

**Mission statement:** First, to contribute to the socio-economic development of the country by providing access to comprehensive financial services to all citizens and legal entities, including those who are normally excluded, e.g. low-income and remote rural households. Second, and equally important, to maximize the value of shareholders' investment, while creating a profitable and sustainable financial institution.



## **ERDENECHIMEG'S STORY**

Many manufacturers were hit hard by unfavorable economic conditions during the transition period of the 1990's - even to the point where they could no longer pay their employees on time. Ms. ERDENECHIMEG Maamhuu used to be an accountant in a large state-owned factory during socialist times. When Erdenechimeg found herself in these difficult economic conditions, she and her husband decided to seek opportunities elsewhere. One popular option was to look abroad for jobs. Erdenechimeg and her husband, Mr. ERDENEBILEG Chagnaadorj, became desperate when their opportunity to find employment in South Korea did not materialize. In retrospect, Erdenechimeg considers herself lucky. It pushed her to start her own business - a small ice-cream shop.



It was a difficult start for Erdenechimeg: she had no experience running a business and ice-cream production was different from her prior professional background and experience. Another problem she encountered was the lack of working capital, a problem faced by all small entrepreneurs. While she was struggling to find funding sources, she was told about Golden Fund for Development (X.A.C.)<sup>1</sup> LLC by a friend. She was a bit skeptical at the beginning. She had heard how hard it was to qualify for a loan for small businesses such as hers.

Nevertheless, she decided to try and applied for a loan at X.A.C. LLC. On her first visit she obtained a loan application form, and returned it in two days. Erdenechimeg was surprised three days later when she was notified by a phone call that she qualified for her first loan in the amount of MNT 150,000.

Erdenechimeg used the first loan to expand her ice-cream shop into a small enterprise - dairy. After the first loan cycle Zech LLC, the company that Erdenechimeg founded, had a capacity to process 30-50 liters of milk a day.

*"XacBank's client training courses are very constructive and staff is supportive. I have no intention of changing my bank because of the bureaucracy-free banking service that I receive from XacBank"* emphasizes Erdenechimeg.

After three years of rewarding relationship with the Bank, and seven cycles of "Start-up" and "Growth" (micro) loans, Erdenechimeg recently qualified for a "Development" (SME) loan. At the same time, Zech LLC has transformed itself into one of the larger dairy enterprises in Ulaanbaatar City. Now Zech has the capacity to process 500-800 liters of dairy products a day, employs seven full-time workers and has a working capital of over MNT 20.0 million. Zech LLC supplies a range of dairy products to most of the supermarkets in Ulaanbaatar City.

<sup>1</sup>Microfinance company, one of the predecessor operations of XacBank



27 December, 2001	XacBank receives its commercial <i>banking license</i>
January	The <i>Central Bank of Mongolia</i> examines merger and transformation related transactions and conducts its first comprehensive on-site examination of XacBank in October and November. Roll-out of the extension unit in <i>Harborin soum</i> <sup>2</sup>
February	Bank-wide introduction of deposit and money transfer services. The capital of the Bank is increased by MNT 300 million through infusion of funds by Mercy Corps, bringing the <i>paid-in capital</i> to the statutory minimum of MNT 3 billion
March	Inauguration of XacBank and opening ceremony of new <i>Headquarter's Building</i> was held
April	The first annual shareholders' meeting approves the Bank's <i>Charter</i> . USAID conducts its on-site evaluation of XacBank and awards USD 1.2 million to be channelled through Mercy Corps to support the development of the Bank
May-July	<i>Five new branches</i> are rolled-out in Dornod, Suhbaatar, Hovd, Uvs, and Bayan-Ulgiy aymags <sup>3</sup>
May	Mr. James Wolfenson, President of the World Bank Group, signs a <i>loan agreement</i> on behalf of IFC with the Bank. Final selection of the Bank's <i>MIS software</i> is made and its configuration started in July
May-August	Several <i>international credit facilities</i> are obtained from sources such as IFC, Deutsche Bank Microcredit Development Fund and BlueOrchard Finance SA
June	GFA Management GmbH from Hamburg, Germany is identified as a <i>technical assistance provider</i> under TA agreements with IFC/CGAP, and performs an extensive on-site work for the Bank covering a wide range of topics for a period of six months
September	A major <i>fraud case</i> is discovered in Hentiy aymag's branch of the Bank. Direct losses from the fraud amount to MNT 148 million
October	Management <i>restructuring</i> is executed to strengthen the organization and address its growth since inception. XacBank marks the 50,000 <sup>th</sup> loan disbursement with cumulative value of MNT 20 billion and a landmark threshold of <i>10,000 active borrowers</i> since 1998. The Bank launches its first comprehensive marketing campaign under the motto " <i>Right Bank. XacBank.</i> "
November-December	Promotional and customer recognition events are held in all aymags of the country allowing senior-management to meet large groups of clients during on-site visits to the Bank's branches

<sup>2</sup> Administrative unit, county

<sup>3</sup> Administrative unit, province of which there are 21 in Mongolia. The notion can be used to refer to the province and/or its capital



**TABLE OF  
CONTENTS**



Letter from the Chairman	5
Background	6
Executive Summary	7
Selected Indicators	8
External Environments	9
Financial Sector	10
Lending Activities	14
Financial Managment & Funds Mobilization	18
Investing for the Future	21
Other	24
2003 Outlook	25
Audited Financial Statements	29







## **BOARD of DIRECTORS**

### **CHAIRMAN**

**Mr. Stephen D. Vance<sup>4</sup>**

Executive Director  
Mongolian Foundation for Open Society  
(Soros Foundation)  
Mongolia

### **DIRECTORS**

**Mr. Ganhuyag Chuluun**

Executive Director  
XacBank  
Mongolia

**Dr. Ekkehard Esser**

Executive Director  
XAC-GE LLC  
Mongolia

**Ms. Erdenechimeg Jambaldorj**

President  
Mongolian Women's Federation  
Mongolia

**Mr. Bekhbat Sodnom**

Executive Director  
Amarjargal Foundation  
Mongolia

**Mr. Lhagvaa Sahiya**

Executive Director  
Mongolian Development Research  
Centre  
Mongolia

**Mr. Stephen Mitchell<sup>5</sup>**

Vice President  
Finance  
Mercy Corps  
USA

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<sup>4</sup> Resigned in April 2003.

<sup>5</sup> Joined in January 2003 and elected as Chairman in April 2003.

Dear Shareholders,

On behalf of the Board of Directors, it is my pleasure to report to you the first and most critical year's performance of XacBank. From the outset we knew that the challenges we faced were both complex in nature and enormous in size. These challenges included consolidating the merger of two of the country's largest non-bank lending institutions, transforming the merged company into a full-fledged commercial bank, recruiting new employees and building the human resources capacity base to meet the current and future needs of the Bank, and maintaining growth across all conceivable business dimensions.

We can now proudly state that the teamwork carried out by employees, management and the Board has produced impressive results beyond our own expectations and exceeding those of our competitors - the Bank is not only up and running, but it has advanced its competitive position significantly. By the end of 2002, it became the country's second largest lender in terms of the number of loans disbursed while concurrently maintaining outstanding repayment rates.

The attention of the Board this year focused on overseeing and guiding the Bank's management as it worked to consolidate the operations and systems of the two merger partners and their employees while transforming and laying the foundation for future growth. We have successfully overcome all barriers and difficulties encountered while advancing the institution in terms of both quantitative and qualitative objectives and in the direction that was established by its founding entities.

In highlighting the achievements of the Bank, I must also mention major drawbacks and failures, which the Bank encountered. These include the fraud case in Hentiy province in which the Bank lost a total MNT 148 million, the unexpected delays in the installation of the new MIS software, together with structural changes and management reorganizations. However, the Board was up to the task. It overcame these challenges and continued to guide and direct the management team to ensure compliance with its institutional mission and objectives, as well as maintain the transparency and accountability required by our clients, shareholders, and bank regulators. The results of those decisions and actions are in the report that follows.

Throughout most of the year, the Bank was managed by a team of co-CEOs, Dr. Ekkehard Esser and Mr. Ganhuyag Chuluun. In September, after the return of Ganhuyag Chuluun, from four months of intensive training abroad, the Board decided to abandon its co-CEO arrangement and named Ganhuyag Chuluun as sole Executive Director of the Bank. This action was in line with earlier plans calling for a gradual shift to a single leadership structure. Dr. Esser was assigned to the position of Executive Director of XAC-GE Group, the parent company of the Bank. Additionally, in late September, the Board initiated a reorganization of the Bank's early management structure, resulting in a more appropriate and efficient management organization.

The Board is confident and it can assure the shareholders of the Bank that they will see stable expansion of operations and steady growth of returns going forward based on the solid foundation established in 2002.



Stephen D. Vance,  
Chairman

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We have successfully overcome all barriers and difficulties encountered, ... advancing ... in the direction that was established by its founding entities.

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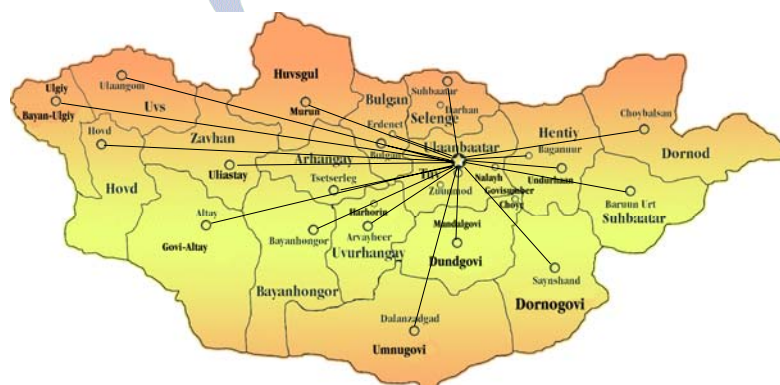
XacBank is a product of the merger of *Goviin Ekhlel, Co.,Ltd* (Gobi Start) and *XAC Co.,Ltd* (Golden Fund for Development), the two largest non-bank lending institutions in Mongolia in the last quarter of 2001. The licensing by the Central Bank of Mongolia and a simultaneous merger and transformation process of two non-bank financial institutions into one commercial bank marks an event without parallel in the financial sector of Mongolia and the microfinance industry worldwide. The merger allowed the Bank to explore synergies by joining together complementary services through an expanded, non-overlapping branch network of merger partners, and to meet the minimum capital requirement set by the Bank of Mongolia<sup>6</sup> to transform into a full-fledged commercial bank. Transformation into a Bank moved the organization closer to its vision of offering comprehensive financial services to target markets with particular emphasis on increased customers' savings.

X.A.C. was founded by six NGOs under the framework of UNDP's MicroStart project and became the first licensed non-bank financial institution (NBFI) in the country. Mercy Corps established *Goviin Ekhlel* as a non-bank financial institution in December 1999 with funding from USAID and received its license in March 2000. XacBank, the banking subsidiary of XAC-GE group, is incorporated as a limited liability commercial bank with a license to conduct banking activities. Headquartered in the country's capital Ulaanbaatar, XacBank currently operates branches in all of the provinces of Mongolia.

The objective of XacBank is to provide comprehensive banking services with a strong commitment to rural and remote areas of Mongolia. Furthermore, the Bank aims to contribute to the socio-economic development of Mongolia by providing sustainable financial services to all members of society, especially those excluded from access to formal financial services.

With 11,063 borrowers as of the end of 2002, it was the country's second largest bank ranked by the number of active borrowers. XacBank builds on the strengths of its two founding institutions, X.A.C. and *Goviin Ekhlel*, which were leaders in the micro- and SME lending sectors respectively.

XacBank is wholly owned by XAC-GE group, a bank holding company. The Group's shareholders include the Mongolian Foundation for Open Society (the local Soros Foundation chapter), Mongolian Women's Federation, Liberal Women's Intellectual Pool, National Association of Mongolian Agricultural Cooperatives, Rotary Club of Ulaanbaatar, Local Governance Development Foundation, and Mercy Corps. Mercy Corps holds 47 percent of the Group's shares and is the largest shareholder.



**BRANCH  
NETWORK**

<sup>6</sup>The Central Bank of Mongolia

## **Management Report**

### **Executive Summary**

The first year of operations as a commercial bank and the *transformation* process from two separate lending institutions into a single depository, was dramatic and included many successes as well as many challenges: new credit facilities from IFC, BlueOrchard Fund SA and Deutsche Bank Microcredit Development Fund were concluded following a liquidity crunch of the spring, the reaching of the ten thousandth active borrower threshold coupled with the Hentiy fraud, expanding into 5 new aymags<sup>7</sup> and experiencing setbacks in the configuration and installation of a new MIS software system.

Management realized from the onset the complexity of the task and challenges ahead and planned accordingly. The management dedicated all of our efforts and a vast majority of the Bank's resources in 2002 to building a solid launch pad for future growth, and to laying the foundation of a *sustainable* banking operation. This entailed investments in the Bank's people, systems and infrastructure. All of this was done on top of continued growth and market penetration through branch rollouts and new product offerings.

The Bank's deposit balances stand at MNT 7 billion at the end of 2002 with loan portfolio *growth* of more than 100 percent. This corresponds to a balance sheet growth of more than 3 fold during the year. Money remittance services grew to their present level of MNT 500 million a month.

The number of total *customers* of the Bank rose from 6,500 to 14 thousand during 2002. XacBank offers twelve loan products; five deposit products, along with payment and transfer services. The Bank opened seven new branch offices bringing the total to 27 by the end of the year.

During the third quarter the Board and management implemented several important decisions in the short history of the Bank, including a complete *overhaul* of the management structure that changed the entire organizational structure of the Bank from top to bottom. This initiative received broad acceptance by the Bank's senior and middle management team as the new structure has proven to be more functional and effective in terms of communication flows and decision-making processes.

The Bank went on marketing offensive and positioned itself in the market under the motto "*Right Bank. XacBank*" in October of 2002.

The enclosed financial statements audited by *Ernst and Young* reflect the strategy adopted by the management -geographical growth, added new products to its mix, doubling of borrowers and employees, and continuously streamlined systems. As a *learning organization*, we have built upon the lessons learned during the year and improved the skills and capacity of the team as bankers. As a result of this strategy, XacBank is ushered into 2003 as strong and competitive as ever, with the expertise and experience of a more mature financial services delivery institution.

With this report, management would like to illustrate both financial and operational results of XacBank in 2002 and the implications of decisions that set the Bank on its strategic course to achieve its mission to contribute to the *development* of Mongolia in the coming years.

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The number of total *customers* of the Bank rose from 6,500 to 14 thousand during 2002

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<sup>7</sup> Seven branches altogether including the branch adjacent to the Head Office and the one in Harhorin soum branch





### Selected Indicators

	31 December 2002	31 December 2001	Change in percent
<b>PORTFOLIO</b>			
Number of active borrowers	11,063	6,542	69.1 %
Loans outstanding (MNT million)	5,496.0	2,630.1	109.0 %
Average size of loans outstanding (MNT)	496,788.2	402,030.5	23.6 %
PAR >1 day <sup>8</sup>	0.86 %	0.29 %	196.6 %
Loan loss (write-offs)	0.08 %	0.3 %	-73.3 %
Risk-coverage ratio (reserve ratio)	1.27 %	1.13 %	12.4 %
<b>DEPOSITS</b>			
Savings deposits (MNT million)	3,491.6	-	n/a
Number of savers and time deposit owners	2,961	-	n/a
Current accounts (MNT million)	3,229.0	-	n/a
Deposit-to-loan ratio	122.3 %	-	n/a
<b>EFFICIENCY AND PROFITABILITY</b>			
Yield on portfolio	46.14 %	61.93 %	-25.5 %
ROA	-2.26 %	5.34 %	-142.3 %
ROE	-6.04 %	8.48 %	-171.2 %
Operating expense to Average Portfolio	38.83 %	52.95 %	-26.7 %
<b>PRUDENTIAL RATIOS</b>			
Capital adequacy	38.17 %	-	n/a
Liquidity	48.93 %	-	n/a
Related party lending to equity	5.15 %	-	n/a
<b>OTHER</b>			
Number of staff	325	168	93.5 %
Number of branches	27	20	35.0 %
Exchange rate (USD to MNT)	1,125	1,102	2.1 %

<sup>8</sup> PAR is calculated for all loan balances with late payment of more than one day

## External Environment

It is a country roughly the size of Western Europe populated by 2.5 million residents



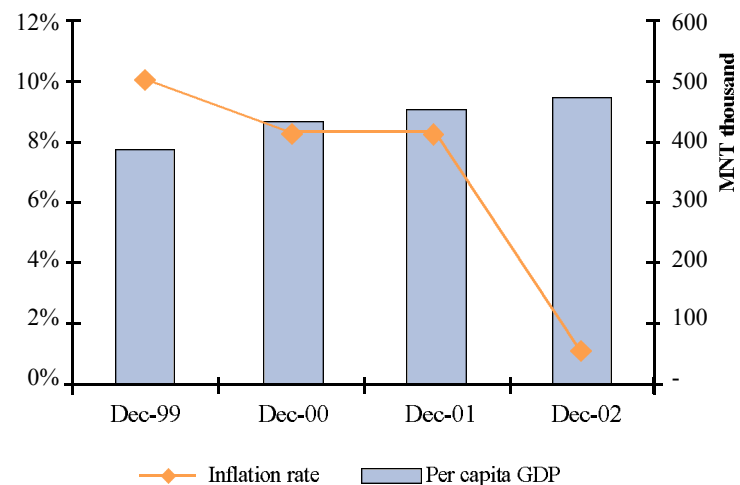
Mongolia is located in Central Asia bordering Russia to the north and China to the south. It is a country roughly the size of Western Europe populated by 2.5 million residents. The economy is heavily dependent on animal husbandry and the mining sector. Severe geographic and climatic conditions coupled with poor infrastructure and a sparse population make it one of the most challenging economic development cases in the World.

**Macroeconomy:** According to the Bank of Mongolia, 2002 was characterized by stable prices for goods and services and further deepening of financial intermediation - competition and innovation in the delivery of financial services and products accelerated, positively influencing the country's economic growth. Industrial output grew by 3.8 percent in 2002 to MNT 271.7 billion. The reason for this performance of the industrial sector was due to a 24.3 percent increase in the manufacturing and processing sector and 4.7<sup>9</sup> percent increase in utilities output despite a 7.4 percent decline in output of the minerals and mining sector. Overall economic growth in Mongolia for 2002 was estimated to be 2.6 percent.

Annual inflation<sup>10</sup> declined to 1.6 percent, down from 8.3 percent in 2001. This is the lowest level of inflation since Mongolia initiated political and economic reforms some twelve years ago. Low food price inflation was the primary reason for this decline, while the increase in residential fuel prices prevented deflation. The Tugrug's value against US Dollar and Chinese Yuan continued to drift downwards - 2.1 percent each, although the drift accelerated in the second half of the year. The Tugrug's appreciation against the Russian Rouble (2.2 percent) slowed, while the Tugrug's appreciation against Japanese Yen and Euro in 2001 reversed into depreciation (11.8 percent and 20.1 percent, respectively) in 2002.<sup>11</sup>

Money supply growth accelerated 35 percent in 2002 from 28 percent in 2001. The sources of the increase in M2 come mainly from increases in time and foreign deposits. Net foreign assets of the banking system increased 40 percent (most of it held by the Bank of Mongolia), while net domestic credit grew 55 percent. Nominal interest rates decreased slightly, but real interest rates increased compared with 2001.

As a result of a decline in exports (3.9 percent) and increase in imports (3.3 percent), the trade deficit expanded to reach USD 158 million or 14 percent of GDP (compared with 11 percent in 2001). Decline in minerals and cashmere were the major declining items on the export side, while imports of textiles, food and machinery accounted for most of the growth.<sup>12</sup>



<sup>9</sup> Using 1995 constant prices

<sup>10</sup> Annual average CPI change

<sup>11</sup> "Monetary and Fiscal Policy Results for 2002", The Central Bank of Mongolia

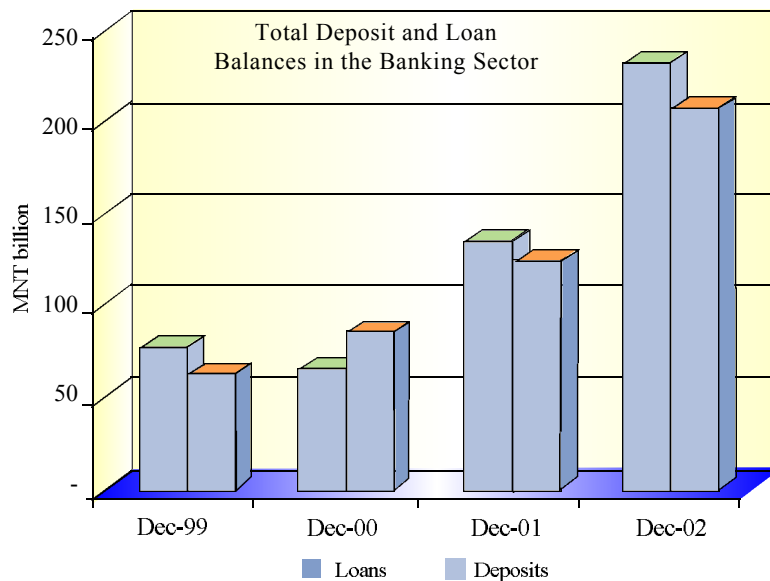
<sup>12</sup> "Monthly Economic Review", December 2002, Economic Policy Support Project/DAI



**Financial Sector:**

The banking sector's total assets grew by 48.2 percent in 2002 and reached MNT 493 billion or 40.1 percent of the country's GDP. As a result of the increasing public confidence in the banking system, banks' total deposits and loans increased to their highest levels in the history of Mongolia's financial sector. By the end of 2002 deposits from individuals and businesses reached MNT 282.4 billion, a 61.5 percent increase from the year before. Confidence in the stability of the Tugrug was illustrated by a 52.1 percent growth in Tugrug designated deposits.

The total loan portfolio of the banking sector reached MNT 231.4 billion - an increase of 69.7 percent in Tugrug and 74.1 percent in foreign currency denominated loans respectively, supported by the stable exchange rate during the year. Total non-performing loans from banks stand at MNT 16.6 billion, representing 7.2 percent of the total loan portfolio.



The ratio of money outside the banking sector to the total money supply (M2) dropped to 25.7 percent contrasting the 39.6 percent of 1999. The M2/GDP ratio, a principal indicator showing the size and scope of financial intermediation, reached 38.2 percent in 2002, compared to 24.8 percent in 2001.

Although the number of commercial banks remained at 16, competition intensified - new branches were opened and products such as telephone-banking, mobile-banking, internet-banking, ATMs, and electronic money transfer products were introduced.

The largest transaction in the domestic banking sector in 2002 was a USD 12.2 million privatization of 76 percent of the Trade and Development Bank with a Swiss-American consortium. Another privatization that was initiated in 2002 and finalized in January of 2003 was the USD 6.8 million sale of Agricultural Bank to the winning bidder - HS Securities from Japan.

Thirty-eight non-bank financial institutions were newly licensed and by the end of 2002 the total number of NBFIs reached 64. Compared with September 2001, consolidated outstanding loans of NBFIs increased sevenfold to MNT 31<sup>13</sup> billion. It is estimated that there are more than 500 Savings and Loan Cooperatives (including mixed coops with savings and loan component) in Mongolia.

Several additional international donor-funded projects in the financial sector are due to be launched in 2003. These include, Asian Development Bank's Rural Finance Project and Housing Project, International Fund for Agricultural Development's Rural Poverty Reduction Project and World Bank's National Household Livelihood Capacity Supporting Program.

As a result of the increasing public confidence in the banking sector, banks' total deposits and loans increased to their highest levels in the history of Mongolia's financial sector

<sup>13</sup> This figure does not include the loans given by Savings and Loan Cooperatives











**Social Context:** At the end of 2001 the population of the country was at 2.4 million, of which 40 percent lived in Ulaanbaatar, Darhan and Erdenet cities. According to the National Statistics Office, a total of 559.6 thousand households were registered in Mongolia at the end of year 2001 and the average household size was 4.4. Thirty one percent of total households are herder families are engaged in businesses related to animal husbandry during all four seasons of the year. A minimum living standard was set by the Government of Mongolia in 2002 at MNT 24,600 per household member in Ulaanbaatar and at MNT 19,550 in other areas.

The findings of the 1995 and 1998 Living Standard Measurement Surveys suggested that the overall poverty headcount in Mongolia remained more or less unchanged over this period at around 36 percent, having risen sharply from 1990, the year in which poverty data was officially recorded. Changes in the depth and severity of poverty were relatively more significant, suggesting a widening of income differentials between the poor and the poorest. The participatory Living Standard Assessment, conducted by the National Statistics Office in 2000 to complement and update earlier studies, showed that the gap between rich and poor was perceived to have widened even more markedly in recent years. While some groups were able to take advantage of new economic opportunities, including those with access to information and right government channels, the majority could not. The share of poor and very poor households was judged to have increased in this period at the expense of medium households, as more people fell into poverty than escaped from it.

Striking differentials in prices of consumer and producer goods and services are observed due to the vast distances and low-population densities across rural Mongolia. As a result geographic location became an important driver of economic opportunity. Seasonal and permanent migration became the choice of livelihood for those in a position to take advantage of opportunities in more central regions or larger urban centres. Inward migration into the cities is fast becoming one of the priority issues for the Government to resolve in the immediate future. Informal statistics show that at the end of 2001 one million people lived in Ulaanbaatar City.

The few rural communities that observed improvements in economic activity in the late 1990s were limited to those with trading points with China during cashmere trading season.<sup>14</sup> Unemployment and underemployment are rampant in the countryside and overall poverty is burgeoning in Mongolia despite efforts of the Government and donor community.

During the last three years over 6 million heads of livestock were lost because of the severe winter conditions named "dzud" (summer droughts followed by very cold winters with heavy snowfall). As a result of this between 2000 and 2002 the number of herder households fell to 175.9 thousand from 191.5 thousand.

	1999	2000	2001	2002
Heads of livestock (million)	33.6	30.2	26.1	23.9
Lost in natural disasters (million)		1.7	2.7	1.6
Herder households		191,526	185,546	175,911



While some groups were able to take advantage of new economic opportunities, including those with access to information and right government channels, the majority could not

All 16 commercial banks compete in the Ulaanbaatar market, eight banks reach Darhan and Erdenet cities respectively, while only four banks on average are open for service in other aymags. Three banks, namely Agricultural Bank, Mongol Post Bank and XacBank, have nationwide networks. Statistics show that 87.7 percent of all bank lending is concentrated in Ulaanbaatar, Darhan and Erdenet cities.

<sup>14</sup>Rural Development Strategy for Mongolia, Center for Policy Research, October, 2002



**Lending Activities**

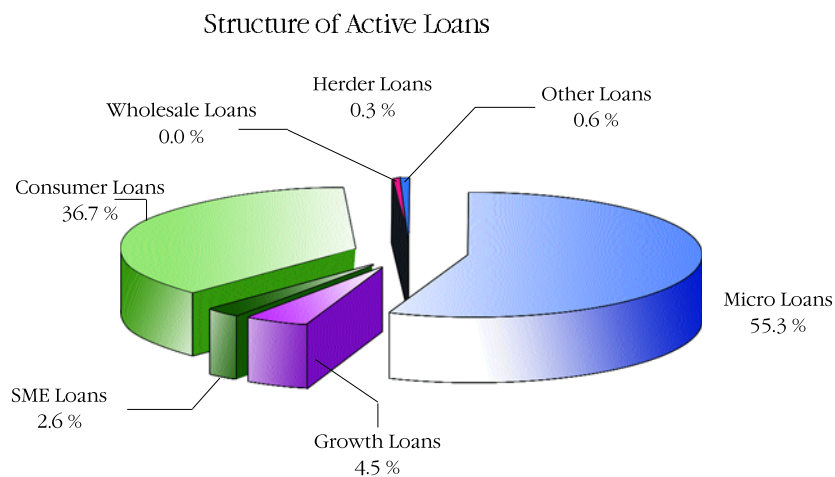
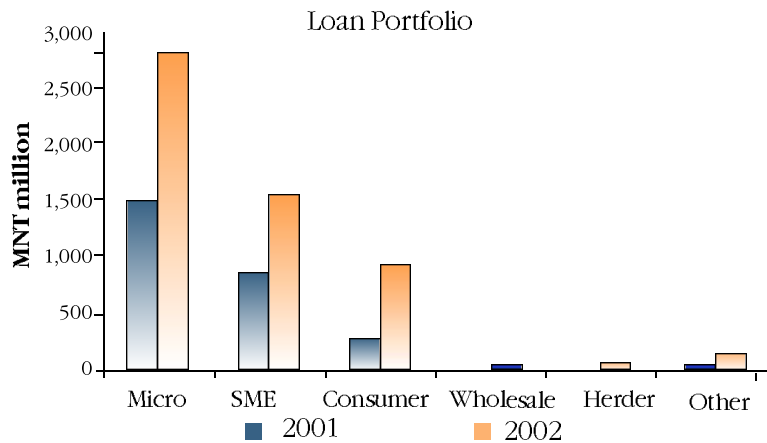
During 2002, the Bank pursued a policy of increasing its market share through both geographic expansion and diversification of its product line. Subsequent to the merger, priority was given to consolidating complementary loan products of the two predecessor institutions across the entire branch network. In particular, Micro- and Consumption loans were introduced in four branches of the former Goviin Ekhlel, while SME lending was gradually marketed in sixteen former X.A.C. branches. The seven branches that started operating in 2002 launched Micro-, Consumption, and SME loan products.

**Portfolio:** Last year the Bank disbursed 21,862 loans amounting to MNT 11,9 billion, almost double the disbursement from the previous year and representing a 41 percent increase in the number of loans. The portfolio grew to MNT 5.5 billion from MNT 2.6 billion. The number of active borrowers increased by 69.1 percent and reached 11,063. During the year the Bank disbursed its 50,000th loan with a cumulative value of MNT 20 billion in disbursements since the commencement of its predecessors' operations, and reached the landmark threshold of 10,000 active borrowers.

	2002	2001	Change in percent
Loan disbursement			
Number of loans disbursed	21,862	15,490	41.1 %
Value of loans disbursed (MNT million)	11,932.2	6,414.6	86.0 %
Average loan size (MNT)	545,796.0	414,116.1	31.8 %
Micro loans	488,174	355,631	37.3 %
SME loans	6,039,710	4,846,267	24.6 %
Consumption loans	304,742	220,686	38.1 %
Wholesale loans	4,240,000	-	-
Herder loans	1,900,607	1,310,000	45.1 %
Other loans	3,557,230	1,644,000	116.4 %
Loan portfolio (MNT million)	5,495.9	2,630.1	109.0 %
Micro loans	2,798.8	1,477.2	89.5 %
SME loans	1,550.5	867.0	78.8 %
Consumption loans	928.3	267.8	246.7 %
Wholesale loans	17.0	-	-
Herder loans	64.0	-	-
Other loans	137.3	18.1	656.8 %
Number of active loans	11,063	6,542	69.1 %
Rural borrowers (percent)	63.4 %	51.7 %	11.7 %



Despite the Bank restricting its portfolio growth during the second and third quarters due to liquidity pressures, we achieved our portfolio target nevertheless by year-end. On average the Bank disbursed over 1,800 loans per month with total value of one billion Tugrugs, a 100 percent increase from the previous year. Average growth of the loan portfolio was MNT 182.3 million per month. As a result of intensified marketing thrust combined with interest rate cuts and revisions in loan policies as well as sufficient refinancing sources, the portfolio growth was most dramatic toward the end of the year - increasing by almost one billion Tugrugs in the third quarter. In the month of December MNT 1.6 billion was disbursed to 2,490 borrowers.



Ms. *MANDAH Doljinsuren's* leather jackets are well known in Bayan-Ulgiy aymag where her products have been sold since 1991



Taking into consideration stable economic condition, market trends, and mounting competition, the interest rates for all loan products were reduced by 3.0 to 12.0 percent in 2002.

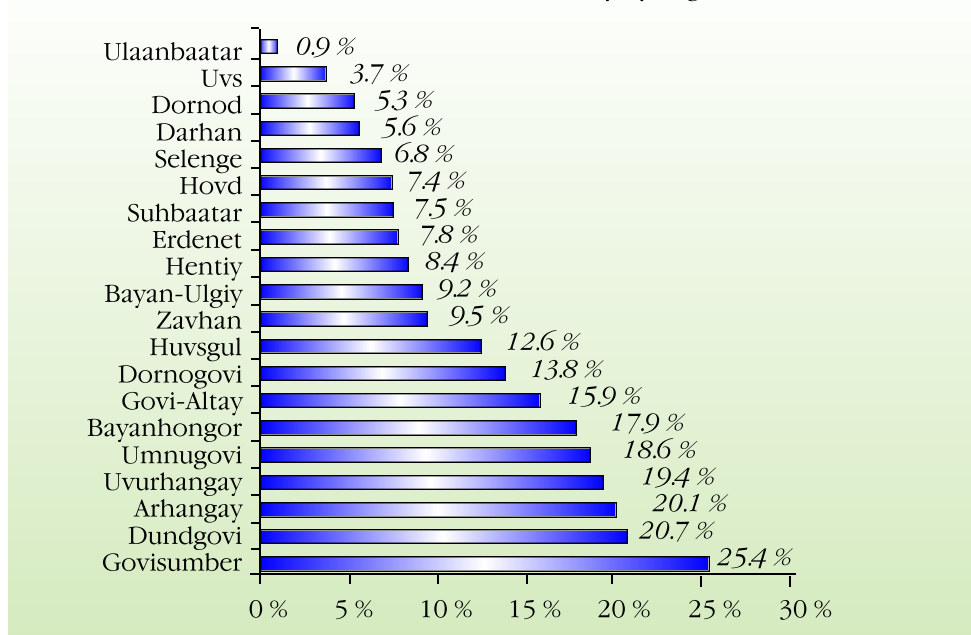
XacBank's market share rose from 1.9 percent to 2.4 percent. 63.4 percent of total borrowers and 57.3 percent of the loan portfolio is concentrated in rural areas.<sup>15</sup>

XacBank's share in markets outside of Ulaanbaatar is 11.1 percent on average.

<sup>15</sup>Defined as everything outside of Ulaanbaatar, Darhan and Erdenet cities



XacBank's Market Share Position by Aymags



Ms. *BATDELGER Damba* is a graduate of medical university, who successfully runs a bakery business with the name "Uj Mand", one of the favorite brands of Ulaanbaatar residents

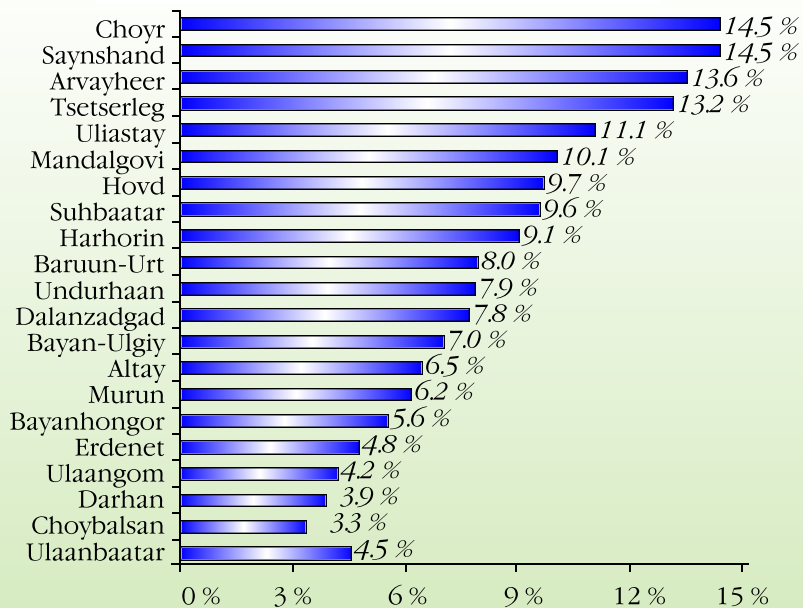


Borrowers with loans below MNT 1.0 million comprise 93.8 percent of the portfolio. Almost half of these borrowers had loans of less than MNT 300 thousand.

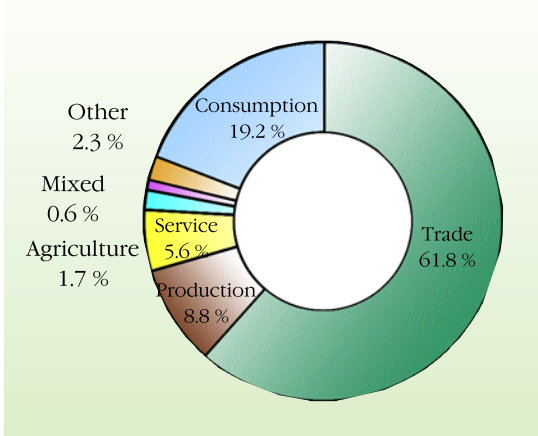


The average size of micro loans is MNT 488,174 consumption loans MNT 304,742 and SME loans MNT 6,039,710.

Number of Borrowers to Total Households

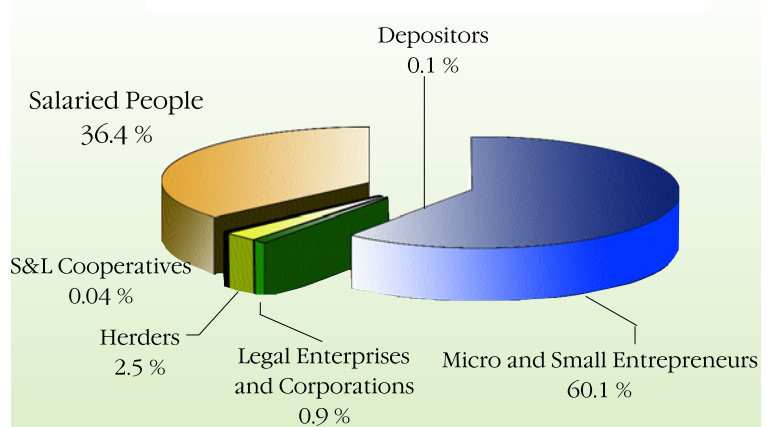


Loan Portfolio Concentration

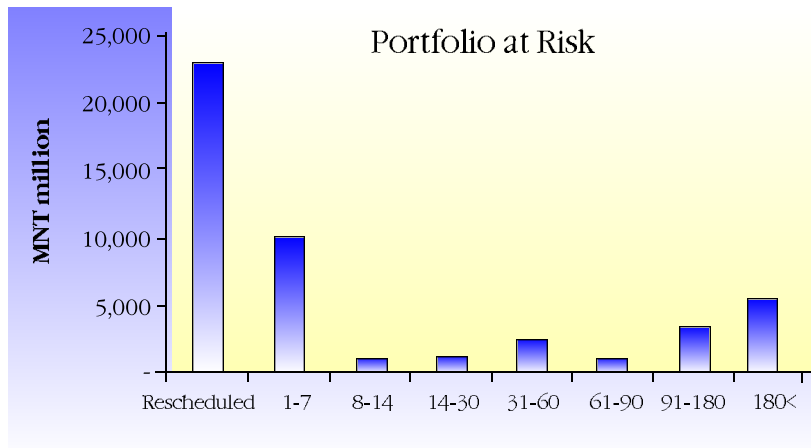


**Credit risk:** As of the end of 2002, the Bank's loan repayment rate was 99.6 percent, with a portfolio at risk with late payments of more than one day of 0.86 percent or MNT 47.4 million.

Loan Clientele

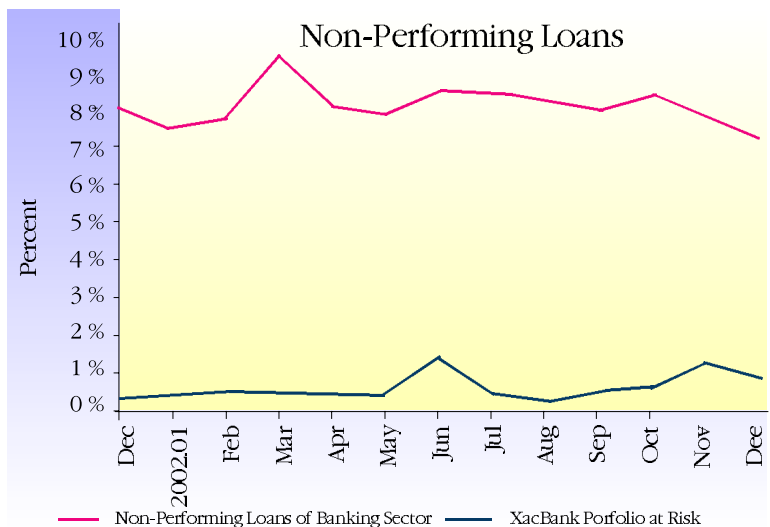


Portfolio at Risk



Sixteen loans with the total value of MNT 2,161,876 or 0.08 percent of the average outstanding portfolio were written-off from the loan loss reserve account. During 2002 XacBank recovered MNT 582,000 from write-offs in previous periods. The Bank has written-off a total of sixty loans of MNT 9.2 million since 1998 in cumulative terms and the average size of write-offs stands at MNT 171,353.

Non-Performing Loans





Financial Management and  
Funds Mobilization

Driven by an environment of constant change and intense competition, XacBank increasingly focused on ensuring the establishment and maintenance of robust and dynamic risk and financial management practices. Special effort was put towards meeting the Bank's funding needs, developing an optimal asset and liabilities structure, and establishing a base for successful risk management systems while controlling financial risks. In addition to the forgoing, the Bank had to adjust its systems to meet prudential and regulatory requirements from the Central Bank of Mongolia. Despite difficulties faced earlier in the year the Bank was able to successfully achieve its projected goals during the 4th quarter.

As of the end of the 2002, the Bank had a before tax loss of MNT 154.4 million as opposed to the projected loss of MNT 128.8 million. The loss figure includes a write-off of MNT 148 million due to a fraud case in Hentiy aymag. Without the Hentiy write-off, the before tax loss would have been approximately MNT 42 million. This loss was anticipated due to investments that were necessary to build a strong foundation of the nation-wide banking network.

**Commercial funds:** In the course of the first three quarters of the year, the Bank's policy was to fund its operations with credit facilities obtained from local and international financial institutions. This policy was pursued following a decision to enter into a passive mode regarding deposit mobilization.

The Bank established relationships and accessed several borrowing facilities, both locally and internationally. In addition the Bank obtained MNT 1 billion in uncommitted lines of credit from local banks in the fourth quarter of the year.

During the year, management completed funding negotiations with IFC, Deutsche Bank Microcredit Development Fund and BlueOrchard Fund SA (Dexia Microcredit Fund), providing in total approximately USD 1 million. A loan from Triodos-Doen Foundation matured at the end of the year and was repaid in full. It is worthwhile noting that the loan agreement with IFC was signed by James Wolfenson, the President of the World Bank, during his official visit in May 2002. This was the first IFC loan in Mongolia since 1996. Altogether the Bank accessed loans of MNT 4.2 billion in cumulative terms and repaid MNT 3.0 billion.

XacBank became one of the first institutions to be included in the pilot website launched by CGAP/Microbanking Bulletin - The MIX Market.<sup>16</sup> Management believes that participation in this initiative opens up broad possibilities to access a more diverse base of international investors in the microfinance industry.

Successful closing of the aforementioned credit facilities allowed the Bank to diversify its funding mix and optimize its liability structure.

**Deposit taking:** Although XacBank began deposit mobilization activities in the first quarter of the year, it was enhanced by an active marketing campaign in the fourth quarter together with substantial revisions to existing deposit products. The policy was to enter the market with high-quality services, which offered a wide array of innovative deposit products. With the increased inflow of public deposits the Bank was able to fully fund its portfolio growth, as well as service its commercial liabilities and maintain a strong credit profile.

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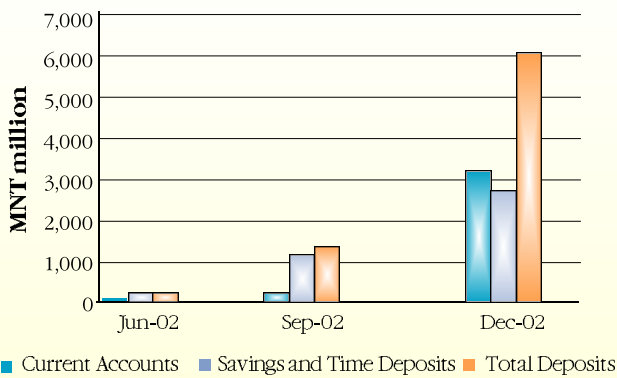
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<sup>16</sup> www.themix.org

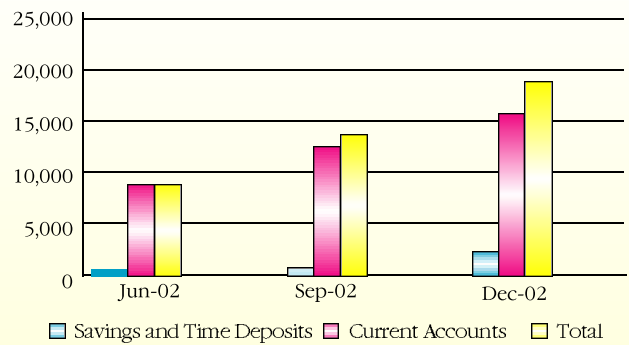


By the end of the year the Bank had attracted 2,961 individual savings and time deposits with a balance of MNT 2.9 billion excluding deposits from foreign and local financial institutions. At the same time, the balance of current accounts reached MNT 3.2 billion comprised of 16,264 individual accounts. Most of the deposit base is concentrated in the cities with dense populations such as Ulaanbaatar, Darhan, and Erdenet, which constitute 76 percent of the total deposit base.

Balance of Public Deposits

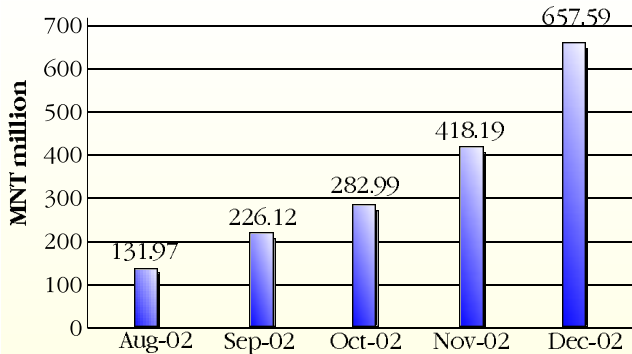


Number of Deposit Accounts

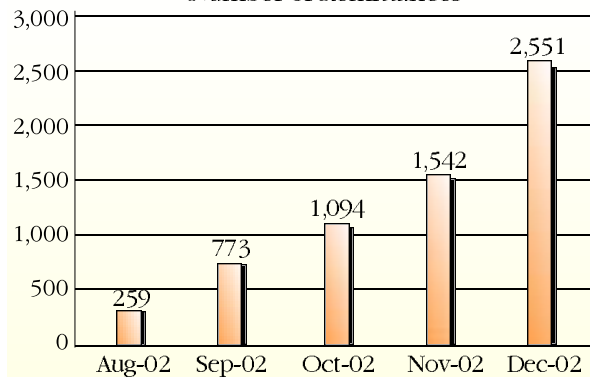


**Remittances:** One service that naturally comes as one of core products of XacBank is money remittance service. This is an opportunity presented by the Bank's branch network covering the entire country. The Bank has been progressively increasing the marketing of its money remittance services during the course of 2002. By the end of 2002 remittance volume amounted to MNT 1.7 billion comprised of 6,219 individual transactions.

Value of Remittances



Number of Remittances

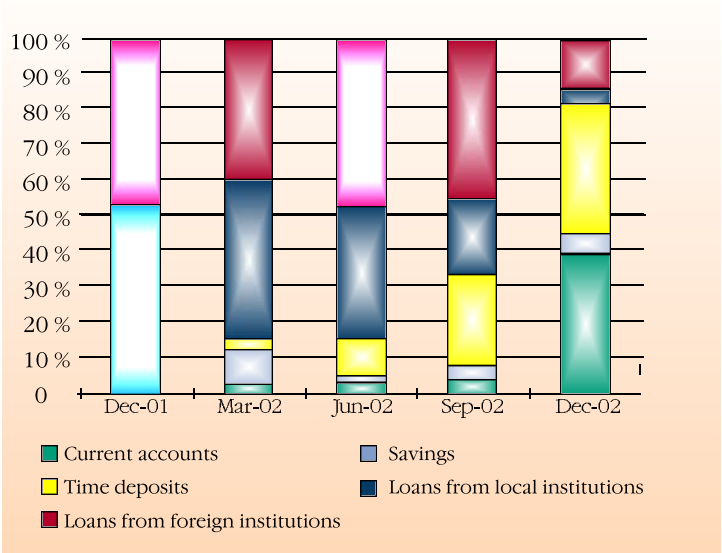


**Asset and liability management:** In February the Bank increased the total capital to MNT 3 billion due to a capital infusion from Mercy Corps, the largest shareholder of XAC-GE Group. The funds provided by Mercy Corps to increase the Bank's capital were placed in the holding company under the Employee Stock Ownership Fund. For the first time employees were able to own shares of the Bank - 4.14 percent or MNT 124.5 million worth of the Bank shares have been transferred to employee ownership in July.

Due to intensive interventions made in asset and liability management and treasury in the 2nd quarter, management was able to install a treasury function in the fourth quarter to manage excess funds in a more systematic and effective fashion. Since then, the Bank has periodically engaged in the Central Bank's bills trading in combination with short-term investments in the local inter-bank market.

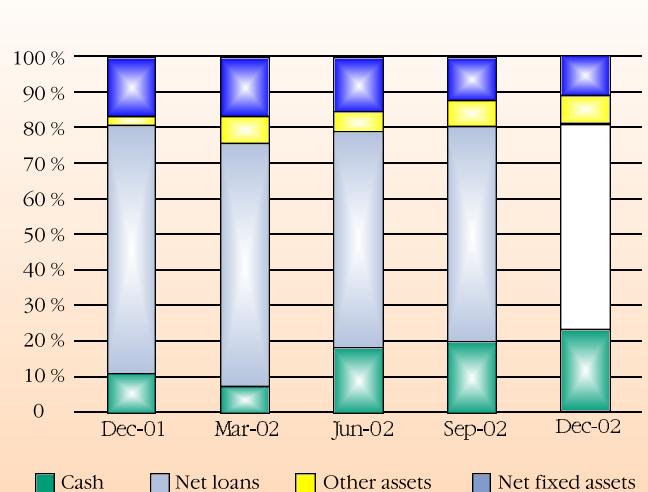
By the end of the year the Bank had a diversified and balanced liability structure providing the ability to match deposits with loan maturities more closely.

Structure of Liabilities



Ms. ARIUNAA Usnik runs "Made in Mongolia" shop which sells leather garments produced by the family owned leather workshop

Structure of Assets







## *Investing for the Future*

The gradual introduction of new services, including careful adjustments to the MIS, building the capacity of the Bank's staff, and investment in facilities and equipment continued throughout the year.

It is in the centerfold of the Bank's philosophy to offer premium quality services to its customers at competitive prices. The Bank believes that physical location and appearance of the premises, staff motivation and turnaround time of customer applications, coupled with secure and dependable service delivery contribute to building the confidence of the public and strong customer loyalty. Building a service organization with a strong commitment to meeting its customers' needs, while establishing long lasting relationships based on mutual trust and respect requires effort and investment in hardware, software and most importantly the employees of the Bank. Put simply, 2002 could be characterized as a year of investment into XacBank's future.

***Human Resources:*** Thanks to its 325 dedicated team members, XacBank achieved something never accomplished before in its short history as a commercial bank and lending institutions. The management successfully merged and combined the systems of two large NBFIs, while maintaining our planned growth and mission to position the Bank securely in the financial services market.

Fusion and transformation processes entail changes in the structure, composition and size of the team. The number of staff rose from 168 to 325 in just one year. This growth was multidimensional - expansion comes from transformation and restructuring, introduction of new positions such as tellers and customer service officers, opening of seven branches in new geographic locations, and enhancement of security, transportation and other support units. The process at times was not easy and smooth - the Bank experienced growth pains in this regard as well - staff turnover increased dramatically to 21 percent from 12 percent in 2001, but XacBank ended the year a more solid institution.

The Bank continued its policy of attracting and retaining the best candidates in the labour market, building skills and ensuring continuous professional development of the staff in line with the growth of the Bank. To ensure that diversity is an inherent part of the Bank, the corporate culture encourages openness towards human individuality while attracting talented employees from all backgrounds.

A new employee strategy, established in 2002, clearly underlines the importance of diversity and details how the Bank attracts, recruits, develops and retains talented employees. The Bank recruits positions both internally and externally. While employees should be attractive to other employers, the Bank's employees choose to stay with XacBank because the Bank offers the best arena for their professional and personal development. The Bank's strong system of values permeates everything the Bank does and supports employees in their work. The Bank's social commitment is something of which both employees and customers can be proud of.



	2002		2001	
Head Office staff	73	22 %	50	30 %
Branch staff	252	78 %	118	70 %
Credit staff	111	34 %	68	40 %
Support staff	62	19 %	15	9 %
Female staff	188	57 %	95	56 %
Staff turnover	69	21 %	20	12 %
Average age of staff	29	n.a.	27	n.a.
<b>Total staff</b>	<b>325</b>		<b>168</b>	

With Bank customers becoming more knowledgeable, the competence development of employees assumes a central role. The Bank, after all, sells knowledge and hopes to add value to customers' business. As an element in the exact tailoring of training courses, and the quality assurance of its services, the Bank continues to work on developing a skills certification program for its employees in their various professional roles. The move is away from being generalists to being customer specialists.

The Bank strives to be a knowledge institution and prioritizes staff competence development. Classroom training by both Bank specialists and external consultants has been combined with local and international training institutes' formal courses.

	Days	Hours	Number of participants	Person hours
In-house training	68	544	185	10,904
Banking Training Centre	10	60	13	780
GFA Management classroom training	15	64	43	1,448
<b>TOTAL</b>	<b>93</b>	<b>668</b>	<b>241</b>	<b>13,132</b>

A new incentive system has been instituted in the Bank in 2002. The incentive system stresses overall branch performance in terms of profits, deposit taking and lending volumes, portfolio quality, and individual contribution to the team's efforts. Revisions have been made to the employee loan policies. Altogether 56 employees have been approved to obtain loans for consumption and housing.

The Bank employs an internal recognition policy and gives its best employees career development opportunities. Eight branch directors were promoted to the managerial position internally and all Head office management staff have held other positions within the Bank previously.





***Information and Communication Systems:*** The Bank decided to reconfigure its existing integrated management information system in the initial stages of the year until the Bank selected and configured the new system. After almost a year of extensive and painstaking investigation the Bank opted for a system called Banker's Realm in June. The vendor of this system brings experience in working in similar environments in Africa, Asia and Eastern Europe on top of the state-of-art technology to address the growing needs of the Bank. The system uses a client-centric approach, is Internet compatible with reliable security controls, and allows for multi-currency handling. It possesses on- and off-line consolidation capacity with flexible and easy to use user interfaces both for front-office transaction handling and back-office controlling and management. The systems conversion of the Bank will be one of the largest and most complex ones in Mongolian financial sector history.

Management concentrated efforts to improve effectiveness and efficiency of communication in the Bank. As a result of this initiative the use of e-mail and mobile SMS between the Head Office and branches started replacing costly telephone calls. An Internet leased line is used for the Bank's web and mail-servers and all users are connected through a LAN network. To enhance the security and integrity of data the Bank's IT infrastructure includes a file-server in the Head Office to back-up critical files and centralize all users' data with restricted access authority.

***Physical Infrastructure:*** By the end of the year XacBank owned 10 of its branch buildings and had lease contracts for the rest with terms of up to 4 years. Full renovation of 17 branch offices was done during the year to respond to the Bank's standards of customer service. To enhance the quality of service delivery all branches were furnished with cars.

The Bank's branches were fully equipped with security alarm systems. The security unit employs 42 people and provides for 24-hour security of the Bank's property.

All professional staff has equipment that corresponds to the demand of a modern banking institution and facilitates creative work and an innovative spirit. Further improvement will be done in the coming years.



Ms. *PUREVTSEREN Dalayjargal*  
*Branch manager, Huvsdul aymag*

“... Real motivation to devote the best to our work comes from our clients' appreciation of what XacBank does to support and facilitate a good quality of life. . . The gratitude of people whom the Bank helped to achieve the faith in the prosperous and happy life inspires and gives us an extra energy to excel in our everyday work. . . The future of the Bank in ten, twenty years depends on our today's work. . .”



Following the Board of Directors' decision in September to overhaul the organizational structure and re-align senior and middle management of the Bank, four new divisions were created in place of the ones that existed in the previous matrix structure, namely, Administrative, Lending, Finance and Controlling Divisions, and a stand-alone Branch Management Unit - a completely new function.

The previous divisions of SME, Micro and Consumer, and Wholesale lending were consolidated within the new Lending Division. The new Finance and Accounting Division incorporates the Accounting and Controlling Division, the Settlement Department of the Operations Division and the Customer Service Division from the old structure and adds Treasury and controlling functions to them. The Operations Division and the Human Resources Division, and the Marketing unit came under the new Administrative Division. The newly established Branch Management Unit is responsible for overall branch management and control in addition to ensuring effective communication within the organization.

With the change of organizational structure and stable growth in funding, management has worked in the direction of improving the overall financial risk management and cash flow management capacity of the Bank. Special attention was put into the treasury, general risk management and management control functions. With the assistance of GFA consultants we started developing the profit-center approach of managing and monitoring the branch and product performances.

Three new committees comprising senior management of the Bank started functioning to ensure effective administration of operations. These are the Management Committee, the Lending Policy Committee and the Risk Management Committee.

The smooth and rapid implementation of the restructuring plan has proven that XacBank possesses the ability to identify, and perseverance to resolve crisis situations and make responsible decisions in a timely fashion.

During August the Bank decided to pursue an acquisition opportunity of the Agricultural Bank of Mongolia in a consortium with Holland's Triodos-Doen Fund. After one and a half months of due diligence, XacBank withdrew from the bidding in the privatization tender.

Finally, the Group acquired a majority stake in NetMon LLC - the country's only wholesale lender to savings and loan cooperatives. The strategies of the Bank on this issue will be further refined in 2003.



Mr. *BAYARJARGAL Gomooroi* inherited carpentry skills from his father. He started his own business after coming back from the army. "MonHiyts-Urguu" now employs more than 10 carpenters in its two workshops

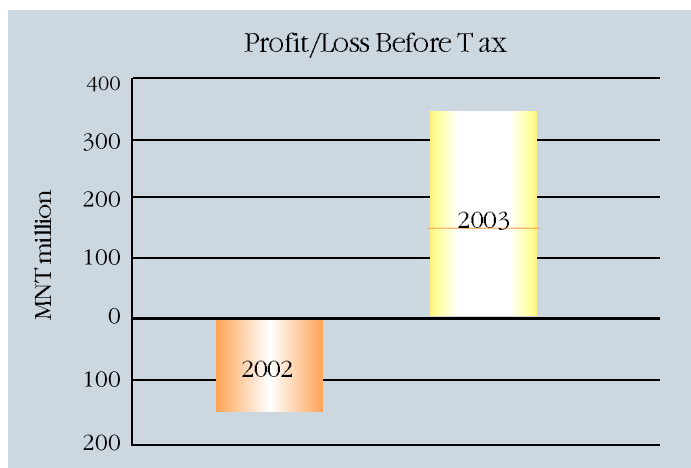
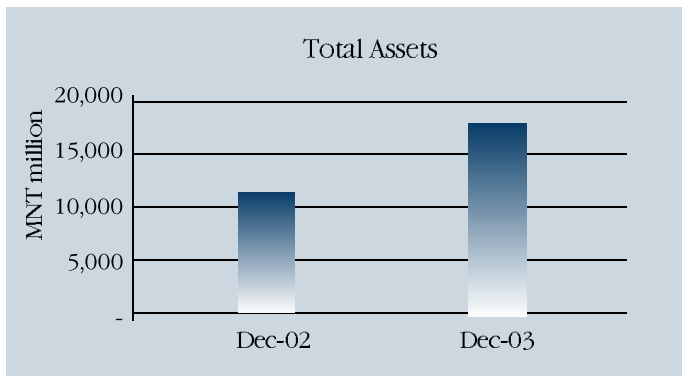


Based on successful operations in 2002 the Bank intends to expand and deepen the service delivery in 2003. Particular emphasis will be given to MIS conversion, strengthening of internal controls, continued improvements in physical infrastructure, and overall enhancement of competitiveness of the Bank. Here is the list of major goals for 2003:

- The Bank will convert to new MIS.
- The Bank will strengthen its internal audit capacity and work through regional auditors.
- The Bank will develop and pilot new products and services.
- The Bank will add six new branches to fully cover the country.
- The Bank will attract strategic investors to meet future the statutory capital requirements of at least MNT 4.0 billion.

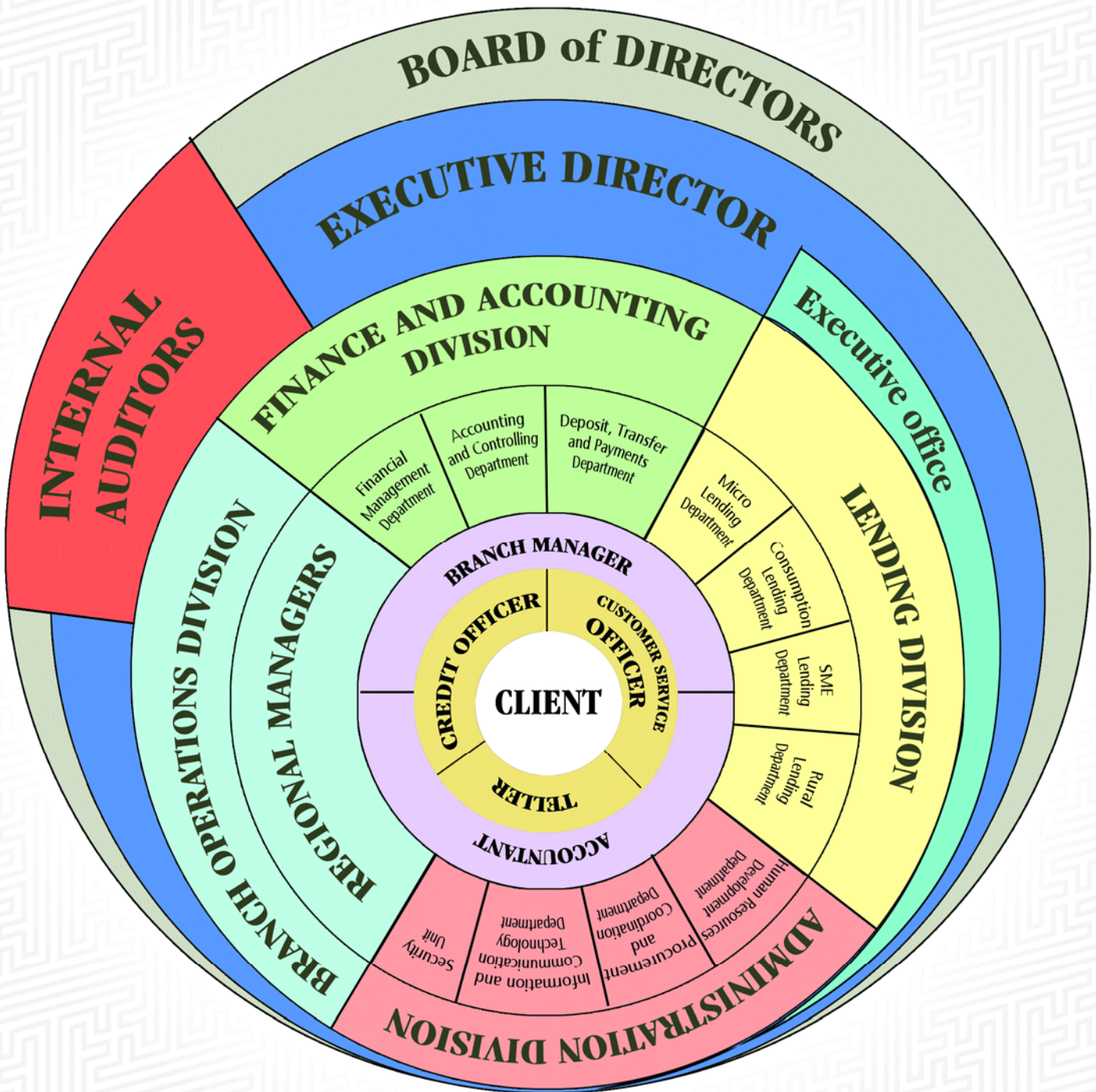
The table below exhibits some of the quantitative goals of the Bank for 2003:

	2002	2003	Change in percent
Total Assets (MNT million)	11,361.1	18,386.4	61.8 %
Gross Loan Portfolio (MNT million)	5,495.9	12,067.7	119.6 %
Number of Borrowers	11,063	17,133	54.9 %
Deposits (MNT million)	3,491.6	7,000.0	100.5 %
Number of Depositors	2,961	7,300	146.5 %
Profit/Loss Before Tax (MNT million)	(154.4)	357.9	236.0 %
Number of Branches	27	33	22.2 %
Number of Employees	325	428	31.7 %



Ms. *BADAMSUREN Lkhanaa* is a professional tailor and she started a small enterprise called "Arvijih" in 2000







## **MANAGEMENT TEAM**

**Mr. Ganhuyag Chuluun**

Executive Director

### **DIRECTORS**

**Mr. Bat-Ochir Dugersuren**

Director

Finance and Accounting Division

**Ms. Delgerjargal Bayanjargal**

Director

Lending Division

**Mr. Soronzonbold Lhagvasuren**

Director

Administration Division

**Mr. Munhsayhan Jargalsayhan**

Director

Branch Operations Division

**Ms. Erdenechimeg Dorjgotov**

Senior Auditor

Internal Audit Department

