CAPITRON BANK

Audited Financial Statements
31 December 2002

AUDITORS' REPORT

To Capitron Bank

We have audited the financial statements of Capitron Bank on pages 3 to 34.

Respective responsibilities of directors and auditors

The Bank's Board of Directors is responsible for the preparation of the financial statements. It is our responsibility to form an independent opinion, based on our audit, on the financial statements and to report our opinion to you.

Specifically, the financial statements of Capitron Bank have been prepared to comply with International Accounting Standards. The Board of Directors is responsible for ensuring that these financial statements, on the basis set out in the financial statements, present fairly the financial position of the Bank as at 31 December 2002 and of the results for the year then ended.

The Board of Directors is responsible for ensuring that proper accounting records are kept, which disclose at any time the financial position of the Bank and enable the Board to ensure that the financial statements comply with the requirements set out in note 2 and note 3 thereto. The Board of Directors is also responsible for safeguarding the assets of the Bank, and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Board of Directors confirm that suitable accounting policies, consistently applied and supported by reasonable and prudent judgement and estimates, have been used in the preparation of the financial statements of the Bank. Applicable accounting standards have been followed in preparing the financial statements of the Bank insofar as they are appropriate to the basis of accounting set out in the notes to the financial statements.

Basis of opinion

We conducted our audit in accordance with International Standards on Auditing in the framework of Accounting and Auditing Laws of Mongolia and rules issued by the Bank of Mongolia (the Central Bank). An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Bank's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud, other irregularities or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements, the basis of which is described in note 2 and note 3.

Opinion

In our opinion, the financial statements on pages 3 to 34 present fairly, in all material respects, the financial position of Capitron Bank as at 31 December 2002 and the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards.

The comparative figures had been audited by another firm of auditors as we were appointed as auditors only for the current year's financial statements. Accordingly, we do not express any opinion on the comparative figures.

Ernst & Young Mongol Audit Co.

Ulaanbaatar
2 April 2003

CAPITRON BANK

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2002

	Note	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Interest and similar income	4	2,454,498	62,687
Interest expense and similar charges	5	(1,246,998)	(2,702)
Net interest income		1,207,500	59,985
Fees and commissions	6	79,016	741
Foreign exchange and translation gains, net of losses	7	12,993	455
Other operating income		3,400	53
Non interest income		95,409	1,249
Operating profit		1,302,909	61,234
Operating expense	8	(601,899)	(31,721)
Profit before provisions		701,010	29,513
Provisions	9	(163,110)	(24,853)
Profit before taxation		537,900	4,660
Taxation	10	(235,559)	(660)
Profit after taxation		302,341	4,000

The annexed notes form an integral part of these financial statements.

CAPITRON BANK

BALANCE SHEET AS AT 31 DECEMBER 2002

	Note	2002 MNT '000	2001 MNT '000
ASSETS			
Cash and short term funds	11	3,222,176	1,196,262
Deposits and placements with other financial institutions	12	5,625	-
Investment securities	13	2,848,695	-
Loans and advances	14	11,944,160	2,460,423
Other assets	15	44,999	8,301
Property, plant and equipment	16	420,756	113,289
TOTAL ASSETS		18,486,411	3,778,275
LIABILITIES AND CAPITAL FUNDS			
Deposits from customers	17	14,151,089	773,350
Deposits and placements of other financial institutions	18	500,000	-
Other liabilities	19	29,381	925
TOTAL LIABILITIES		14,680,470	774,275
CAPITAL FUNDS			
Statutory fund	20	3,500,000	3,000,000
Retained earnings		305,941	4,000
TOTAL CAPITAL FUNDS		3,805,941	3,004,000
TOTAL LIABILITIES AND CAPITAL FUNDS		18,486,411	3,778,275
OFF BALANCE SHEET ITEMS	21	82,886	-

The annexed notes form an integral part of these financial statements.

CAPITRON BANK

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 2002

	Note	Statutory fund MNT'000	Retained earnings MNT'000	Total MNT'000
At 16 November 2001		3,000,000	-	3,000,000
Profit for the year		-	4,000	4,000
At 31 December 2001		3,000,000	4,000	3,004,000
Profit for the year		-	302,341	302,341
Transfer to Social Development Fund		-	(400)	(400)
Issue of shares	**20**	500,000	-	500,000
At 31 December 2002		3,500,000	305,941	3,805,941

The annexed notes form an integral part of these financial statements.

CAPITRON BANK

CASH FLOW STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 2002

	Note	2002 MNT '000	2001 MNT '000
CASH FLOWS FROM OPERATING ACTIVITIES			
Profit before tax		537,900	4,660
Adjustments for :-			
Depreciation of property, plant and equipment		32,552	942
Provisions		163,110	24,853
Operating profit before working capital changes		733,562	30,455
Increase in operating assets:-			
Loans and advances		(9,646,847)	(2,485,276)
Other assets		(36,698)	(8,301)
Increase in operating liabilities			
Deposits from customers		13,377,739	773,350
Deposits and placements of other financial institutions		500,000	-
Other liabilities		28,456	925
Cash generated from operations		4,956,212	(1,688,847)
Income tax paid		(235,559)	(660)
Net cash flow from operating activities		4,720,653	(1,689,507)
CASH FLOW FROM INVESTING ACTIVITIES			
Net increase in investment securities		(2,848,695)	-
Proceeds on disposal of property, plant and equipment		512	-
Purchase of property, plant and equipment		(340,531)	(114,231)
Net cash flow from investing activities		(3,188,714)	(114,231)
CASH FLOWS FROM FINANCING ACTIVITIES			
Increase in paid-up share capital		500,000	-
Social Development Fund contribution		(400)	-
Net cash flow from financing activities		499,600	-
Net increase / (decrease) in cash and cash equivalents		2,031,539	(1,803,738)
Cash and cash equivalents brought forward		1,196,262	3,000,000
Cash and cash equivalents carried forward		3,227,801	1,196,262
Cash and cash equivalents comprise of:			
Cash and short term funds	11	3,222,176	1,196,262
Deposits and placement with other financial institutions	12	5,625	-
		3,227,801	1,196,262

The annexed notes form an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS - 31 DECEMBER 2002

1. CORPORATE INFORMATION

Capitron Bank ("the Bank") is a 100% privately owned commercial bank incorporated in Mongolia and the Bank's major shareholder and ultimate parent company is Petrovis Co. Ltd. The Bank was established on 14 November 2001 and commenced operations on 16 November 2001.

The principal activities of the Bank are that of the provision of banking and financial services, pursuant to License No.30 issued by the Bank of Mongolia ("BOM"). There have been no significant changes in the nature of these activities during the year.

The registered address and the principal place of business of the Bank is Capitron Bank Building, Peace Avenue, Ulaanbaatar-210648, Mongolia.

The financial statements of the Bank for the year ended 31 December 2002 were authorised for issue in accordance with a resolution of the Board of Directors on 2 April 2003.

2. BASIS OF PREPARATION

The Bank's financial statements have been prepared so as to present fairly the financial position of the Bank, and its profits or loss, cash flows and total recognized gains or losses, and in accordance with applicable International Accounting Standards ("IAS"). These financial statements have also complied with the Commercial Banks Financial Statement Reporting Rules and the Unified Accounting Principles issued by the Central Bank - the Bank of Mongolia.

The financial statements have been prepared on the historical cost basis of accounting. The reporting currency used in the financial statements is the Mongolian Togrog, which is denoted by the symbol MNT, shown rounded to the nearest thousand.

In 2002, the Bank adopted IAS 39 "Financial Instrument: Recognition and Measurement". Further information is disclosed in the accounting policies and related notes.

Capitron Bank constitutes a single business, all conducted in Mongolia. The Bank has no branches or operations abroad. Accordingly, no further analysis into business or geographical segments is appropriate in the financial statements.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Interest income and expense

Interest income and expense are recognised on an accruals basis.

The recognition of interest income is suspended when the probability of recoverability of either the principal or interest is ascertained as doubtful. In accordance with the requirements of Bank of Mongolia, interest is suspended when repayments are in arrears for 3 months. On commencement of suspension, previously accrued interest not received is clawed-back. Recognition of interest subsequent to suspension is on a cash basis. Interest recognition will resume on an accruals basis when the uncertainties surrounding the recoverability are removed.

(b) Fee income and commissions

Fee income and commissions are accounted for in the period when receivable, except where the fee is charged to cover the costs of a continuing service to, or risk borne for, the customer, or is interest in nature. In these cases, the fee is recognised on an appropriate basis over the relevant period.

(c) Foreign currencies

Monetary assets and liabilities denominated in foreign currencies are translated into Togrog at the rates of exchange ruling at the balance sheet date. Non-monetary assets and liabilities denominated in foreign currencies are stated at cost or revalued amount, being the Togrog equivalent of the foreign currency at the date of acquisition of the assets or incidence of the liability, or on the date the asset or liability was revalued. Income and expenditure are translated into Togrog at the exchange rates ruling at the date of transactions.

The resulting exchange gain or loss arising from monetary assets and liabilities, and foreign currency transactions are recognised in the income statement.

The official exchange rates used at the end of the year are:-

	2002	**2001**
US Dollar ("USD")	1,125.00	1,102.00
Euro ("Euro")	1,169.40	988.90

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

(d) Provision for loan loss

Provision for loan loss is made as considered necessary having regard to both specific and general factors. In determining the need for provisions, management considers, among other things, the financial position of the borrowers, the value of any collateral and guarantees received, industry performance, current economic conditions and past experiences. Provision made (less amounts released) during the year is charged against the income statement.

Based on the revised guidelines on provisions issued by the Bank of Mongolia in September 2002 pertaining to provision on loan losses, there has been a change in the provision estimate for the overdue classification. Based on the new guidelines, the required provision on overdue accounts are 5% (2001: 1%).

The provision for loan loss has complied with the requirements of Bank of Mongolia.

(e) Maturity of loans and advances

The maturity of the loan portfolio is presented in Note 14 which shows the remaining period of loans from the balance sheet date to the contractual maturity. Long-term credits are generally not available in Mongolia except for programs set up by international financial institutions and under government financing arrangements. However, in the Mongolia marketplace, short-term credits are granted with the expectation of renewing the loans at maturity. Accordingly, the effective maturity of a loan portfolio may be longer than indicated by a classification based on contractual terms.

(f) Taxation

The Bank provides for income tax based on its income for financial reporting purposes, adjusted for items which are not assessable or deductible for income tax purpose, in accordance with the regulations of the Mongolian Government.

(g) Cash and cash equivalents

Cash and cash equivalents consist of cash and short term funds, deposits and placements with other financial institutions that are readily convertible to cash with insignificant risk of changes in value.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

(h) Investment securities

All investments in securities are initially recognised at cost, being the fair value of the consideration given and acquisition charges associated with the investment.

After initial recognition, investments which are classified as available-for-sale are measured at fair value. Gain or loss on available-for-sale investments is recognised in the income statement.

Other long-term investments that are intended to be held-to-maturity, such as government bonds, are subsequently measured at amortised cost using the effective interest rate method. Amortised cost is calculated by taking into account any discount or premium on acquisition, over the period to maturity. For investments carried at amortised cost, gains or losses are recognised in income statement when the investments are derecognised or impaired, as well as through the amortisation process.

All regular way purchases of financial assets are recognised on the trade date i.e. the date that the Bank commits to purchase the assets. All regular way sales of financial assets are recognised on the settlement date i.e. the date the asset is delivered to the counterparty. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the time frame generally established by regulation or convention in the market place.

(i) Property, plant and equipment

Property, plant and equipment are stated at cost or at revalued amount less depreciation calculated on a straight line basis over the estimated useful lives of the asset and impairment in value, if any. The costs of property, plant and equipment comprise their purchase cost and any incidental costs of acquisition.

The estimated useful lives used by the Bank are as follows :-

Buildings	40 years
Office equipment and vehicles	10 years
Computers	5 years

Assets under construction are not depreciated. Depreciation of these assets begins when the related assets are placed in service.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

(j) Deposits of customers and other financial institutions

Deposits of customers and other financial institutions are initially recognised at cost. Subsequently, for time deposits with terms over one month, amounts due are stated at amortised cost and any differences between net proceeds and the redemption value is recognised in the income statement over the term of the deposits using the effective yield method.

(k) Collateral obtained from loan customers

Collateral obtained from loan customers in lieu of loans receivable are stated at the lower of the agreed value between the Bank and the customers, and the net realisable value. Net realisable value is based on estimated normal selling prices, less further costs expected to be incurred to disposal.

(l) Impairment of assets

The Bank reviews the carrying amounts of its assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, impairment is measured by comparing the carrying values of the assets with their recoverable amounts. Recoverable amount is the higher of net selling price and value in use, which is measured by reference to discounted future cash flows. Recoverable amounts are estimated for individual assets or, if it is not possible, for the cash-generating unit to which the asset belongs.

An impairment loss is charged to the income statement immediately, unless the asset is carried at revalued amount. Any impairment loss of a revalued asset is treated as a revaluation decrease to the extent of any available previously recognised revaluation surplus for the same asset.

(m) Statement of cash flows

The statement of cash flows classifies changes in cash and cash equivalents according to operating, investing and financing activities. The Bank does not consider any of the assets other than non-fiduciary cash and bank balances and short term deposits to meet the definition of cash and cash equivalents. The statement of cash flows is prepared using the indirect method.

(n) Use of estimates

The preparation of financial statements in conformity with IAS requires the Directors to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

4. INTEREST AND SIMILAR INCOME

	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Loans and advances	2,375,224	62,687
Deposits with the Bank of Mongolia	2,436	-
Treasury bills	76,838	-
	2,454,498	62,687

5. INTEREST EXPENSE AND SIMILAR CHARGES

	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Time and saving account deposits	1,246,998	2,702
	1,246,998	2,702

6. FEES AND COMMISSIONS

	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Service charges	2,089	488
Loan fees and commissions	70,950	218
Others	5,977	35
	79,016	741

Others include fees and commission earned from cash withdrawals and escrow accounts.

7. FOREIGN EXCHANGE AND TRANSLATION GAINS NET OF LOSSES

	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Net foreign currency transaction gains	18,410	391
Net foreign currency translation (losses) / gains	(5,417)	64
	12,993	455

8. OPERATING EXPENSE

	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Salaries and retirement benefits, and provision for staff welfare and bonus	120,760	7,727
Rental of premises	133,501	2,297
Membership and auditing expenses	98,262	-
Repair and maintenance	66,451	6,755
Advertising	48,830	2,229
Depreciation	32,552	942
Travelling	21,060	1,330
Communication	17,012	1,216
Stationery	16,924	2,348
Transportation expenses	15,264	1,285
Security and safety expenses	15,251	360
Entertainment	4,249	399
Cash collection service	4,209	-
Training expenses	2,313	15
Other operating expenses	5,261	4,818
	601,899	31,721

8. OPERATING EXPENSE (CONTD.)

The number of persons employed by the Bank at the end of the year was made up as follows:

	2002 Number	2001 Number
Directors and heads of departments	5	5
Officers	45	16
Clerks etc.	6	2
	56	23
Of which:		
- Head office	47	23
- Branches	9	-
	56	23

9. PROVISIONS

	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Provision for loan losses	163,110	24,853

10. TAXATION

	1.1.2002 - 31.12.2002 MNT '000	16.11.2001 - 31.12.2001 MNT '000
Current income tax	235,559	660
	235,559	660

The Bank provides for income taxes on the basis of its income for financial reporting purposes, adjusted for items which are not assessable or deductible for income tax purposes, in accordance with the regulations of the tax authorities. The tax rate is 15% for taxable profits up to MNT100 million and 40% for taxable profits in excess of MNT100 million.

11. TAXATION (CONTD.)

A reconciliation of income tax expense applicable to profit from operating activities before income tax at the statutory income tax rate to income tax expense at the Bank's effective income tax rate for the years ended 31 December is as follows:

	2002 MNT '000	2001 MNT '000
Income tax at statutory rates based on profit before taxation	201,410	699
Non deductible expenses	24,848	1,063
Over / (Under) provision in current year	8,199	(1,102)
Underprovision in prior year	1,102	-
Provision for income tax	235,559	660

11. CASH AND SHORT TERM FUNDS

	2002 MNT '000	2001 MNT '000
Balances with Bank of Mongolia	2,141,903	1,127,515
Cash and balances with other banks	1,080,273	68,747
	3,222,176	1,196,262

Balances maintained with Bank of Mongolia are in accordance with the Central Bank's requirements and bear no interest. The balances maintained with Bank of Mongolia are determined at set percentages based on 15 days average cash balances.

12. DEPOSITS AND PLACEMENTS WITH OTHER FINANCIAL INSTITUTIONS

	2002 MNT '000	2001 MNT '000
Licensed bank	5,625	-

This represents foreign currency current accounts maintained with foreign financial institutions. Current accounts with foreign financial institutions are generally denominated in US Dollars and bear interest at 3.6% per annum (2001 : 3.6% per annum).

13. INVESTMENT SECURITIES

	2002 MNT '000	2001 MNT '000
Bank of Mongolia bills	2,784,625	-
Corporate bonds	50,000	-
	2,834,625	-
Accretion of discounts	14,070	-
	2,848,695	-

Bank of Mongolia bills are non interest bearing short term bills with maturities of less than one year, and are issued at a discount to the fair value of the bills upon maturity. The effective annual interest rates of these bills range from 7.0% to 11.5% per annum (2001: Nil).

The corporate bond was issued by a non-banking financial institution with maturity of less than one year. The interest rate earned on this bond is 21.6% per annum (2001 : Nil).

14. LOANS AND ADVANCES

	2002 MNT '000	2001 MNT '000
Term loans	11,785,718	2,485,276
Staff loans	5,822	-
Loans to stakeholders and related parties	340,000	-
Gross loans and advances	12,131,540	2,485,276
Provisions		
- specific provision	(73,000)	-
- general provision	(114,380)	(24,853)
	(187,380)	(24,853)
Net loans and advances	11,944,160	2,460,423

14. LOANS AND ADVANCES (CONTD.)

	2002 MNT '000	2001 MNT '000
Maturity structure		
Maturing within 1 year	11,160,065	2,320,276
One year to five years	971,475	165,000
	12,131,540	2,485,276

Loans and advances analysed by their economic purposes are as follows:-

	2002 MNT '000	2001 MNT '000
Agriculture	67,100	-
Mining related	958,446	200,000
Processing related industries	2,373,566	581,800
Construction	2,017,011	-
Trading	4,224,087	1,429,908
Tourism	265,810	-
Services	1,615,759	273,568
Small and medium industries	609,761	-
	12,131,540	2,485,276

Movements in the non-performing loans ("NPL") are as follows:-

	2002 MNT '000	2001 MNT '000
Balance as at 1 January / 16 November	-	-
NPL during the year - gross	529,083	-
Recoveries	(18,500)	-
Amount written off	(583)	-
Gross balance as at 31 December	510,000	-
Less: Specific Provision	(73,000)	-
Net balance as at 31 December	437,000	-
Gross NPL ratio as a percentage of gross total loans	4.2%	-
Net NPL ratio as a percentage of net total loans	3.7%	-

14. LOANS AND ADVANCES (CONTD.)

Movements in the provision for bad and doubtful debts accounts are as follows:-

	2002 MNT '000	2001 MNT '000
Specific Provisions		
Balance as at 1 January / 16 November	-	-
Charge for the year less write backs	68,292	-
Transferred from general provisions	5,291	-
Written off	(583)	-
Balance as at 31 December	73,000	-
General Provisions		
Balance as at 1 January / 16 November	24,853	-
Charge for the year less write backs	94,818	24,853
Transferred to specific provisions	(5,291)	-
Balance as at 31 December	114,380	24,853

Included in loans and advances is accrued interest totalling MNT183.5 million.

The Bank's balance sheet credit exposures as at 31 December 2002 amounted to MNT12.1 billion (2001:MNT2.5 billion), of which MNT510 million (2001: Nil) are due on accounts which have been classified as non-performing loans ("NPL").

Specific and general provisions of MNT187.4 million (2001: MNT24.9 million) have been allocated against the NPLs, of which the specific provisions represent a coverage ratio of 14% (2001: Nil) of the total NPL amount.

The current practice of the Bank is to base the level of specific provisions on an evaluation of each customer's present situation and the level of general provision on an evaluation of the present situation of the Bank's entire performing loans and advances portfolio. As such, the provisions are based on conditions prevailing and information available at the date of these financial statements. The provisions do not incorporate an assessment of the potential for future deterioration in the asset quality of the Bank.

The provision for possible loan losses is considered adequate by the Credit Committee of the Bank, based upon their formal review and analysis of existing credits using their knowledge of prevailing economic conditions.

15. OTHER ASSETS

	2002 MNT '000	2001 MNT '000
Foreclosed properties	12,014	-
Prepaid expenses	2,779	-
Inventory	28,960	8,301
Other receivables	1,246	-
	44,999	8,301

16. PROPERTY, PLANT AND EQUIPMENT

	Buildings	Office Equipment and Vehicles	Computers	Construction in Progress	Total
	MNT' 000	MNT' 000	MNT' 000	MNT' 000	MNT' 000
Net Book Value					
At 1 January 2002	-	87,850	25,439	-	113,289
Additions	23,500	118,390	193,466	5,175	340,531
Disposals	-	(512)	-	-	(512)
Depreciation charge	(294)	(16,068)	(16,190)	-	(32,552)
At 31 December 2002	23,206	189,660	202,715	5,175	420,756
At 31 December 2002					
Cost	23,500	206,173	219,368	5,175	454,216
Accumulated depreciation	(294)	(16,513)	(16,653)	-	(33,460)
	23,206	189,660	202,715	5,175	420,756
At 31 December 2001					
Cost	-	88,329	25,902	-	114,231
Accumulated depreciation	-	(479)	(463)	-	(942)
	-	87,850	25,439	-	113,289

17. DEPOSITS OF CUSTOMERS

	2002 MNT '000	2001 MNT '000
Current accounts	1,094,021	337,587
Savings deposits	1,166,577	500
Time deposits	11,887,491	435,172
Other deposits	3,000	91
	14,151,089	773,350

Current account generally bears no interest, however for depositors maintaining a balance above a prescribed limit, interest is provided at annual rates of approximately 1% and 3% (2001 : 1% and 3%) for foreign currency and local currency current accounts respectively.

Foreign currency saving deposits bear interest at an annual rate of approximately 6.0% (2001 : 4.2%), while local currency saving deposits at approximately 6.6% (2001: 6.0%).

Interest rates for time deposits vary for different types of accounts. Foreign currency time deposits bear interest at an annual rate ranging from approximately 7.2% to 13.2% (2001: 4.8% to 13.2%), while for local currency time deposits, at a range of approximately 12.0% to 24.0% (2001: 18.0% to 24.0%).

18. DEPOSITS AND PLACEMENTS OF OTHER FINANCIAL INSTITUTIONS

	2002 MNT '000	2001 MNT '000
Deposit placed with a local bank	500,000	-
	500,000	-

The deposit placed with a local bank represents a local currency time deposit which bears an annual interest rate of 21.6%.

19. OTHER LIABILITIES

	2002 MNT '000	2001 MNT '000
Social Development Fund	3	-
Delay on clearing settlement	30	-
Other payable	29,348	925
	29,381	925

20. STATUTORY FUND

	2002 MNT '000	2001 MNT '000
As at 1 January / 16 November	3,000,000	3,000,000
Issued during the year	500,000	-
	3,500,000	3,000,000

During the financial year, the Bank increased its statutory fund by MNT500 million by issuing 500,000 ordinary shares of MNT1,000 each.

21. OFF BALANCE SHEET ITEMS

	2002 MNT '000	2001 MNT '000
Interest held in suspense	82,886	-
	82,886	-

22. CAPITAL ADEQUACY

The Bank of Mongolia requires commercial banks to maintain a minimum capital adequacy ratio of 10%, compiled on the basis of total equity and total assets as adjusted for their risk. As at 31 December 2002, the Bank has a core capital ratio of 30.4% (2001 : 115.6%) and risk weighted capital ratio of 31.4% (2001 : 115.6%), as computed below:

	2002 **MNT '000**
Tier I capital	
Statutory fund	3,500,000
Retained earnings	305,941
Total Tier I Capital	3,805,941
Tier II capital	
General reserve for bad and doubtful debts	114,380
	3,920,321

Breakdown of risk weighted assets in the various categories of risk weights are as follows:-

	2002 **MNT '000**
%	
0	-
10	-
20	111,559
50	-
100	12,390,756
	12,502,315

Core capital ratio	30.44%
Risk weighted capital ratio	31.36%
Core capital ratio - 2001	115.60%
Risk weighted capital ratio - 2001	115.60%

23. TRANSACTIONS WITH RELATED PARTIES

The transactions with related parties of the Bank in 2002 relate solely to loans to related companies and staff.

	MNT' 000
Total Loans to Related Companies	340,000
Total Loans to Staff	5,822
Gross Related Party Loans	345,822

24. RISK MANAGEMENT POLICIES

The Bank is currently structuring its risk management framework to improve its internal procedures and techniques to assess and evaluate capital needs in light of its risk profiles. In addition to complying with the established minimum regulatory requirements set by the Bank of Mongolia, the Bank strives to assess capital adequacy on the basis of risks assumed by individual lines of business activity and product. Thus, the Bank is in the stage of examining and scrutinising modern risk management tools and methodologies and to subsequently adopt them where most appropriate. These integrated rules of monitoring and measuring all types of risks inherent to the Bank are being drafted.

At the organisational level, overall risk management is assigned to Asset & Liability Management Committee ("ALMC") of the Bank, which reports to the Planning and Coordination Department ("PCD") with its functions of integrating and evaluating effects of all types of risk on the Bank's operations. In addition, the PCD should develop policies and procedures of managing risk, verify models that are used for pricing risks, and review existing models as development takes place in the financial market while identifying new exposures. Individual departments are responsible for identifying, monitoring and measuring specific types of risks. ALMC selects the appropriate risk and return profile for the Bank and approves and evaluates policies and strategies that determine the allocation of capital. It comprises the Chief Executive Officer, Chief Financial Officer, and other directors of the Bank's main departments such as Planning & Coordination, Loan and Finance & Accounting.

The ALMC's responsibility is shouldered by the Loan Committee ("LC"), which is responsible for reviewing and approving policies governing credit exposure for all types of loans and reviewing loan portfolio performances. Moreover, the Executive Board of Directors is responsible for reviewing and approving policies relating to the internal procedures and administrating all lines of activities of the Bank.

Thus, ALMC articulates risk management policies, procedures, prudential risk limits, and reviews mechanisms and reporting and auditing systems.

24. RISK MANAGEMENT POLICIES (CONTD.)

The Bank's financial intermediary activities generate credit, market and liquidity risks in particular:

(a) Credit risk, perhaps the most significant type of risk to the Bank, is the possibility of loss from a customer's failure to perform according to the terms of the loan contract.

(b) Market risk is the possibility that changes in future market rates or prices will make the Bank's positions below expected or planned results as indicated by the prudential ratios set by the Bank of Mongolia.

(c) Liquidity risk is the possibility of being unable to meet all present and future financial obligations in a timely manner.

Compensation for assuming these risks is reflected mostly in interest income combined with other fee income. In addition, these risks are factored into the allocation of capital to support various financial products and services offered by the Bank. Optimising its capital structure weighted at risk assists the Bank's management to gain a net margin over its cost of capital providing a desired rate of return.

Key capital management objectives are:

(i) Generate attractive returns to enhance shareholder value;
(ii) Maintain a capital base which commensurates with the overall risk profile;
(iii) Maintain strong capital ratios; and
(iv) Meet and exceed all regulatory guidelines.

In conjunction with the annual financial planning process, a financial plan is established to ensure that the Bank and all of its branches have capital structures and portfolios as well as key financials consistent with prudential ratios of BOM and regulatory requirements.

The Bank is a party to transactions involving financial instruments that create risks that may or may not be reflected on a traditional balance sheet. These financial instruments can be subdivided into three categories:

(a) Cash financial instruments, which are generally characterised as on-balance-sheet transactions, and include loans, bonds, stocks and deposits.

(b) Credit-related financial instruments, which include such instruments as commitments to extend credit.

(c) Derivative financial instruments, which include such instruments as interest rate, foreign exchange, commodity price contracts including forwards, swaps and options.

24. RISK MANAGEMENT POLICIES (CONTD.)

(a) Credit Risk Management

The Bank provides a wide range of financial services, including various credit products to customers, middle sized corporations and large corporate customers. The Bank has developed credit policies and procedures to manage the level and composition of risk in its credit portfolio. Credit policies and processes emphasise diversification of risk among industries and borrowers. The objective of these credit risk management processes and borrower's credit ratings is to quantify and manage the risk on a portfolio basis as well as models based on differentiating approaches according to a customer's net worth and risk.

Thus, the Bank takes on exposure to credit risk, which is the risk that a counterparty or borrower will be unable to pay amounts in full when due. Such risks are monitored by the Loan Department and subject to more frequent reviews. The Bank structures the levels of credit risk by placing limits on the amount of risk accepted in relation to each borrower or industrial segment. The Loan Committee approves limits on the level of credit risk by product, borrower and industry sector.

Credit risk is managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and principal payment obligations and by changing these lending limits where appropriate. Exposure to this risk is also managed in part, by obtaining collateral as well as corporate and personal guarantee. The Loan Department practices newly accepted internal credit ratings rules and procedures when managing loan operations to reduce credit risk exposure.

The following general rules are applied:

(a) Total amount of a loans issued to a single borrower shall not exceed 20% of the Bank's equity.

(b) The amount of a loan issued to a single borrower, who is a related person to the Bank, should not exceed 5% of the Bank's equity, and the total amount of these loans should not exceed 20% of the Bank's equity.

In addition, the following procedures, in both quantitative and qualitative approaches, are set to control credit risk: (i) evaluation of credit capability; (ii) loan control; and (iii) rate loan portfolio performance.

To ensure risk estimation for each customer in all aspects of business, the following procedures are put in place in the loan operations:

- Management
- Marketing
- Financial capability
- Company development
- Business risk

24. RISK MANAGEMENT POLICIES (CONTD.)

(a) Credit Risk Management (Contd.)

The credit risk concentrations of the Bank are set out in the following table.

	Cash and short term funds and deposits and placements with other financial institutions	Investment securities	Loans and advances	General provision	Other Asset	Total
	MNT' 000	MNT' 000	MNT' 000	MNT' 000	MNT' 000	MNT' 000
Agriculture	-	-	67,100	-	-	**67,100**
Mining related	-	-	958,446	-	-	**958,446**
Processing related industries	-	-	2,373,566	-	-	**2,373,566**
Construction	-	-	2,017,011	-	-	**2,017,011**
Trading	-	-	4,224,087	-	-	**4,224,087**
Tourism	-	-	265,810	-	-	**265,810**
Services	-	-	1,615,759	-	-	**1,615,759**
Small and medium industries	-	-	609,761	-	-	**609,761**
Finance, insurance and business services	1,080,273	50,000	-	-	-	**1,130,273**
Government and government agencies	2,141,903	2,798,695	-	-	-	**4,940,598**
Others	-	-	-	(187,380)	44,999	**(142,381)**
	3,222,176	**2,848,695**	**12,131,540**	**(187,380)**	**44,999**	**18,060,030**

24. RISK MANAGEMENT POLICIES (CONTD.)

(b) Market Risk Management

Market risk arises from changes in interest rates, exchange rates and prices. The Bank has created its structure to monitor and limit exposure to market risk and is assigning this responsibility to the Department of Planning and Coordination. Through its marketing activities, the Bank strives to take advantage of profit opportunities available in interest and exchange rate movements. As for asset and liability management activities, policies are designed to minimize structural interest rate and foreign exchange rate risk. The final decision on the Bank's deposit and loan interest rate changes is made based on a thorough market watch analysis that provides continuously strong diagnoses of both the retail deposit and loan interest rates.

(i) Interest Rate Risk

The Bank is studying different techniques for measurement of interest rate risk, ranging from the traditional Maturity Gap Analysis (to measure the interest rate sensitivity of earnings), Duration (to measure interest rate sensitivity of capital) and Simulation and Value at Risk (VAR).

The Bank is exposed to interest rate risk, principally as a result of lending and advances to customers and borrowers, at fixed interest rate, in amounts and for periods which differ from those of term deposits and other borrowed funds at fixed interest rates. In practice, interest rates are generally fixed on a short-term basis, normally at three months intervals.

Thus, the Bank is exposed to the effects of fluctuations in the prevailing levels of market interest rates on its financial position and cash flows. Interest margins may increase as a result of such changes, but also may reduce or create losses in the event that unexpected movements arise. Interest rates that are contractually fixed on both assets and liabilities are subject to renegotiation and reconsideration to reflect current market conditions.

The Bank's Asset and Liability Management Committee is responsible of such re-establishment of interest rates, as well as seting limits on the value of risk that may be accepted, which are monitored on a daily basis, whereas Planning and Coordination Department together with Marketing Unit is responsible of conducting monthly market sensitivity analysis.

24. RISK MANAGEMENT POLICIES (CONTD.)

(b) Market Risk Management (Contd.)

(i) Interest Rate Risk (contd.)

The Bank's average effective interest rates as of 31 December 2002 for monetary financial instruments are as follows:

	2002	
	MNT	**Foreign Currencies**
Interest earning assets		
Investment securities	21.60%	-
Bank of Mongolia bills	8.64%	-
Loan to customers	37.44%	26.16%
Interest bearing liabilities		
Deposits of customers	19.92%	13.32%
Deposits and placements of banks and other financial institutions	21.60%	-

(ii) Foreign Currency Risk

To evaluate foreign exchange rate risk the Bank considers, at first, the announced exchange rate by the Bank of Mongolia, rates at the international markets and forex trading centers. Holding positions are provided as follows:

- Individual foreign currency positions should not exceed +15% or -15% of equity.

- Total foreign currency position converted to the given date exchange rate into USD should not exceed 40% of equity.

24. RISK MANAGEMENT POLICIES (CONTD.)

(ii) Foreign Currency Risk (contd.)

The Bank's exposure to foreign currency exchange rate risk are as follows:

	31 DECEMBER 2002 (MNT' 000)		
	MNT	**Foreign Currencies**	**Total**
Assets			
Cash and short term funds	1,067,972	2,154,204	3,222,176
Deposits and placements with other financial institutions	-	5,625	5,625
Investment securities	2,848,695	-	2,848,695
Loans and advances	7,109,509	4,834,651	11,944,160
Other assets	44,999	-	44,999
Property, plant and equipment	420,756	-	420,756
	11,491,931	6,994,480	18,486,411
Liabilities			
Deposits from customers	6,668,614	7,482,475	14,151,089
Deposits and placements of other financial institutions	500,000	-	500,000
Other liabilities	3,835,322	-	3,835,322
	11,003,936	7,482,475	18,486,411
Net position	487,995	(487,995)	-

(c) Liquidity Risk Management

Liquidity risk management encompasses the Bank's ability to meet all present and future financial obligations in a timely manner. The Consolidated Statement of Cash Flows presents data on cash and cash equivalents provided by and used in operating, investing and financing activities. The Bank considers strong capital ratios, credit quality and core earnings as essential to retaining high credit ratings and consequently, cost effective access to market liquidity. The departments of both Finance and Accounting, and Planning and Coordination are responsible for liquidity risk management.

The Bank believes its management policies and guidelines will ensure adequate levels of liquidity to fund anticipated needs of on and off-balance sheet items. The objectives of liquidity management policies are to maintain:

(i) Strong capital ratios;
(ii) Adequate liquid assets;
(iii) Liability diversification among instruments, maturities and customers.

Liquid assets, besides BOM requirement of 14% reserves and assets quality prudential ratios, are maintained in the form of selected investment securities to meet any immediate cash flow obligations.

24. RISK MANAGEMENT POLICIES (CONTD.)

(c) Liquidity Risk Management (Contd.)

The Bank segments its balance sheet into liquid assets and other core assets for liquidity management purposes. Liabilities are grouped as core liabilities as customer savings. Core assets and liabilities consist primarily of customer driven lending and deposit-taking activities.

The contractual maturities of monetary assets and liabilities as at 31 December 2002 are as follows:

	Up to 1 month MNT' 000	1 to 3 months MNT' 000	3 months to 1 year MNT' 000	1 to 5 years MNT' 000	Over 5 years MNT' 000	Total MNT' 000
Assets						
Cash and short term funds	3,222,176	-	-	-	-	3,222,176
Deposits and placements with other financial institutions	5,625	-	-	-	-	5,625
Investment securities	2,798,695	-	50,000	-	-	2,848,695
Loans and advances	-	548,001	10,434,399	961,760	-	11,944,160
Other assets	32,985	12,014	-	-	-	44,999
Property, plant and equipment	-	5,175	-	202,715	212,866	420,756
	6,059,481	565,190	10,484,399	1,164,475	212,866	18,486,411
Liabilities						
Deposits from customers	596,854	5,088,302	7,822,542	643,391.00	-	14,151,089
Deposits and placements of other financial institutions	-	-	500,000	-	-	500,000
Other liabilities	-	29,381	-	-	-	29,381
	596,854	5,117,683	8,322,542	643,391	-	14,680,470
Net position	5,462,627	(4,552,493)	2,161,857	521,084	212,866	3,805,941
Accumulated gap	5,462,627	910,134	3,071,991	3,593,075	3,805,941	

25. FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES

The following table summarises the carrying values and fair values of financial assets and liabilities of the Bank.

	Carrying Amount **MNT' 000**	Fair value **MNT' 000**
Assets		
Cash and short term funds	3,222,176	3,222,176
Deposits and placements with other financial institutions	5,625	5,625
Investment securities	2,848,695	2,848,695
Loans and advances	11,944,160	11,944,160
Other assets	465,755	465,755
Total Assets	**18,486,411**	**18,486,411**
Liabilities		
Deposits from customers	14,151,089	14,151,089
Deposits and placements of other financial institutions	500,000	500,000
Other liabilities	3,835,322	3,835,322
Total Liabilities	**18,486,411**	**18,486,411**

As no readily available market exists for a large part of the Bank's financial instruments, judgment is necessary in arriving at fair value, based on current economic conditions and specific risks attributable to the instrument. The estimates presented herein are not necessarily indicative of the amounts the Bank could realise in a market exchange from the sale of its full holdings of a particular instrument.

As of 31 December 2002, the following methods and assumptions were used by the Bank to estimate the fair value of each class of financial instrument for which it is practicable to estimate such value:

Cash and short term funds

For these short term instruments, the carrying amount is a reasonable estimate of fair value.

Deposits and placements with other financial institution

For these short term instruments, the carrying amount is a reasonable estimate of fair value.

25. FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES (CONTD.)

Investment in securities

As set out in Note 3, securities held by the Bank for investment purposes as of 31 December 2002 are carried at cost, adjusted for accretion and amortisation of discounts and premiums, respectively, less any provision for permanent diminution in value.

Loans and advances

The fair value of the loan portfolio is based on the credit and interest rate characteristics of the individual loans. The estimation of the provision for loan losses includes consideration of risk premiums applicable to various types of loans based on factors such as the current situation of the borrower and collateral obtained. Accordingly, the provision for loan losses is considered a reasonable estimate of the discount required to reflect the impact of the credit risk. The carrying amount of loans is a reasonable estimate of fair value.

Other assets

For these short term instruments, the carrying amount is a reasonable estimate of fair value.

Deposits from customers

For these short term instruments, the carrying amount is a reasonable estimate of fair value.

Deposits and placements of other financial institution

For these short term instruments, the carrying amount is a reasonable estimate of fair value.

Other liabilities

For these short term instruments, the carrying amount is a reasonable estimate of fair value.

26. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform with current year's presentation, based on information available for 2002.

The comparative figures have been audited by a firm of public accountants other than Ernst & Young Mongolia Audit Company.

27. MONGOLIAN TRANSLATION

These financial statements are also prepared in the Mongolian language. In the event of discrepancies or contradictions between the English version and the Mongolian version, the English version will prevail.