OUR MISSION

The mission of the Bank is 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, but equally important, to maximize the value of shareholders' investment, while creating a profitable and sustainable financial institution.

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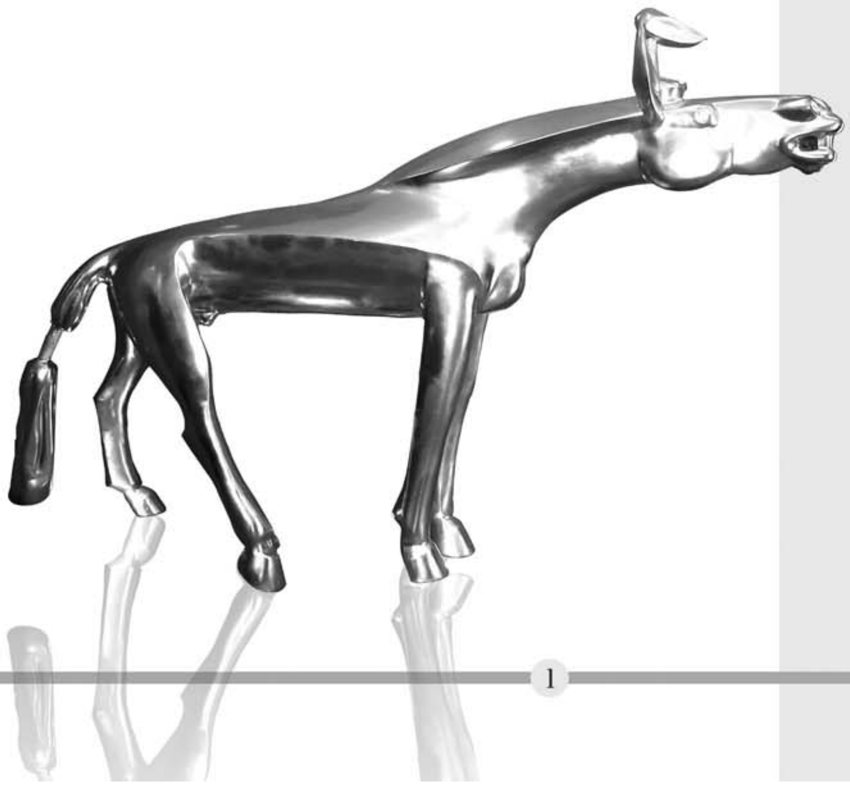

Board of Directors

Chairman

Mr. STEPHEN MITCHELL
Chief Financial Officer
Mercy Corps

Directors

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President
Mongolian Women's Federation

Ms. ENHTUYA TSEND
President
Liberal Women's Intellectual Pool

Mr. JARGALSAIHAN SER-OD
President
Rotary Club of Ulaanbaatar

Ms. TUMENBAYAR NYAMAA
Legal Advisor
National Association of Mongolian Agricultural Cooperatives

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XacBank

Mr. MUNHBAT GANHUYAG
Vice Chairman
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Mr. GALBAATAR TUVDENDORJ
Chairman
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Mr. STEVEN ZIMMERMAN
Country Director
Mercy Corps Mongolia

Mr. JAMES ANDERSON
Chief Operating Officer
XacBank

Chairman's Letter to The Shareholders

Dear Shareholders,

On behalf of our Board of Directors, I am truly excited and pleased to report on XacBank's second full year of operation as a fully fledged, full-service commercial microfinance bank. Since assuming the Chair of XacBank slightly more than one year after its formation, I have seen outstanding progress. The Bank has matured remarkably and demonstrated its ability to adapt and capitalize on a wide range of challenges. Above all, the Bank has remained true to its mission of serving the marginalized citizens of Mongolia while generating a commercial return for you, its shareholders.

I am pleased to report that XacBank earned record profits in the year just concluded while growing and expanding its outreach to the citizens of Mongolia. XacBank now has at least one branch in every aymag of Mongolia, and is continuing its efforts to selectively expand our products and services to better serve our unique client base.

During the year, we saw the departure of several experienced members of our Board. I want to thank them for their dedication and valuable contribution and guidance in the formation and governance of XacBank. The Board joins me in wishing them well in their future endeavors. Throughout the year we also added new members, expanding our Board to eleven Directors. This structure has given each of our founding shareholder organizations an opportunity to participate in the governance of the Bank, thereby strengthening it considerably. Our Board will further expand in 2004 reflecting the addition of one of our newest shareholders, Tuushin Group, a prominent member of the local business community. We welcome Mr. Zorigt, CEO of Tuushin Group, to the Board.

To further strengthen our governance, the Board has established subcommittees to oversee the Audit, Executive and Risk Management functions of the Bank. Each of these committees will provide key inputs to the full Board on the Bank's operational strategies and strategic direction.

While we have achieved many of our goals during the year, I am most proud of our executive management team's accomplishment of meeting the Bank of Mongolia's 1 April 2004 mandated minimum Paid-In Capital requirement of MNT 4 billion. The management team, with significant oversight and contribution from the Board, overcame serious challenges in achieving the capital level necessary to satisfy the Central Bank's requirement. I congratulate the entire management team and Board of Directors for their outstanding efforts.

Besides Tuushin Group, I want to extend the warmest welcome to our other new investors, CYDAN and Monnis International. In addition to attracting new equity investments, the Bank expanded its stakeholders during the year by concluding new debt arrangements with international investors, which include Credit Suisse Microfinance Fund Management Company and Calvert Foundation, USA. Such sources of medium and long-term funding will allow us to better manage our liquidity and strengthen our balance sheet.

Operationally, the Bank used this year to restructure its overall organization to better serve our clients and direct our resources where they can be best utilized at the 32 branches. I am pleased to report that our new management information system has been installed, and is fully operational. Our 32 branch network is now connected electronically, providing timely and accurate reporting to management. It should also be noted that we have strengthened our branch internal auditing by increasing staff and enhancing policies.

To expand our outreach in rural communities, we are working with valued partners, and have concluded agreements to cooperate with organizations such as CHF (Community Habitat Finance)-Ger Initiative to provide services to urban ger-district dwellers as well as by forming strategic alliances with rural savings and loan co-operatives to franchise our services, allowing cooperative members to access a range of banking services at competitive prices.

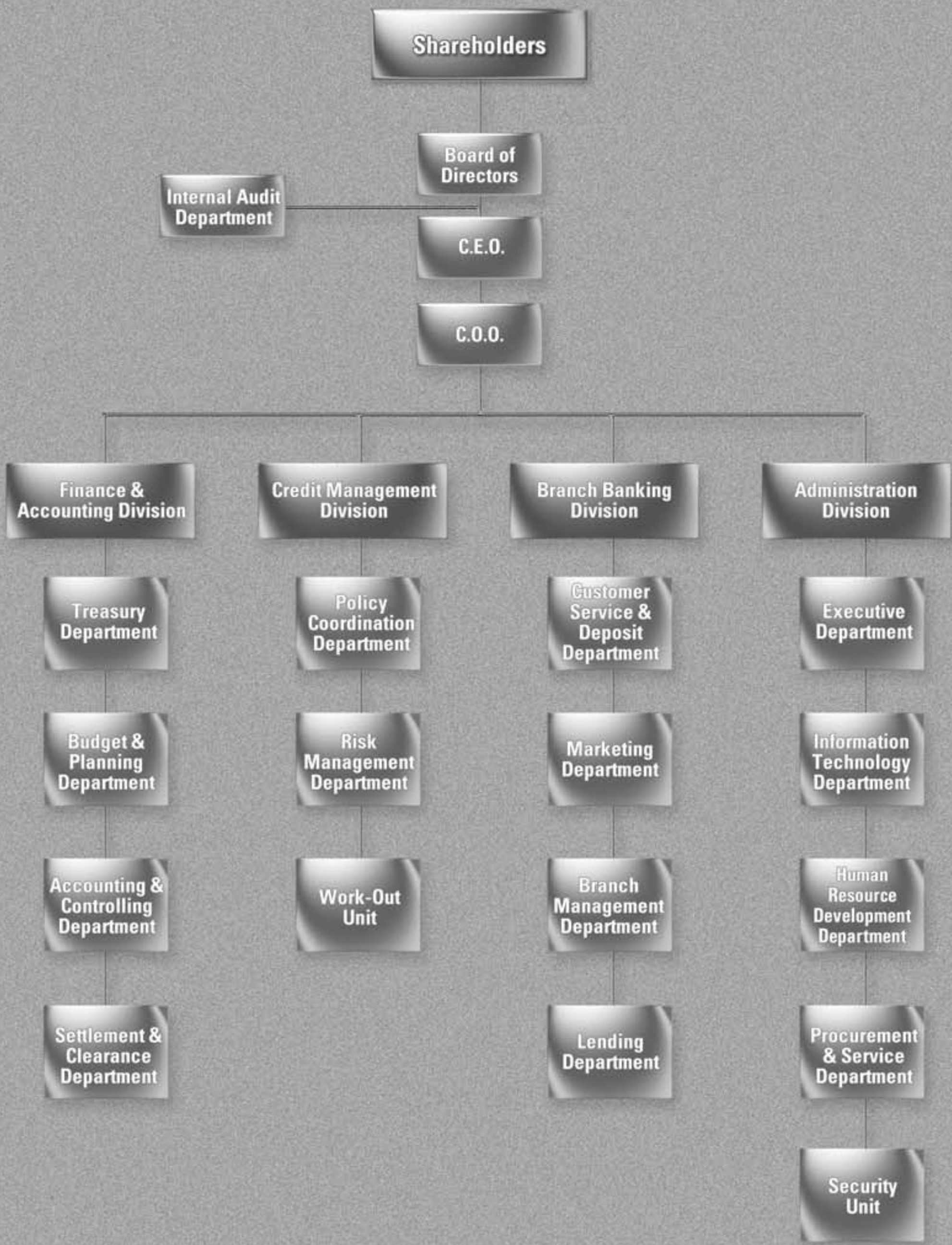
We have significant challenges ahead of us. Paramount will be XacBank's need to raise substantial equity in the months ahead as the Bank of Mongolia has announced it will raise the minimum Paid-In Capital requirement again. As I look ahead to this challenge and other challenges we face in 2004 and beyond, I see a vibrant organization with dedicated and hard working employees who carry the dream and mission of XacBank in their hearts. We will meet our challenges. Our team is up to the task.

With the guidance of our Board and the leadership of our executive management team, I am confident that we will meet your expectations for the years ahead.

Most sincerely,

Stephen Mitchell
Chairman of the Board

Organizational Chart



Management Report

Life is a progress, and not a station...
Ralph Waldo Emerson

Executive Summary

2003 was characterized by intensive efforts to build and develop systems aimed at realizing the Bank's mission of a double bottom-line– combining and balancing developmental objectives with commercial goals. We did this by expanding our position in the market, strengthening the institution at all levels and investing for the future.

There are two main criteria for us according to our mission statement. These are serving the marginalized citizens of Mongolia while generating a commercial return for our shareholders. During 2003 we disbursed more than MNT 46.5[1] billion in loans and ended the year with a loan portfolio of MNT 11.0 billion and 18,610 active borrowers. Portfolio quality remained strong, with a repayment rate of 99.1 percent. As a result of an intensive marketing program, competitive rates and outstanding customer service, total deposits mobilized from the public reached MNT 10.0 billion at year end. This number is distributed among 25,574 savings accounts and 26,402 current accounts. The volume of domestic money remittances continued to rise and reached MNT 8.0 billion for 2003. Total assets rose by MNT 6 billion ending 2003 at MNT 17.8 billion.

Interest income reached MNT 3.7 billion, operating income MNT 2.9 billion and pre-tax income was a record MNT 503 million. Our operational and administrative expenses were MNT 2.3 billion and our Cost to Income Ratio improved to 55.9 percent from 64.8 percent last year due to tighter cost controls.

We are pleased to report that the Bank earned an after-tax profit of MNT 276 million following a loss of MNT 170 million last year due to a major fraud case at one of our branches. As a result in early 2004 we distributed a stock dividend of MNT 262 million to our shareholders.

In accordance with the Bank of Mongolia's resolution to raise the Minimum Paid-In Capital level for all banks in 2004, we attracted new investors from the local business community and as of 31 March 2004, XacBank's Paid-In Capital was MNT 4.1 billion.

By opening five new branches in 2003, bringing our total to 32, XacBank became the third commercial bank of 17 commercial banks in Mongolia to provide financial services throughout the country. This branch expansion brought the total number of staff to 420.

During the year, a total of MNT 2.8 billion in new long-term funding was sourced from the following institutions: Asian Development Bank's Agricultural Sector Development Project, International Fund of Agricultural Development (IFAD) Rural Poverty Reduction Project, the Mongolian Government's Employment Generation Fund, Dexia BlueOrchard and Calvert Foundation. This was added to existing term funding previously provided by Deutsche Bank Microenterprise Fund and International Finance Corporation (IFC). Additionally, the Bank entered into swap agreements with local banks for MNT 3.7 billion to convert foreign currency debt into local currency financing.

The Bank had grant funding available from IFC and Consultative Group to Assist the Poorest (CGAP) which was complemented by a grant from USAID to assist in certain asset acquisitions as well as to provide various technical assistance and training.

The Bank's Board convened its sessions five times during the year, setting strategic goals and overseeing the executive management, while providing advice and guidance on the Bank's operations, reviewing achievements and challenges, and setting future strategy.

[1] MNT 1,176 = USD 1 as of end of 2003

Highlights of 2003

- Installed a new Management Information System in all branches.
- Received 1.8 CAMEL rating from the Bank of Mongolia, improved from 2.85 in 2002.
- Organized the Tuul River environmental clean-up in collaboration with Mercy Corps /Gobi Initiative/, Nike, MCS Coca Cola and other governmental and civil society organizations. Over 2,000 people participated to remove over 40 tons of debris from an environmentally sensitive area.
- Achieved 1,000 active borrowers at the Erdenet branch in Orhon aymag during September. Erdenet became the first branch in the XacBank network to reach this level. This branch is likely to become the first branch with a MNT 1.0 billion loan portfolio.
- Merged Netmon, the NBFI subsidiary of the Group, fully into the Bank in the fourth quarter.
- Launched rural lending services in 14 soums and successfully piloted a franchising concept in one soum. Released a documentary film commemorating the 5th anniversary of the start of the Bank's predecessor non-bank financial institutions.
- Organized the first football tournament among commercial banks in September with participation from eight commercial banks.
- Appointed Senior Technical Advisor to work with management on strategic issues.
- Executive Director received the "Best Manager in Banking and Finance" award from Entrepreneur 2003, an annual ceremony organized by Mongolian National Chamber of Commerce and Industry.

Looking To The Future

In 2004 XacBank will further refine its strategic patterns and continue building a solid foundation for managing rapid growth ahead.

The Bank of Mongolia has been contemplating a further increase in the Minimum Paid-In Capital requirement for banks. As a result, attracting new strategic investors, both domestic and international, together with additional investment from current investors and continued strong earnings will be required in the coming year.

We will continue sourcing medium and long-term funds from international organizations, particularly those which invest in microfinance institutions and share our mission.

Negotiations with top quality international investors will be reactivated in 2004 to attract new equity to meet the mandated Paid-In Capital requirement.

Over the next year, we will implement intensive measures to improve the depth of management and accommodate strong growth in 2004. Our competitiveness will be enhanced through improvements in efficiency and more streamlining in the organization.

The Bank is implementing a series of steps to reduce employee turnover and attract and retain only the highest quality staff.

Loan portfolio quality will remain our highest priority. The portfolio at risk rose to 2.24% in the final months of the year due to a single loan delinquency. We are confident, however, of a significant recovery from collateral liquidation.

Following its mission statement, the Bank developed a plan for further penetration into the rural and suburban ger districts and will aggressively implement that plan.

The Bank will enter new markets with new products, including issuing payment cards, installing ATMs, and moreover, introducing electronic, telephone and mobile phone banking services. In addition, international money transfer and transaction services will be launched during the year.

Improving customer service quality will remain a high priority. With increased competition, greater efficiency at all levels is essential. We will continuously maintain a long-term vision when addressing the Bank's systems and network infrastructure.

With the year 2005 designated by the United Nations as the International Year of Microcredit, we will organize events and activities to introduce XacBank to representatives from other microfinance institutions worldwide while increasing public understanding of the enormous benefits of microfinance as a means of reducing poverty in a sustainable manner.

The Bank's Board is currently discussing a dividend strategy for 2004 to provide a return to our shareholders until more liquid markets for trading equity can be established in Mongolia.

Management is committed to implementing step by step actions with the goal of strengthening the Bank's position and reputation while maximizing the value of our shareholders' investment.

External Environment

Background

Mongolia is a landlocked country roughly the size of Western Europe located in Central Asia bordering Russia to the north and China to the south. The territory of Mongolia is divided administratively into 21 aymags (provinces) and its capital city Ulaanbaatar, where over 40 percent of Mongolia's 2.7 million residents live.

Macroeconomy

Mongolia's economy has traditionally been based on agriculture and breeding of livestock, while it also has extensive mineral deposits including copper, coal, molybdenum, tin, tungsten, and gold which account for a large part of its industrial production. Falling prices for these primary exports and adverse effects of weather on agriculture restrained real GDP growth in 2000-2001. Despite recurring drought in 2002, GDP rose 4.0[2] percent while preliminary reports indicate that GDP rose by 5.0 percent in 2003.

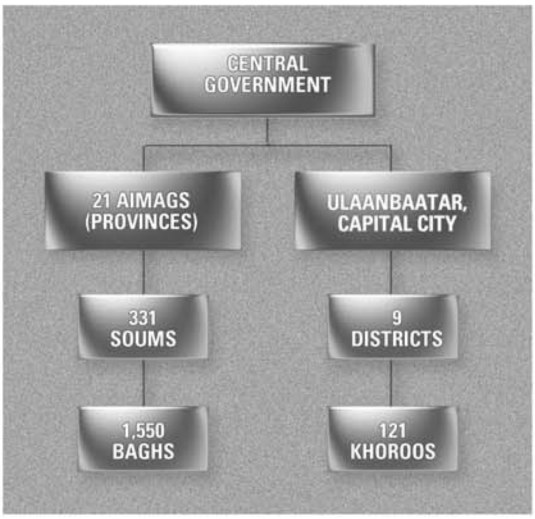
Between 1991 and 2001, external debt denominated in convertible currency jumped from 6 percent to nearly 85 percent of GDP. In 2001, annual debt service amounted to approximately 4 percent of GDP. Multilateral and bilateral official creditors hold virtually all of this debt, of which the Asian Development Bank, World Bank and Japan are the largest creditors[3]. In addition to the convertible currency debt, the Russian Federation claimed a massive debt pertaining to transactions with the former Soviet Union. By the end of 2003, the Mongolian Government settled this debt with an agreement to pay approximately USD 250 million, or approximately 2 percent of the amount claimed.

According to the Asian Development Bank, money supply (M2) rose 42.0 percent in 2002 and rose a further 49.6 percent in 2003, reaching MNT 703.3 billion. Inflation, measured by the consumer price index, rose by 1.5 percent in 2002 and 5.6 percent in 2003.

The Bank of Mongolia reported total loans by banks and non-bank financial institutions to the private sector reached MNT 115 billion in 2002, rising to MNT 210.7 billion in 2003. Moreover, in 2003 Non-Bank Financial Institutions (NBFI's) as well as Savings and Loan Cooperatives (SLC's) expanded their activities due to a favorable legal and economic environment. As a result, the number of NBFI's and SCL's grew to over 380 by year end 2003.

The overall budget deficit in 2002 was MNT 70 billion while the trade deficit was USD 252 million. International reserves were USD 400 million at year end 2002 which covered 6.9 months of imports during the year.

Mongolia's Human Development Index is ahead of 58 countries and placed 117th among the 175 countries ranked globally. There are stark differences in the quality of life of the people in rural and urban areas. The extent of rural poverty in Mongolia is striking even though a higher proportion of the poor now live in urban areas. In 1998 more than half (57 percent) of the poor lived in urban areas, including 26 percent in the capital city, whereas, 43.0 percent lived in the rural areas[4]. In 2002, the urban sector generated 62 percent of the country's GDP and conversely, the rural sector only 38 percent.



Administration Structure of Mongolia

According to the global Human Development Report 2003, Mongolia ranks 117th out of 175 countries for which the HDI (Human Development Index) is calculated. The National Statistical Office (NSO) has computed Mongolia's HDI for 2002 as 0.679.

[2] Asian Development Bank
[3] Human Development Report

[4] ibid

Largest Ever Regional Microcredit Summit Held In Bangladesh

More than 1,200 delegates from 47 countries attended the Asia/Pacific Microcredit Summit in Dhaka, Bangladesh from February 16-19, 2004 making it the largest regional Microcredit Summit ever. Hundreds of delegates made field visits to ASA, BRAC, Grameen Bank, Padakhep and PKSF in the days leading up to the Summit. Palli Karma-Sahayak Foundation (PKSF) was the Local Organizer of the Meeting.

The Opening Ceremony was inaugurated by Ms. Begum Khaleda Zia, Prime Minister of Bangladesh. Other Opening Ceremony speakers included H.M. Queen Sofia of Spain, Madam Zanele Mbeki, First Lady of South Africa, Bangladesh Finance Minister Mr. Saifur Rahman, and Grameen Bank Managing Director Dr. Muhammad Yunus. The Closing ceremony was addressed by Ms. Sheikh Hasina, Leader of the Opposition in Bangladesh Parliament and Bangladesh Education Minister Dr. Osman Faruk, among others.

Below is the excerpt of Opening Ceremony Speech of Microcredit Summit Campaign Director Mr. Sam Daley-Harris:

Excellency, Majesty, Honorable Guests and Distinguished Delegates,

Seven years ago this month more than 2,900 of us from 137 countries gathered at the original Microcredit Summit in Washington, DC. At the Summit we launched a nine-year campaign to reach 100 million of the world's poorest families, especially the women of those families, with credit for self-employment and other financial and business services by the end of 2005.

We didn't set the goal merely to see a dramatic increase in the number of clients reached. We set the goal because we wanted to see a dramatic reduction in poverty. We didn't set the goal merely to see financial services reach the un-reached. We set the goal because we wanted to see a dramatic decrease in the scandal of global poverty and a dramatic increase in the number of families finding a dignified route out of poverty.

We knew that there was confusion in the world, especially in the world of development, about what works to reduce poverty. We knew this because none of the important UN Summits of the 1990s emerged with a compelling measurable goal in the area of microcredit. We knew that if a goal was set to reduce global poverty dramatically (as was set at the Millennium Summit in 2000) that there would be many poorly designed and poorly targeted programs in response to the poverty reduction goal…

Well, how far have we come?
The State of the Microcredit Summit Campaign Report 2003 was released last November at the United Nations. It outlines end of 2002 data.

More than 2,500 institutions reported reaching 67.6 million clients, 41.6 million of whom were among the poorest when they started with the program. The 41.6 million poorest are the clients we are tracking toward the Summit's 100 million poorest goal. 234 institutions had their data verified by a third party. Those 234 institutions had 86 percent of the 41.6 million poorest. You can find all of these figures and the list of verified institutions in the State of the Microcredit Summit Campaign Report placed in your registration bag. Of the 41.6 million poorest, 79 percent are women. And listen to this, of the 41.6 million poorest reached by the end of 2002, 87 percent are in Asia. This bears repeating.

What are the challenges we face?
From the very first Microcredit Summit we have been guided by four core themes:

1) reaching the poorest,
2) reaching and empowering women,
3) building financially self-sufficient institutions, and
4) ensuring a positive measurable impact on the lives of clients and their families.

We have been hindered by three particularly insidious myths. These myths argue, incorrectly, that you cannot reach the very poor with microcredit; they are too costly to identify and motivate. They argue, incorrectly, that if you do reach the very poor you cannot build a financially self-sufficient institution. And they argue, incorrectly, that if you do reach the very poor sustainably, you are only adding a debt burden to very poor families…
So we have much to learn and much to teach others. Your innovations have changed lives. And additional innovations will change millions of more lives for the better.

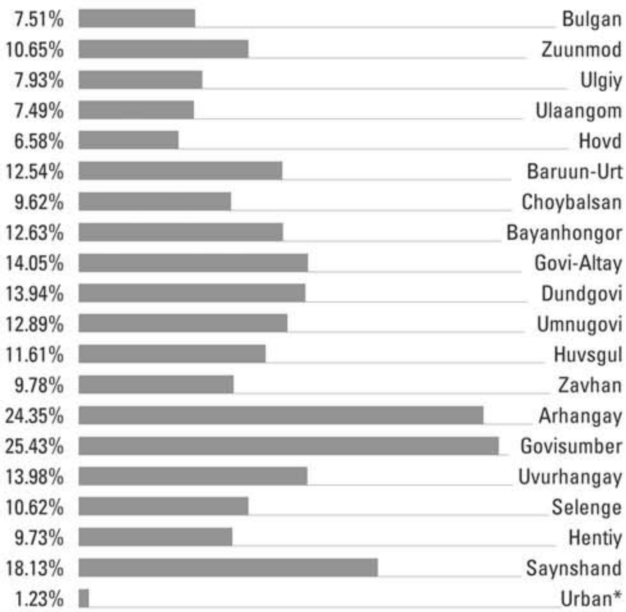
Congratulations for your work. Congratulations for your commitment to excellence and congratulations for your commitment to changing the world.

Portfolio Review

In 2003, XacBank put greater focus on its loan portfolio growth by shaping credit policy around a comprehensive mission in spite of competition from NBFI's, SLC's and local commercial banks.

The Bank continued to show strong loan growth as the portfolio grew by 100 percent from 2002 to MNT 11 billion while the number of active borrowers rose by over 68 percent to 18,610. While the Bank's share of the market showed a marginal increase from last year, to 2.5 percent, the Bank is well positioned for a significant expansion of our market share in 2004, particularly in the rural areas of the country.

XacBank Share of Lending Market by Aymag December, 2003



/*cities of Ulaanbaatar, Erdenet & Darhan/

The percentage of microloans (Start-Up and Growth loans) in the total portfolio rose by 0.8 percent from the previous year to 51.7 percent of the total portfolio. At the same time the consumption loan portfolio increased by 1.6 fold and constituted 21.9 percent of the total portfolio at year end.

The SME loan portfolio increased by 57.7 percent from the previous year but its percentage in the total portfolio declined by 6.0 percentage points and comprised 22.1 percent of the total loan portfolio.

Last year, we expanded our credit product offerings and in February 2003 offered a leasing service to our customers, contracting 15 suppliers. As a result, the Bank offers microleasing for electronic tools, furniture, mobile phones, computers and agricultural equipment. By the end of 2003 we concluded 425 lease contracts for over MNT 155 million.

In September 2003, in response to falling market interest rates, the Bank reduced its loan interest rates by 3-12 percentage points. As a result, the weighted average interest rate on the loan portfolio decreased by 7.88 percentage points from the beginning of the year to 39.02 percent at year end.

	2003	2002	Change	Change in percentage
Number of Loans Disbursed	32,677	21,862	10,815	49.57%
Value of Disbursement (MNT, million)	24,286.7	11,932.2	12,354.5	103.5%
Average Loan Size (MNT)	743,237	545,796	197,441	36.2%
Number of Loans Disbursed since 1998	85,397	52,720	32,677	61.9%
Disbursements, Cumulative since 1998 (MNT, million)	46,513.1	22,226.4	24,286.7	52.2%
Number of Active Loans	18,610	11,063	7,547	68.2%
Outstanding Loan Portfolio (MNT, million)	11,012.2	5,496.0	5,516.2	100.4%
Number of Loans Per Credit Officer	158	107	51	46.8%
Portfolio Per Credit Officer (MNT, million)	93.3	53.3	40.0	74.9%
Market Share	2.49%	2.37%	0.12%	-

Ms. Enhtuya Yansan

From the first moment when I heard that XacBank is about to open a branch in my district, I kept up hope for financing for my newly opened stationary shop. Other banks in town wouldn't offer such small amounts required for small and start-up businesses.

I clearly remember the day that XacBank opened its branch in our district and the first meeting with the people of Nalayh. I even won a free lottery prize which I now appreciate as a sign of the goodwill of our relationship.

I opened the stationary shop in 2002 with 300,000 tugrug and it was one of the first stationary providers around. Demand for such products was strong and I saw good potential to expand my business. However, due to lack of working capital I was unable to expand my business. It was not going well until XacBank opened its branch nearby and I had my first access to credit. My first loan was 600,000 tugrug followed by two cycles of Growth Loans, which I used to expand my business by opening a photo shop and buying my own accommodation for the business in the center of town.

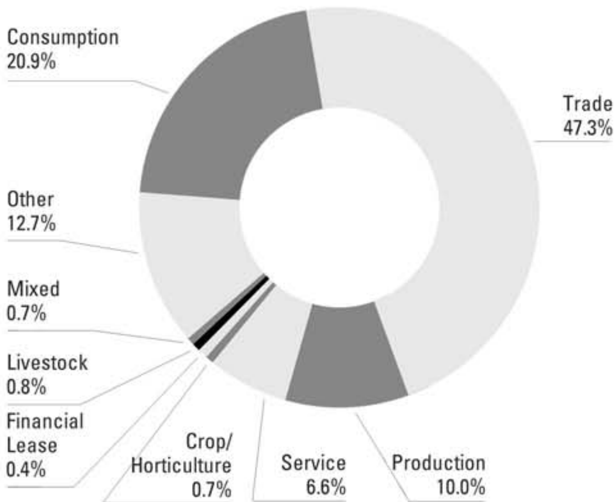
Now I consider myself as having access to comprehensive financial services such as money transfer to my business partners as well as the ability to receive loans for my business when it's required. Also, I would like to thank XacBank staff who were there when I needed help.

Borrowers

Borrowers engaged in small or informal businesses comprise 49.0 percent of total borrowers, small and medium sized entities 1.5 percent, whereas 47.4 percent are salaried people, and 1.4 percent are herders. The remaining 0.1 percent are loans to SLC's and deposit-backed loans.

66.1 percent of the business loan portfolio is in trading, 13.8 percent in production, and 9.1 percent comprises service with the remaining 2.7 percent in agricultural business.

Loan Portfolio Concentration



The Start-Up Loan, the Bank's most popular credit product, is disbursed to small businesses and finances trading and other types formal and informal small businesses.

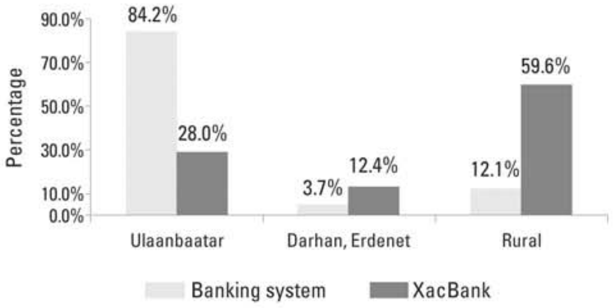
Eighty nine percent of the Bank's 18,610 loans are below MNT 1.0 million while 41.7 percent are less than MNT 300,000.

Focus on Rural Areas

The Bank continued its strategic focus on rural markets by opening five new branch offices making XacBank the third banking network with nationwide presence. As a result, 21 branches (65 percent) are located in rural areas, while rural area borrowers now comprise 62 percent of total borrowers.

In 2002 the Bank piloted an agricultural lending program in six aymags and disbursed loans of MNT 50,000-15,000,000 for primary agriculture. We continued seeking opportunities for expanding our activities in this sector and piloted loans in 14 additional soums continuing our mission to serve remote households without access to comprehensive financial services.

Loan Portfolio



A key factor in reaching the rural households in remote areas will be expansion of our franchising model. This model was piloted in the 4th quarter 2003 with a loan package to a rural savings and loan cooperative in Tuvshruuleh soum of Arhangay aymag.

In June, the Bank activated its facility under IFAD's Rural Poverty Reduction Program in collaboration with the Government of Mongolia. This program was targeted toward Arhangay, Bulgan, Huvsgul and Hentiy aymags, which are mainly agricultural and livestock breeding regions. 2,435 loans totaling MNT 1.9 billion were disbursed in the four aymags of which 1,650 loans of MNT 1.2 billion were for financing micro-businesses, 709 loans of MNT 283 million were for consumption purposes, 64 loans of MNT 375 million were for small and medium enterprises and loans for other purposes. As an implementer institution under the IFAD program, 14 soums within these aymags were selected for lending activities and technical assistance, and 148 loans of MNT 70.7 million were disbursed.

Additionally, the Bank was selected as a participating institution for the Agricultural Development Programme of the Asian Development Bank, implementing lending programs in Darhan-Uul, Selenge, Uvs, Zavhan, Govi-Altay and Hovd aymags. In connection with this initiative, a contract was concluded with the Bank of Mongolia and XacBank disbursed 481 loans worth MNT 396.1 million.

Employment Generation Support Fund

In 2003 XacBank secured financing of MNT 200 million from the Employment Generation Fund of the Government of Mongolia (EGF) bringing the total amount of financing from this Fund to MNT 445 million, disbursing loans for generating and securing employment. XacBank disbursed 1, 028 loans for MNT 729 million throughout Mongolia for generating and securing employment for 1,877 people with the funding provided by EGF.

Mr. Hurelbaatar Tserenpil

I was working as a policeman for Bayanzurkh District Police Department until 1996. My decision to start my own business was inevitable due to the low salary I received which wasn't enough to meet the basic needs of life for my family. While people were migrating to Ulaanbaatar hoping to improve their lives, I decided to move out of the capital city with my family to the nearest town to start my own farm. With my wife Saynbileg and two sons, we started a small farming business in Baganuur District.

Lack of working capital was a serious problem I encountered in expanding my farm, especially after we purchased a vehicle, which was vital for transporting the harvest to the town for sale. I consider it was my family luck that XacBank opened a branch in Baganuur district. In a XacBank client meeting I learned that even small farmers like me could qualify for credit services and shortly thereafter I got my first loan.

After three cycles, my farm has expanded enough to allow me to buy piglets and young goats in addition to growing vegetables which I sold in the town from my own sales spot. Now I understand that for people engaged in all types of business, responsive credit service is very important. XacBank offers microloans with conditions that let me succeed in a businesslike manner.

Ms. Sarantsetseg Sengee

When I started my clothing business in 1996, taking a loan from a bank was not an option. At least that's what I used to believe. Until I received my first loan from XacBank my only business goal was to meet the living expenses of my family, seven of us including my husband, four children and a grandchild. However, after three cycles of loans from XacBank, my business has grown, my average profit per month is about 200,000 tugrug, and we are able to send our children to university.

In the near future I am planning to move out of my rented premises to buy and own a tailor shop in the ger district. I will stay with XacBank for as long as I have this business.

Credit Risk Management

Following an organizational restructuring in October 2003, Lending and Credit/Portfolio Management, two primary functions of the Credit Division, were separated into a Branch Banking Division and Credit/Portfolio Management Division. By doing so, the Bank will be able to manage its portfolio risk more effectively.

The Board of Directors, through its Risk Management Subcommittee, has set risk limits for the Bank that address portfolio, liquidity and foreign exchange risk.

Loan approval authorities were established at different levels of the Bank, giving each branch individual credit authority based on the skills and experience of the individual managers.

	Percentage of Total Loan Portfolio	Percentage of Equity
Loans to the 20 Largest Borrowers	11.5%	39.0%
Loan to the Largest Single Borrower	3.7%	12.5%
Loans to Related Parties	2.3%	7.9%
Loans to a Single Related borrower	0.5%	1.7%

	2003	2002	Change
Loan Repayment Rate	99.15%	99.68%	-0.53%
Portfolio At Risk > 1 day (MNT, million)	247.9	47.4	199.5
Portfolio At Risk > 1 day as a percentage of Loan Portfolio	2.24%	0.86%	1.38%
Portfolio At Risk > 30 days as a percentage of Loan Portfolio	1.92%	0.61%	1.31%
Loan Loss Reserve (MNT, million)	13.1	3.1	10.0
Loan Loss Ratio	0.16%	0.08%	0.07%
Recovered Loans (MNT, million)	3,803.6	682.0	3,121.6
Recovery Rate	29.0%	22.1%	6.9%
Loan Loss Reserve as a percentage of Loan Portfolio	1.56%	1.27%	0.29%

Loan Portfolio Quality

At year end, the Portfolio-At-Risk (PAR) greater than 1 day was 2.24 percent of the loan portfolio, or MNT 247 million.

Rescheduled loans constituted 9.3 percent of the total PAR while 39.5 percent are loans which are up to 30 days past due, 30.6 percent is 31-90 days past due, and 20.6 percent is comprised of loans past due for more than 90 days.

This PAR is above our historical trends due to an aggressive increase of the loan portfolio in the first half of the year and one large delinquent loan, which accounts for 68.5 percent of total past due loans.

With increased PAR, the Bank has reacted with changes in its loan limits and lending policies, taking intensive measures to recover past dues and reviewing procedures to avoid similar occurrences.

A total of 21 loans of MNT 13.1 million were written-off during the year. This is 0.16 percent of the average portfolio while 29.0 percent of total loans written-off during the year were recovered.

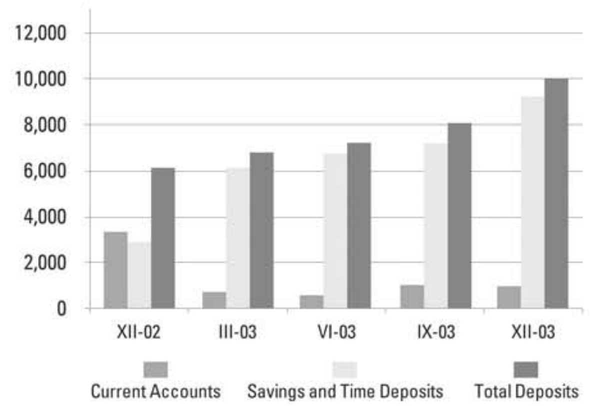
Deposit Mobilization

Public Deposits

In 2003 the Bank sourced a total of MNT 9.1 billion to our 25,666 savings accounts and MNT 880.0 million to 26,402 current accounts, an increase of 64.6 percent over the previous year. This was the result of well designed savings products that met customers' needs and successful promotional campaigns. The number of savings products offered is now six.

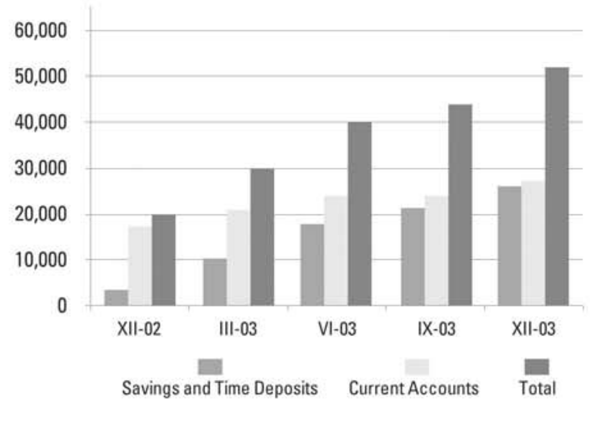
A new long-term savings product named Age Gracefully was introduced in May. This product has the features of a pension scheme for middle aged savers.

Balance of Public Deposit (MNT million)



A majority of the deposits, 76 percent, is concentrated in urban markets such as Ulaanbaatar, Darkhan, and Erdenet cities.

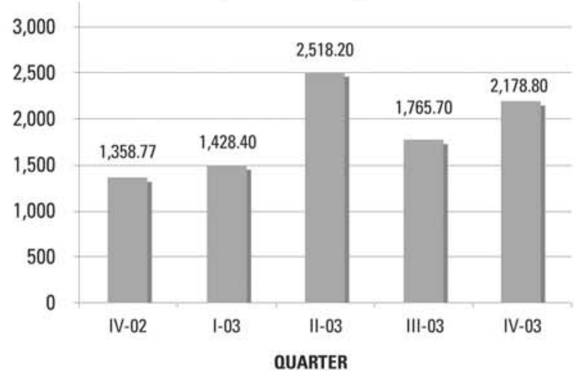
Number of Deposit Accounts



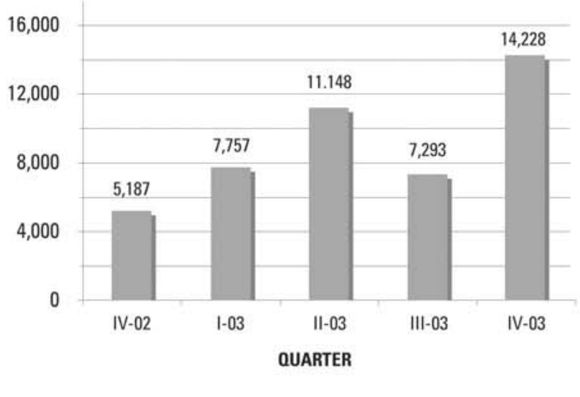
Money Remittance

In 2003 the Bank made 40,426 money remittance transactions totaling MNT 7.9 billion. In comparison to the 4th quarter of 2002, the value of remittances in the 4th Quarter 2003 increased by 60.3 percent while the number of transactions rose by 174.3 percent.

Value of Remittances (MNT million)



Number of Remittances



Financial Review

2003 was characterized by a strong improvement in financial performance. Based on the enabling platform of the growth built in 2002, the Bank achieved its targets by increasing its business in a more efficient and productive way.

As a result, profitability and efficiency increased, asset and liability management improved bringing positive changes in the balance sheet structure while asset quality remained high. The Bank met all the prudential norms set by the Bank of Mongolia and received an unqualified opinion by an international accounting firm.

The table below represents selected financial performance indicators for 2002 and 2003:

	2003	2002	Difference
PROFITABILITY			
Return on Average Assets	1.90%	-2.04%	-184.16%
Return on Average Equity	9.15%	-5.47%	-251.52%
Net Interest Margin	68.55%	79.66%	-13.95%
Net Income After Taxes	276,878,672	-170,461,294	262.43%
EFFICIENCY AND ASSET STRUCTURE			
Average Cost of Funds	10.11%	7.85%	28.79%
Cost to Income Ratio	55.88%	83.00%	-32.68
Earning Assets to Total Assets	79.21%	75.67%	4.68%
PRUDENTIAL RATIOS			
Risk Weighted Assets	24.71%	38.14%	-35.22
Liquidity Ratio	33.50%	48.93%	-31.54%
20 Largest Borrowers to Shareholders Equity	12.48%	10.76%	15.99%
Related Party Loans to Shareholders Equity	7.94%	5.13%	54.78%
Foreign Currency Exposure in USD to Shareholders Equity	1.96%	-0.48%	-507.31%
Total Foreign Currency Exposure to Shareholders Equity	2.83%	-0.39%	-825.97%

Fee and commission income rose by 217 percent and investment income increased by 699 percent in comparison with the previous year, improving the Bank's revenue mix.

Internal Systems Development

During the year, management focused on establishing and maintaining the risk management and accounting systems that would accommodate the growth of the Bank during the year and for the future.

Major achievements during the year were as follows:

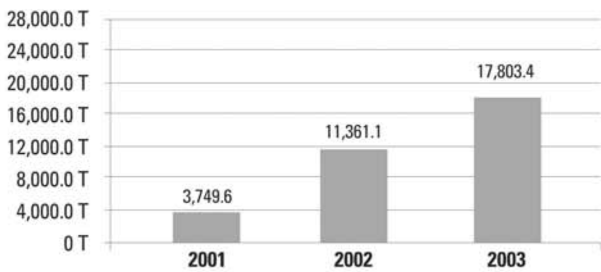
- A daily management reporting system was established providing management with daily information on liquidity, foreign currency position, and credit and deposit activities. As a result, the Bank now has day-to-day liquidity and foreign currency position reporting which allows better monitoring of compliance with prudential requirements.
- Internal risk limits were developed and approved by the Board of Directors improving the risk management systems.
- The Bank successfully installed its loan and accounting management software system, Bankers Realm, which processes transactions faster for customers, provides more accurate reporting and allows each teller to serve more clients. The system became effective throughout all the Bank's branches in the third quarter.

Asset and Liability Structure

The Bank's assets have grown 3.7 fold since 2001 and reached MNT 17.8 billion in 2003. One of the objectives set by management was to maintain an efficient asset and liability structure while steadily expanding operations.

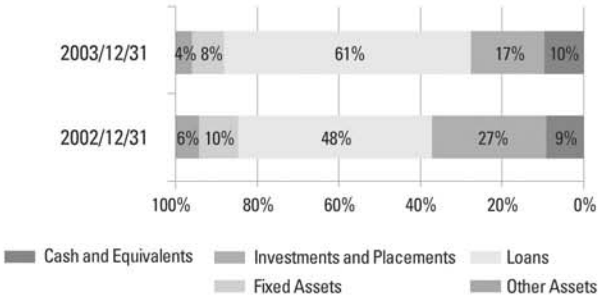
	Annual Growth	
	MNT	%
2001 to 2002	7,611.53	203.0%
2002 to 2003	6,442.31	56.7%

Assets (MNT Million)



The Bank deployed its mobilized funds, deposits and borrowings, to increase its earning assets and improve its liquidity while keeping the percentage of non-earning assets below 10 percent of the total balance sheet. This change in the asset structure contributed to the income generating capacity and profitability of the Bank during the year.

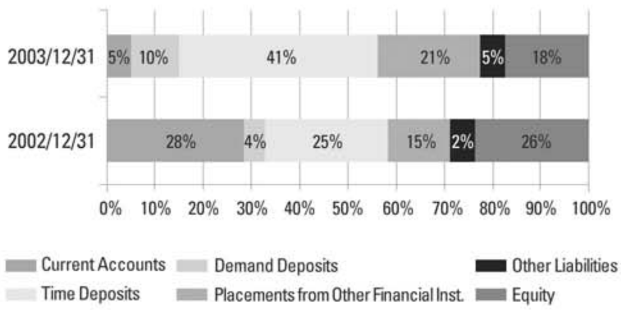
Assets Structure



The number of demand and current accounts grew to 29,012, increasing from 16,796 at the beginning of the year. These short term deposits provide the Bank with low cost liquidity to meet cash demands for maturing large deposits and expanding the earning asset base.

Pursuing a policy of further diversification of the liability structure, the Bank successfully negotiated new term borrowings from Dexia/BlueOrchard for a total USD 1.0 million as well as new debt from the Calvert Foundation for USD 200,000.

Liabilities and Equity Structure

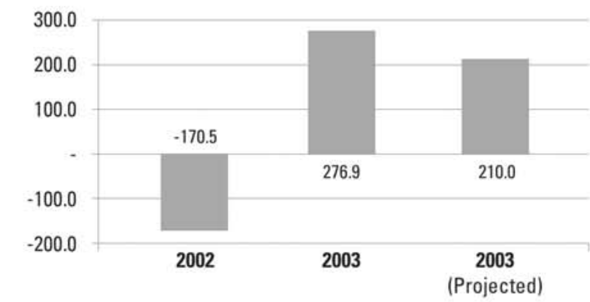


Profitability

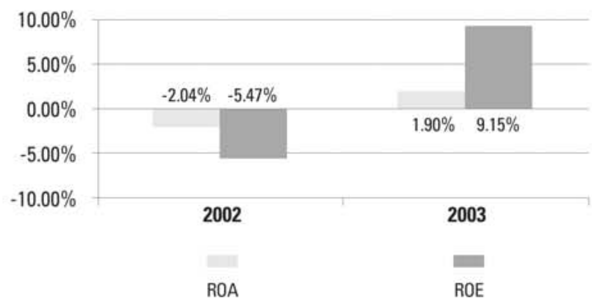
The following measures were introduced to improve efficiency in operations, reduce interest expense and increase fee income, allowing the Bank to exceed its income targets for the year. As a result, a MNT 262 million share dividend was paid to the holding company which was reinvested back into the Bank to meet its Minimum Paid-In Capital requirement.

The Bank achieved Return on Average Assets and Return on Average Equity of 1.90 percent and 9.15 percent, respectively, compared to a net loss for 2002.

Net Income/Loss (MNT Million)



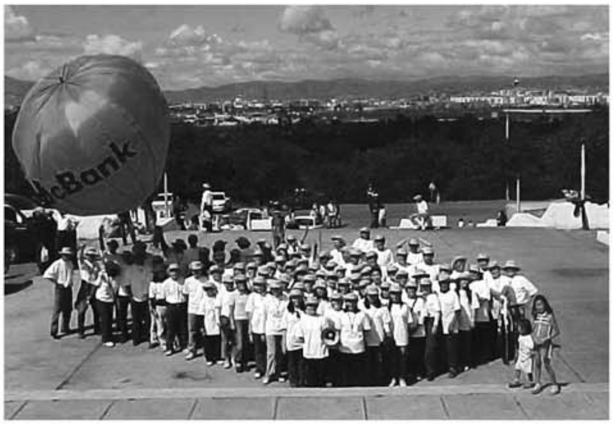
Profitability



Organizational Development and Human Resources

Management Team

The Bank assigns high importance to the management style and structure within the organization. A major reorganization was undertaken in the fourth quarter which streamlined many activities and decentralized decision-making authority, resulting in improved customer service. This has enhanced the Bank's competitiveness by allowing us to approve and disburse loans faster than our competition and still maintain credit quality. Further refinement of this organizational structure will continue in 2004.



Selection

People are our most important resource. The Bank ended 2003 with 420 staff, an increase of 95 during the year. This increase was due in part to the need to staff five new branches opened during the year as well as to accommodate the growing demand for the Bank's products and services. To facilitate integration of our staff into the organization, an orientation program, which includes classroom training and on-the-job training, is consistently delivered to all new team members.

The Bank recruits both internally and externally and strives to attract the best candidates. Externally, the Bank may recruit from leading national universities, as well as offering students internships and scholarships underwritten by the Bank. Publishing job openings allows the Bank to use a transparent selection process, which enables us to reach the most qualified candidates among those who aspire to work for XacBank.

Training

Training is crucial to staff development and retention. As a result, more that 757 hours of in-house and external training is offered each year to staff at all levels.

In-house developed training continues to have a considerable impact, representing over 51 percent of the overall training activity during the year.

To further improve transparency, a Code of Conduct was issued during the year and circulated to all staff. This Code defines ethical guidelines for all staff at all levels.

Human Capital as of Year End 2003

Number of Employees	420
Average Age	28
Men/Women Ratio	51 : 49
Support Staff	88

Intellectual Capital Development in 2003

Total Investment in Training	MNT 49,9 Million
Hours of In-House Training Given	385 hours
Total Training Hours	757 hours
Staff Promoted (percentage in total headcount)	30%

Network

The Bank now has a total of 32 branches in all 21 aymags of Mongolia and all the districts of Ulaanbaatar. Five new branches were opened in 2003, located in Tuv and Bulgan aymags, Nalayh and Baganuur districts of Ulaanbaatar and Mandal soum of Selenge aymag.

A Remote Access Server was also installed to provide a secondary communications channel between branches and the Head Office in case of a failure of service delivery by the Bank's internet service providers. The Bank continued making investments to improve its facilities and security systems.

All branches were furnished with vehicles by year end, allowing us to stay in closer contact with clients in the more remote areas and adding to the efficiency of our lending staff.

Branch Network

Mr. Ganbat Baramsay
Branch Manager, Erdenet

Our branch in Erdenet was established in 2001. After one year of operation, our team was awarded the Best Financial Institution in the Province by Mongolian National Chamber of Commerce and Industry and the Best Branch of XacBank in 2003.

In year 2003, our branch disbursed 1,863 loans for over MNT 1.8 billion in cumulative figures with a repayment rate of 99. 9 percent while attracting over MNT 400 million in new deposits.

Core to our success is the support of our Head Office, while allowing us the independence to quickly respond to customers' needs. Our staff receive high quality training in the headquarters then bring those skills back and share them among the branch staff to better serve our customers and meet their expectations.

In the three years since the establishment of our branch, competition between financial institutions has grown very strong on the local market. Therefore, managing activities with less risk, determining the right vision, sensing the competitor's actions and delivering products and services with high quality while increasing the reputation of the Bank are vital for our successful and sustainable operation in the local market.

Our team is starting 2004 filled with enthusiasm to build on the achievements of last year.

Internal Audit

The Internal Audit Department increased from two to eight during the year to improve controls and ensure that risk management systems were properly installed and applied. While each of the Bank's branches was audited at least once during the year, in cases where inconsistencies were discovered, follow-up audits were conducted.

Following a fraud loss in 2002, the Internal Audit team was particularly diligent in preventing this activity. In total, six minor fraud cases were discovered and all were closed with no direct losses to the Bank. Auditors were an active part of the team involved with installing the loan and accounting system and provided assistance during the installation phase and staff training at 10 branches.

Mr. Tsogbadrah Galbadrah, formerly Manager of the Bank's main branch office, was appointed Director, Internal Audit Department during the second quarter. All audit staff received training during the year organized by the Banking Training Center and the Ministry of Finance and Economy.

Marketing and Public Relations

2003 was the first full year of the Bank's marketing operations. These operations expanded from a single staff person to a dynamic team of three. Overall marketing activities were carried out under the motto "XacBank Right Bank" subsequent to a promotional campaign which successfully introduced the Bank in 2002, its first year of operation.

The Bank's marketing and promotion efforts became more frequent and were carried out through more channels. The main marketing channels were television advertisements during popular programs, sponsorship of television programs, distribution of brochures, newspaper placements and charity events.

A remarkable community appeal for the Tuul River Clean-Up was initiated and organized by the Bank to contribute to environmental protection of the area by raising public awareness and participation, while illustrating the Bank's socially oriented activities and corporate responsibility.

A documentary film was also produced by the Bank to capture its unique history. Released in October, the film commemorates the five year anniversary of the Bank's predecessor NBFI's.

With the launch of two new deposit products and a leasing product, the Bank successfully maintained its image as a financial service provider which offers products with new features and flexible terms and conditions. "Future Millionaire," a savings product designed for youth, had a successful promotion campaign resulting in over 5,000 new accounts in the first quarter of its promotional launch and over 18,000 in new accounts in 2003.

Audited Financial Report

XacBank LLC

Financial Statements for the year ended
31 December 2003

on pages 4 to 32

XacBank

Banking Licence No. 24	dated 27 December 2001, issued by the Bank of Mongolia.	
Board of Directors	Stephen Mitchell	Chairman (from April 2003)
	Stephen D. Vance	Chairman (until April 2003)
	Jambaldorj Erdenechimeg	Director
	Chuluun Ganhuyag	Director
	Tsend Enhtuya	Director (from July 2003)
	Ser-Od Jargalsaihan	Director (from July 2003)
	Nyamaa Tumenbayar	Director (from July 2003)
	Chuluun Ganbold	Director (from July 2003)
	Ganhuyag Munhbat	Director (from October 2003)
	Tuvdendorj Galbaatar	Director (from October 2003)
	Steve Zimmerman	Director (from October 2003)
	Lhagvaa Sahiya	Director (until October 2003)
	Ekkehard Esser	Director (until July 2003)
	Bekhbat Sodnom	Director (until July 2003)
	James Anderson	Non-voting Director (from April 2003
Executive Committee	Chuluun Ganbold	Chairman (from December 2003)
	Nyamaa Tumenbayar	Member
	Steve Zimmerman	Member
	Chuluun Ganhuyag	Member
	James Anderson	Non-voting Member
Audit Committee	Stephen Mitchell	Chairman
	James Anderson	Non-voting Vice-chairman
	Ser-Od Jargalsaihan	Member
	Jambaldorj Erdenechimeg	Member
Risk Management and Lending Committee	James Anderson	Non-voting Chairman
	Tsend Enhtuya	Member
	Tuvdendorj Galbaatar	Member
	Ganhuyag Munhbat	Member
Executive Officers	Chuluun Ganhuyag	Executive Director
	Dugersuren Bat-Ochir	Finance and Accounting Division, Director
	Lhagvasuren Soronzonbold	Branch Banking Division, Director
	Bayanjargal Delgerjargal	Lending Division, Director
	Ganzorig Zul	Administration Division, Director
	Galbadrah Tsogbadrah	Internal Audit Unit, Director
Registered office	XacBank Building Prime Minister Amar's Street Sukhbaatar District, Ulaanbaatar Mongolia	
Auditors	XacBank Building Prime Minister Amar's Street Sukhbaatar District, Ulaanbaatar Mongolia	
	KPMG Limited Vietnam	
	ITGELT-AUDIT LLC	

KPMG

ITGELT-AUDIT LLC

REPORT OF INDEPENDENT AUDITORS

To the Shareholders
XacBank LLC

Scope

We have audited the accompanying balance sheet of XacBank LLC as of 31 December 2003 and the related statements of income, changes in equity and cash flows for the year then ended, as set out on pages 4 to 32. These financial statements are the responsibility of the Company's Directors. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Company for the year ended 31 December 2002 were audited by another firm of auditors whose report dated 7 March 2003 expressed an unqualified opinion on the financial statements.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Audit opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of XacBank LLC as of 31 December 2003 and the results of its operations and its cash flows for the year then ended in accordance with the International Financial Reporting Standards adopted by the International Accounting Standard Board ("IASB").

KPMG Limited

KPMG Limited
Vietnam
Investment Licence No: 863/GP

Ulaanbaatar, Mongolia

Itgeltaudit

ITGELT-AUDIT LLC
Certified Public Accountants
Licence No 24/1001

Date: 31 March, 2004

	Note	2003 MNT'000	2002 MNT'000
ASSETS			
Cash on hand	3	637,419	497,393
Balances with other banks	3	1,143,765	2,228,751
Balances with the Bank of Mongolia	3	1,121,497	553,158
Investment securities	3	1,946,792	898,060
Loans and advances	4	10,840,446	5,401,168
Amounts due from the holding company	5	-	101,868
Property, plant and equipment	6	1,386,299	1,113,460
Other assets	7	727,184	567,229
TOTAL ASSETS		**17,803,402**	**11,361,087**
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities			
Placement from financial institutions		-	400,000
Deposits from customers	8	10,012,172	6,180,013
Loans from local financial institutions	9	1,680,000	280,000
Loans from foreign financial institutions	10	1,197,200	1,153,125
Loans from government agencies	11	856,245	245,000
Deferred grants	12	88,365	93,189
Other liabilities	13	849,571	166,790
Total liabilities		14,683,553	8,518,117
Shareholders' equity			
Share capital	14	3,004,000	3,004,000
Reserves		9,436	9,436
Retained earnings/(accumulated losses)		106,413	(170,466)
Total shareholders' equity		3,119,849	2,842,970
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY		**17,803,402**	**11,361,087**

Chuluun Ganhuyag
Executive Director

Dugersuren Bat-Ochir
Finance and Accounting Division Director

The notes set out pages 9 to 32 form an integral part of these financial statements

	Note	2003 MNT'000	2002 MNT'000
Interest and similar income	15	3,715,511	1,826,684
Interest expense and similar charges	16	(1,168,688)	(371,623)
Net interest income		2,546,823	1,455,061
Fees and commissions	17	218,398	68,721
Net foreign exchange gains/(losses)		(451)	(1,879)
Other operating income	18	151,930	62,674
Net non-interest income		369,877	129,516
Operating income		2,916,700	1,584,577
General and administration expenses	19	(2,290,314)	(1,577,492)
Impairment losses	20	(123,164)	(161,533)
Grant income		241,187	33,372
Other expenses		(241,187)	(33,372)
Profit/(loss) from operations		**503,222**	**(154,448)**
Corporate income tax	21	(226,343)	(16,018)
Net profit/(loss) after tax		**276,879**	**(170,466)**
Earning per share			
Basic earning/(loss) per share (MNT)	22	**85**	**(53)**

Chuluun Ganhuyag
Executive Director

Dugersuren Bat-Ochir
Finance and Accounting Division Director

The notes set out pages 9 to 32 form an integral part of these financial statements

Statement of changes in equity for the year ended 31 December 2003

	Share capital MNT'000	Total MNT'000	Retained earnings / (accumulated losses) MNT'000	Total MNT'000
Balance at 1 January 2002	2,704,000	9,436	-	2,713,436
Issue of share capital	300,000	-	-	300,000
Net loss for the year	-	-	(170,466)	(170,466)
Balance at 1 January 2003	3,004,000	9,436	(170,466)	2,842,970
Net profit for the year	-	-	276,879	276,879
Balance at 31 December 2003	3,004,000	9,436	106,413	3,119,849

Chuluun Ganhuyag
Executive Director

Dugersuren Bat-Ochir
Finance and Accounting Division Director

The notes set out pages 9 to 32 form an integral part of these financial statements

	Note	2003 MNT'000	2002 MNT'000
CASH FLOWS FROM OPERATING ACTIVITIES			
Profit/(loss) before tax		**503,222**	**(154,448)**
Adjustments for			
Depreciation and amortisation		168,555	96,208
Write-off of property, plant and equipment		-	5,020
Allowance for loan losses		115,079	47,591
Impairment losses of other assets		8,085	113,942
(Gain)/losses on disposal of property, plant and equipment		(5,324)	5,811
Operating profit before changes in operating assets and liabilities		**789,617**	**114,124**
Increase in loans and advances		(5,554,357)	(2,900,113)
Decrease/(increase) in amount due from the holding company		101,868	(101,868)
Increase in other assets		(212,097)	(385,914)
(Decrease)/increase in placements from financial institutions		(400,000)	400,000
Increase in deposits from customers		3,832,159	6,180,013
Increase in other liabilities		637,072	128,531
		(805,738)	**3,434,773**
Corporate income tax paid		(136,577)	(60,075)
Net cash flows (absorbed by)/generated from operating activities		**(942,315)**	**3,374,698**
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of property, plant and equipment		(457,317)	(638,758)
Proceeds from disposals of property, plant and equipment		21,247	5,635
Net cash flows used in investing activities		**(436,070)**	**(633,123)**

The notes set out pages 9 to 32 form an integral part of these financial statements

	Note	2003 MNT'000	2002 MNT'000
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from the issues of shares		-	300,000
Increase/(decrease) in loans from local financial institutions		1,400,000	(220,000)
Increase in loans from foreign financial institutions		44,075	714,325
Increase in loans from government agencies		611,245	245,000
(Decrease)/increase in deferred grants		(4,824)	34,129
Net cash flows generated from financing activities		**2,050,496**	**1,073,454**
Net cash flows generated in the year		**672,111**	**3,815,029**
Cash and cash equivalents at the beginning of the year	**3**	**4,177,362**	**362,333**
Cash and cash equivalents at the end of the year		**4,849,473**	**4,177,362**

Chuluun Ganhuyag
Executive Director

Dugersuren Bat-Ochir
Finance and Accounting Division Director

The notes set out pages 9 to 32 form an integral part of these financial statements

These notes form an integral part of and should be read in conjunction with the accompanying financial statements.

1. Corporate information and principal activities

X.A.C. Co., Ltd. commenced operations in 1999 as a non-bank financial institution. The Company first started its operation by rendering five types of loan services. In October 2001, this company entered into a merger agreement with Goviin Ekhlel Co., Ltd., another non-bank financial institution, to form XAC-GE Group, a holding company, which owns a majority stake in XacBank LLC. The shareholders of the holding company are:

- Mercy Corps
- Mongolian Foundation for Open Society
- Mongolian Women's Federation
- Liberal Women's Intellectual Pool
- National Association of Mongolian Agricultural Cooperatives
- Rotary Club of Ulaanbaatar
- Local Governance Development Foundation

The principal activities of XacBank LLC ("the Bank"), which is incorporated as a commercial bank under the Mongolian Banking Law, are to provide a wide-range of banking products and services, including deposit taking, lending, international and domestic payment services, foreign exchange dealing, securities trading, financial and investment consulting, under Banking Licence No. 24 issued by the Bank of Mongolia on 27 December 2001 (referred to as "the Banking Licence").

The Bank has been and continues to be predominantly involved in providing micro financing to the general public to develop retail and small and medium enterprises.

As at 31 December 2003 the Company had 413 employees (2002: 325 employees).

2. Summary of significant accounting policies

The financial statements were authorised for issue by the Board of Directors on 31 March 2004. The following significant accounting policies have been adopted by the Bank in the preparation of these financial statements.

(a) Statement of compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") issued and adopted by the International Accounting Standards Board ("IASB"), and interpretations issued by the Standing Interpretations Committee of the IASB.

(b) Basis of financial statement preparation

The financial statements are presented in Mongolian Tugrug ("MNT"), rounded to the nearest thousand. MNT is the Bank's measurement currency. The financial statements are prepared on the historical cost basis, except the following financial assets and liabilities are stated at fair value: investments held for trading and investments available-for-sale. The accounting policies have been consistently applied by the Bank and are consistent with those used in the previous year.

(c) **Foreign currency transactions**

Transactions in foreign currencies are translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated at the foreign exchange rate ruling at that date. Foreign exchange differences arising on translation are recognised in the income statement. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated at the foreign exchange rate ruling at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at fair value, are translated into MNT at foreign exchange rates ruling at the dates that the values were determined.

(d) **Financial instruments**

(i) Classification

Trading instruments are those that the Bank principally holds for the purposes of short-term trading and liquidity management.

Originated loans and receivables are loans and receivables created by the Bank providing money to a debtor other than those created with the intention of short-term trading. Originated loans and receivables comprise loans and advances to bank and customers.

Held-to-maturity assets are financial assets with fixed or determinable payments and fixed maturity that the Bank has the intent and ability to hold to maturity.

Available-for-sale assets are financial assets that are not held for trading purposes, originated by the Bank, or held to maturity.

(ii) Initial recognition

Financial instruments are measured initially at cost, including transaction costs, when purchased or originated by the Bank.

(iii) Subsequent measurement

Subsequent to initial recognition, all trading instruments and all available-for-sale assets are measured at fair market value, except that any instrument that does not have a quoted market price in an active market and whose fair market value cannot be reliably measured is stated at cost, including transaction costs, less impairment losses.

All non-trading financial liabilities, originated loans and receivables and held-to-maturity assets are measured at amortised cost less impairment losses. Amortised cost is calculated on the effective interest rate method. Premiums and discounts, including initial transaction costs, are included in the carrying amount of the related instrument and amortised based on the effective interest rate of the instrument.

(iv) Specific instruments

Please refer to the respective accounting policy notes for specific financial instruments.

(e) ***Cash and cash equivalents***

Cash comprises cash balances on hand, and cash deposits with the Bank of Mongolia and other banks. Cash equivalents are short-term and highly liquid investments with maturities of three months or less when purchased, which include the Bank of Mongolia's bills, with maturity of one month when purchased and eligible for rediscounting with the Bank of Mongolia.

(f) **Loans and advances**

Loans and advances originated by the Bank are classified as originated loans and receivables. Loans and advances are reported net of allowances to reflect the estimated recoverable amounts (refer to accounting policy (i)).

(g) **Property, plant and equipment**

(i) Cost

Property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The initial cost of an item of property, plant and equipment comprises its purchase price, including import duties, non-refundable purchase taxes and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditure incurred after property, plant and equipment have been put into operation, such as repairs and maintenance and overhaul costs, are normally charged to income in the year in which the costs are incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment beyond its originally assessed standard of performance, the expenditure is capitalised as an additional cost of property, plant and equipment.

(ii) Depreciation

Depreciation is charged to the statement of income on a straight-line basis over the estimated useful lives of property, plant and equipment. The estimated useful lives are as follows:

■ buildings	40 years
■ motor vehicles	10 years
■ office equipment	10 years
■ computers	5 years

(h) **Construction in progress**

Construction in progress represents the cost of construction of new buildings and premises, which have not been fully completed or installed. No depreciation is provided for construction in progress during the period of construction.

(i) **Impairment**

The carrying amounts of the Bank's assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If such an indication exists, the asset's recoverable amount is estimated.

(i) Originated loans and advances

Loans and advances are presented net of specific and general allowances for uncollectability. Specific allowances are made against the carrying amount of loans and advances that are identified as being potentially impaired, based on regular reviews of outstanding balances, to reduce these loans and advances to their recoverable amount. General allowances are maintained to reduce the carrying amount of portfolios of similar loans and advances to their estimated recoverable amounts at the balance sheet date. Increases in the allowance account are recognised in the statement of income. When a loan is known to be uncollectible, all the necessary legal procedures have been completed and the final loss has been determined, the loan is written off directly.

If in a subsequent period the amount of impairment loss decreases and the decrease can be linked objectively to an event occurring after the write down, the write-down or allowance is reversed through the statement of income.

(ii) Assets other than loans and advances

The recoverable amount is the greater of the asset's net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs. An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the statement of income.

An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised. All reversals of impairment are recognised in the statement of income.

(j) Non-trading financial liabilities

Non-trading financial liabilities include deposits from customers and from other financial institutions, interest-bearing borrowings and other amounts payable. Non-trading financial liabilities are initially stated at cost. Subsequent to the initial recognition, they are stated at amortised cost with any difference between cost and redemption value being recognised in the statement of income over the period of the instrument on an effective interest basis.

(k) Grants

Grants are recognised initially in the balance sheet as deferred grants when there is reasonable assurance that they will be receivable and that the Bank will comply with the conditions attaching to them. Grants that compensate the Bank for expenses incurred are recognised as revenue in the statement of income on a systematic basis in the same period in which the expenses are incurred. Grants that compensate the Bank for the cost of an asset are recognised in the statement of income on a systematic basis over the useful life of the asset.

(l) Provisions

A provision is recognised in the balance sheet when the Bank has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessment of the time value of money and, where appropriate, the risk specific to the liability.

(m) Revenue

(i) Interest income

Interest income and expense is recognised in the statement of income as it accrues, taking into account the effective yield of the asset. Interest income and expense include the amortisation of any discount or premium or other differences between the carrying amount of an interest bearing instrument and its amount at maturity calculated on an effective interest rate basis. The recognition of interest income is suspended when the recoverability of principal or interest becomes doubtful. In accordance with the requirement of the Bank of Mongolia, interest is suspended when payment are in arrears for three months (non performing loans). On the commencement of the suspension, related interest receivable is written off. Subsequent to the suspension, interest income is recognised on a cash basis. Interest income recognition will resume on an accrual basis when the uncertainties surrounding the recoverability are removed.

(ii) Fee income and commission

Fee and commission income is charged to customers for the financial services provided. Fee and commission income is recognised when the corresponding service is provided.

(iii) Rental income

Rental income from leased property is recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives granted are recognised as an integral part of the total rental income.

(n) Operating lease payments

Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease expense.

(o) Income tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the statement of income except to the extent that it relates to items recognised directly to equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the year, using the tax rates approved at balance sheet date and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not provided for temporary differences arising on the initial recognition of assets or liabilities that affect neither accounting nor taxable profit. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using the tax rates approved at balance sheet date. Deferred tax assets are recognised in the financial statements only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

(p) Employee benefits

(i) Defined contribution plan

Employee benefits include statutory social insurance payments to the State Social Insurance Scheme. Contributions to this defined contribution plan are recognised as an expense in the statement of income as incurred.

(ii) Equity compensation benefits

The Employee Stock Ownership Plan allows the Bank's staff to acquire shares of the Bank from XAC-GE Group. The purchase price is at 10% of the par value. No compensation cost or obligation is recognised when shares are sold. When shares are purchased, the holding company records the proceeds and share discount in respect of the options exercised and shares will be transferred from the holding company to the employees. No change is made to the Bank's total share capital and no compensation cost is recognised by the Bank.

3. Cash and cash equivalents

	2003 MNT'000	2003 MNT'000
Cash	637,419	497,393
Balances with other banks	1,143,765	2,228,751
Balances with the Bank of Mongolia	1,121,497	553,158
Total cash	2,902,681	3,279,302
Investment securities	1,946,792	898,060
Total cash and cash equivalents	4,849,473	4,117,362

Balances are maintained with the Bank of Mongolia in accordance with the Bank of Mongolia's requirements and bear no interest. Balances are determined based on average deposits and liabilities balances.

Investment securities represent zero-coupon bills issued by the Bank of Mongolia at a discount and stated at amortised cost, with cost adjusted for amortisation of discount to maturity date on a straight-line basis. The investment securities are classified as cash equivalents for the statement of cash flows.

4. Loans and advances

Included in the gross balance of loans and advances is an amount of non-performing loans of MNT212 million (2002: MNT11 million). As at 31 December 2003, assets valued at MNT14,607 million (2002: MNT6, 868 million) were pledged as collateral for loans outstanding.

Movements in the allowance for impairment losses of loans and advances during the year were as follows:

	2003 MNT'000	2002 MNT'000
Loans and advances to customers	10,753,582	5,344,149
Loans to staff	203,732	92,921
Loans to executive officers	54,901	33,897
	11,012,215	5,470,967
Allowance for impairment	(171,769)	(69,799)
Net loans and advances	10,840,446	5,401,168

Included in the gross balance of loans and advances is an amount of non-performing loans of MNT212 million (2002: MNT11 million). As at 31 December 2003, assets valued at MNT14,607 million (2002: MNT6, 868 million) were pledged as collateral for loans outstanding.

Movements in the allowance for impairment losses of loans and advances during the year were as follows:

	2003 MNT'000	2002 MNT'000
Balance as at 1 January	69,799	29,720
Additional allowance during the year	115,079	47,591
Recoveries	-	(5,350)
Write off	(13,109)	(2,162)
Balance as at 31 December	171,769	69,799

Loans and advances can be analysed by industry as follows:

	2003 MNT'000	2002 MNT'000
Textile and production	771,066	83,429
Trading	5,188,031	2,672,516
Food processing	314,608	164,728
Services	717,099	209,751
Consumption	2,298,856	1,055,433
Others	1,463,922	1,158,292
Loans to staff	203,732	92,921
Loans to executive officers	54,901	33,897
	11,012,215	5,470,967

5. Amounts due from the holding company

Amounts due from the holding company, XAC-GE Group, as at 31 December 2002 have been fully repaid in 2003. The loans bore interest at a rate of 14% (2002: 13% to 14%) per annum.

6. Property, plant and equipment

	Buildings MNT'000	Motor vehicles MNT'000	Office equipment MNT'000	Computers MNT'000	Construction in progress MNT'000	Total MNT'000
Cost						
Opening balance	459,451	238,605	144,443	462,491	-	1,304,990
Additions	3,000	120,010	116,013	182,294	36,000	457,317
Disposals	(10,992)	(10,260)	(305)	-	-	(21,557)
Closing balance	451,459	348,355	260,151	644,785	36,000	1,740,750
Accumulated depreciation						
Opening balance	12,728	32,639	29,336	116,827	-	191,530
Charge for the year	11,472	27,280	43,960	85,843	-	168,555
Disposals	(883)	(4,512)	(239)	-	-	(5,634)
Closing balance	23,317	55,407	73,057	202,670	-	354,451
Net book value						
Closing balance	428,142	292,948	187,094	442,115	36,000	1,386,299
Opening balance	446,723	205,966	115,107	345,664	-	1,113,460

Included in the cost of tangible fixed assets were assets costing approximately MNT8 million which were fully depreciated as of 31 December 2003 (2002: Nil), but which are still in active use.

7. Other assets

	2003 MNT'000	2002 MNT'000
Foreclosed properties	32,698	3,155
Prepaid expenses	284,717	289,803
Inventory	96,034	32,491
Low value assets	60,137	21,341
Accrued interest receivable	206,722	113,338
Corporate income tax receivable	-	44,057
Other receivables	46,876	63,044
	727,184	567,229

8. Deposits from customers

	2003 MNT'000	2002 MNT'000
Current accounts	880,022	3,228,979
Savings deposits	1,816,232	467,327
Time deposits	7,315,918	2,483,707
	10,012,172	6,180,013

Current accounts bear interest at a rate of 3.6% per annum applicable to individual balances more than MNT5 million (2002: Nil). Savings deposits bear interest at a rate of approximately 8.60% (2002: 9.39%) per annum. Time deposits bear interest at rates ranging from 3.60% to 18.00% (2002: 6.60% to 22.80%) per annum.

9. Loans from local financial institutions

	2003 MNT'000	2002 MNT'000
Loan from Anod Bank	280,000	280,000
Loan from MongolPost Bank	400,000	-
Loan from Golomt Bank	1,000,000	-
	1,680,000	280,000

10. Loans from foreign financial institutions

	2003 MNT'000	2002 MNT'000
Loan from Deutsche Bank Micro Credit Development Fund ("DBMCDF")	146,000	140,625
Loan from International Finance Corporation ("IFC")	467,200	450,000
Loan from Dexia Micro Credit Fund ("DMCF")	584,000	562,500
	1,197,200	1,153,125

The loan from the DBMCDF is in the form of a promissory note issued by the Bank for a principal amount of USD125,000. The note bears interest at a rate of 2% (2002: 2%) per annum and is repayable in August 2007.

The loan from IFC, amounting to USD400,000, bears interest at a rate of LIBOR+3.5%% (2002: LIBOR +3. 5%). The loan is repayable in twelve semi-annual instalments commencing 15 January 2005.

The loan from DMCF, amounting to USD500,000, bears interest at rate of LIBOR+6% (2002: LIBOR+6. 5%) per annum. The loan is repayable in four equal bi-monthly instalments of USD125,000 each, commencing in February 2006.

These loans are to support further expansion of the Bank's micro-finance and small-medium enterprise lending activities and to strengthen the Bank's technical capability.

11. Loans from government agencies

	2003 MNT'000	2002 MNT'000
Loans from Employment Generation Support Fund	445,000	245,000
Loans from Bank of Mongolia	411,245	-
	856,245	245,000

The objective of the loans from Employment Generation Support Fund is to channel funds to small business entities and individuals. The loans, which are in Mongolian Tugrug, bear interest at a rate of 6% (2002: 6%) per annum and are repayable on 24 May 2004.

IFAD and UNDP loans were channelled through the Bank of Mongolia. The objective of the loans from the Bank of Mongolia is to develop Mongolia's agriculture sector and credit and saving cooperatives. The loans, which are in Mongolian Tugrug, bear interest at rates ranging from 5.5% to 6% per annum and are repayable from 19 May 2004 to 15 January 2006.

12. Deferred grants

	2003 MNT'000	2002 MNT'000
Grant from Consultative Group to Assist the Poorest ("CGAP")	46,557	21,712
Grant from International Finance Corporation ("IFC")	38,872	67,500
Others	2,936	3,977
	88,365	93,189

The CGAP grant was approved in 2001 with the objective of assisting the XAC Co., Ltd in making a successful transition to a micro-finance bank. The grant allows the Bank to carry out the following activities:

- Develop internal systems that meet the requirements and needs of a micro-finance bank;
- Secure higher standard of external audit services; and
- Strengthen senior management and governance, in particular, financial management and banking skills.

The IFC grant was received during the year 2002 with the objective of providing funds for technical assistance in the following initiatives: technical advice, training for senior managers with an established micro-finance institution and participation by an international participant in the meetings of the Bank's Board of Directors and training for the Bank's Board members.

13. Other liabilities

	2003 MNT'000	2002 MNT'000
Interest payable	299,941	46,351
Remittances payable	248,492	16,699
Corporate income taxes payable	45,709	-
Other payables	255,429	103,740
	849,571	166,790

Included in other payables are accruals for audit fees and staff salary.

14. Share capital

	2003	2002
In thousand of shares		
On issue at 1 January	300,400	270,400
Issue for cash	-	30,000
On issue at 31 December – fully paid	300,400	300,400

As at 31 December 2003, the authorised capital of the Bank was MNT4,000 million (2002: MNT4,000 million), which consists of 400,000 ordinary shares at par value of MNT10,000 each. Subsequent to the year-end, each share was split into ten shares in accordance with the Bank's bylaw. The par value was reduced to MNT1,000. The Bank is required to issue this share capital in full by 1 April 2004. See the subsequent event described in note 28.

The holders of ordinary shares are entitled to receive dividends as declared from time to time and entitled to one vote per share at meetings of the Bank, except employees owning shares under the Employee Stock Ownership Plan, who do not have such rights for the first three years of ownership. All shares rank equally with regard to the Bank's residual assets.

As at 31 December 2003, 96% (2002: 96%) of issued shares are owned by XAC-GE Group, the holding company, and 4% (2002: 4%) are owned by other shareholders.

15. Interest and similar income

	2003 MNT'000	2002 MNT'000
Loans and advances	3,573,322	1,805,975
Placements with other banks	98,258	15,614
Investment securities	43,931	5,095
	3,715,511	1,826,684

16. Interest expense and similar charges

	2003 MNT'000	2002 MNT'000
Time and savings deposits	970,169	130,289
Loans	178,180	226,317
Others	20,339	15,017
	1,168,688	371,623

17. Fees and commissions

Fees and commissions represent income from loan application fees, payment service fees, loan commissions and money transfer service fees.

18. Other operating income

	2003 MNT'000	2002 MNT'000
Rental income	122,994	55,624
Other	28,936	7,050
	151,930	62,674

19. General and administrative expenses

	2003 MNT'000	2002 MNT'000
Salaries, provision for staff welfare and bonus	922,244	579,640
Depreciation on property, plant and equipment	168,555	95,454
Travel	83,571	72,685
Rental	329,255	254,269
Representation	39,040	27,714
Fuel and maintenance of vehicles	77,367	45,721
Communication	111,341	86,414
Advertising	68,389	33,540
Maintenance of property and equipment	12,797	57,188
Office supplies	96,744	63,054
Social insurance	177,003	110,945
Other	204,008	150,868
	2,290,314	1,577,492

20. Impairment losses

	2003 MNT'000	2002 MNT'000
Allowance for loan losses	115,079	47,591
Impairment losses of other assets	8,085	113,942
	123,164	161,533

21. Corporate income tax

Recognised in the statement of income:

	2003 MNT'000	2002 MNT'000
Current tax expense		
Current year	228,403	16,018
Under/(over) provided in prior years	(2,060)	-
Income tax expense in the statement of income	226,343	16,018

Reconciliation of effective tax rate:

	2003 MNT'000	2002 MNT'000
Profit/(loss) before tax	503,221	(154,448)
Tax at income tax rate of 15%	75,483	(23,167)
Tax effect of non-deductible expenses	16,835	43,042
Tax effect of tax exempt revenues	(576)	(4,493)
Under/(over) provided in prior years	(2,060)	-
Tax effect of progressive tax rate of 40% on the portion of taxable income exceeding MNT100 million	136,661	636
Income tax expense	226,343	16,018

The calculation of income tax is subject to the review and approval of the tax authorities.

According to Mongolian Tax Laws, the Company has an obligation to pay the Government Income Tax at the rate of 15% of the portion of taxable profits up to MNT100 million and 40% of the portion of taxable profits above MNT100 million.

According to the Mongolian Tax Laws, tax losses cannot be carried forward to offset against future taxable income.

22. Earnings per share

The calculation of basic earnings per share at 31 December 2003 was based on the net profit attributable to the ordinary shareholders of MNT276,879,000 (2002: net loss of MNT170,466,000) and a weighted average number of ordinary shares outstanding during the year ended 31 December 2003 of 320,358 (2002: 315,358), calculated as follows:

In thousands of shares	2003	2002
Issued ordinary shares at 1 January	3,004,000	2,704,000
Effect of shares issued at par in February 2002	-	250,000
Effect of bonus shares issued in January 2004 (note 28)	199,580	199,580
Effect of bonus shares issued in March 2004 (note 28)	61,950	61,950
Weighted average number of ordinary shares	3,265,530	3,215,530

The number of shares issued as part of dividend distributions in 2004 has been added to the number of shares outstanding as at 31 December, as if these shares had been issued at the beginning of the year.

The share split in 2004, whereby each outstanding share was split into ten shares, has been added to the number of shares outstanding as at 31 December, as if these shares had been split at the beginning of the year.

23. Employee benefits

Equity compensation benefits

Under the Bank's Employee Stock Ownership Plan, shares are allocated to employees on the following conditions:

- Employment duration with the Bank and its predecessor companies must be at least one year;
- Performance rating in the most recent evaluation period; and
- No disciplinary action is pending or due.

The number of shares offered for sale will be determined at the discretion of the Bank's management. The Plan enables employees to purchase shares in XacBank LLC already held by XAC-GE Group. The share capital of XacBank LLC is not affected by these transactions.

The shares are purchased within the financial year in which they are offered at a discount price of 10% of the par value.

	Movement of shares offered (expressed in number of shares)	
	2003	**2002**
Shares offered vested during the year	10,160	12,450
Shares offered outstanding at 1 January	-	-
Shares offered during the year	10,160	12,450
Shares offered and purchased during the year	(8,030)	(11,400)
Shares offered and expired during the year	(2,130)	(1,050)
Options outstanding at 31 December	-	-

The Bank does not bear or incur any cost in connection with these transactions.

24. Significant transactions with related parties

The Bank has a controlling related party relationship with XAC-GE Group, the holding company.

The Bank also has a related party relationship with the shareholders of XAC-GE Group (see note 1), and with its directors and executive officers.

As at 31 December 2003, executive officers held 3,200 (2002: 3,200) voting shares of the Bank.

During the year the Bank had the following transactions with related parties:

	2003 MNT'000	**2002 MNT'000**
Loan to executive officer	54,901	33,897
Loans to the holding company	-	101,868
	54,901	135,765

Total remuneration of directors and executive officers included in general and administrative expenses:

	2003 MNT'000	2002 MNT'000
Directors	3,050	3,000
Executive officers	80,264	70,040
	83,314	73,040

25. Capital adequacy

The Bank of Mongolia requires commercial banks to maintain a capital adequacy ratio of 10%, compiled on the basis of total equity and total assets as adjusted for their risk. As at 31 December 2003, the Bank has a risk weighted capital ratio of 24% (2002: 37%), calculated as follows:

	2003 MNT'000	2002 MNT'000
Tier I capital		
Share capital	3,004,000	3,004,000
Retained earnings/(accumulated losses)	106,413	(170,466)
Reserve	9,436	9,436
Total Tier I capital	3,119,849	2,842,970
Tier II capital	-	-
Total Tier I and II capital	3,119,849	2,842,970

Breakdown of risk weighted assets as follows:

Risk weighted factor (%)	2003 MNT'000	2002 MNT'000
0	3,705,708	1,948,611
10	-	-
20	1,143,765	2,228,751
50	-	-
100	12,953,929	7,183,725
Total	17,803,402	11,361,087
Risk weighted capital ratio	24%	37%

26. Risk management disclosure

This section provides details of the Bank's exposure to risk and describes the methods used by management to control risk. Because of the Bank's activities, which are predominantly non-trading, assets structure consists mainly of loans and advances, and their financing, which is mainly from deposits from customers. The most important types of financial risk to which the Bank is exposed are credit risk, liquidity risk, interest rate risk and, to a less extent, foreign currency risk.

Below is a discussion of these risks and the approach taken to manage them:

(i) Credit risk

The Bank's primary exposure to credit risk arises through its loans and advances. The amount of credit risk exposure in this regard is represented by the carrying amounts of the assets on the balance sheet.

The Bank structures the level of credit risk it undertakes by placing limits on the amount of risk acceptable to one individual borrower or a group of borrowers and to an industry sector. Exposure to credit risk is managed through regular analysis of the ability of the borrowers and potential borrowers to meet interest and capital repayment obligations. Credit limit is changed when needed. Exposure to credit risk is also managed by obtaining collateral and corporate and personal guarantees.

The major concentration of credit risk arises by industry sector in relation to the Bank's loans and advances to customers. See note 4 for analysis of total loans and advances to customers by industry sector. The Bank has concentration of credit risk by geographical location as all borrowers are in Mongolia. However, the Bank has no significant exposure to any individual borrower.

(ii) Liquidity risk

Liquidity risk arises in the general funding of the Bank's activities and in the management of its positions. It includes both risk of being unable to fund assets at appropriate maturities and rates and risk of being unable to liquidate an asset at a reasonable price in an appropriate time frame.

The Bank has access to a diverse funding base. Funds are raised using a broad range of instruments including deposits, interest-bearing borrowings from local and overseas financial institutions and share capital. This enhances funding flexibility and limits dependence on any source of funds or any fund provider. The Bank continually assesses liquidity risk by identifying and monitoring changes in funding required to meet business goals and targets set in terms of the overall strategy.

In addition, the Bank holds a portfolio of liquid assets as part of its liquidity risk management policy.

The following table provides an analysis of the financial assets and liabilities of the Bank into relevant maturity groupings based on the remaining periods to repayment:

As at 31 December 2003

	Less than three months MNT'000	Three to six months MNT'000	Six months to one year MNT'000	One to five years MNT'000	Over five years MNT'000	Total MNT'000
Financial assets						
Cash on hand	637,419	-	-	-	-	637,419
Balances with other banks	63,365	350,400	-	730,000	-	1,143,765
Balances with the Bank	1,121,497	-	-	-	-	1,121,497
of Mongolia	1,946,792	-	-	-	-	1,946,792
Investment securities						
Loans and advances	1,314,462	2,726,718	5,911,499	887,767	-	10,840,446
Other assets	269,086	-	83,900	172,502	-	525,488
	5,352,621	3,077,118	5,995,399	1,790,269	-	16,215,407
Financial liabilities						
Deposits from customers	2,713,309	1,661,750	4,156,326	421,240	1,059,547	10,012,172
Loans from local financial institutions	-	400,000	280,000	1,000,000	-	1,680,000
Loans from foreign financial institutions	-	-	-	1,010,320	186,880	1,197,200
Loans from government agencies	-	452,500	215,320	188,425	-	856,245
Other liabilities	688,664	-	61,859	99,048	-	849,571
	3,401,973	2,514,250	4,713,505	2,719,033	1,246,427	14,595,188
Net financial assets/(liabilities)	1,950,648	562,868	1,281,894	(928,764)	(1,246,427)	1,620,219

As at 31 December 2002

	Less than three months MNT'000	Three to six months MNT'000	Six months to one year MNT'000	One to five years MNT'000	Over five years MNT'000	Total MNT'000
Financial assets						
Cash on hand	497,393	-	-	-	-	497,393
Balances with other banks	2,228,751	-	-	-	-	2,228,751
Balances with the Bank of Mongolia	553,158	-	-	-	-	553,158
Investment securities	898,060	-	-	-	-	898,060
Loans and advances	1,196,062	1,592,432	1,989,059	308,210	315,405	5,401,168
Amounts due from holding company	-	-	-	101,868	-	101,868
Other assets	213,254	285,209	-	-	-	498,463
	5,586,678	1,877,641	1,989,059	410,078	315,405	10,178,861
Financial liabilities						
Placement from financial institutions	400,000	-	-	-	-	400,000
Deposits from customers	4,753,935	219,315	418,963	-	787,800	6,180,013
Loans from local financial institutions	-	-	280,000	-	-	280,000
Loans from foreign financial institutions	-	-	562,500	140,625	450,000	1,153,125
Loan from government agencies	-	245,000	-	-	-	245,000
Other liabilities	166,790	-	-	-	-	166,790
Net financial assets/(liabilities)	5,320,725	464,315	1,261,463	140,625	1,237,800	8,424,928
Net financial assets/(liabilities)	265,953	1,413,326	727,596	269,453	(922,395)	1,753,933

(iii) Interest rate risk

The Bank's operations are subject to the risk of interest rate fluctuations to the extent that interest-earning assets and interest-bearing liabilities mature or reprice at different times or in different amounts. In the case of floating rate assets and liabilities the Bank is also exposed to basis risk, which is the difference in repricing characteristics of the various floating rate indices, such as six months LIBOR and different types of interest. Risk management activities are aimed at optimising net interest income, given market interest rate levels consistent with the Bank's business strategies.

Assets-liabilities risk management activities are conducted in the context of the Bank's sensitivity to interest rate changes. In general, the Bank is liability sensitive because its interest assets have a longer duration and reprice less frequently than interest-bearing liabilities. This means that in rising interest rate environments, margins earned will narrow as liabilities reprice. However, the actual effect will depend on a number of factors, including the extent to which repayments are made earlier or later than the contracted dates and variations in interest rate sensitivity within repricing periods and among currencies.

Interest rate risk is managed by increasing or decreasing positions within limits set by the Bank's management. These limits restrict the potential effect of movement in interest rates on interest margin and on the value of interest sensitive assets and liabilities.

The table below summarises repricing mismatches on the Bank's financial assets and liabilities at the balance sheet date. The carrying amounts of interest rate sensitive assets and liabilities are presented in the periods in which they next reprice to market rate or mature, and are summed to show the interest rate sensitivity gap.

As at 31 December 2003				Fixed rate instruments				
	Effective interest rate	Total	Floating rate instruments	Less than three months	Three to six months	Six months to one year	One to five years	Over five years
	%	MNT'000	MNT'000	MNT'000	MNT'000	MNT'000	MNT'000	MNT'000
Financial assets								
Cash on hand	-	637,419	-	637,419	-	-	-	-
Balances with other banks	5% - 7.5%	1,143,765	-	63,365	350,400	-	730,000	-
Balances with the Bank of Mongolia	-	1,121,497	-	1,121,497	-	-	-	-
Investment securities	7% - 11.5%	1,946,792	-	1,946,792	-	-	-	-
Loans and advances	7% - 31.45%	10,840,446	-	1,314,462	2,726,718	5,911,499	887,767	-
Other assets	-	525,488	-	269,086	-	83,900	172,502	-
		16,215,407	-	5,352,621	3,077,118	5,995,399	1,790,269	-
Financial liabilities								
Deposits from customers	3.6% - 18%	10,012,172	-	2,713,309	1,661,750	4,156,326	421,240	1,059,547
Loans from local financial institutions	12% - 15%	1,680,000	-	-	400,000	280,000	1,000,000	-
Loans from foreign financial institutions	2% - 7.22%	1,197,200	1,051,200	-	-	-	146,000	-
Loans from government agencies	5.5% - 6%	856,245	-	-	452,500	215,320	188,425	-
Other liabilities	-	849,571	-	688,664	-	61,859	99,048	-
		14,595,188	1,051,200	3,401,973	2,514,250	4,713,505	1,854,713	1,059,547
Net financial assets / (liabilities)		1,620,219	(1,051,200)	1,950,648	562,868	1,281,894	(64,444)	(1,059,547)

As at 31 December 2002

				Fixed rate instruments				
	Effective interest rate	Total	Floating rate instruments	Less than three months	Three to six months	Six months to one year	One to five years	Over five years
	%	MNT'000	MNT'000	MNT'000	MNT'000	MNT'000	MNT'000	MNT'000
Financial assets								
Cash on hand	-	497,393	-	497,393	-	-	-	-
Balances with other banks	6.75% - 12.5%	2,228,751	-	2,228,751	-	-	-	-
Balances with the Bank of Mongolia	-	553,158	-	553,158	-	-	-	-
Investment securities	4.5%	898,060	-	898,060	-	-	-	-
Loans and advances	24.7% - 48.2%	5,401,168	-	1,196,062	1,592,432	1,989,059	308,210	315,405
Amounts due from holding company	13%-14%	101,868	-	-	-	-	101,868	-
Other assets	-	498,463	-	213,254	285,209	-	-	-
		10,178,861	-	5,586,678	1,877,641	1,989,059	410,078	315,405
Financial liabilities								
Placement from financial institutions	18%	400,000	-	400,000	-	-	-	-
Deposits from customers	3.6% - 20.1%	6,180,013	-	4,753,935	219,315	418,963	-	787,800
Loans from local financial institutions	15%	280,000	-	-	-	280,000	-	-
Loans from foreign financial institutions	5.34% - 9.37%	1,153,125	1,012,500	-	-	-	140,625	-
Loans from government agencies	6%	245,000	-	-	245,000	-	-	-
Other liabilities	-	166,790	-	166,790	-	-	-	-
		8,424,928	1,012,500	5,320,725	464,315	698,963	140,625	787,800
Net financial assets / (liabilities)		1,753,933	(1,012,500)	265,953	1,413,326	1,290,096	269,453	(472,395)

(iv) ***Foreign currency risk***

The Bank is exposed to foreign currency risk through transactions in foreign currencies, primarily in USD. The Bank's management sets limits on the level of exposure by currencies. These limits have been set below the minimum requirements of the Bank of Mongolia.

The Bank's transactional exposures comprise the monetary assets and monetary liabilities that are not denominated in the measurement currency. These exposures are as follows:

	31 December 2003			31 December 2002		
	MNT de-nominated MNT'000	Foreign currencies MNT'000	Total MNT'000	MNT de-nominated MNT'000	Foreign currencies MNT'000	Total MNT'000
Financial assets						
Cash on hand	517,222	120,197	637,419	360,539	136,854	497,393
Balances with other banks	36,052	1,107,713	1,143,765	1,511,578	717,173	2,228,751
Balances with the Bank of Mongolia	700,923	420,574	1,121,497	357,618	195,540	553,158
Investment securities	1,946,792	-	1,946,792	898,060	-	898,060
Loans and advances	10,321,670	518,776	10,840,446	4,980,708	420,460	5,401,168
Amounts due from holding company	-	-	-	101,868	-	101,868
Other assets	243,609	281,879	525,488	422,205	76,258	498,463
	13,766,268	2,449,139	16,215,407	8,632,576	1,546,285	10,178,861
Financial liabilities						
Placement from financial institutions	-	-	-	400,000	-	400,000
Deposits from customers	9,382,519	629,653	10,012,172	5,875,807	304,206	6,180,013
Loans from local financial institutions	1,680,000	-	1,680,000	280,000	-	280,000
Loans from foreign financial institutions	-	1,197,200	1,197,200	-	1,153,125	1,153,125
Loans from government agencies	856,245	-	856,245	245,000	-	245,000
Other liabilities	399,500	450,071	849,571	65,554	101,236	166,790
	12,318,264	2,276,924	14,595,188	6,866,361	1,558,567	8,424,928
Net financial assets/(liabilities)	1,448,004	172,215	1,620,219	1,766,215	(12,282)	1,753,933

27. Fair value information

As there is no active market for a large part of the Bank's financial instruments, judgement is necessary in estimating fair value, based on current economic conditions and specific risk attributable to the instrument. Based on these estimates, fair value of financial assets and liabilities are considered to not differ significantly from their carrying amount. The following methods and assumptions are used in estimating the fair value of financial instruments:

(i) Loans and advances

The fair value of the loan portfolio is based on the credit and interest rate characteristics of each individual loan. The estimation of the provision for loan losses includes consideration of risk premium 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 their fair value.

(ii) Deposits from customers

For demand deposits and deposits with no defined maturity, fair value is taken to be the amount payable on demand at the balance sheet date. The estimated fair value of fixed-maturity deposits is based on discounted cash flows using rates currently offered for deposits of similar remaining maturities. As most of the deposits have original maturity of less than one year and the rates offered by the Bank are similar to the market rate, the carrying amount of deposits is considered to be a reasonable estimate of fair value.

(iii) Loans from local financial institutions government agency

These loans mature within one year. Their carrying amount is considered to be a reasonable estimate of fair value.

(iv) Loans from foreign financial institutions

Most of the loans bear interest at floating rate. Their carrying amount is considered to be a reasonable estimate of fair value.

27. Subsequent events

(i) Dividend distributions

Subsequent to the year-end, a MNT200,000,000 dividend was proposed by the Directors to the shareholders existing at 31 December 2003, with MNT199,580,000 in the form of 19,958 new shares issued and MNT420,000 in cash. The new shares were allocated to shareholders so as to cover as much as possible the amount of the dividend to the nearest MNT10,000. The balance was paid by cash.

Subsequent to the year-end, a further MNT62,000,000 dividend was proposed by the Directors to the shareholders existing at 31 December 2003, with MNT61,950,000 in the form of 61,950 new shares issued at par of MNT1,000 and MNT50,000 in cash. The new shares were allocated to shareholders so as to cover as much as possible the amount of the dividend to the nearest MNT1,000. The balance was paid by cash.

These dividend distributions were not recognised in these financial statements except in the calculation of earnings per share (note 22).

(ii) Share capital contributions

Subsequent to the year-end, the following capital contributions were made:

- On February 2004, the Bank issued 52,000 new shares at par to the holding company for cash. The Bank received proceeds of MNT520,000,000 for this share issue. To fund this transaction, the holding company issued 40,000 new shares to Tuushin LLC, a company incorporated in Mongolia, for cash of MNT520,000,000.

- On March 2004, the Bank issued 221,960 shares at MNT1,020, MNT20 above par, to the holding company for cash. To fund this transaction, the holding company issued shares to Mercy Corps, a company incorporated in United States of America and Monnis, a company incorporated in Mongolia, for cash.

- On March 2004, the Bank issued 50,000 shares at MNT1,020, MNT20 above par, to Cydan S&C, a company incorporated in Mongolia.

These transactions resulted in issued capital, amounting to MNT4,061,930,000, exceeding the minimum issued capital of MNT4,000,000,000 set out by the Bank of Mongolia. They have not been not recognised in the financial statements.

29. Corresponding figures

Certain corresponding figures have been reclassified to conform with the current year's presentation.

Chuluun Ganhuyag
Executive Director

Dugersuren Bat-Ochir
Finance and Accounting Division Director