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Corporate Governance in Mongolia

by

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I. Background

Mongolian People's Republic, which was both politically and economically dependent on the Soviet Union, embarked on a path to democracy and a market economy in 1990. The people have thrown the then reigning government and elected a new one, headed by the Parliament. Since then, several Parliamentary, Presidential and local government elections took place.

In 1992, the Parliament adopted the new Constitution, which changed the country's name to Mongolia and allowed private ownership.

The lawmaking body in Mongolia is a unicameral Parliament with 76 seats. The Parliament appoints the Prime Minister who then forms his Cabinet. The President is the symbol of the state and has limited powers of vetoing some Parliament decisions. The judiciary branch consists of the Supreme Court; aimag[1] and city level courts; and soum[2] and district level courts.

Bold measures were taken to facilitate transition to a market economy, including liberalisation of prices, exchange rates and interest rates; privatisation of a large part of government enterprises; privatisation of livestock and housing; adoption of hundreds of legislative acts that regulate relations between agents in a democratic country and market economy. However, major exogenous factors hinder economic growth and development. Mongolia is a small country located between two superpowers; it has extreme weather conditions and is separated by thousands of miles from the nearest sea ports and world's major markets. In addition, several weaknesses persist. The government has yet to privatise its most valued companies, to reform the stagnating energy sector, to pay out its external debts and interests, to fix structural problems with internal and external balances and to create a truly favourable environment for both foreign and domestic investment.

Main economic indicators and effect of the 1998 crisis:

Table 1. GDP growth and GDP per capita

	1995	1996	1997	1998	1999	2000
GDP growth		2.4%	4.0%	3.5%	3.0%	
GDP per capita, in US$	507	493	446	406	352	

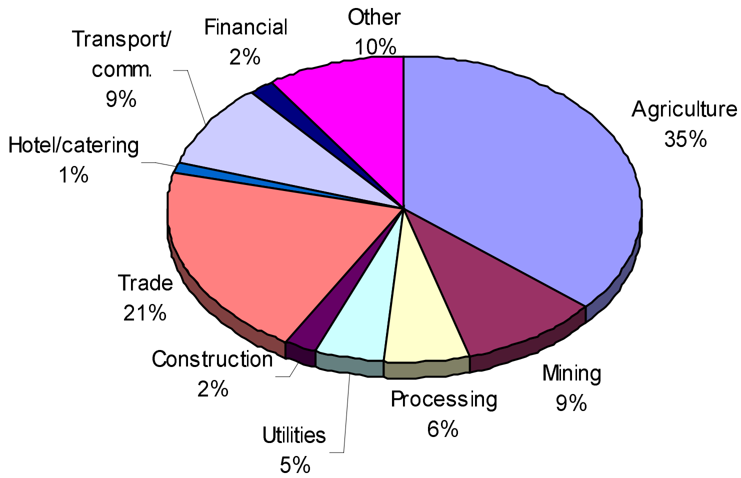
Mongolia's GDP has experienced a positive growth since 1994, after several years of contraction. GDP growth has been increasingly fuelled by the private sector.

Although GDP data for 2000 is not yet available, the rate of growth will probably be below that in 1999. Reduction in the rate of growth in the last two years is mainly due to natural disaster, Zud, that killed millions of livestock.

GDP per capita is steadily decreasing, reflecting growth of GDP slower than growth of population.

[1] Administrative/ territorial unit of Mongolia.
[2] Smaller administrative/ territorial unit of Mongolia, several of which form an aimag.

Figure 1. Structure of GDP



The largest sector is agriculture (35%), followed by trade (21%), mining (9%) and transport/ communication (9%) and processing/ light industry (6%). Over 90% of agricultural value added is produced in the livestock sector. It also employs about 40-50% of Mongolia's population. The agricultural sector's share has been growing due to continuous growth in the number of livestock since its privatisation in early 1990es.

Table 2. Macroeconomic indicators

	1995	1996	1997	1998	1999	2000
CPI	53.1	44.6	20.5	6.0	10.0	8.1
Exchange rate of Tg per US$	473.5	562.4	789.7	840.1	1021.8	1076.4
NIR in weeks of import	8.9	6.6	11.9	8.3	11.9	12.8
Fiscal balance, in % of GDP	-2.1%	-2.3%	-8.5%	-11.9%	-9.7%	
Trade in GDP	5.0%	-2.3%	-1.6%	-16.2%	-18.1%	

Inflation that galloped at 3 digits in early 1990es was calmed down and reached a modest 6% in 1998. Mongolian currency, Togrog, has seen the slowest devaluation in the same year. Thus the crisis of 1998 that resulted in deterioration of value of countries-trading partners created favourable conditions for Mongolian Togrog. However, this made Mongolian exports more expensive and imports to Mongolia cheaper. The crisis of 1998 also indirectly, but badly affected world prices of Mongolia's exports, namely, copper and gold. This, combined with the effect of strong domestic currency, sharply widened the trade deficit. Fiscal balance also deteriorated because a large portion of fiscal receipts consisted of taxes and dividends from companies that exported the above commodities. In the same year, net official international reserves expressed in terms of weeks of imports has fallen largely due to increase in imports.

Foreign investment:

The Law on Foreign Investment was adopted in 1993. Liberalisation of trade also had a positive effect of foreign investment. However, the level and growth of foreign investment remains low by any standards. The main reasons for this are structural weaknesses, political uncertainty and minor, but annoying impediments such as excessive licensing requirements, bureaucracy, etc.

Table 3. Foreign direct investment

	1995	1996	1997	1998	1999	2000
FDI, US$ mln	80.0	80.8	78.9	57.4	61.4	66.0

The level of registered FDI far exceeds the actual. Actual FDI fell sharply in 1998 and then has been slowly increasing. The single major target of foreign investment is mining which receives over 50% of all foreign investment. Other sectors include light industry, education, culture, tourism, etc. The biggest investor countries are China, South Korea and Russia.

Corporate governance

Prior to 1990 Mongolians had no tradition of doing business in a form of companies. All business activity was conducted by state-owned plants, collectives, and, to a limited extent, cooperatives.

Since early 1990es it has become possible to engage in business activities in any form, based on any type of property. The government started to privatise its property and most enterprises were incorporatised and listed on the stock exchange. Privatisation in 1991-1996 was carried out by 'blue' and 'pink tickets', privatisation vouchers distributed to Mongolia's adult population. Blue vouchers entitled their holders to buy shares of large enterprises, while pink vouchers were given to buy smaller ones. As a result of privatisation, over 86% of Mongolians became owners of 470 stockholding companies, larger enterprises, which were incorporatised and listed on the stock exchange. Share ownership initially was very dispersed, with 1.3 million people holding shares of these companies. Due to such structure, in early 1990-es executive management of companies was the most powerful tier in the corporate governance structure. Because distributed privatisation vouchers carried names of their holders, influential individuals were not able to get hold of controlling shares of companies from the start, as it happened in Russia.

The secondary market for share trading commenced in 1995, giving the start to a very intensive process of consolidation of controlling packages in hands of a few. By 1998 share ownership of listed companies became very concentrated and trading activity notably slowed. Gradually, large shareholders gained more power.

While privatised companies developed in their own way, a brand new class of companies emerged - private companies. Most private companies are relatively small, but their size and importance to the economy is growing. There is currently a number of large holding groups which started from scratch. However, none of private companies is a publicly listed company. Therefore, in this paper we will discuss corporate governance in the context of listed companies.

Mongolian stock market

Infrastructure and regulation: The Mongolian Stock Exchange was established in 1991 and served as a vehicle for selling shares of state-owned companies in exchange for privatisation vouchers. The Stock Exchange is a government institution and has the Central Depository as one of its departments.

The Securities Commission was established in 1994 with a mandate to protect investors' interests. The Commission also issues regulations which, together with the Law on Securities adopted in 1994, form the securities legislation in Mongolia.

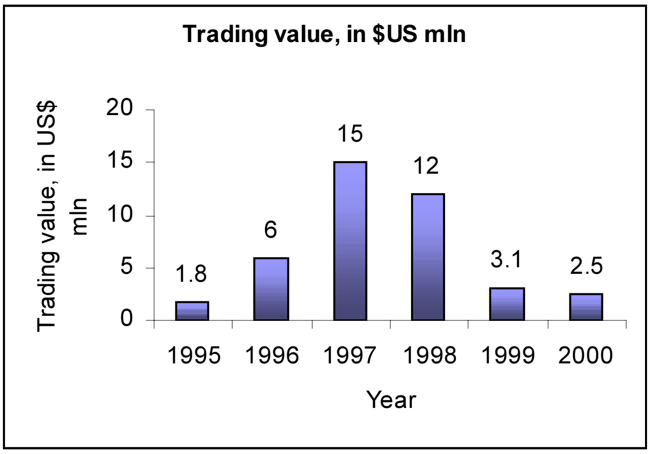
Both the Stock Exchange and the Securities Commission will have to play a bigger role in having companies issue more accurate and reliable financial information, proper auditing and reporting, and thereby in protecting interests of shareholders.

Secondary share trading commenced in 1995, and since then the stock market has seen both ups and downs.

Market capitalisation: After beginning of secondary trading, market capitalisation sharply declined, from US$50.6 to US$27.1 at the end of the year. At the end-1996, it slightly fell to US$25.6 and then more than doubled in 1997, reaching US$53,2. Since then market capitalisation has kept decreasing, to US$39.8 at end-1998, US$32.0 at end-1999 and US$30.0 at end-2000. However, market capitalisation includes both traded and untraded shares of listed companies. In a stock market like Mongolia's, where most shares are not being traded actively, a better indicator for stock market activity will be the trading value.

Trading value and other indicators of trading activity: The stock market is very thin and illiquid and it has become even more so since 1998, probably after a certain degree of consolidation was reached.

Figure 2. Value of shares traded on the Mongolian Stock Exchange



Trading value reached its peak at end-1997 and then kept declining. In an average month in 2000, shares of 175 companies (or 44% of all listed companies) have been traded, while this number reduced to 132 (33%) in 2001. Market capitalisation of the biggest 10 companies (out of 403 companies) was 77% of the total market capitalisation.

Market index: The TOP-75 index has changed as follows in the past 6 years:

Table 4. Market index

	1995	1996	1997	1998	1999	2000
1. TOP-75 index	113,7	118,4	251,0	235,2	230,3	396,3
2. Consumer price index	100,0	144,6	174,2	184,7	203,1	219,6
3. TOP-75 index adjusted for inflation	113,7	81,8	144,1	127,3	113,4	180,5

TOP-75 index adjusted for inflation varied throughout this period. Due to limited data it is not possible to name the reasons for such fluctuations. However, the changes in the index mirror quite closely changes in market capitalisation and trading value, allowing us to suggest that share prices of companies included in TOP-75 strongly affect indicators of the whole market.

Number of companies: There were 474 companies listed at the opening of secondary share trading, and about 10 listed after that. The number of listed companies has been steadily decreasing, reaching 403. The reasons for delisting of companies are mergers and acquisitions, conversion to a status of closed (limited liability) companies[3], failure to meet reporting and other requirements of the Securities Commission, etc.

The stock market in Mongolia is very underdeveloped and does not play a meaningful role in the economy. Also, because most people did not buy shares with their own money, they remain ignorant and uninterested in whatever changes occur on the stock exchange.

[3] Occurs when one shareholder owns 2/3rd of shares and decides to delist.

Ownership structure

Government: The largest institutional shareholder is the government, but its share has been steadily decreasing. Since the beginning of privatisation, shares of 470 companies were issued and sold through the stock exchange. Now only about 60 stockholding companies remain, partially owned by the state[4]. However, the remaining companies operate in sensitive and strategic industries, and are of relatively high value.

Depending on the share of government ownership, the government appoints some or all board members of companies. In some cases it also appoints executive directors. These appointments are often based not on consideration of management skills, but on connections and political considerations.

The government is planning to privatise most of the remaining companies by 2004. Privatisation of most valuable companies is scheduled for this year and government is hoping to attract large, reputable foreign investors.

Individual shareholders: Most shareholders in Mongolia are individuals. The reason for that is probably due to several factors, including privatisation of companies in Mongolia to individual, not institutional shareholders from the beginning; less scrutiny by regulatory bodies in case of individual shareholders; etc.

At the beginning of privatisation, a total of 1.3 million people were shareholders, while today this number has reduced to 449 thousand. Currently, 2400 individuals or 0.5% of all shareholders own 83% of all shares traded on the stock exchange. Companies owned by three to eight large shareholders constitute the majority of companies on the stock exchange. These large shareholders play a major role in controlling activities of corporations, their oversight and design of their organisational structure.

Investment companies: These companies were established in each aimag after distribution of privatisation vouchers to the population. Their function initially was to give advice and do administrative work related to purchase of companies' shares by vouchers. When secondary share trading commenced, these companies started to engage in dealing and brokerage of shares. About 40 investment companies operating currently are the only institutional investors in addition to the government. Most of them are located in Ulaanbaatar and some have branches in rural areas.

Banks: An amendment made to the Banking Law in 1999 prohibited banks from keeping assets equal to more than 20% of banks' capital in form of companies' shares, and stipulated that banks may own no more than 5% of shares of any one company. The central bank would strictly examine compliance to this provision and take strong actions in case of incompliance. This, and also the fact that traded shares are highly risky and very illiquid, prevents banks from buying and holding large amounts of shares. As of end-2000, only about 0.1% of banks' assets were held in form of shares.

Ownership of banks: The past 5 years have seen major changes in the Mongolian banking system. Altogether, 12 banks were closed down or went under, of which 8 were relatively small, and 4 were large banks.

Of the 12 banks currently operating in Mongolia, three of the largest four are owned by the government (2 are fully owned and one is 70 percent state-owned). And control 68% of all assets[5] in the banking system. The third largest bank is a private bank owned by a large holding company. The holding company has, beside the bank, daughter companies in computing, leasing and insurance sectors. Since the company is not a publicly listed company, but a limited liability one, it is very difficult to get any more definite data on its

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[4] In addition, government owns about 60 companies which are not listed, and entities which not incorporatised.

[5] As of end-2000.

ownership. Two medium-size banks are indirectly (through state-owned enterprises) owned by central and local governments. One small bank is owned by a gold-mining company which, in addition to the bank, also has affiliated companies in insurance, education and mining sectors. Other banks are private and small.

Although poor bank performance in the past can not be always attributed to their public ownership, there have been many instances of control over and pressure on banks by government to a degree that prevented banks from successful and business-like operations, restructuring and good performance.

Pension and mutual funds: There are no pension or mutual funds in Mongolia. During socialism pensions were paid by the government, and mutual funds did not exist at all. Although some changes were made in the pension insurance sector since 1990, the legal and other environments for operations of a commercial pension system are still not in place. The current pensions system is an old pay-as-you-go system, whereby pension premiums are spent entirely on payment of pensions. The system works adequately in a country where people under 60 constitute 95% of population, as it was in Mongolia according to the 2000 census. However, the Government, recognising the need for a system capable of sustaining itself in an environment of aging population, adopted a program whereby the pension system will gradually be changed to a funded system. Part of pension premiums will be used commercially, that is, will be invested in foreign and domestic markets, transforming the state pension fund into a large investor.

Insurance companies: Insurance companies are required by law to establish reserve funds equal to 60% of their net premiums. Up to 30% of this reserve fund can be invested in Government securities and other long-term securities. In practice, however, most insurance companies keep their money in various bank accounts, and the remaining in cash, because Government bonds were not offered to the public until recently, and there are no alternative long-term, relatively low-risk and liquid securities available.

1. Finance

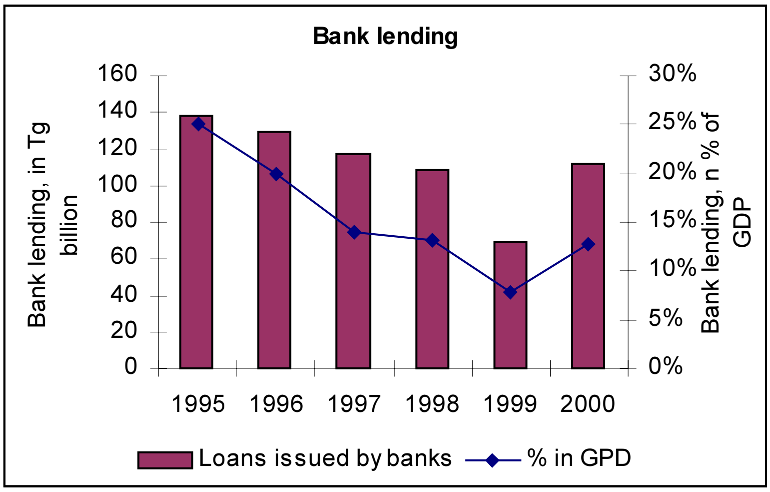
Since types of finance generally do not differ by form of incorporation of a company, but rather by size, ownership (state-owned or private) and other factors, in this section we will look at sources of finance in general, not necessarily confined to listed companies.

Public and donor finance: A large, but decreasing source of finance is subsidies/ investment from the state budget and loans of donor governments and institutions directly to companies or through on-lending arrangements with government and banks. Naturally, the biggest recipient of this finance is state-owned enterprise sector. Most on-lending arrangements and direct loans by foreign donors to enterprises have been unsuccessful. Examples include defaults of a large mini-metal plant, a meat factory, defaults on loss loans issued through some large banks, etc.

Companies internal finance: This type of finance includes re-investment of companies' profits in the company, additional investment into share capital, loans from foreign partners (mainly with domestic bank guarantees), credit purchases from foreign suppliers, prepayment sales to buyers, etc. Private companies, in absence of alternative funding have turned to these methods, some of which are quite innovative. For example, large construction companies that build residential building make contracts with future owners of these apartments and take a portion (about 40-50%) of the selling value in advance, with the rest payable either upon completion or amortised during a certain period. This has become a predominant method of finance for these companies in the past years.

Financing by banks and non-banks: Both supply and interest rates on bank loans make them available to only a few companies. Bank lending has been decreasing, reaching its lowest level in 1999, while real interest rates have been rising. The banking system has undergone a deep and recurring crisis and is still not in good shape. A big percentage of loans, especially those issued prior to 1996-1997 went bad due to poor lending practices of banks, unstable economic environment and many other factors, causing several bankruptcies of banks and extreme cautiousness of the remaining banks in issuing credit.

Figure 3. Bank lending



Due to such shortage of credit, many non-bank financial institutions started to spring up, backed by some government support. Of comparatively large non-bank financial institutions operating today, there are 7 lending companies and 7 leasing companies. 3 lending companies were established to address the issue of loan shortage, with funds of donor countries; the remaining lending companies are very small. One or two of the leasing companies do financial leasing, mainly of mining equipment. The remaining companies engage in operational leasing.

In the short history of the stock exchange, there were no cases of listed companies using share issuance as a vehicle to raise finance and no companies seeking listing voluntarily[6].

Legal environment

Relations between shareholders, boards and management: The first law regulating relations between shareholders, boards and management was enacted in 1991, called the Law on Business Enterprises. It was subsequently replaced by the Law on Partnerships and Companies in 1993 and then by the Law on Companies in 1999. Although we can not say that the last law is superior to the previous in all respects, it is more specific and is more consistent with other laws.

[6] That is, by ways other than privatisation.

Table 5. Board governance in companies' legislation

	The Law on Business Enterprises (1991)	The Law on Partnerships and Companies (1993)	The Law on Companies (1999)
Board responsibility	- Policy and planning - Determining management structure and remuneration - Appointing the executive director - Determining rights of the executive director in governing and spending property - Maintaining a registry of shareholders - Making conclusions (analysis) on the financial accounts	- Preparing business plans - Determining management structure and remuneration - Appointing the executive director - Determine rights of the executive director in governing and spending property - Implementing internal controls - Calling meeting of shareholders - Proposing changes in financial accounts and share capital - Reporting to the meeting of shareholders	- Approving main strategic direction - Calling meetings of shareholders and determining the agenda - Issuing shares up to the announced - Issuing other securities - Valuing assets - Re-purchasing shares, valuing them - Appointing the executive director - Appointing auditors - Making conclusions on financial accounts - Determining dividends - Determining procedures of board and the executive director - Establishing branches - Approving large and conflict-of-interest transactions - Proposing and implementing structural changes
Requirements on the board	3 or more members May serve in boards of other companies	3 or more members May serve in boards of other companies	9 or more members Members may not be present on discussion of/decision on some issues if they have a conflict of interest

	The Law on Business Enterprises (1991)	The Law on Partnerships and Companies (1993)	The Law on Companies (1999)
Member appointment	By meeting of shareholders The board may fill vacant places by appointing members itself, until the next meeting of shareholders	By meeting of shareholders	By meeting of shareholders (procedures are specified)
Appointment of outside members	Outside members may be appointed	Outside members may be up to 1/3rd of all members	Outside members may be appointed
Election of the chairman	Elected by the board	Elected by the board	Elected by the board
Supervisory council	Must be, with no less than 3 members	Appointed by the meeting of shareholders	Appointed by and reporting to the meeting of shareholders Specific rights and obligations listed
Accounting and bookkeeping	-	In accordance with the Law on Accounting	In accordance with international accounting standards
Financial reporting	Presented by the executive director to the board	The executive director responsible for accuracy. Includes the following: - Balance sheet - Profit and loss statement - Statement of accumulated profit - Notes - Activities of the board and executive management	The executive director responsible for accuracy. Includes the following, in addition to financial accounts: - Activities - Organisational structure - Conflict-of-interest transactions - Assets - Management expenditures - Other components defined in the charter
Auditing	-	Must be audited	Must be audited; auditor selection/ appointment, determination of their fees, and requirements on auditors are specified in the law

In addition, the new Companies Law clearly states rights of the meeting of shareholders, individual shareholders and executive management.

Share issues and acquisitions: Any new issues of shares, according to the Companies Law, must be offered first to existing shareholders who can buy shares in amount proportional to their current share ownership. They can pay for shares both by cash and in-kind, and the price must not be lower than 90% of the market price.

The Law on Securities requires any one who purchased (directly and indirectly) 5 or more percent of a company's shares to report to the Securities Commission, while those willing to buy 20 or more percent have to go through a tender procedure. These requirements are too strict, and, if implemented, would have a negative effect on prompt operation of the market. In reality there have been major problems with implementation of these provisions. Many investors would buy small chunks of shares of target companies using their agents, 'individuals with similar interests'.

Control: Controlling package of shares is defined in the new Companies law as one third of shares. However, shareholders that own 10% or more of company's shares may exercise some rights, such as requesting an audit of company's accounts.

Shareholders are generally very reluctant to accept new equity investment. Let us take an example from the banking sector. An amendment was made in the law requiring banks to increase their minimum capital (share capital) to twice the previous level, requiring closing in case of incompliance. Responding to this, banks did not merge, as was anticipated, but some acquired additional investment from friends, some preferred to be downgraded to non-banks.

Accounting and auditing: The Law on Accounting was adopted in 1993 and required companies to maintain accounting in accordance with International Accounting Standards. In practice, few companies follow international standards and most issue reports only for tax purposes. There is a certification program of accountants based in the Ministry of Finance, but its value is undermined because of emphasis on the tax accounting and neglect of international accounting.

The Law on Auditing was approved in 1997. It requires certain types of companies to have their accounts audited, states rights and responsibilities of auditors, auditing standards etc.

In practice, however, accounting and reporting standards of stockholding companies are very low, penalties for incompliance are minor, resulting in frequent abuse or neglect of interests of minority shareholders. For instance, only about 30-50% of listed companies submits their financial statements, and does not have a habit of automatic submission unless requested.

Corruption and cronyism: It can be observed that cronyism exhibits itself stronger in Mongolia than in most other countries. This can be attributed to both cultural factors and the size of population. It is very common that people in business circles or government know or even related to each other quite closely. Corruption is also an issue, but more with regard to taxes and business licensing and can be characterised as corruption that 'speeds the wheels of commerce'. There was an attempt to resolve these issues by inclusion of a concept of persons with similar interests in the Law on Companies, adopting ethical codes of civil servants, adopting the Law on Corruption, etc. However, no major change can occur unless high levels of government are fully committed to this change.

Although the current legislation provides an adequate framework for corporate governance, there are problems with its implementation. In practice, many companies do not comply with laws and regulations; penalties for incompliance are low and government regulatory bodies change too often to be able to ensure uniform enforcement.

Characteristics of corporate groups

Role in the economy: Almost no large corporations operate in sectors producing most value added[7] are agriculture (36%) and trade (21%). The next largest, the mining sector (9%) hosts the largest company[8] which produces 7.6% of GDP alone. This company also feeds the third

[7] GDP data for 2000 are not yet available. Therefore, we have taken the data for 1999.

[8] It is the largest company in the country and is a joint venture between Russian shareholders and Mongolian government. It is not a publicly listed company.

largest city in Mongolia and deterioration of its operations in 1996 and 1998 was among the major reasons for bankruptcy of its correspondent bank (one of the largest in Mongolia) and deterioration of the fiscal and trade balances. Transportation, storage and communication sector produces less than 9 percent of GDP and is dominated by large fully or majority state-owned airlines, railways, and telecommunications companies. There are also a few large groups in trade, agroprocessing and services, but they are far from influencing the economy in a big way in terms of both numbers of employees and value added. Many of these groups are limited liability companies, not listed. There are only a few listed companies that are truly large.

The current corporate income tax structure, taxing smaller companies at 15% and larger companies at 40%, creates incentives for companies not to grow big.

Diversification: There are a number of companies with fairly diversified operations. Probably, the main reasons for diversification are structural: the Mongolian economy has very strong seasonal characteristics due to severe continental climate; also the market is very small. Diversification is mainly done through affiliates or daughter companies, rather than directly by companies themselves.

Financial indicators: The stock exchange does not publish financial indicators of companies beyond share prices and their numbers. In addition, both the Stock Exchange and the Securities Commission have real problems in making companies comply with their reporting requirements.

Therefore, we have taken indicators of 7 companies whose shares are traded most actively and with highest market capitalisation in order to give readers a feel of characteristics of corporate groups.

Table 6. Financial indicators of selected listed companies

	Field of activities	Ownership structure	P/E ratio	Market capitalisation in US$ mln	Return on equity	Leverage (debt-to-assets)
1.	Fuel importing and retail	80% by gov, 2% by 1 sh-r	110,1	2,7	0,1%	36,5%
2.	Cashmere processing	75% by gov, 10% by 4 sh-rs	4,7	11,1	7,7%	1,9%
3.	Telecommunication	55% by gov, 41% by 2 sh-rs	1,7	7,1	32,7%	24,9%
4.	Hotel	81% by 11 sh-rs	1,9	0,8	18,8%	2,7%
5.	Tourism	93% by 7 sh-rs	9,8	1,5	8,3%	41,3%
6.	Drinks and beverages	51% by gov, 33% by 4 sh-rs	1,6	0,6	7,5%	22,2%
7.	Retail trade	18% by gov, 51% by 3 sh-rs	26,3	1,0	1,3%	1,3%

The P/E ratio which was calculated based earnings of only one year, 2000, can be misleading. However, the above data indicate that the fuel importing company with P/E ratio over 100 is clearly overvalued.

Return on equity is the highest for the telecommunications and the hotel company, while the fuel importing and retail trade companies have the least ROE, just over 1%.

The fuel importing and tourism companies which are able to obtain finance from the government budget and banks have the highest leverage, around 40%.

Certainly, none of the above indicators can represent the stock market or any average listed company. But since their capitalisation is equal to 67% of the entire stock market's, these data may be deemed as characteristic of large and actively traded companies on the stock exchange.

Restructuring: Since the 1998 crisis did not affect performance of companies directly, it did not by itself stimulate their restructuring. A few restructuring programs financed by donor governments/ institutions were organised to improve loan payment by some companies and improve performance of privatised companies, which has not changed, or has even deteriorated under the new management.

II. Conclusion

Good corporate governance is a critical element for attraction of investment and development of a strong corporate sector that is able to be the source of economic growth. In Mongolia, things are far from perfect, but measures being taken lead us to believe that corporate governance will be improving.