflect the cashflows from the mortgage loans used as collateral, the pooled mortgage loans should have cashflows that are attractive to MBS investors.

As securitization of loans through MBS becomes more widespread, lenders will tend to originate loans that meet the investors' criteria for securitization. Lender underwriting policies and procedures also will become standardized to satisfy MBS investors' credit concerns.

As the investor market develops, new types of MBS can be issued. This in turn will enable the creation of new mortgage products.

Improved pricing efficiency of housing finance products

As securitization becomes a more common way for lenders to finance their mortgage lending, lenders will begin to price loans as a spread over the cost of securitization in order to lock in a profit for the securitized loans. Over time mortgage lenders will determine the interest rate that they charge mortgage borrowers based on their desired margin for the mortgage lending business.

The lender's profit margin for a mortgage loan should be calculated as follows:

profit margin = mortgage interest rate – all-in securitization cost¹ – servicing, origination, and other expenses related to the mortgage business – estimated retained risk of credit loss²

For example, if a mortgage loan has an interest rate of 18% per year, MBS investors require an annual interest rate of 12%, the annualized fees and expenses associated with the MBS issuance are 1%, the annualized cost of originating and servicing the loan is 2%, and the estimated risk of credit loss is 0.5%³, the lender's expected margin for the loan is 2.5% (18% - 12% - 1% - 2% - 0.5%).

Improved capital efficiency for financial institutions

Securitization can allow originators to run their mortgage business off-balance sheet, freeing capital for other uses. Also, because they are collateralized by loans with very strong credit quality, in many countries MBS are assigned a lower risk weighting for capital purposes than other non-Government investment securities. Therefore, depending on the risk weighting assigned for MBS in Mongolia, MBS can provide an attractive return on capital for bank investors, even if their yield is lower than the yield for other investments having the same maturity.

Development of the Mongolian debt capital markets

MBS can provide Mongolian investors with a new type of bond having very strong credit quality and a longer maturity than is currently available, although initially, before investors become comfortable with the credit quality of MBS, it may be necessary for an institution with strong credit quality to provide some form of guarantee for the MBS and/or some of the loans used as collateral.

Since MBS will increase the range of maturities available in the Mongolian debt market, they can establish a benchmark for other longer dated securities. Also, as the MBS market develops over time, mortgage loan cashflows can be engineered to create more exotic types of securities, which appeal to specific investor demands.

Benefits of an MBS Program to Mongolian Financial Institutions

The issuance of MBS will provide financial institutions with a stable low-cost source of funding for housing finance. Also, since MBS breaks down mortgage lending into its component parts (originating, servicing, and funding), banks and other financial institutions can participate in the activities that best match their strengths and objectives. Furthermore, financial institutions can earn fee income for originating

¹ In addition to the interest rate paid to MBS investors, the all-in cost of securitization should include fees and expenses associated with MBS issuance, including amortized set-up costs.

² Often the originator retains some credit exposure to the securitized loans. Normally, this is achieved by paying the originator any cash remaining after mortgage loan collections have been used to make principal and interest payments to investors and to pay on-going fees and expenses related to the MBS issuance. Shortfalls caused by delinquent loan payments and defaulted loans will reduce the amount that the originator will receive.

³ For example, if the loan has 10% chance of defaulting and the likely loss after foreclosure is 5%, the statistical expected loss would be 10% * 5% = 0.5%

and/or servicing mortgage loans without holding the loans on their balance sheets or using capital. Finally, MBS will provide banks and other institutional investors with a liquid, long-term investment product that has strong credit quality.

CURRENT MORTGAGE LENDING ENVIRONMENT IN MONGOLIA

Mortgage Lending Products Currently Available

The housing finance market Mongolia is very new, and the loans currently available have high interest rates and short maturities. Several Mongolian banks were asked to provide the terms and conditions for the loans secured by immovable property that they currently are offering. Based on the response that was received, an indicative range of the terms and conditions is as follows:

- interest rates range from 1.5% to 5% per month (18% to 60% per annum);
- maturities range from 6 months to 3 years;
- loan amounts range from 5 million MNT to 30 million MNT;
- loans normally are fully amortizing with level monthly payments;
- collateral is immovable property, but sometimes also includes movable property (in some cases only apartments are acceptable as collateral);
- in some cases the borrower must be an existing customer;
- loan approval time ranges from 3 to 7 days;
- origination fees, where applicable, range from 5,000 MNT to 1% of the loan value;
- application fees, where applicable, range from 500 MNT to 5,000 MNT;
- maximum and average loan-to-value ratios range from 50% to 70%; and
- in some cases subsequent loans to existing customers will have longer maturities and/or lower interest rates.

Example of Current Housing Finance Products – Ag Bank

Currently, Ag Bank is offering housing finance loans to its employees. The current characteristics of their loans are as follows:

- current portfolio is roughly 350 million MNT;
- maturity is up to 3 years;
- interest rate is 1.5% per month (18% per annum);
- fully amortizing, level monthly payments;
- monthly payments are up to 80% of total family income;
- payments are directly debited from employee's bank account;
- if funds are not available to make the debit, the loan officer will follow-up immediately; and
- all loans are approved by a credit committee.

The estimated current breakdown of their mortgage portfolio is as follows:

- 90% for purchase (mostly apartments);
- 10% for improvements;

- maximum loan-to-value ratio is 70%, with the average close to 70%; and
- average loan amount is 10 million MNT in Ulaan Baatar and 5-6 million MNT outside UB.

Ag Bank feel that it would not be difficult for them to develop the capability to act as servicer for MBS issuances. If they were able to use an MBS issuance program to increase their portfolio size, they would market actively, and use newspapers, radio, and television to reach potential borrowers. In order to streamline the present foreclosure process for defaulted loans, Ag Bank would consider structuring loans on a hire purchase basis, whereby the bank would retain legal ownership of the collateral until the loan is fully repaid.

Current Foreclosure Process

Because of conflicting language in different sections of the Civil Code, it is unclear whether collateral ownership can be transferred to a lender automatically in the event of a loan default or whether the lender must submit a foreclosure petition through the court system resulting in the forced sale of the collateral by auction. Until this issue is clarified, lenders seem inclined to proceed via the court system.

Example of Current Foreclosure Process and Timetable – Innovation Bank

If a borrower doesn't make a loan payment on time, Innovation Bank decides if the borrower is able to make the payment. If the borrower is unable to pay, the bank can terminate the loan contract.

In that case the lender has two options.

- 1) The lender declares that the loan is in default.
- 2) In some circumstances the lender grants the borrower an extension. If this occurs, the borrower must request the loan extension 14 days before the maturity date of the loan. The extension can be given one time and for up to six months. This situation normally arises when the borrower is unable to pay due to a third party default, for example if a customer of the borrower does not pay on time. In this situation the lender may try to involve the third party in the process and get a pledge of rights from the borrower in addition to the immovable property pledged.

If the loan is declared in default, the following occurs.

- 1) The bank may grant an optional period of up to 14 days for the borrower to pay the due amount. (The time period will depend on the borrower and his/her situation.)
- 2) If the payment is not received within the specified period, the lender again has two options.
 - a) Option 1: The borrower and lender agree to forego the auction process, and the borrower assigns the right of ownership of the collateral to the bank.
 - i) The transfer of the right of ownership normally takes one to three days.

- ii) The timing of the sale of the collateral depends on market conditions. (Recent experience has been within one month.)
 - iii) Registration and payment of stamp duties should occur twice: once for the transfer from the borrower to the lender and once for the sale from the lender to the ultimate purchaser of the collateral.
- b) Option 2: The lender proceeds with the auction process. This involves the following steps.
- i) The lender submits a foreclosure petition to the area court nearest to the location of the borrower. This will include three documents:
 - (1) a statement that includes the amount of the lender's claim, including the costs associated with the foreclosure,
 - (2) the collateral contract with the borrower; and
 - (3) a schedule showing the payments made by the borrower.

Stamp duty will be payable on the amount of the claim. This can be recovered from the auction proceeds.
 - ii) The court will accept the documents and assign a judge to the case.
 - iii) Within 60 days a judgement will be rendered.
 - iv) The borrower and lender have 10 days to appeal the judgement.
 - v) After the end of the 10-day appeal period, the borrower has 14 days to pay the total amount due, including expenses.
 - vi) If the borrower does not make the payment within the 14-day period, an auction organizer will be assigned to run the auction. The auction organizer will decide when the auction should take place. The auction should occur within 30 days after the auction organizer is assigned. (In certain situations the auction can be postponed temporarily at the request of the lender.)
 - vii) The auction proceeds will be applied in the following order:
 - (1) payment of expenses associated with the auction,
 - (2) payment for improvements made to the collateral during the auction process,
 - (3) payment of any taxes due,
 - (4) payment of the amount due to the lender, and
 - (5) any remaining amounts will be paid to the borrower.
 - viii) If the auction price is not sufficient to cover (1) through (4) above, a second auction can be held.

REQUIREMENTS FOR ESTABLISHING AN MBS MARKET IN MONGOLIA

Factors Necessary to Establish an MBS Market in Mongolia

In order for an MBS market to be developed successfully in Mongolia, it will be necessary to gain acceptance among both housing finance lenders and potential investors. The lenders will need to be convinced that the MBS will provide them with a longer term, low cost source of funding which they can use to offer longer term, lower interest rate mortgage loans to borrowers. In order to entice them to buy longer term securities with a relatively low interest rate, investors will need to be comfortable that MBS have very strong credit quality and, for bank investors in particular, that there will be sufficient liquidity in the MBS market so that the securities can be sold if necessary.

To determine their potential interest in participating in an MBS market, several banks were asked to provide feedback in response to the following questions.

- Do you think that your financial institution would be interested in participating in an MBS market?
- What areas would be most interesting to your financial institution: investing, origination, and/or servicing?
- How interested would your financial institution be in investing in MBS, and what questions or concerns would you have about investing in MBS? What characteristics would you like MBS to have?
- Would your institution be willing to co-operate and share information with other banks and NBFIs to help to develop an MBS market?

Unfortunately, the banks were given a very short timeframe in which to respond, and strategic questions of this nature are difficult to answer without detailed discussions occurring within the respective organizations. Therefore only a small number of institutions provided feedback, but the feedback was consistent.

- The responding banks were interested in participating in an MBS market.
- The banks were interested in all three roles: origination, investing, and servicing.
- The banks felt that a Government or Bank of Mongolia guarantee should be provided to ensure that the MBS have strong credit quality.
- The banks would be willing to share information in order to help the MBS investor market develop efficiently.
- The interest rate requirements for the MBS varied significantly from institution to institution and would depend on whether or not the MBS were guaranteed.
- In order to entice the banks to buy longer term MBS as investors, the Government or Bank of Mongolia would need to provide some assurance that the securities could be sold if the banks needed to increase their liquidity.

In addition to gaining lender and investor acceptance, it also will be necessary to develop a mechanism so that mortgage loans can be packaged into MBS quickly,

efficiently, and cost effectively. The support of Parliament, the Bank of Mongolia, and Government will be necessary in order for this mechanism to be developed, and their assistance also will be required in the following areas:

- to achieve the changes in law and regulations that will be required develop an MBS market and the related mortgage lending business;
- to provide any guarantees necessary to ensure investors that MBS have strong credit quality; and
- to create a mechanism that ensures that the MBS investor market has liquidity.

Finally, for the MBS market to gain credibility and require less reliance on guarantees over time, it is important that the underlying mortgage loans are high quality and that loan payments are received promptly. In order to achieve this, effective policies and procedures, infrastructure, and staff will need to be developed at mortgage originators and servicers to ensure that mortgage loan credit quality is maintained and that servicing is effective and reliable.

Obstacles to Establishing an MBS Market in Mongolia

There are some obstacles that could hinder the development of an MBS market in Mongolia.

There is limited market experience in mortgage lending to date. Therefore there is limited underwriting/credit experience, limited experience servicing mortgage loans, and limited foreclosure/recovery experience. Also, there are not yet mortgage loans available that could be packaged easily into MBS.

The private sector debt capital markets also are not well developed. Aside from a few short-term bonds issued by construction companies, the market consists of short-term central bank bills and Government securities. Therefore investors initially may not accept new types of bonds such as longer term MBS unless they are assured that there will be a liquid market if they want to sell.

Furthermore, since no credit rating agencies exist in Mongolia, there is no way to evaluate the credit quality of MBS relative to other securities. This could hinder investor demand for MBS during the early stages of the market unless some form of credit guarantee is provided for the MBS.

There are also legal and regulatory issues that will need to be addressed in order to establish an MBS market in Mongolia. In particular the registration, transfer of ownership, and foreclosure of mortgage loan collateral can be time-consuming and costly.

Means of Overcoming Obstacles

The obstacles to establishing an MBS market in Mongolia can be overcome by a combination of extensive lender and investor education and Government and regulatory support.

Using other countries where MBS markets have been established successfully as benchmarks, lenders can become familiar with the standards that they will need to adopt in order to support an effective MBS market. This should lead to the development of loan products that are attractive to borrowers and can be packaged

into MBS, the adoption of prudent lending criteria and credit policies, and effective collection procedures, including payment tracking and collection of overdue loans.

Initially, it is likely that some form of guarantee will be required to create investor acceptance of MBS. Concurrently, investor seminars can be given that explain the mechanics of MBS, their risks and benefits, and how to evaluate the quality of the underlying collateral. Over time, as historical information regarding collateral performance becomes available, the tracking and sharing information related to loan and MBS performance will increase market knowledge and efficiency, and guarantees should no longer be necessary.

The Parliament, Bank of Mongolia, and Government can provide support to enact the changes in law and regulations that are necessary to develop an MBS market and to ensure that the market acts efficiently and provides strong credit quality and liquidity to investors. This support should include providing necessary guarantees and taking whatever steps are necessary to ensure that an active trading market exists for MBS.

RECOMMENDATIONS FOR THE DEVELOPMENT OF AN MBS MARKET IN MONGOLIA

Summary of Recommendations

It is possible and advisable to establish an MBS market in Mongolia. Recommendations for accomplishing this within the current environment in Mongolia follow.

- 1) Since both the mortgage lending and debt capital markets are in their early stages in Mongolia, it is advisable to establish a new secondary market mortgage company (“SMMC”) supported by the Government to co-ordinate MBS-related activity. The SMMC would acquire mortgage loans from lenders and issue MBS securities to investors. It would be responsible for establishing the criteria for the mortgage loans that it will acquire. The ownership of the SMMC could be structured to include both the Government and the private sector (possibly including the financial institutions that will participate in the MBS market).
- 2) At the initial stages of the market, in order to encourage investors to buy MBS and accept a lower interest rate, the MBS should be issued with a guarantee that interest payments will be made on time and that any outstanding principal balance will be repaid on the maturity date. For the guarantee to have the most credibility among investors, either the Government or Bank of Mongolia should provide it directly or indirectly. The guarantee provider should paid a guarantee fee and should expect to have any drawings on the guarantee repaid (with interest) from future mortgage loan collections and foreclosure proceeds.
- 3) Over time, as historical mortgage loan data becomes available and investors become more comfortable with MBS and their underlying collateral, guarantees should be phased out. Possible ways that this can be done include increasing the guarantee fee to create an incentive for originators to utilize other forms of credit enhancement and/or reducing the percentage of the MBS interest and principal payments that will be guaranteed over time to steadily decrease investors’ reliance on the guarantee.
- 4) For banks to be interested in investing in MBS with longer maturities, they will need to be convinced that there is sufficient liquidity in the market so that they can sell MBS if necessary. Until an active secondary trading market develops for MBS in Mongolia, either the Government or the Bank of Mongolia should provide market liquidity. Possible ways for them to do this include:
 - acting as an MBS market maker;
 - entering into reverse repurchase agreements with MBS investors in order to provide short-term liquidity; or
 - agreeing to exchange central bank bills or Government securities for MBS.
- 5) For the securitization of mortgage loans to be efficient and cost-effective in Mongolia, legal and regulatory changes will be required. Mostly likely this will require amendments to the Civil Code and creation of new laws to regulate securitization and enable the establishment and operation of the SMMC.

Role of the SMMC

The newly established SMMC would be responsible for facilitating, developing, and expanding an MBS market in Mongolia. Its activities would include the following:

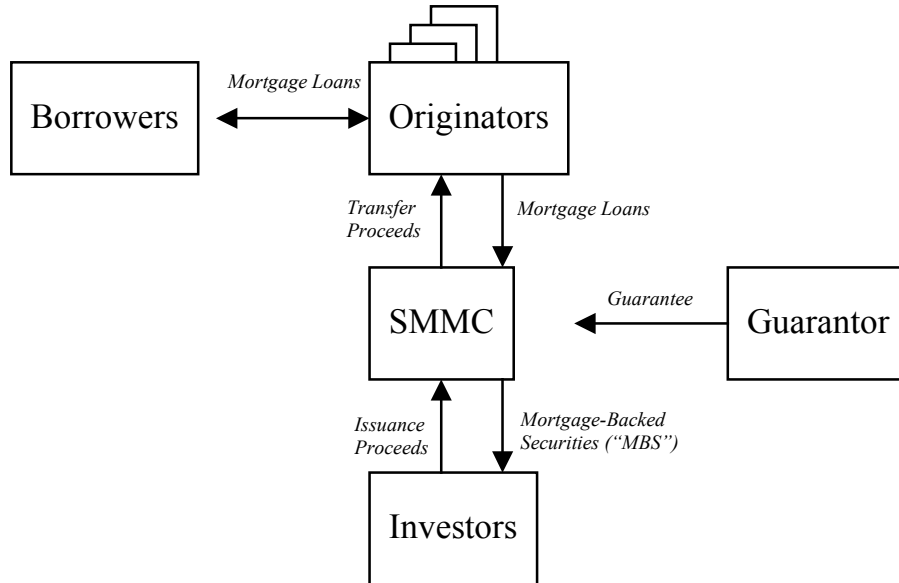
- acquiring mortgage loans from financial institutions;
- issuing mortgage-backed securities collateralized by the mortgage loans it acquires;
- establishing credit guidelines and eligibility criteria for loans it will acquire;
- establishing servicing guidelines and foreclosure procedures for the loans it will acquire;
- if required by investors and/or originators, providing or procuring MBS guarantees which would ensure that investors receive timely interest payments and full repayment of outstanding principal on or before the MBS maturity dates;
- acting as servicer of mortgage loan collateral for loan originators which prefer not to perform the servicing themselves or are unable to perform the servicing as required by the guidelines established by the SMMC (since certain financial institutions may want to specialize in servicing, these originators also would have the option of finding alternative servicers acceptable to the SMMC);
- acting in a “trustee”⁴ capacity and tracking and holding collections received from mortgage loan collateral and ensuring that they are applied correctly to pay principal and interest to MBS investors and to pay fees to third-party service providers and other on-going expenses;
- maintaining a detailed historical database of information regarding loan performance, including delinquencies, defaults and recoveries, and prepayments;
- engaging in risk management and funding strategies which ensure that the SMMC maintains the strongest credit quality possible; and
- acting as a liaison with the Government and Bank of Mongolia to ensure that required legal and regulatory changes are implemented to support the development of the MBS market in Mongolia.

Possibly, the new SMMC could also provide or procure loan guarantees for low-income and other priority borrowers in order to reduce the interest rates on those particular loans even further than the general rate reduction that should result from an efficient MBS market.

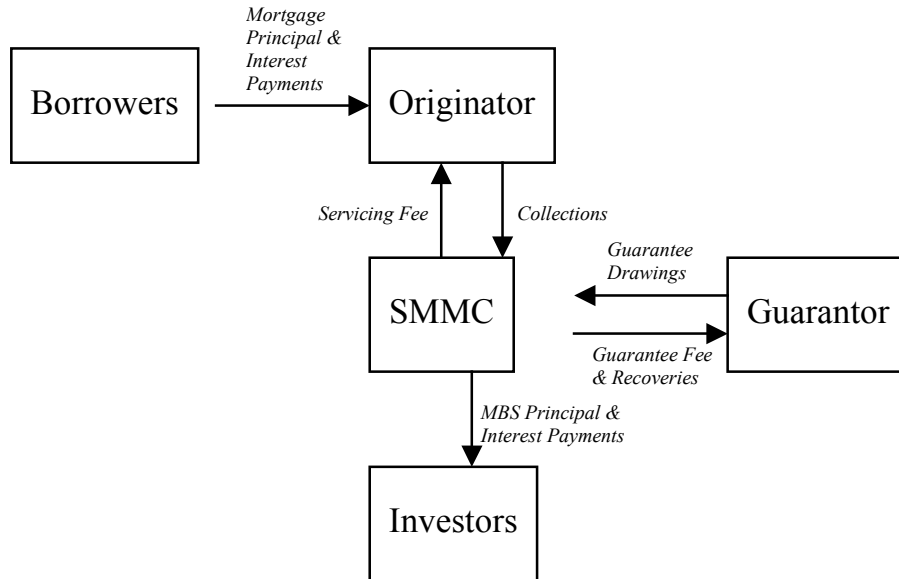
The SMMC should receive fee income for the various services it provides. These fees would include a servicing fee when it acts as servicer on behalf of an originator, a trustee fee for the trustee services it provides, and a guarantee fee in the cases where the SMMC is the actual provider of a guarantee.

⁴ The term “trustee” is used here to define the role described. Since trustee may not be an appropriate legal term in Mongolia to describe this role, other terms for the providers of the various trustee functions described include “custodian”, “collateral agent”, “depository”, and “issuing and paying agent”.

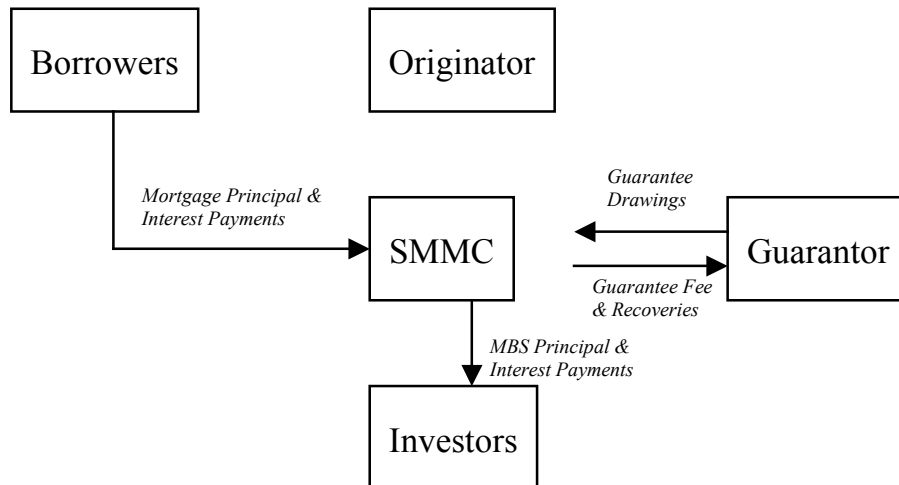
Recommended Structure – Newly Established Secondary Market Mortgage Company (“SMMC”)



SMMC Structure - On-going Cash Flows if Originator Acts as Servicer



SMMC Structure - On-going Cash Flows if SMMC Acts as Servicer



KEY ISSUES TO BE CONSIDERED

Required Bank of Mongolia and Government Support

The development of an MBS market in Mongolia will require Government and Bank of Mongolia support, particularly in the following areas:

- ensuring that necessary legal and regulatory changes are enacted,
- establishing and setting up the new SMMC,
- providing necessary guarantees to attract investors, and
- ensuring that there is liquidity in the MBS market.

Recommended Legal Changes

Several existing laws could affect the development of an MBS market in Mongolia. Appendix II identifies the particular laws and the provisions in those laws that should be revised for an MBS market and SMMC to operate efficiently.

Because of the number of laws that would need to be revised in order to facilitate the development of an efficient MBS market, it is recommend that new legislation be enacted that supercedes existing and future law for issues specific to the development of an MBS market. A section should be added to the Civil Code that relates specifically to securitization and establishes procedures for loan and collateral registration, transfer, foreclosure, and auction that supercede the procedures described in other sections of the Civil Code. At least two additional laws will need to be created: one to establish the mechanism for securitization in Mongolia and one to establish and regulate the newly established SMMC. Possibly, the Civil Code amendments and new laws could be drafted to allow the future securitization of other types of collateralized loans and leases in addition to mortgage loans.

Ownership of the SMMC

It will be necessary to determine the ownership structure of the SMMC. In other countries where secondary market mortgage companies have been established, the ownership structures range from full Government ownership to 100% private sector ownership. Although in Mongolia the Government should have some ownership interest in order to show its support for the SMMC, there are benefits to having private sector shareholders, too. In particular it may be beneficial to include as shareholders certain financial institutions that are likely to participate in the MBS market as originators or investors in order to encourage their support for the new company. It is also worth considering foreign shareholders that can provide the SMMC with technical assistance.

Capitalization and Funding of the SMMC

The capitalization and funding requirements for the SMMC will be determined by its scope of business and the costs of setting it up and are impossible to determine at this time. If the SMMC's primary activity will be to acquire mortgages and issue MBS simultaneously, its funding requirements will be minimal since the loan acquisitions

will be funded by MBS issuance. Alternatively, if the SMMC will purchase loans on an on-going basis and then issue MBS after sufficient loan pools are accumulated, its requirements will be greater. It will be necessary to develop a detailed business plan for the SMMC in order to determine the specific amounts of capital and funding that will be required.

Guarantee Provider

The MBS guarantee could be provided by either the Bank of Mongolia, the Government, or the SMMC. The choice of the guarantee provider should be influenced heavily by investor demand since the objective of the guarantee is to convince investors to accept the lowest possible interest rates for the MBS. If the SMMC is to be the guarantee provider, it will need to be made clear to investors that the SMMC is fully supported by the Government and/or central bank.

Guarantee Fee

The guarantee fee should be set somewhere within the difference between the interest rates that investors would require for MBS with and without a guarantee. Therefore if investors would require a yield of 18% per annum for MBS without a guarantee and 15% for guaranteed MBS, the guarantee fee should no more than 3% per annum. Subject to that cap, the guarantee fee should be set at a level that allows lenders to originate loans with an interest rate that is attractive to borrowers but that allows the lenders to make a profit after the all-in cost of securitization is considered.

For example, if it is desired that mortgage loans be offered to Mongolian borrowers with a 5-year maturity and an interest rate no higher than 18% per annum, and the all-in cost of issuing guaranteed MBS is 16.35% per annum prior to accounting for the guarantee fee⁵; an “excess yield” of 1.65% per annum would be available to pay the guarantee fee.

In practice it is advisable to allow the loan originators to keep a portion of this excess yield. If this excess amount is only paid to the originators after MBS interest and principal and all other fees and expenses (including the guarantee fee) are paid, it provides a level of protection to the guarantee provider against payment shortfalls and encourages lenders to originate high quality loans in order to receive on-going income in addition to the origination fees that they received previously. In order to minimize drawings on the guarantee, the guarantee fee should be set at a level that allows the excess yield to cover estimated payment shortfalls from the underlying collateral pool.

For example, if the excess yield is 1.65% per annum and a conservative estimate of expected losses is 1% per annum, the guarantee fee should be no more than 0.65% per annum. This will leave at least 1% per annum available to cover expected losses and reduce the likelihood that guarantee drawings will occur.

Since payment shortfalls will not occur consistently throughout the life of the loan pool, it is common to deposit some or all of the entire excess yield from an originator’s loan pool into a “reserve fund”. The reserve fund then is used to cover

⁵ Assumptions: 15% MBS interest rate + 1% servicing fee + 0.25% trustee fee + 0.10% loan transfer/MBS issuance fee (0.50% fee amortized over 5 years)

intermittent shortfalls in order to minimize guarantee drawings. Amounts in the reserve fund are released to the originator as the mortgage loan pool balance declines over time and the reserve fund is sufficient to cover expected future shortfalls.

In addition to the guarantor receiving a fee, any guarantee drawings should be repaid from collateral recovery proceeds, and the guarantee provider should receive interest on the drawn amount until the drawing is repaid.

Other Fees

The various counterparties to the MBS issuance, such as the SMMC, originator, servicer and guarantor, should receive fees for their services.

Loan origination fees will be determined by the financial institutions originating mortgage loans. It is likely that origination fees will vary dramatically during the early stages of the market but will converge as the market becomes more developed and competitive.

Servicing fees should be determined by each servicer based on its actual cost of servicing plus its desired profit margin. The cost of servicing should include the allocation of fixed costs incurred when setting up the servicing operation. In other countries servicing fees can range from 0.25% to 2% of the outstanding principal balance of the loans being serviced. In Mongolia it is likely that servicing fees will be high initially, but will decrease as the volume of loans being serviced increases and servicers achieve economies of scale.

The SMMC's fees will depend on whether or not it acts as the servicer and whether or not it is established with the intention of being profitable. At a minimum it should receive a trustee fee based on the actual cost of performing trustee services, including recovery of fixed costs over time. It may also be beneficial for the SMMC to receive a fee each time it acquires loans from originators to recover costs associated with the loan transfer process.

NEXT STEPS

There needs to be an evaluation of these recommendations by Bank of Mongolia and Government officials. Then a decision needs to be made as to whether or not to proceed and, if so, how and when?

If a decision is made to proceed with the recommendations, the following should occur:

- further education of relevant Government and Bank of Mongolia officials and financial institution staffs regarding mortgage lending and MBS issuance in other countries and the application to the Mongolian market;
- establishment of the framework for the SMMC, including the ownership structure, capitalization, required funding, form of guarantees to be provided, permitted activities, management structure and composition, and staffing requirements;
- amendments to the Civil Code and creation of new laws and regulations required to facilitate the development of the market; and
- provision of foreign technical assistance, where required, to facilitate the development of an MBS market and the establishment of the SMMC.

Currently, the Mongolian Builders Association is preparing a policy paper for Parliament. The scope of that paper includes making recommendations for increasing the supply and lowering the cost of housing finance in Mongolia. The inclusion of the recommendations of this report in that paper should expedite the development of an MBS market in Mongolia.

APPENDICES

- I. STTA Scope of Work - Mortgage-Backed Securities Advisor**
- II. Laws Reviewed and Issues Identified**
- III. Principal Documents Consulted for Background Information**
- IV. Persons Consulted**

APPENDIX I. STTA SCOPE OF WORK - MORTGAGE-BACKED SECURITIES ADVISOR

STTA SCOPE OF WORK

Mortgage-backed securities issuance adviser

Background and Justification:

There is a great liquidity in most of the larger banks and outside of the banks in Mongolia. Most of the larger banks hold more liquidity today that can be invested in Bank of Mongolia bills or government bonds. There is a lack of significant domestic investment instruments.

Concurrently, there is a great demand for housing. Mongolia has urbanized rapidly in the last three decades. Until the early 1990s, the norm for new housing provision was public sector construction of prefabricated apartment buildings. With Mongolia's transition to a market economy, the construction industry has collapsed and public sector housing supply has ended. The total cessation of public housing construction coupled with high migration into the city has led to a rapid growth in ger housing areas in Ulaanbaatar. Most ground floor housing has been converted into cafes, bars, restaurants, shops, and offices. Such conversions have reduced the apartment housing in Ulaanbaatar, by approximately 15 percent.

However, there is a lack of experience with housing finance in the country, and Mongolian banks today lack long-term deposits to make long-term housing loans. In addition, the interest rate market in Mongolia is substantially higher than the rate homeowners can afford. For instance, most alternative sources of loan volume that are available to the banks at the moment are in the 2.5%-4% per month interest rate range, which will require monthly payments significantly higher than most homeowners can pay. Therefore, packaging individual housing loans into mortgage-backed securities, which will be available both to banks and other investors as investments, will be an optimal solution to provide affordable housing loans in Mongolia.

Although there is an external assistance to the housing finance sector from the Asian Development Bank, it does not address the securitization of the mortgage loans. It is in the form of direct loan of 11.817 million Special Drawing Rights (\$15 million equivalent), which is on-lent through participating commercial banks to the private and public enterprises, and through them to their employees to finance their housing. Therefore, USAID was asked by the Bank of Mongolia to get involved in this area to develop mortgage-backed securities issuance. Please see the attached letter of request.

Counterparts:

Bank of Mongolia

Objective:

The objective of this STTA is the following: a) setting up an appropriate and sustainable mechanisms for packaging mortgage loans and issuing mortgage-backed securities for providing housing finance at market rates; including origination, funding and servicing, and the participants' fee structure; b) establishing institutional

framework for government backing of the securities (Bank of Mongolia or government sponsorship); c) coordinate with the counterpart

Outputs:

The consultant will accomplish the following tasks:

- Design an appropriate mechanism for the securitization of the mortgage loans into asset-backed securities
- Identification of legal and institutional changes, which will be required to implement such a mechanism
- Evaluation of risks, and recommendations of counter measures to reduce such risks
- Completion of the model for this type of long-term housing finance, which can be implemented in Mongolian conditions

Work Schedule and Reporting:

This assignment should begin in November 2002. The consultant will provide a brief written report at the end of the assignment on findings and recommendations. The consultant will report to the Chief of Party, EPSP.

Proposed Level of Effort: Up to 20 days of LOE, excluding travel days

APPENDIX II. LAWS REVIEWED AND ISSUES IDENTIFIED

Laws Reviewed

- 1) Banking Law of Mongolia
- 2) Law of Mongolia (Civil Code)
- 3) Company Law of Mongolia
- 4) Law on Deposits, Loans and Banking Transactions
- 5) General Law of Taxation of Mongolia
- 6) Law of Mongolia on Registration of Immovable Property
- 7) Immovable Property Tax Law of Mongolia
- 8) Law on Insurance
- 9) Law on Allocation of Land to Mongolian Citizens for Ownership
- 10) Law of Mongolia on Land
- 11) Law of Mongolia on Land Fees
- 12) Law of Mongolia on State Stamp Duties
- 13) Securities Law of Mongolia
- 14) Value-Added Tax Law of Mongolia
- 15) Housing Law of Mongolia
- 16) Mongolian State Policy on Housing
- 17) Procedures for Creation, Administration and Reporting of the Capital of the Housing Development Fund
- 18) Law of Mongolia on Housing Privatization
- 19) Amendments to the Housing Privatization Law
- 20) Condominium Law of Mongolia

Issues Identified

- 1) Banking Law of Mongolia
 - Article 6. Banking activities
It may be necessary to broaden this Article to allow banks to participate in MBS-related activities such as selling loans, servicing, and providing trustee services.
 - Article 7.2. (Prohibited activities for banks) “The shareholders, chairman and members of the Representative Governing Board, the executive director and officers of a bank shall not release to others, disclose or use any information which is considered by the bank, its customers, and/or third parties to be confidential, except in the following cases:

- 1) with the consent of the person about whom the confidential information relates; ...”

What is considered to be confidential information, and will this affect having 3rd party servicers and providing disclosure of loan information to investors, servicers, guarantors, trustees, rating agencies, and other 3rd parties? Will borrower consent be required to provide information?

- Article 7.4. (Prohibited activities for banks) “In addition to the prohibitions in paragraph 1 of this article, a bank shall not:

- 1) carry out or participate in activities aimed at providing the bank, alone or together with others, a position of dominance in the financial markets, or creating unfair advantage to itself or any third party; ...”

Will this prevent a small number of institutions from specializing in servicing?

- Article 16.1. (Restrictions on banking activities) “The total value of loans, loan equivalent assets and guarantees provided to one person or group of related persons shall not exceed 20 percent of the capital of the bank.”

Will the 20% asset limit apply to MBS? This could be an issue if a Fannie Mae-type entity is set up to be the MBS issuer.

2) Law of Mongolia (Civil Code)

- Article 84.3. “Land and assets that cannot be used for their original purpose when they are in separation with land shall be classified as immovable property.”
- Article 85.2. “Houses, constructions, installations and other things, that are constructed for permanent purposes but not to meet temporary needs and inseparably attached to the land shall be main components of land.”
- Article 109. Transfer of ownership rights for immovable property
- Article 142. Ownership of communal apartment
- Article 166. Registration of hypothec

Articles 84.3, 85.2, 109, 142, and 166 are related to the definition of immovable property, the transfer of ownership rights for immovable property, and the mortgage of immovable property. No issues were identified.

- Article 170. Protection of creditor rights
 - Article 170.2. “If a situation endangering the immovable property emerges, creditor may set a period of time for owner to remove the danger. If owner did not take actions to eliminate the danger by expiration of the period, then creditor shall be entitled to have his/her demands immediately satisfied from the property concerned.”
 - Article 170.3. “If immovable property is insured, then in the event of emerging insurance, insurer shall be obligated to notify the creditor and then provide insurance compensation to insured.”

Articles 170.2 and 170.3 do not seem to provide the creditor with much protection. It may be better to require, as a condition of the loan, the

borrower to fully insure the collateral and to assign the insurance proceeds to the creditor. Separately, in some countries credit life insurance also exists. This insurance will ensure that the loan payments will continue to be made if the borrower dies.

– Article 171. Non-restriction of owner transaction right

- Article 171.1. “Transaction, obligating the owner not to use the immovable property serving as a hypothec, not to transfer it to ownership of others, and not to otherwise entitle rights to it to a third party, shall be invalid.”

What happens to loan if property is transferred? Does the new owner become the borrower? Can the loan be structured with a “due on sale” clause, i.e. the loan becomes due and payable if the property ownership is transferred?

- Article 171.2. “Validity of the transaction concluded by hypothec owner with a third party shall depend on the creditor’s permission.”

Does this mitigate any risks caused by Article 171.1 above?

- Article 171.3. “Transaction about agreeing that right to ownership of immovable property shall be transferred to creditor unless the latter demand is satisfied completely or partially, shall be invalid.”

This could force lender to go through Court process as described in Article 175.1 below.

– Article 172. Transfer of hypothec and demand

- Article 172.2. “Demand (serving as grounds for hypothec) is considered as transferred if documents of hypothec certified with notary is transferred to a new creditor and this new creditor is registered with State register.”

This requires registration every time the loan is transferred.

- Article 172.3. “If obligation performer executed his/her obligations before the previous creditor after the transfer of demand to the new creditor, but was unaware of such a transfer, then the previous creditor shall perform obligations before the new creditor to the extent to which obligation was performed by debtor”

Notification of borrower may only be necessary if there is a new servicer after loan transfer. Also, if there are to be “third-party” servicers, there may need to be some legal mechanism to allow the servicer to be an entity separate from the creditor.

– Article 174. Demand on sale of immovable property

- Article 174.1. “Creditor shall be entitled to demand to sell the immovable property, in case the debtor exceeded the period of satisfaction of hypothec demand.”

- Article 174.2. “Provision of this law shall be applied for sales of immovable property, and regulations of this law shall be deemed more detailed.”

This seems to cause Article 175.1 to supercede Article 158 (Satisfaction of pledger's demand) and Article 453.2 (see below).

- Article 175. Forced sale of pledge based on Court ruling
 - Article 175.1. "In case the obligation performer failed to fulfill obligations when demanded as provided by Article 174 of this Law, immovable property serving as hypothec shall be subject to forced sales at the decision of Court, unless otherwise provided by law."

Does this Article supercede Article 158 (Satisfaction of pledger's demand) and Article 453.2 (see Article 174.2 above)?

- Article 176. Suspending and postponing auction
 - Article 176.2. "Court may postpone the auction based on the request from the owner and having considered proposals by parties entitled to ownership rights by up to six months in the following cases:"
 - Article 176.2.1. "if it is possible to postpone the auction depending on the nature of debt to be paid by debtor;"
 - Article 176.2.2. "if it is necessary to consider the personal and commercial relations of owner."
 - Article 176.3. "If Court deems that temporary postponement of auction, stated in Article 176.2 of this Law, may potentially create an explicitly negative consequences for the creditor, it may decline the owner's request."

How does the Court make this decision?

- Article 177. Auction price

This Article describes the auction process. It provides for a second auction if no price offer was up to the level of the determined price. It is not specified what happens if the determined price is not reached at the second auction. Are there subsequent auctions, or is the second auction the final one? Article 179.2 refers to the case where the auction price is not sufficient to satisfy the requirements of all of the creditors. At what point is that determination made?

- Article 406. Property entrusting contract
 - Article 406.1. "Under the property entrusting contract the settlor undertakes to transfer the right of disposal over movable property or assets to the trustee, and the latter undertakes the obligation, upon receiving them, to manage and dispose the trust funds in the best interests of the settlor."

It might be possible to utilize this law for MBS transactions where a trustee can be useful for allocation of collected funds.

- Article 453. The borrower's obligations
 - Article 453.2. "In case the borrower fails to fulfill its obligations under the loan contract and if the contract provides that the pledge will be transferred to the lender without dispute, the lender shall exercise the right of disposal over the pledged assets on the next day after the contract expiration."

This article seems to be in conflict with Articles 171.3, 174.1, 174.2, and 175.1 for immovable property collateral.

3) Company Law of Mongolia

– Article 32. Minimum Owner’s Equity

- “97.1. The owner’s equity of a joint stock company must be at least ten million (10,000,000) togrogs at the date of its registration. The owner’s equity of a limited liability company must be at least one million (1,000,000) togrogs at the date of its registration.”

If a new company is established specifically as the MBS issuer, this capital requirement will increase the cost of the issuance greatly. This is especially true if a new company must be established for each MBS issuance. Also, as per Article 15, there will be a fee payable for the registration of the company.

4) Law on Deposits, Loans and Banking Transactions

No issues were identified.

5) General Law of Taxation of Mongolia

If a new company is established specifically as the MBS issuer, will it have to be registered as a taxpayer (Article 6)? Since the timing of its collections (revenues) and disbursements (expenses) will be slightly different, will it be liable for taxes even if it distributes all of the collections that it receives (Articles 7 and 9)? Is it possible for the MBS issuer to receive an exemption in order to stimulate the market (Article 8)?

6) Law of Mongolia on Registration of Immovable Property

Under the law, the transfer of a mortgage loan from a loan originator to an MBS issuer would require registration (Articles 19 and 20). Furthermore, foreclosure could require two additional transfers: the transfer of the collateral to the MBS issuer and the transfer of the collateral from the MBS issuer to the end purchaser (Articles 14 and 18).

Article 21 indicates that the Registration Office would be the organizer of an auction ordered by a court.

7) Immovable Property Tax Law of Mongolia

No issues were identified.

8) Law on Insurance

– Article 4. Definitions

- “4.1.17. “insurance reserve fund” shall mean the saved pecuniary assets saved by the insurer from the net income of insurance duties for the purpose of reimbursing damages which may occur to the insured;”
- Article 14.4. “In order to enrich its Reserve Fund, the insurance company may use up to 30 percent of it to purchase bonds and securities as a long-term investment.”

Insurance companies should be eligible to be investors in mortgage-backed securities.

9) Law on Allocation of Land to Mongolian Citizens for Ownership

No issues were identified.

10) Law of Mongolia on Land

No issues were identified.

11) Law of Mongolia on Land Fees

No issues were identified.

12) Law of Mongolia on State Stamp Duties

Stamp duty will be payable each time that immovable property needs be registered in the course of an MBS transaction (Article 17²).

13) Securities Law of Mongolia

– Article 3. Definitions

Currently, the definition of “security” does not include a bond having a maturity date longer than one year from the date of its issue. It will be necessary for the Securities Committee to determine that MBS are “securities”.

– Article 4. Issuers of Securities

Currently, only the Government and companies registered in Mongolia may issue securities. If the issuer of MBS is to be some form of “special purpose entity”, it will be necessary to amend this article.

14) Value-Added Tax Law of Mongolia

It’s not clear if VAT will be payable for services provided on behalf of the MBS issuer, e.g. servicing and trustee services. Article 5.1.3 states that VAT should be imposed for services rendered in the territory of Mongolia, but the services that will be required for MBS issuance may fall under the banking services exemption (Article 9.1.1.b).

15) Housing Law of Mongolia

Article 3.1.3 defines the “housing development fund” as “a financial fund to be established for the purpose of financing activities aimed at improvements and increase of housing stock and associated infrastructure”. Article 12 indicates that one use of the fund is for loans for individuals and legal bodies for the renovation, upgrading and construction of condominiums and private houses, and their infrastructure. It may be possible to incorporate loans issued through this fund into an MBS issuance program.

16) Mongolian State Policy on Housing

Articles 44 and 45 also refer to the housing development fund and its purpose and uses and are consistent with the Housing Law of Mongolia.

17) Procedures for Creation, Administration and Reporting of the Capital of the Housing Development Fund

Article 15.A states that one of the uses of the fund is for the “purchase, new construction, renovation and upgrading of housing of citizens, public organizations and private business entities”. The references to the fund in the Housing Law of Mongolia and the Mongolian State Policy on Housing hadn’t included purchase of housing as one of the uses.

Article 19 states that “where the borrower failed to perform his obligations undertaken by the contract, the housing, housing building or other assets which are taken as a guarantee shall be transferred to the ownership of the commercial bank”. It’s not clear how this relates to the Civil Code with respect to foreclosure.

In the Procedures for Issuance of Loans from the Housing Development Fund, Provision 6 states that “Proposals to change interest rate of loans with respect to changes in exchange rate, inflation rate, loan repayment and investments shall be made by the Member of the Cabinet in charge of housing issues.” If this is only for the interest rate charged on new loans, it is not a problem; but if the interest rates on existing loans can be changed, it will affect the ability to package them into MBS.

18) Law of Mongolia on Housing Privatization

No issues were identified.

19) Amendments to the Housing Privatization Law

No issues were identified.

20) Condominium Law of Mongolia

No issues were identified.

APPENDIX III. PRINCIPAL DOCUMENTS CONSULTED FOR BACKGROUND INFORMATION

- 1) ADB Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to Mongolia for the Second Finance Sector Program
- 2) ADB Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Mongolia for the Housing Finance (Sector) Project
- 3) ADB Introduction to the Housing Finance (Sector) Project ADB MON-1847
This document describes the proposed mechanics of loan issuance through the housing development fund. It includes proposed loan terms, loan eligibility, loan security, loan application and approval process, loan disbursement mechanics, and loan repayment.
- 4) Slides from Presentation to the ADB Regarding Country Assistance Program Evaluation: Financial System Development Preliminary Report (presented by Gravitas International, LLC & Premier International, Inc.)
- 5) Bank of Mongolia Annual Report 2001
- 6) Bank of Mongolia Annual Report 2000
- 7) Monthly Bulletin of Statistics – October 2002 (produced by the National Statistical Office of Mongolia)
- 8) Household Income and Expenditure Survey – 2000 and 2001 (produced by the National Statistical Office of Mongolia)
- 9) Housing Survey – 2000 and 2001 (produced by the National Statistical Office of Mongolia)

APPENDIX IV. PERSONS CONSULTED

The following people were consulted during the course of this project.

Bank of Mongolia

- Ms. Ariuntungalag (Assistant to the Governor and Chief Economist)
- Mr. Boldbaatar (Director, Monetary Policy Division)
- Mr. Togtokhbaatar (Director, Supervision Department - Banking Division)

Office of the Prime Minister

- Mr. Khurelbaatar (Advisor to the Prime Minister)

Mongolian Parliament

- Mr. T. Ochirkhuu (Chairman of the Standing Committee on Economic Policy)

Mongolian Ministry of Finance and Economy

- Mr. Enkhtaivan (Vice Minister)
- Mr. O. Erdembileg (Director, Financial Sector Division)

Mongolian Ministry of Justice and Home Affairs

- Mr. Ts. Munh-Orgil (Deputy Minister)
- Mr. E. Ganbat (Officer, Legal Policy Department)

Implementing Agency of Mongolian Government Administration of Immovable Property Registration

- Ms. Dolgormaa (Head)

Mongolian Bankers Association

- Mr. Unenbat (Executive Director & Member of the Managing Board)

Mongolian Builders Association

- Mr. M. Batbaatar (President)
- Mr. Ju. Jargal (Executive Director)
- Ms. Sh. Buted (Director of Investment and Research Center)

Economic Policy Support Project

- Harry Baumann (Chief of Party)

Asian Development Bank

- Mr. Darius Teeter (Deputy Country Director)
- Ms. Ts. Enkhbayar (Project Manager, Housing Finance)
- Ms. Ts. Oyun (Financial Manager)

AgBank

- Mr. Peter Morrow (CEO)
- Ms. Delgermaa (Vice Director)

Innovation Bank

- Ms. Narantuya (Legal Department)

Deltasan Finance Company

- Mr. Tsagaan (CEO)
- Mr. Sodkhuu (Executive Director)

Itgelt-Audit Co., Ltd

- Mr. Baatar (Advisor, Doctor, Professor)
- Mr. Bayanmunkh (Director)

In addition the following presentations were given. They provided an introduction to mortgage-backed securities and the benefits that an MBS market can provide to banks in Mongolia. Feedback was solicited from the presentation attendees.

Presentation at the Bank of Mongolia to six targeted banks

Attendees:

- Bank of Mongolia (Mr. Boldbaatar, Director - Monetary Policy Division)
- Savings Bank (Mr. Batjargal, Senior Credit Officer)
- Agriculture Bank (Mr. Enkhtur, Deputy Director)
- Golomt Bank (Mr. Munkhtur, Director of Credit Department)
- Capitron Bank (Mr. Munkhbat, CEO & Mr. Erdene, Director of Planning and Coordination Department)
- Mongol Post Bank (Mr. Khurelbaatar, Deputy Director)
- Trade and Development Bank (Mr. Ekhbat, Director of Credit Department)

Presentation to Mongolian Bankers Association representatives

- approximately 50 people attended

Presentation of recommendations at the Bank of Mongolia

Attendees:

- Bank of Mongolia
 - Mr. A. Batsukh (First Deputy Governor)
 - Ms. T. Ariuntungalag (Assistant to the Governor and Chief Economist)
 - Mr. D. Boldbaatar (Director, Monetary Policy Division)
 - Mr. G. Togtokhbaatar (Director, Supervision Department - Banking Division)
- Office of the Prime Minister
 - Mr. Khurelbaatar (Advisor to the Prime Minister)
- Mongolian Parliament
 - Mr. Ts. Nyam-Osor (Member of Parliament, Member of Economic Standing Committee)
 - Mr. D. Tumendemberel (Member of Parliament, Member of Economic Standing Committee)
- Mongolian Ministry of Finance and Economy
 - Mr. O. Erdembileg (Director, Financial Sector Division)
- Mongolian Ministry of Justice and Home Affairs

- Mr. Ts. Munh-Orgil (Deputy Minister)
 - Mr. E. Ganbat (Officer, Legal Policy Department)
- Mongolian State Property Committee
 - Mr. D. Bailikhuu (Advisor)
- USAID/Mongolia
 - Ms. D. Sukhgerel (Program Specialist)
- Economic Policy Support Project
 - Harry Baumann (Chief of Party)