



ANNUAL REPORT 2001

Board of Directors of XacBank

Stephen D.Vance

Chairman of Board of Directors
Resident Representative of Mercy Corps
Chief of Party, Gobi Regional Economic Development Initiative funded by USAID

Bekhbat Sodnom

Member of Board of Directors
Executive Director of Amarjargal Foundation

Erdenechimeg Jambaldorj

Member of Board of Directors
President of Mongolian Women's Federation

Lhagvaa Sahiya

Member of Board of Directors
Vice Chairman of Board of Directors, Mongolian Development Research Center

Dr.Ekkehard Esser

Member of Board of Directors and Co-Executive Director of XacBank

Ganhuyag Chuluun

Member of Board of Directors and Co-Executive Director of XacBank



BOARD REPORT

We are proud to present the Annual Report of XacBank for 2001. Although XacBank only received its banking license from the Bank of Mongolia in December 2001, it came into being as the result of a merger of the two largest non-bank lending institutions in Mongolia, the Golden Fund for Development LLC (X.A.C.) and Goviin Ekhlel LLC, leaders in micro-credit and SME credit sectors respectively. By joining forces, X.A.C. and Goviin Ekhlel have created the first national network for the delivery of comprehensive financial services. In the true spirit of a merger of equals, we bring to life an entity called the XAC-GE Group Inc. Our priorities are to serve market segments that are currently underserved and largely neglected by the commercial banking sector, e.g., those clients in the lower income brackets and those in remote rural areas of Mongolia. The new bank will build upon the strengths of its two founding companies a customer-oriented culture of service, pro-active and transparent management practices, zero-tolerance towards delinquency, and top-notch utilization of technology.

This Annual Report is unique in the sense that it describes the operations of the two

founding companies, which are no longer operating on their own. But we would like to assure our readers that the spirit and mission, achievements and lessons, and the systems and people of the two are the determining forces behind the new bank and its future direction.

We would like to thank and congratulate the Board members of the two founding organizations for their invaluable input into defining the right direction for X.A.C. and Goviin Ekhlel throughout the year and for having the courage and wisdom in jumpstarting the process of transformation and integration. XacBank exemplifies the sound and transparent conduct of business to the nascent private sector of Mongolia.

X.A.C. and Goviin Ekhlel owe the United Nations Development Programme, the United States Agency for International Development, the Embassy of the United States of America, and the Government of Mongolia for their considerable support in the development of the micro- and small and medium-enterprise finance sectors to its present level and, in fact, making it possible for us to exist by providing financial support and encouragement.



MANAGEMENT REPORT

EXECUTIVE SUMMARY

The activities of X.A.C. and Goviin Ekhlel (hereinafter referred to as XacBank) during the year centered on achieving the ambitious goals set in our respective business plans - building a solid foundation of a true financial intermediary in the low-income and rural segments of the market. We consider the merger of X.A.C. and Goviin Ekhlel, and

the creation of XacBank as the culmination of our past operations.

Although management was engaged almost full-time in merger-related activities in the second half of the year, each of the companies was able to effectively manage the growth of their respective portfolios

The following is a summary of key data of XacBank as of 31 December 2001:

| INDICATOR | 2001 Plan ¹ | Dec, 2001 | Dec, 2000 ² | Change | |
|-------------------------------------|------------------------|------------------|------------------------|---------|---------|
| | A | B | C | (B-A)/A | (B-C)/C |
| Number of active clients | 6,907 | 6,542 | 3,694 | -5.3% | 77.1% |
| Loans Outstanding | 2,642,152,280.00 | 2,630,083,851.00 | 1,120,899,447.00 | -0.5% | 134.6% |
| Average disbursal loan size | 445,941.39 | 414,116.12 | 289,321.63 | -7.1% | 43.1% |
| Average loan outstanding | 382,532.54 | 402,030.55 | 303,437.86 | 5.1% | 32.5% |
| PAR >1 day | 4.90% | 0.29% | 0.43% | -94.1% | -33.1% |
| Loan Loss (Write-offs) | 1.82% | 0.28% | 0.18% | -84.6% | 51.8% |
| Percentage of female clients | — | 68.86% | 62.50% | — | 10.2% |
| Number of branches ³ | 23 | 20 | 16 | -13.0% | 25.0% |
| Number of employees | 156 | 168 | 86 | 7.7% | 95.3% |
| Clients per credit officer | 110 | 107 | 88 | -2.4% | 21.7% |
| Operational efficiency (LTM) annual | 45.19% | 49.68% | 69.50% | 9.9% | -28.5% |
| Operational self-sufficiency | 139.51% | 101.85% | 71.56% | -27.0% | 42.3% |
| Yield on Portfolio (LTM) | 63.05% | 61.93% | 60.88% | -1.8% | 1.7% |
| ROA | 7.78% | 5.34% | -4.92% | -31.4% | -208.5% |
| ROE | 12.21% | 8.48% | -10.45% | -30.5% | -181.2% |
| Equity (MNT) | 3,136,000,000.00 | 2,713,435,717.04 | 1,049,366,020.44 | -13.5% | 158.6% |
| Capital adequacy ratio | 99.93% | 72.37% | 47.03% | -27.6% | 53.9% |
| Exchange rate (USD 1/MNT) | 1,101.47 | 1,102 | 1,097 | 0.0% | 0.5% |

¹ X.A.C. and Goviin Ekhlel combined.

² Ibidem.

³ Central branch office included, Ayrag sum branch taken out, Uvurhangay branch merged.

effectively - some 15,490 loans with the value of MNT 6,415 million were disbursed by XacBank during the year. As of year end 6,542 loans with a total value of MNT 2,630 million were outstanding, while the portfolio at risk of more than one day remained excellent at 0.29 per cent.

Total assets size of the Bank is MNT 3,749 million of which MNT 2,704 million is contributed by the paid-in capital held by the XAC-GE Group (hereinafter referred to as the Group).

According to the merger agreement a new Board of Directors of the Bank was named in October from the shareholders of XAC-GE Group comprising 5 representatives of shareholders and the 2 Co-CEOs. This Board replaced the separate boards of the two merger partners.

We continued receiving technical assistance from FACET under funding from the IFC. At the end of the year we were able to secure further TA from CGAP and IFC to support the merger and bank transformation.

Major events during the Year:

- ? Organized an Annual Clients Trade Fair in Ulaanbaatar with the participation of more than 300 clients from all over the country. The Mongolian National Chamber of

Commerce and Industry awarded the first-ever Best Micro-entrepreneur award to one of our clients during the event.

- ? Introduced at the Donors Seminar on Sustainable Microfinance Practices co-organized by UNCDF/ UNDP and CGAP in Ulaanbaatar as a model of the best micro-finance practice in Mongolia.
- ? Short-term commercial notes were issued and sold through private placements on the local market for the first time in Mongolia to support portfolio growth.
- ? The Group acquired super majority stake in Netmon Inc. – the country's only wholesale lender to savings and loan cooperatives.
- ? Introduced consumption loans and piloted herder loan products.
- ? Merged Goviin Ekhlel and X.A.C. operations and started the process of transforming into a commercial bank.
- ? Was recognized as a leading supporter of small and medium enterprises in 2001 by the Mongolian National Chamber of Commerce and Industry.
- ? Underwent an investment due-diligence carried out by Shorebank, USA and full on-site examination by the Bank of Mongolia.



CONTEXT and COMPETITION

After two consecutive years of natural disasters (zud, hoof-and-mouth disease) that hit Mongolia, 2001 turned out to be a better year than many predicted or feared. Some macroeconomic indicators are presented below:

- ? Growth of Mongolian industrial sector in 2001 was 11.8 percent. GDP grew by 1.2 percent.
- ? Year-to-year inflation for 2001 as measured by CPI was 11.2 percent with a moving average of 8.2 percent.
- ? Mongolian Tugrug (MNT) depreciated by 0.4 percent against the US dollar and appreciated against the Euro by 3.4 percent.
- ? Monetary supply grew by 28 percent (MNT 72.2) primarily from the growth of deposits – the public responded to improved performance of banks by reducing their holdings of currency notes. 62 percent of this increase translated into growth of domestic credit.
- ? The share of non-performing loans fell from 23 percent to less than 10 percent at the end of 2001 as a result of the general improvement in external and internal constraints.
- ? Fiscal deficit shrank from 7 percent of GDP in 2000 to 4 percent.

- ? Trade deficit expanded from 7.5 percent to 9 percent of GDP.

In the banking sector we saw a resurrection of Agricultural Bank in 2001 as well – the largest bank in terms of branch network in Mongolia. Agricultural Bank added 67 new branches to its network and currently has around 340 throughout the country. Its outstanding loan portfolio increased from MNT 196 million to over MNT 10 billion in the year. Other banks exploring XacBank's traditional markets are Savings Bank, and Zoos Bank and almost all other banks to a certain extent.

Four new commercial banks obtained their licenses from the Bank of Mongolia, including a subsidiary of the Russian Menatep Bank and XacBank. There were significant increases in the number of non-bank financial institutions and savings and loan cooperatives as well.

In its efforts to increase the efficiency of the banking sector through consolidation, the Bank of Mongolia, in an unexpected move, increased the minimum capital requirements for commercial banks to MNT 3 billion in October 2001 - right as we were filing our application for a bank license. Furthermore, all commercial banks are required to comply with a statutory minimum share capital of MNT 4 billion by December 2003.



MERGER and SUPERNOVA

XacBank is a product of the merger of Goviin Ekhlel, LLC and the Golden Fund for Development (X.A.C. LLC), the two largest non-bank lending institutions in Mongolia, which was completed in the last quarter of 2001. Mercy Corps, a US-based non-profit organization engaged in development and humanitarian assistance, established Goviin Ekhlel as a non-bank lending institution in December 1999 and received its license in March 2000; X.A.C. started its operations in 1998 and was officially incorporated by a group of six local NGOs in 1999, as the first licensed non-bank lending institution in the country.

The principal reasons for the merger were complementary missions and strategic fit, since each organization operated in a different, non-overlapping geographic area (with the exception of Uvurhangai aymag) and offered complementary services - micro and SME loans. Moreover, each had short to mid-term goals of transforming into full-fledged commercial banks offering a number of financial services.

As a result of the merger, XacBank will be able to cover all provinces of Mongolia by the end of 2002, offer a full package of financial services to its existing client base, and expand those services to the

remotest areas of Mongolia, including nomadic herders. XacBank becomes more competitive in terms of client attraction and retention through its diversified range of products targeting different segments of the market and will enjoy economies of scale through wider market coverage and product mix.

On October 1st, 2001 the shareholders of X.A.C. and Goviin Ekhlel signed the Merger and Bank Establishment Agreement. According to this Agreement Goviin Ekhlel would become a holding company and change its name to XAC-GE Group and X.A.C. would be transformed into a commercial bank called XacBank. The shareholders of both companies would own shares of the Group only, and in turn the Group would hold 100 percent of XacBank's shares initially. In line with a merger evaluation performed during the summer the institutional shareholders of X.A.C. own 53 percent of the shares and exercise 60 percent of voting rights and Mercy Corps holds 47 percent and has 40 percent of the voting rights in XAC-GE Group. The difference between ownership and voting rights derive from the fact that X.A.C. had MNT 300 million dedicated to an ESOP before the merger. These funds were originally provided by UNDP and are held under trust in XAC-GE Group until they are transferred to employees.

The shares of the Holding are divided as follows:

| # | Shareholders | Share capital | Shareholding percentages |
|---|--------------|------------------|--------------------------|
| 1 | Mercy Corp. | 1,071,565,000.00 | 47.00% |
| 2 | LEOS | 214,581,000.00 | 9.41% |
| 3 | MWF | 198,507,000.00 | 8.71% |
| 4 | Soros | 264,141,000.00 | 11.59% |
| 5 | NAMAC | 214,581,000.00 | 9.41% |
| 6 | LGDF | 166,226,000.00 | 7.29% |
| 7 | Rotary | 150,153,000.00 | 6.59% |
| | Total | 2,279,754,000.00 | 100% |

The simplified balance sheet of the Group is as follows:

| | | | |
|--------------------|------------------|--------------------|------------------|
| Investment XacBank | 2,704,000,000.00 | Sharecapital | 2,279,754,098.00 |
| Investment Netmon | 95,568,300.00 | Employee trust | 300,000,000.00 |
| Other | 16,934,999.00 | Reserves | 100,000,000.00 |
| | | Earnings year 2001 | 43,002,096.00 |
| | | Payable to XacBank | 76,868,300.00 |
| | | Other payables | 16,878,805.00 |
| | 2,816,503,299.00 | | 2,816,503,299.00 |

As the employee trust cannot hold shares in a bank, XAC-GE holds the shares until they will be sold to the individual staff members who will then become shareholders of XacBank.

Headquartered in Mongolia's capital, Ulaanbaatar, XacBank currently operates branches in Ulaanbaatar and in two-thirds of the provinces. XacBank is incorporated as a limited liability commercial bank with a license to offer savings and current accounts, foreign exchange, and transfer and payments services, in addition to its lending activities.

XacBank is run by a joint management team of two CEOs, one national and one international. The

Co-CEOs report to a five-member Board of Directors. As the single largest shareholder, Mercy Corps has two seats on the Board; the remaining three seats are elected by the shareholders. Internal auditors report directly to the Board.

The Bank has a flat hierarchical structure with matrix information and reporting lines. XacBank currently operates through seven divisions structured as profit/cost centers: Micro Lending (includes consumer lending), SME Lending, Customer Services (savings and deposit mobilization), Human Resources, Accounting and Controlling (includes treasury and Risk Management), Operations, and Internal Audit. Each department is responsible for functional areas and reports directly to one of the two CEOs.



MISSION and OBJECTIVES

The Mission of XacBank, as stipulated in our Founding Charter, is to contribute to the socio-economic development of Mongolia by providing comprehensive banking services to all members of society including those who normally do not have easy access from conventional service providers, with a strong commitment to rural areas, and at the same time maximizing shareholders' value in order to create a financially viable financial institution. To actualize this mission, the management of XacBank have devised a five year strategic plan that foresees the establishment of not only sound banking operations, but a comprehensive, cutting-edge financial services corporation utilizing state-of-the-art technological innovations in service delivery. All marketing activities of the Bank will be conducted under a corporate motto - Universe of Trust.

The driving vision of XacBank is to be a leader in the financial services industry by demonstrating that a commercial bank can be profitable while serving the needs of the lower income strata of the population. By the end of 2006, XacBank shall have at least \$13.4 million in total assets, of which nine million will be outstanding to 20,000 active borrowers. In the context of Mongolia, with an annual GDP of \$1.0 billion, this will be a significant contribution. In addition to XacBank and Netmon, the Group will launch other financial services companies, such as insurance (especially for livestock), leasing and consulting.

PORTFOLIO and PRODUCTS

The number of active clients reached 6,542 from 3,692 at the end of 2001, an increase of 77.2 percent. The organization disbursed in cumulative terms a total of 15,490 loans in 2001 – almost 1,300 new loans every month on average. And this growth is accompanied by a PAR of more than 1 day of 0.29 per cent. During the year we lowered interest rates charged across all loan products and selectively based on the individual client's track-record with the institution.

At the end of the year the Bank offered five loan products: Start-Up, Growth, SME, Household, and Herder. A brief description of each follows:

Start-Up loans are provided to groups and individuals engaged in trading, production and services. This is a core loan product. Start-up loans range from about MNT 20 thousand to MNT 1 million, with a term of up to 12 months. Clients who have successfully repaid their loans have the opportunity to obtain repeat loans with more favorable terms. Interest rates are currently 5.0 percent per month for first-time borrowers, and go as low as 3.75 percent for repeat clients.

Growth loans ensure stable growth and normal business operations of clients who have effectively used Start-Up loans. These loans are used to purchase fixed assets, to expand businesses, and to penetrate new markets. Loan terms are based on potential growth. Demand for this loan has proven



to be higher than expected, and many clients have demonstrated that they are able to expand significantly the size of their businesses. Loan sizes range from MNT 1 million to MNT 2 million for a term of 1-18 months, with monthly interest rates of 3.5-4.0 percent.

Small and Medium Size Enterprise loans are a cash-flow based loan product. SME loans have flexible terms of one year for working capital requirements and up to three years for investment purposes. They range in size from MNT 2 million to MNT 30 million. Interest rates decrease for repeat borrowers and are 3.0-4.0 percent per month. The product is structured in a very flexible way to cater to the specific needs of different types of businesses including production cooperatives.

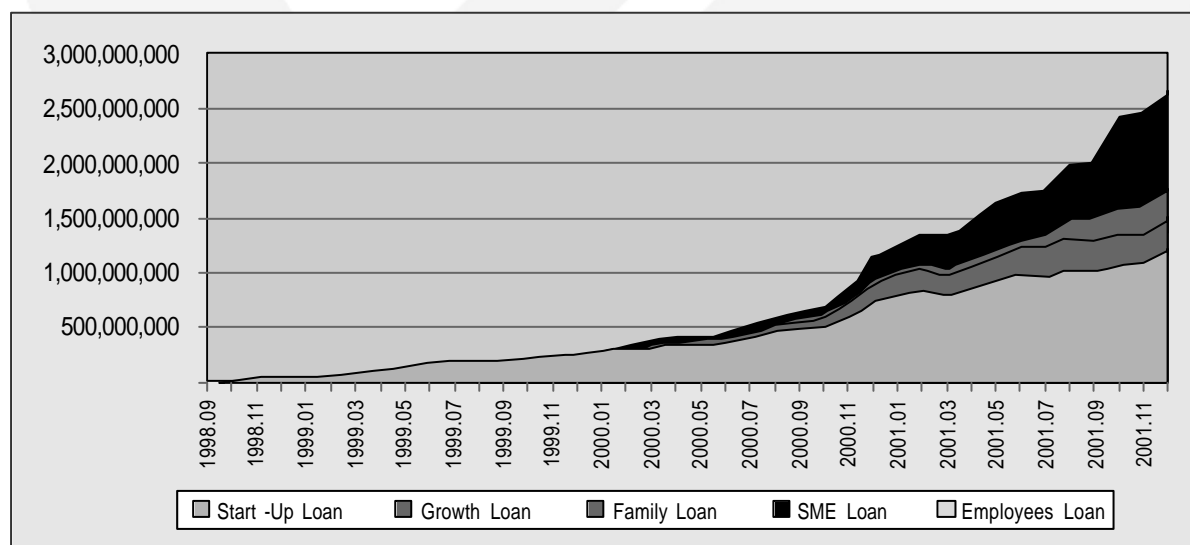
Household loans directly target public sector employees and other salaried employees for consumption purposes. Clients use these loans to pay for appliances, renovation, school fees, etc. Maximum size is MNT 300 thousand and carries a monthly interest rate of 5.0 percent and a term of up to eight months. With the prevailing monthly salary levels of MNT 30-70 thousand, this product has a broad impact on clients, as it gives them access to cash they would not otherwise have at affordable terms. It will be further expanded into a range of consumer loan products in 2002.

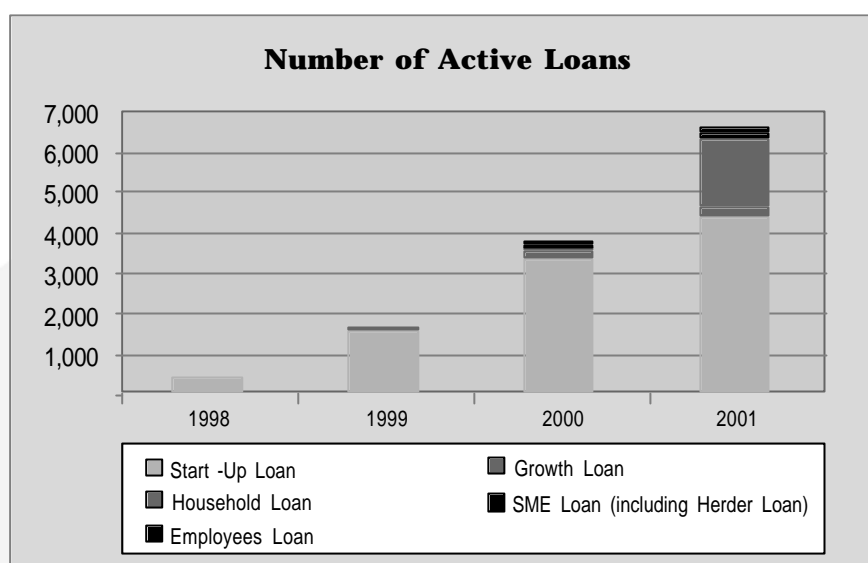
Herder loans target larger individual herder enterprises and herder cooperatives. Experience has shown that a modified cash-flow analysis based loan product can be successful, but can only be efficiently delivered in the proximity of branch offices. The pricing of the loan is flexible (ratio based) on a case-by-case basis. An interesting aspect of the loan is that it allows for a balloon payment at the end of the term. Interest rates are between 3.0-4.0 percent monthly and term is up to 12 months.

By the end of year 2001, 55.2 percent of the total portfolio is concentrated in trading and 11.3 percent in manufacturing, 18.5 percent in service, 2.4 percent in mixed business, and 10.7 percent of total portfolio or 26.6 percent of active clients had consumption loans. The remaining 1.9 percent of the portfolio is in loans to herders.

68.9 percent, or 4,505 of the total active clients, are female and 59.7 percent are between 36-55 years of age. 51.7 percent of total clients live in rural areas (aimag centers), and 3,160 clients live in Ulaanbaatar, Darhan and Erdenet.

21 loans with total value of MNT 5,815,606 (0.22 percent of the total portfolio outstanding) were written-off during the period. Collateral was seized on 19 loans with a total value of MNT 5,689,291. MNT 4,273,156 was recovered in cash including

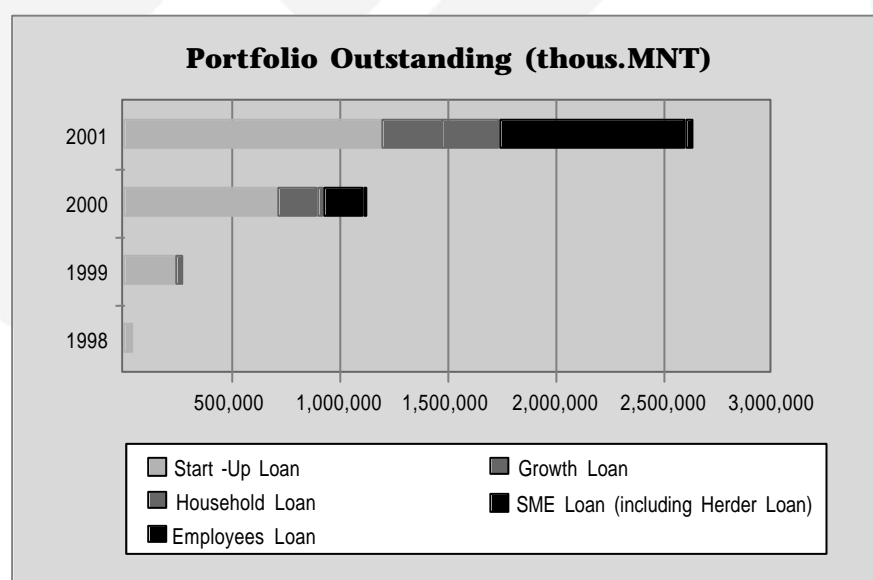




previous and current period loan write-offs. Cumulative (since 1998) loan write-off is 7,648,968 which is 0.29 percent of the portfolio outstanding.

Altogether six new branches (Zavhan, Arhangai, Huvsgul and Bayanhongor aimags, Erdenet City and the Bayangol district of Ulaanbaatar) were rolled out in 2001 and one branch liquidated

through assets/share swap with Netmon, a wholesale lending subsidiary of the Group. A sub-branch was set-up in Harhorin of Uvurhangai Aimag- an ancient capital of Mongolia. After these, 6 aimags out of 21 are still not reached by XacBank. If we are successful in opening our branches there in 2002, XacBank will become a truly national network of financial services delivery with 27 branches.



FINANCIALS and FINANCING

According to X.A.C. and Goviin Ekhlel's separate budgets, we planned a combined MNT 201.6 million in net profits for 2001. The actual net profit is about MNT 160.0 million (XacBank and XAC-GE Group). Management had already predicted a decrease in profitability compared to the projections in July on a consolidated basis due to the merger. The following factors influenced the decrease in profitability this year:

- ? The average portfolio in the fourth quarter was lower than that of the projection due to the fact that the SME product was cancelled in the first quarter of 2001 by X.A.C. (difficulties encountered, expected merger with Goviin Ekhlel and probably an overly ambitious plan) thus making the average income from the portfolio lower from the plans;
- ? Interest rates were selectively lowered in July and November;
- ? Merger, bank transformation related expenses, costs of moving into the new Head Office building, investment into a communications network and banking infrastructure, financial costs, and the personnel expenses for newly hired staff.

In order to implement the merger plan and operate

as a commercial bank, XacBank management had to invest heavily into human resources, communication and security systems, new office space, furniture and equipment. Direct total investments related to the transformation into a commercial bank are estimated to be MNT 202.1 million in 2001.

Of MNT 3,749 million of the Bank's total assets at the end of the year, MNT 2,704 is derived from the paid-in capital owned by the Group.

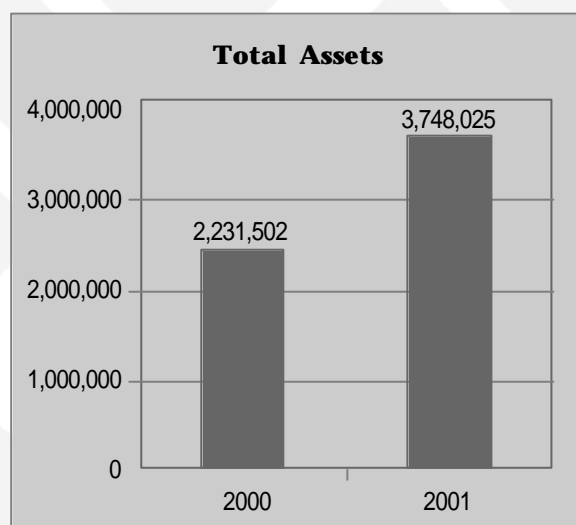
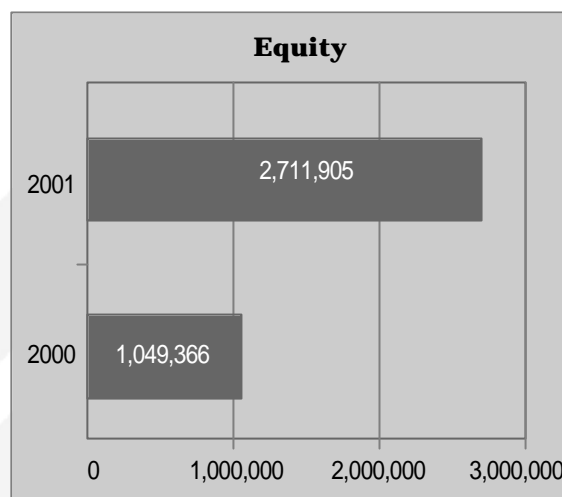
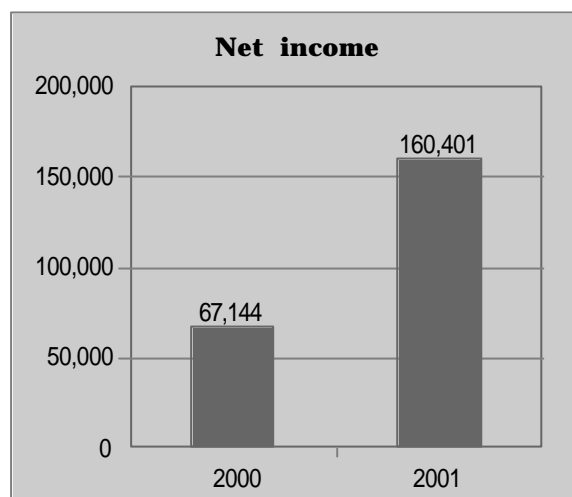
Altogether the Bank was able to raise an additional MNT 749.290 million in share capital from its shareholders to bring the total equity of the bank to MNT 2.7 billion.

A Memorandum of Understanding outlining the manner in which the transfer of UNDP donated assets (UNDP/Mongolia has transferred in full MNT 560 million outstanding as a secondary payable up to 5 years) to the company's equity (NGO's, employees) was signed with UNDP/Mongolia in October. According to this agreement MNT 300 million worth of shares in the Bank are placed in an employee stock trust to be distributed in the future. Attracting short-term commercial liabilities from the local banks started in the third quarter. Golomt Bank was first to purchase MNT 100 million in short term notes offered through private placement. Mongol



Post Bank issued a line of credit for MNT 250 million, followed by Trade and Development Bank's subscription for notes of MNT 150 million. We consider these investments into XacBank not

only a commercial decision by banks but a show of support and contribution to the development of micro and small businesses in Mongolia.



Synopsis:

- ? The reserve fund of MNT 100 million is booked at the Group level and XacBank issued new shares to the Group for the same amount;
- ? MNT 140 million from the accumulated earnings and reserve fund was distributed as share capital to X.A.C. shareholders;
- ? Share capital was increased by MNT 1,396

million after the swap of Goviin Ekhlel assets for XacBank shares;

- ? Triodos-Doen Foundation managed by Triodos Bank of Holland is expected to become the first strategic shareholder of XacBank by converting its outstanding loan of USD 400,000 to share capital in 2002;
- ? XacBank became a bank with a single shareholder – XAC-GE Group.

HUMAN RESOURCE POLICY and TECHNICAL ASSISTANCE

The capacity of human resources and management skills are of strategic importance. XacBank, and the Group as a whole, will strive to be at the forefront of development finance in Mongolia and in the region. As a learning organization, XacBank's growth will be impossible to attain without human growth. XacBank employees are charged with a mission and the Bank stresses the importance of inspired, motivated, loyal and satisfied staff at all levels. Innovation, creativity, affability and reliability are all qualities that management looks for in its employees, which is why XacBank itself is generally viewed by outsiders to possess those qualities and characteristics.

The Bank offers training on a wide range of topics to its employees: from general orientation to the Bank and its philosophy to building of leadership and communication skills or professional, such as loan portfolio management, risk management and accounting. Beside in-house trainings we collaborated with one national and three international training institutes in which 13 staff participated.

Recruitment intensified in the last quarter of 2001 – 60 percent of all new recruits (45 new employees) were hired during the quarter, bringing the total number of staff to 167 at the end of 2001.

The Company continued receiving TA services from FACET under contract with IFC. Two VSO English teachers have successfully completed their one-year commitment to teach the Bank's staff

English. In the second half of the year MIS specialists under UNV contracts started working on identifying information technology solutions for the Bank.

Given the transformation into a bank, ambitious growth plan, increasing competition and stressed HRD capabilities, Management clearly recognizes the need for intensive TA and advisory services. As part of an overall HRD strategy, a comprehensive TA plan was developed, and CGAP approved and disbursed the funds for TA in December. A TA funding proposal was made to IFC's SME Capacity Building Fund and we expect the closing of the deal in early 2002. These funds will be primarily used for enhancing the banking and management skills, and development of new products and services.

For the growth plans to be successful, XacBank will need to invest heavily in management information systems as well. The foremost priority is therefore to develop and install a computerized MIS that will serve the information and control needs within constraints faced in the environment. It is expected to improve efficiency, workload and satisfaction of employees as well.

| | 2001 | 2000 |
|-------------|------|------|
| Head Office | 50 | 25 |
| Branches | 118 | 67 |



OTHER and OTHERS

At the time of finalization of the merger agreement, it was decided to look for new office space for XacBank. In October the two companies moved into a newly built property in the center of Ulaanbaatar. The lease agreement sets the price for five years with an option for extension for another five. Difficulties in moving and setting up an adequate internal infrastructure were overcome. This new office building will accommodate not only the Bank's Headquarters but also a retail branch office, Netmon and other companies to be rolled out by the Group.

XacBank provided a loan of USD 300,000 to the owner of the building in order to allow completion of the construction work on the building. The loan is fully collateralized by the building, matures in four years and yields an interest of 14.4 percent per year (repayments are tied to the rental payments on the five-year lease with an option for another five-year extension).

XacBank plans to occupy 750 square meters of the building and to rent out the remaining 250 square meters. The increased costs of office space (5 times more than former office) are a necessary investment for future expansion of XacBank's activities.

The team worked hard on the development of systems, new policies and procedures for the Bank during the quarter. Major areas of challenge and efforts were MIS software preparation/development,

and development of policies and procedures in the newly created Client Services Division, encompassing savings products, business accounts and transfer/payments services. As savings products, current accounts and money transfers are new areas for XacBank, we are planning a controlled roll-out of these products. Pilot branches will introduce new products allowing for product design and software testing.

Development of new savings products will be preceded by market research planned for the first quarter of 2002.

As part of the merger initiative, the companies are also developing and piloting a franchising system of financial services through savings and loan cooperatives. The Group holds majority shares of Netmon LLC, which is a wholesale lender to savings and loan cooperatives and will serve as the on-lending vehicle to reach nomadic herders and remote rural communities.

After several discussions with Netmon, we decided to restructure the Ayrag branch of former X.A.C. (the only sum based branch office) and net assets of this branch were swapped for Netmon shares, bringing our total shareholding in the company from 51 percent to 85 percent. The restructuring process was completed in December and the Ayrag branch transformed into a savings and loan cooperative under close monitoring by Netmon staff. This pilot



case will serve as a learning tool for the Group to reach rural markets with financial services by franchising of XacBank's products and systems.

Wholesale loans to savings and loan cooperatives has been successfully piloted using an adapted version of the PEARLS system developed by

WOCCU, and is currently being extended to remote rural clients herders.

The Client Satisfaction Survey has been outsourced to a team of university professors in April. 600 active clients and drop-outs from five UB and four rural branches were included in the survey.



AUDITOR'S REPORT

We have audited the beginning balance sheet of XacBank Ltd., as of December 31, 2001. Preparation and submission of the beginning balance sheet is the responsibility of the bank management. Our responsibility is to express an opinion on the balance sheet based on our auditing.

Our auditing was conducted according to the International Standards on Auditing in the framework of Auditing and Accounting Laws of Mongolia, rules issued by Mongolbank, and other effective legislation. We performed the auditing procedures to obtain reasonable evidence that the

beginning balance sheet is free from material misstatements, we also evaluated the accounting principles used to prepare the balance sheet. In addition we considered management decisions, their implementation and examined significant transactions on a test basis. We hope that our auditing could become a reasonable basis to express an opinion and we are expressing our opinion as follows.

The beginning balance sheet of XacBank Ltd., presents fairly, in all material respects, the financial position of the bank in accordance with the accounting rules followed in Mongolia as December 31, 2001.

NIMM Audit Co., LTD

XacBank Ltd.,
BEGINNING BALANCE SHEET
As of December 31, 2001
(In tugrugs)

| Assets | Note | |
|-----------------------------------|------|------------------|
| Cash and cash equivalents | 2A | 362,332,885.45 |
| Loans (net) | 2B | 2,600,364,502.01 |
| Other owned assets (net) | 2C | 1,010,709.00 |
| Fixed assets (net) | 2D | 587,376,070.38 |
| Other assets | 2E | 198,471,017.93 |
| Total assets | | 3,749,555,184.77 |
| Liabilities | | |
| Short term loans from other banks | | 250,000,000.00 |
| Notes payable | | 250,000,000.00 |
| Long term liabilities | 2F | 499,085,967.97 |
| Other liabilities | 2G | 37,033,499.76 |
| Total liabilities | | 1,036,119,467.73 |
| Equity | | |
| Share capital | 2H | 2,704,000,000.00 |
| Reserve fund | | 9,435,717.04 |
| Retained earnings | | - |
| Total equity | | 2,713,435,717.04 |
| Total liabilities and equity | | 3,749,555,184.77 |

DISCLOSURE TO THE BEGINNING BALANCE SHEET

As December 31, 2001
(in thousand tugrugs)

1. ORGANIZATION AND OPERATION

Mongolian largest non-bank financial institutions X.A.C. Co., LTD and Goviin Ekhlel Co., LTD merged together, and established a holding company named XAC-GE Group Ltd.,. Further they decided to establish XacBank with 100 percent investment of XAC-GE Group and signed a Letter of Intent on the 20th of August 2001 and a Merger Agreement on the 1st of October 2001.

According to the contract, X.A.C. Co., LTD became an operating subsidiary company and organized as a commercial bank named XacBank Ltd., as soon

as receiving permission to establish a bank while Goviin Ekhlel Co., LTD is organized as a holding company named XAC-GE Group Ltd., .

XAC-GE Group Ltd., was given permission to establish a bank, and its subsidiary XacBank Ltd., was given permission to conduct a banking operation and a Banking certificate (number 24) by the Decree No. 610 of the President of Mongolbank dated December 27, 2001. As a result, it was newly registered at the State Registration and the beginning balance sheet of XacBank Ltd., was prepared as of December 31, 2001.

XacBank Ltd., is conducting operations such as cash saving, loan, account transactions, and other according to the Banking Law and other legislation of Mongolia. XacBank Ltd., is a profit-oriented bank and has total 21 branches and account centers, 6 in Ulaanbaatar, and 15 in aimags.

2. DISCLOSURE TO ACCOUNTS

A. Cash

| Categories of cash | Dec 31, 2001 |
|---|--------------|
| A. Cash on hand in domestic currency | 51,213.8 |
| in foreign currency | 724.4 |
| | 51,938.2 |
| B. Current accounts at other commercial banks | |
| in domestic currency | 168,156.9 |
| in foreign currency | 62,008.5 |
| | 230,165.4 |
| C. Cash deposits at other commercial banks | |
| in domestic currency | 80,206.9 |
| in foreign currency | 22.4 |
| | 80,229.3 |
| Total cash | 362,332.9 |

B. Loans

| Loans classification | Dec 31, 2001 | |
|----------------------|--------------|------------|
| | Loan | Reserve |
| Performing loan | 2,622,465.6 | (26,224.6) |
| Re-scheduled loan | 1,542.6 | (385.6) |
| Non-performing loan | | |
| Past due loan | 900.1 | (9.0) |
| Sub-standard loan | 121.0 | (30.3) |
| Doubtful loan | 3,969.6 | (1,984.8) |
| Bad loan | 1,085.0 | (1,085.0) |
| Total | 2,630,083.9 | (29,719.3) |

C. Other Owned Assets

| | Dec 31, 2001 | |
|----------|--------------|---------|
| | O.O.Assets | Reserve |
| Normal | 643.5 | (6.4) |
| Abnormal | 239.0 | (59.7) |
| Doubtful | 388.7 | (194.4) |
| Bad | 144.9 | (144.9) |
| Total | 1,416.1 | (405.4) |

D. Fixed Assets

| Fixed asset classification | Dec 31, 2001 | |
|----------------------------|--------------|-------------|
| | His. Cost | Accum. Dep |
| Building | 266,760.0 | (2,729.7) |
| Vehicles | 106,303.1 | (20,435.2) |
| Furniture & fixture | 78,524.8 | (17,651.3) |
| Computer | 246,815.2 | (70,210.8) |
| Total | 698,403.1 | (111,027.0) |

E. Other Assets

| | Dec 31, 2001 |
|------------------------------|--------------|
| Receivables | 87,114.6 |
| Prepaid accounts | 7,236.9 |
| Advances to employees | 371.9 |
| Materials | 13,895.6 |
| Supplies | 10,213.9 |
| Prepaid income taxes | 5,191.3 |
| Deferred income tax assets | 12,827.2 |
| Accrued interest receivables | 61,619.6 |
| Total | 198,471.0 |

F. Long Term Liabilities

| | Dec 31, 2001 |
|---|--------------|
| A. Long term loan from the foreign bank | 438,800.0 |
| B. Funding from UNDP | 3,716.3 |
| C. CGAP payable | 55,083.5 |
| D. MSM project | 1,486.2 |
| Total | 499,086.0 |

G. Other Liabilities

| | Dec 31, 2001 |
|-----------------------------|--------------|
| Payables | 20,487.6 |
| Social insurance payable | 4,283.5 |
| Withholding tax payable | 2,306.6 |
| Deferred income tax payable | 3,114.1 |
| Accrued interest payable | 6,841.7 |
| Total | 37,033.5 |

H. Share Capital

XAC-GE Group owns 100 percent of these 270400 shares (par value of 10,000 tugrugs or total 2,704.0 million tugrug) as December 31, 2001.

To: THE STOCKHOLDERS OF XacBank Ltd.,

Subject: Auditor's report

We have audited the beginning balance sheet of XacBank Ltd., as of December 31, 2001. Preparation and submission of the beginning balance sheet is the responsibility of the bank management. Our responsibility is to express an opinion on the balance sheet based on our auditing.

Our auditing was conducted according to the International Standards on Auditing in the framework of Auditing and Accounting Laws of Mongolia, rules issued by Mongolbank, and other effective legislation. We performed the auditing procedures to obtain reasonable evidence that the beginning balance sheet is free from material misstatements, we also evaluated the accounting principles used to prepare the balance sheet. In addition we considered management decisions, their implementation and examined significant transactions on a test basis. We hope that our auditing could become a reasonable basis to express an opinion and we are expressing our opinion as follows.

The beginning balance sheet of XacBank Ltd., presents fairly, in all material respects, the financial position of the bank in accordance with the accounting rules followed in Mongolia as December 31, 2001.

NIMM Audit Co., LTD

XacBank Ltd.,
BEGINNING BALANCE SHEET
As December 31, 2001
(In togrogs)

| Assets | <u>Note</u> | |
|-------------------------------------|-------------|--------------------------------|
| Cash and cash equivalents | 2A | 362,332,885.45 |
| Loans \net\ | 2B | 2,600,364,502.01 |
| Other owned assets \net\ | 2C | 1,010,709.00 |
| Fixed assets \ net\ | 2D | 587,376,070.38 |
| Other assets | 2E | <u>198,471,017.93</u> |
| Total assets | | <u>3,749,555,184.77</u> |
| Liabilities | | |
| Short term loans from other banks | | 250,000,000.00 |
| Notes payable | | 250,000,000.00 |
| Long term liabilities | 2F | 499,085,967.97 |
| Other liabilities | 2G | <u>37,033,499.76</u> |
| Total liabilities | | <u>1,036,119,467.73</u> |
| Equity | | |
| Share capital | 2H | 2,704,000,000.00 |
| Reserve fund | | 9,435,717.04 |
| Retained earnings | | <u>-</u> |
| Total equity | | <u>2,713,435,717.04</u> |
| Total liabilities and equity | | <u>3,749,555,184.77</u> |
| | | - |

To: THE STOCKHOLDERS OF X.A.C Co., LTD

Subject: Auditor's report

We have audited the financial statements of X.A.C Co., LTD NBFI for the year ended December 31, 2001. Financial statements preparation and submission is the responsibility of the company management. Our responsibility is to express an opinion on the financial statements based on our auditing.

Our auditing was conducted according to the International Standards on Auditing and pre-planned auditing program in the framework of Auditing and Accounting Law of Mongolia, rules issued by Mongolbank, and other effective legislation. We performed the auditing procedures to obtain reasonable evidence that the financial statements are free from material misstatements, we also evaluated the accounting policies, principles, and internal control systems used to prepare the statements. In addition we considered management decisions, their implementation and examined significant estimates on a test basis. We hope that auditor's findings and checked amounts could become a reasonable basis to express an opinion on the above-mentioned financial statements and we are expressing our opinion as follows.

The financial statements of X.A.C Co., LTD Non-Bank Financial Institution present fairly, in all material respects, the financial position, operating results, changes in financial position, and cash flows of the company for the year ended December 31, 2001 in accordance with the accounting standards followed in Mongolia and rules issued by Mongolbank.

NIMM Audit Co., LTD

X.A.C CO., LTD
NON BANK FINANCIAL INSTITUTION
BALANCE SHEET
As December 31, 2000 and 2001
(In togrogs)

| | Note | Dec 31, 2000 | Dec 31, 2001 |
|-------------------------------------|------|-------------------------|-------------------------|
| Assets | | | |
| Cash and cash equivalents | 4 | 339,227,861.80 | 362,332,885.45 |
| Loans \net\ | 5 | 933,160,398.02 | 2,600,364,502.01 |
| Other owned assets \net\ | 6 | 786,619.14 | 1,010,709.00 |
| Fixed assets \ net\ | 7 | 124,414,364.56 | 587,376,070.38 |
| Other assets | 8 | 46,756,783.57 | 198,471,017.93 |
| Total assets | | 1,444,346,027.09 | 3,749,555,184.77 |
| Liabilities | | | |
| Short term loans from other banks | | - | 250,000,000.00 |
| Notes payable | | - | 250,000,000.00 |
| Long term liabilities | 9 | 1,129,219,396.58 | 499,085,967.97 |
| Other liabilities | 10 | 48,224,706.46 | 37,033,499.76 |
| Total liabilities | | 1,177,444,103.04 | 1,036,119,467.73 |
| Equity | | | |
| Share capital | 11 | 180,000,000.00 | 2,704,000,000.00 |
| Reserve fund | | - | 9,435,717.04 |
| Retained earnings | | 86,901,924.05 | - |
| Total equity | | 266,901,924.05 | 2,713,435,717.04 |
| Total liabilities and equity | | 1,444,346,027.09 | 3,749,555,184.77 |

X.A.C CO., LTD
NON BANK FINANCIAL INSTITUTION
STATEMENT OF PROFIT AND LOSS
For the years ended December 31, 2000 and 2001
(In togrogs)

| | Note | Dec 31, 2000 | Dec 31, 2001 |
|--|------|-----------------------|-----------------------|
| Interest income | | 348,424,152.16 | 896,237,967.75 |
| Interest expense | | (7,298,533.00) | (125,159,007.55) |
| Net interest income | 12 | 341,125,619.16 | 771,078,960.20 |
| Gain \loss\ on foreign currency trading and exchange rate difference | 13 | 2,314,626.38 | 139,014.69 |
| Other operating income | 14 | 13,551,824.72 | 32,083,438.07 |
| Total other income | | 15,866,451.10 | 32,222,452.76 |
| Operating income | | 356,992,070.26 | 803,301,412.96 |
| Operating expense | 15 | (303,038,425.36) | (602,377,162.80) |
| Income before provisions for contingent loss | | 53,953,644.90 | 200,924,250.16 |
| Provisions for contingent loss | | (7,263,088.99) | (21,423,506.28) |
| Income before income tax | | 46,690,555.91 | 179,500,743.88 |
| Income tax expense | 16 | (13,311,800.00) | (62,866,365.79) |
| Net income | | 33,378,755.91 | 116,634,378.09 |

X.A.C CO., LTD
NON BANK FINANCIAL INSTITUTION
STATEMENT OF CHANGES IN EQUITY
For the year ended December 31, 2001
(In togrogs)

| | Share capital | Secondary payable | Reserve fund | Retained earnings | Total equity |
|--|-------------------------|-------------------|---------------------|----------------------|-------------------------|
| Balances as December 31, 2000 | 180,000,000.00 | - | - | 86,901,338.95 | 266,901,338.95 |
| Issued shares | 1,656,000,000.00 | - | - | - | 1,656,000,000.00 |
| Transferred from the UNDP Funding | 120,000,000.00 | 560,000,000.00 | 100,000,000.00 | | 780,000,000.00 |
| Transferred from the secondary payable | 560,000,000.00 | (560,000,000.00) | | - | - |
| Allocation of previous period retained earnings: | | | | | |
| Stock dividends | 48,000,000.00 | - | | (48,000,000.00) | - |
| Allocated to Reserve fund | - | - | 38,901,338.95 | (38,901,338.95) | - |
| Decrease in reserve fund | | | (106,100,000.00) | | (106,100,000.00) |
| Net income for the current period | | | | 116,634,378.09 | 116,634,378.09 |
| Stock dividends allocated from the net income for the current period | 140,000,000.00 | | | (140,000,000.00) | - |
| Allocation of reserve fund | - | - | (23,365,621.91) | 23,365,621.91 | - |
| Balances as December 31, 2001 | 2,704,000,000.00 | - | 9,435,717.04 | - | 2,713,435,717.04 |

X.A.C CO., LTD
NON BANK FINANCIAL INSTITUTION
STATEMENT OF CASH FLOWS
For the year ended December 31, 2001
(In togrogs)

| | Subtotal | Total |
|---|-----------------|------------------------|
| Income before income tax | | 179,500,744 |
| Adjustment: | | |
| Fixed asset depreciation | 56,016,592 | |
| Provisions for contingent loss | 18,625,041 | |
| Interest income | (896,237,968) | |
| Interest expenses | 125,159,008 | (696,437,327) |
| Operating income before working capital changes | | (516,936,584) |
| Increase \decrease\ in operating assets | | |
| Loans | (1,685,767,484) | |
| Other owned assets | (449,449) | |
| Other assets | (152,245,292) | (1,838,462,226) |
| Increase \decrease\ in operating liabilities | | |
| Notes payable | 250,000,000 | |
| Other liabilities | (8,463,770) | 241,536,230 |
| Cash flows used in operating activities | | (2,113,862,579) |
| Interest received | 862,817,841 | |
| Interest paid | (118,924,845) | |
| Payment of income tax | (70,416,552) | |
| Loans written down to reserve for contingent loss | | 671,047,078 |
| Net cash flows used in operating activities | | (1,442,815,501) |
| Cash flows from investing activities | | |
| Purchase of fixed assets | (514,520,603) | |
| Net cash flows used in investing activities | | (514,520,603) |
| Cash flows from financing activities | | |
| Increase in share capital | 2,524,000,000 | |
| Increase in reserve fund /net/ | 9,435,717 | |
| Increase in short term loans from other banks | 250,000,000 | |
| Decrease in long terms liabilities | (661,204,637) | |
| Dividends distributed | (188,000,000) | |
| Net cash flows provided by financing activities | | 1,934,231,080 |
| Net cash flows | | (23,105,023) |
| Cash and cash equivalents, beginning of the year | | 339,227,862 |
| Cash and cash equivalents, ending of the year | | 362,332,885 |

To: THE STOCKHOLDERS OF GOVIIN EKHLEL Co., LTD

Subject: Auditor's report

We have audited the financial statements of Goviin Ekhlel Co., LTD NBFI for the year ended December 31, 2001. Financial statements preparation and submission is the responsibility of the company management. Our responsibility is to express an opinion on the financial statements based on our auditing.

Our auditing was conducted according to the International Standards on Auditing and pre-planned auditing program in the framework of Auditing and Accounting Laws of Mongolia, rules issued by Mongolbank, and other effective legislation. We performed the auditing procedures to obtain reasonable evidence that the financial statements are free from material misstatements, we also evaluated the accounting policies, principles, and internal control systems used to prepare the statements. In addition to we considered management decisions, their implementation and examined significant estimates on a test basis. We hope that auditors' findings and checked amounts could become a reasonable basis to express an opinion on the above-mentioned financial statements and we are expressing our opinion as follows.

The financial statements of Goviin Ekhlel Co., LTD Non-Bank Financial Institution present fairly, in all material respects, financial position, operating results, changes in financial position, and cash flows of the company for the year ended December 31, 2001 in accordance with the accounting standards followed in Mongolia and rules issued by Mongolbank.

NIMM Audit Co., LTD

GOVIIN EKHLEL Co., LTD
NON-BANK FINANCIAL INSTITUTION
BALANCE SHEET
As December 31, 2000 and 2001
(In togrogs)

| | Note | Dec,31,2000 | Dec,31,2001 |
|-------------------------------------|------|-----------------------|-------------------------|
| Assets | | | |
| Cash and cash equivalents | 4 | 496,346,927.36 | 8,834,367.84 |
| Loans \net\ | 5 | 174,817,249.92 | - |
| Fixed assets \ net\ | 6 | 102,398,766.43 | - |
| Long terms investment | 7 | - | 2,799,568,300.00 |
| Other assets | 8 | 13,593,070.49 | 8,100,631.00 |
| Total assets | | 787,156,014.20 | 2,816,503,298.84 |
| Liabilities | | | |
| Long term liabilities | 9 | - | 376,868,300.00 |
| Other liabilities | 10 | 4,691,916.36 | 16,878,805.00 |
| Total liabilities | | 4,691,916.36 | 393,747,105.00 |
| Equity | | | |
| Share capital | 11 | 882,986,611.51 | 2,279,754,000.00 |
| Reserve fund | | - | 100,000,097.84 |
| Retained earnings | | (100,522,513.67) | 43,002,096.00 |
| Total equity | | 782,464,097.84 | 2,422,756,193.84 |
| Total liabilities and equity | | 787,156,014.20 | 2,816,503,298.84 |
| | | | - |

GOVIIN EKHLEL Co., LTD
NON-BANK FINANCIAL INSTITUTION
STATEMENTS OF PROFIT AND LOSS
For the years ended December 31, 2000 and 2001
(In togrogs)

| | Note | Dec 31, 2000 | Dec 31, 2001 |
|--|------|-------------------------|-----------------------|
| Interest income | | 60,458,613.43 | 235,324,419.02 |
| Interest expenses | | - | - |
| Net interest income | 12 | 60,458,613.43 | 235,324,419.02 |
| Gain \loss\ on foreign currency trading and exchange rate difference | 13 | 123,867.15 | (984,569.94) |
| Other operating income | | 612,402.23 | 3,919,650.25 |
| Total other income | | 736,269.38 | 2,935,080.31 |
| Operating income | | 61,194,882.81 | 238,259,499.33 |
| Operating expenses | 14 | (159,951,566.40) | (178,814,903.33) |
| Income before provisions for contingent loss | | (98,756,683.59) | 59,444,596.00 |
| Provision for loan loss | | (1,765,830.08) | (4,058,300.00) |
| Income before income tax | | (100,522,513.67) | 55,386,296.00 |
| Income tax expense | 15 | - | (12,384,200.00) |
| Net income | | (100,522,513.67) | 43,002,096.00 |

-

GOVIN EKHLEL Co.,LTD
NON BANK FINANCIAL INSTITUTION
STATEMENT OF CHANGES IN EQUITY
For the years ended December 31, 2000 and 2001
(In togrogs)

| | Share capital | Reserve fund | Retained earnings | Total equity |
|--------------------------------------|-------------------------|-----------------------|-------------------------|-------------------------|
| As beginning balance sheet | 700,000,000.00 | - | - | 700,000,000.00 |
| Increase in share capital | 182,986,611.51 | | | 182,986,611.51 |
| Decrease in share capital | | | - | - |
| Net income (or loss) for the period | - | | (100,522,513.67) | (100,522,513.67) |
| Balances as December 31, 2000 | 882,986,611.51 | | (100,522,513.67) | 782,464,097.84 |
| Increase in share capital | 1,497,289,902.16 | | | 1,497,289,902.16 |
| Increase in reserve fund | | 100,000,097.84 | - | 100,000,097.84 |
| Allocation of retained loss | (100,522,513.67) | | 100,522,513.67 | - |
| Net income for the current period | - | | 43,002,096.00 | 43,002,096.00 |
| Balances as December 31, 2001 | 2,279,754,000.00 | 100,000,097.84 | 43,002,096.00 | 2,422,756,193.84 |

GOVIN EKHLEL Co.,LTD
NON BANK FINANCIAL INSTITUTION
STATEMENT OF CASH FLOWS
For the year ended December 31, 2001
(In togrogs)

| | Subtotal | Total |
|---|-----------------|------------------------|
| Income before income tax | | 55,386,296 |
| Adjustment: | | |
| Fixed asset depreciation | 12,700,016 | |
| Provision for loan loss | 4,058,300 | |
| Interest income | (235,324,419) | |
| Interest expense | - | (218,566,103) |
| Operating profit before working capital changes | | (163,179,807) |
| Increase \decrease\ in operating assets | | |
| Loans | 176,583,080 | |
| Other assets | 3,334,356 | 179,917,436 |
| Increase \decrease\ in operating liabilities | | |
| Other liabilities | 4,485,589 | 4,485,589 |
| Cash flows from operating activities | | 21,223,218 |
| Interest received | 241,205,986 | |
| Payment of income tax | (4,682,900) | 236,523,086 |
| Net cash flows provided by operating activities | | 257,746,305 |
| Cash flows from investing activities | | |
| Purchase of fixed assets | (108,416,410) | |
| Price of disposed fixed assets | 289,090,060 | |
| Purchase of long term investment | (2,799,568,300) | |
| Net cash flows used in investing activities | | (2,618,894,650) |
| Cash flows from financing activities | | |
| Increase in share capital | 1,396,767,388 | |
| Increase in reserve fund | 100,000,098 | |
| Increase in long terms liabilities | 376,868,300 | |
| Net cash flows provided by financing activities | | 1,873,635,786 |
| Net cash flows | | (487,512,559) |
| Cash and cash equivalents, beginning of the year | | 496,346,927 |
| Cash and cash equivalents, ending of the year | | 8,834,368 |