

## GIRAFE

## Khan Bank, Mongolia

August 2006

### Rating

A+	
A	
<b>A-</b>	<b>Excellent</b> The institution excels in the evaluation area and is a model for the sector. There is a long-term vision for continual improvement.
B+	
B	
B-	There are no risks in the short and medium term for operations. Long-term risks are well managed and monitored.
C+	
C	
C-	
D	
E	

### Trend

<b>Positive</b>	The process of turning online the entire network will further streamline the financial services and strengthen internal controls. Khan Bank brand, financial strength and unmatched market penetration should allow the bank to face competition.
Stable	
Uncertain	
Negative	

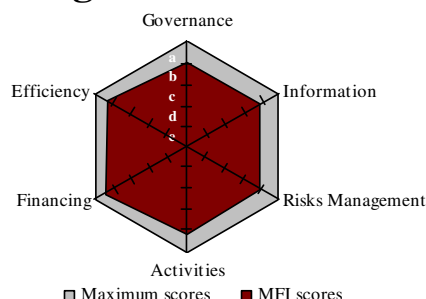
### Performance indicators

(K USD, unless otherwise noted)

	Dec. 03	Dec. 04	Dec. 05	Jun. 06
<b>ACTIVITY</b>				
Total number of staff	1,787	1,951	2,226	2,372
Assets	75,871	121,604	168,135	219,913
Assets (M MNT)	88,617	147,019	205,292	257,518
Loan portfolio	44,599	67,059	110,037	142,320
Outstanding deposits	67,821	108,150	150,254	190,435
Active borrowers	108,960	130,695	177,581	207,284
Active savers	371,108	456,064	621,406	767,956
APR*	See annexes for details on APR			
PAR 31-365	1.0%	3.3%	1.6%	1.2%
PAR > 365	0.1%	0.4%	1.2%	1.3%
Write-off ratio	0.0%	0.0%	0.2%	0.0%
Risk coverage ratio	151.1%	90.8%	134.8%	124.0%
<b>PERFORMANCE</b>				
ROE	38.3%	38.7%	36.6%	60.4%
Liabilities / Equity	15.03	13.16	12.66	11.63
ROA	2.8%	2.6%	2.6%	4.6%
OSS	122.8%	118.8%	121.5%	142.3%
FSS	122.2%	117.6%	119.6%	139.6%
Portfolio Yield	42.0%	35.6%	33.1%	31.9%
Op. expense ratio	19.8%	14.9%	13.4%	11.6%
Staff productivity	61	67	80	87
Fund. expense ratio	17.3%	19.3%	16.5%	13.1%
<b>GROWTH</b>				
Portfolio growth	108. %	55.6%	65.7%	24.0%
Saving port. growth	73.3%	65.1%	40.3%	21.6%
Asset growth	76.2%	65.9%	39.6%	25.4%
<b>USD/ K MNT</b>	<b>1.17</b>	<b>1.21</b>	<b>1.22</b>	<b>1.17</b>

June 2006 ratios have been annualized.

\* The APR of existing products varies between 11.7% (Staff Loans) and 38.0% (Pension Loans). The average interest rate reported by the bank as of June 2006 was 31.1%.



### Description of the institution

Khan Bank was first established in 1991 under the name of Agricultural Cooperative Bank of Mongolia (Ag Bank), with the specific goal of serving the rural sector. It stemmed from the assets of the former State bank that was liquidated at the end of the communist era. Poor management and financial insolvency led the Government of Mongolia, the Bank of Mongolia, the World Bank and USAID to implement in 2000 a restructuring plan that included a recapitalization and a management turnaround. Under this plan, Development Alternatives, Inc. was contracted to manage the bank. Khan Bank now offers various financial services, including 14 loan products, three types of deposit products and Visa cards. With 410 branches, the bank has the most extensive banking network of Mongolia. As of June 2006, Khan Bank had an outstanding portfolio of 142.3 M USD for 207,284 borrowers and deposits of 190.4 M USD for 767,956 depositors. Its owners are HS Investment Co. Ltd. - a subsidiary of the Japanese holding HS Securities Co. Ltd - (53.2%), Tavan Bogd Trade Co. Ltd. (35.5%), the International Finance Corporation (9.1%) and Development Alternatives, Inc. (2.2%).

### Rating summary

**Khan Bank has been assigned a global rating of A-.**

This rating reflects Khan Bank leading position in the Mongolian banking sector. In an increasingly competitive environment, Khan Bank is one of the most profitable banks of Mongolia and has been growing continuously thanks to its excellent reputation and its rural market dominance. It has developed a diversified range of financial services and reports an excellent portfolio quality. The management team, led by skilled and committed expatriate top managers, is being strengthened with experienced local managers. The main challenges of Khan Bank in the medium term are turning all its branches and sub-branches to the online MIS in the most cost-effective way and bringing additional capital to accompany the growth of the institution.

### Support

In the event of financial difficulties, Khan Bank would turn to its shareholders for support, who have both the capacity and propensity to support the bank.

### Rating Trend

This grade has been given with a **Positive** trend. The process of turning online the entire network will further streamline the financial services and strengthen internal controls. Khan Bank brand, financial strength and unmatched market penetration should allow the bank to face competition.

### Financing needs

Khan Bank finances itself mainly through deposits and does not require financing through debt to grow.

### Planet Rating

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## ▪ Microfinance sector

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Following three banking crisis and subsequent reforms in the late 1990s, Mongolia's banking sector has been growing very briskly. Banking sector assets have doubled between 1999 and 2002 and have since maintained high growth rates. Banking assets grew by 43% between 2004 and 2005 and loans outstanding similarly grew by 42% during the same period. On the surface, Mongolia's 2.5 million population is well served by 16 commercial banks registered with the Bank of Mongolia (BOM), and 162 non-bank financial institutions (NBFI) and 316 saving and loan associations (SL) registered with the Financial Regulatory Commission.

However, many actors are not committed to transparency. SLs are not effectively regulated, endangering members' deposits. Additionally, there have been recent signs of alarm: in a very competitive environment, the margins of the smallest banks have decreased to the extent that, as of June 2006, four were reporting losses. There are fears that some small banks will not be able to reach the new minimum statutory capital of 8 billion MNT required by the BOM from March 2006.

Among the commercial banks, two clearly stand out as premier microfinance banks: Khan Bank and Xac Bank together control an estimated 75% of microfinance loans outstanding. Of the 162 NBFIs, about 60 are donor-funded NGOs engaging in microfinance with Credit Mongol being the most prominent. Despite growing outreach to rural areas, more than 80% of microfinance loans outstanding are still concentrated in the capital city and larger towns. Coverage of the rural areas is dominated by Khan Bank with Xac Bank being a strong contender and with SLs filling the gaps left by these two banks.

According to the 2004 UNDP's sub-sector review of microfinance in Mongolia, 70% of all households can be qualified as clients of microfinance. The Government of Mongolia considers microfinance as an important tool to fight poverty. According to a survey of public opinion published by the BOM in 2005, 67.3% of the 5,341 surveyed participants have a general idea of microfinance. Of these, 60% stated that they have access to micro-loans. Most of micro-loans are used for trading and service businesses with a significant portion going to agriculture-related businesses including animal herding or husbandry and growing crops or vegetables. The BOM stated that demand for loans remains high and that microfinance is becoming an important source of self-employment that deserves policy and financial support.

## ▪ Political and economic environment

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Due largely to a cyclical upswing in commodity prices, Mongolia's economy remained dynamic after the exceptional year registered in 2004, with GDP growth of 6.2% in 2005. The country has benefited from a high degree of specialization in minerals with copper and gold respectively representing 33% and 28% of total exports. The economy also benefits from the dynamism of neighboring China (half of exports) currently eager for raw materials. Services, notably tourism, have been posting good performance, as have the agricultural and livestock industries. The economic situation has nonetheless remained tied to raw material price trends.

The main sovereign indicators continued to improve in 2005. The country had significant surpluses in both the current and capital accounts at year-end 2005. Foreign exchange reserves are forecast to grow to record levels by year-end 2006. The country's financial outlook has been brighter since the conclusion of an agreement with Russia, end 2003, on debt contracted before 1991. The external debt and interest service burden remains manageable thanks to concessional interest rates and favorable maturities, while the gross financing requirement is projected to fall to the lowest level since 1997. The Government authorities have moreover undertaken to reform state-owned companies. According to the IMF, governance of public institutions needs improvement.

Nambaryn Enkhbayar, the Mongolian Revolutionary Party candidate, won the May 2005 presidential election. The new president would like to increase presidential powers, which could cause internal tensions. In the international arena, thanks to its mineral wealth and strategic position, the country has maintained good relations with its neighbors and its main financial backers, including the United States.

Mongolia is a medium human development country and occupies the 114<sup>th</sup> position out of 177 in the 2005 Human Development Report of the UNDP.

USD millions	2003	2004	2005	2006p
Economic growth (%)	5.6	10.6	6.2	6.0
Inflation (%)	0.0	8.2	13.0	4.5
Public sector balance (%GDP)	-4.0	-2.0	3.2	-1.6
Current External Receipts CXR	1066	1546	1760	1955
Current External Payments CXP	1240	1482	1676	1868
Trade balance	-174	63	84	87
Current account balance (%GDP)	-12.9%	3.8%	4.4%	4.2%
Gross External Debt (%GDP)	100.3%	92.9%	83.9%	79.6%
Debt service (%Exports)	33.3%	6.0%	2.3%	5.9%
Foreign exchange reserves (import months)	2.4	2.0	3.1	3.6

Source: COFACE's Country Risk Ratings Guidebook 2006 and FitchRatings website. *Disclosure Statement:* Data is provided with authorization from COFACE - a shareholder of Planet Rating.

## ■ Institutional presentation

### Networks

Khan Bank is a member of the Bankers Association of Finance and Trade (BAFT), the Mongolian Bankers Association (MBA), the National Chamber of Commerce and Industry (NCCI) and the Art Council of Mongolia.

### History

Khan Bank was first established in 1991 with the name of Agricultural Cooperative Bank, later becoming Agricultural Bank of Mongolia (Ag bank), with the specific goal of serving the rural sector. It stemmed from the assets of the former State Bank that was liquidated at the end of the communist era. Ag Bank was initially owned by agricultural cooperatives, which were later broken apart into private agricultural companies. The bank inherited a massive network of branches from the former monopoly State Bank.

The bank faced serious financial problems related to poor management and political favoritism in the disbursement of loans. Insolvency led to a first rescue plan in 1996 financed by the Asian Development Bank (ADB), involving the placement of Government Bonds to replace bad debt. However, this strategy did not come along with a management shift, so that by 1999 the bank was again insolvent and placed under receivership by the BOM. Given the key role of the institution in the provision of financial services in rural areas, the Government of Mongolia and the BOM drew up a restructuring plan that met the conditions of the World Bank's Financial Sector Adjustment Credit. Under the plan, the government recapitalized the bank and installed an external management team, funded by USAID. Development Alternatives, Inc (DAI) was contracted to manage the bank. DAI's management team was charged with restoring the bank to financial soundness and preparing the bank for privatization.

### Ownership

*Members of the Board in annexes.*

The owners of Khan Bank are HS Investment Co. Ltd - a subsidiary of the Japanese holding HS Securities Co. Ltd - (53.20%), Tavan Bogd Trade Co. Ltd (35.46%), the International Finance Corporation - IFC - (9.11%) and DAI (2.23%). As of June 2006, paid in capital was 11.5 billion MNT (9.8 M USD). In 2003 HS Securities won a tender organized for the privatization of the bank and purchased 100% of the shares. Some months later Tavan Bogd Trade, a leading local holding involved in services and commercial activities, purchased 40% of the shares from HS Securities and became a shareholder of the bank. IFC invested in December 2004 as part of its strategy to reinforce the financial sector of Mongolia, and DAI invested at the same time in the context of its commitment to manage the bank.

Khan bank is governed by a Board of Directors (BOD) of five members, representing the shareholders. HS Securities is represented by two members: the President - Chairman of the BOD - and the General Manager of the company. Khan Bank's CEO is a member of the BOD, where he represents DAI and the Management Team. The BOD meets monthly, either through face to face meetings or by phone. An Audit Committee has been recently created with three members of the BOD.

### Management team

*Organizational chart in annexes.*

The expatriate Senior Management Team provided by DAI consists of the CEO J. Peter Morrow (in this position since 2000) and the Deputy CEO Ben Turnbull (former COO, in the bank since 2003). Both have more than 30 years of banking experience in the US and overseas. The bank routinely engages consultancy services when needed. The European Bank for Reconstruction and Development (EBRD) provided technical assistance for two years. One of the consultants remained with the bank as an advisor primarily for credit activities.

The rest of Senior Management includes experienced local staff that has been promoted to senior positions. Key positions are Chief Operating Officer (COO), Chief Administrative Officer (CAO), Chief Financial Officer (CFO), Chief Information Officer (CIO) and two business managers for Ulaanbaatar and rural operations. The COO S. Sukhbold and the CFO R. Munkhtuya were promoted in 2005. The CIO position is vacant at the moment but all IT related issues are supervised by an external advisor and various local IT Managers.

Besides headquarters Management Team, the bank has 23 rural branches managed by knowledgeable branch managers. There is a wide delegation of power to rural branches for issues like human resources, planning of sub-branches and loan decision. Ulaanbaatar branches are less autonomous.

## Donations

Khan Bank has not received donations as such. The only reported donations are fixed assets transferred from USAID for an amount of 13,990 K MNT (11,947 USD). These assets have already been fully depreciated.

## Legal form, supervision and audit

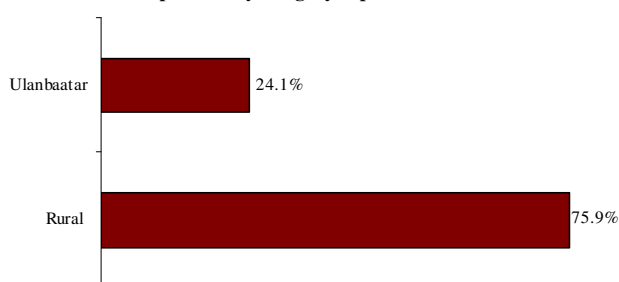
Khan Bank operates as a licensed bank with the status of a Limited Liability Company. It operates under the banking law and is supervised by the BOM. Requirements for such a license include monthly reporting of financial statements and prudential ratios, annual supervision missions, and BOM approval of new shareholders.

Financial statements are audited every year and there is a financial review at mid-year. Ernst and Young is the external auditor of the bank since 2003. Auditors have always provided unqualified opinions for Khan Bank's financials.

## Market penetration

Khan Bank headquarters are in the capital city Ulaanbaatar. The service network includes 23 rural branches and 35 branches in Ulaanbaatar. Mongolia is divided in 21 provinces or aimags, which are sub-divided in soums. Khan Bank has a branch in each aimag center. These branches are responsible for a network of 360 sub-branches based in almost all the soums of the country. All credit and deposit operations are performed at the branches and sub-branches through tellers. Services to the corporate customers (Corporate Banking) are available primarily in Ulaanbaatar since there is no demand for them in other areas of the country. Visa card payments are available in Ulaanbaatar and in each aimag centre.

Loan portfolio by category of product as of June 2006



Khan Bank is today the third bank of Mongolia in terms of assets behind Trade and Development Bank (TD Bank) and Golomt Bank. However, it is clearly the largest retail bank, with the highest number of depositors and 51.9% of total deposits in local currency as of June 2006.

## Products and services

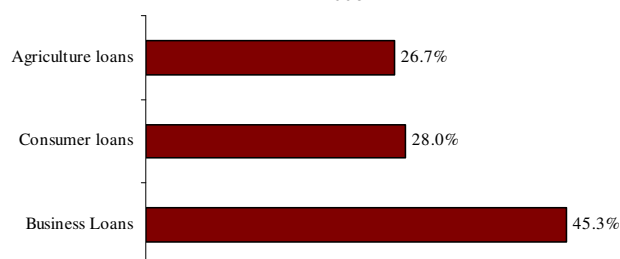
*Please see annexes for more details*

Khan Bank offers 14 loan products, sub-divided in three broad categories:

- **Business loans:** short term business loans, term loans, investment loans, loans in USD, Express Micro. These products have variable lengths, from up to nine months for Express Micro to 60 months for investment loans. For almost all loans there is no maximum amount, and the average loan disbursed ranges from 744 USD for Express Micro to 55,313 USD for investment loans. Short term business loans, the most developed business product with 30.4% of total portfolio, reports an average loan disbursed of 3,473 USD as of June 2006.
- **Consumer loans:** salary loans, pension loans, staff loans, leasing loans, mortgage loans, secured by deposits loans. Products under this category can also have a term of up to 60 months (mortgage loans) and even 120 months for some staff loans, although they are mainly short term. The average loan disbursed ranges from 88 USD for pension loans to 3,230 USD for mortgage loans. Salary Loans, the most developed consumer product with 9.7% of total portfolio, reports an average loan disbursed of 392 USD as of June 2006.
- **Agriculture loans:** herder loans and agricultural loans. These loans are short term and are capped at 8,540 USD. The average loan amount is 881 USD for herder loans (the most developed agriculture product with 25.0% of portfolio) and 707 for agriculture loans.

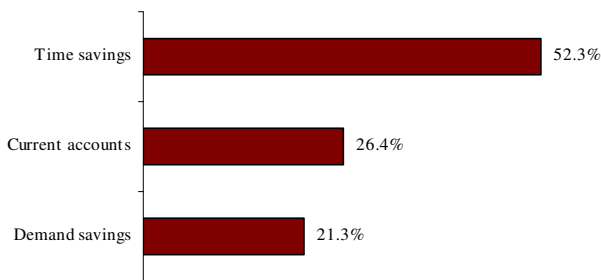
Interest rates are very flexible according to the kind of product and the credit history of the client. They can also vary from region to region depending on competition. As of June 2006, the average interest rate charged by the bank was 31.1%, with an average interest rate of 23.9% in Ulaanbaatar branches and 32.7% in rural branches. Nominal interest rates range from 12% for staff loans to 48% for some herder loans.

Loan portfolio by category of product as of June 2006



Khan Bank offers three main deposit products: current accounts, demand savings and time savings, all both in local and foreign currency. Time savings –mainly of individuals- are the most developed deposit product and represent 52.3% of total deposits as of June 2006. They are subdivided in various sub-products according to their maturity and purpose (Children, Herder, Marriage, etc.). Interest rates on time savings in local currency can go up to 15%. The average interest rate paid by the bank on deposits was 9.9% as of June 2006.

Deposit portfolio by category of product as of June 2006



Khan Bank is a major provider of fee-based payment services due to its wide network: money transfers, payment of salaries, pensions, public services, benefits, collection of customs revenues, etc. Many local and international projects have signed agreements with the bank to work as their financial partner. The “French Food Aid” program, the Agricultural Field Development Project of the ADB and the “Micro Finance Fund” under the Sustainable Livelihood Project of the World Bank and the Government of Mongolia use Khan Bank tellers to reach their final beneficiaries.

Over the last years Khan Bank has also developed products for its urban clients with more specific financial needs. The bank offers Visa payment services and has recently created its own cards processing centre. A Corporate Banking department has been created at the headquarters for serving local companies that require personalized services.

## ■ Governance

**Governance and Decision Making** is rated “b”

### Decision-making

Khan Bank has a strong governance structure that effectively oversees the institution and provides strategic orientation:

- The shareholder structure includes reputable local and international investors.
- All shareholders are financially solid and committed to the financial soundness of the bank. The shareholders have recently shown their willingness to bring additional resources in order to enhance the capitalization of the bank.
- The members of the BOD all have valuable experience and bring added value to the discussions. The monthly meetings of the BOD lead to an effective follow up of activities. The meetings are on average one hour and a half long and well documented through detailed minutes.
- The management information to the BOD is comprehensive, detailed and follows a standard format that enables a quick understanding of results. Financial performance is clearly explained, with analysis of trends and comparison to sector benchmarks.

The BOD, with five members, is relatively small for the size of the bank. This limitation hinders the capacity of the BOD to create sub-committees which are very necessary to follow up specific issues. In 2006 the BOD went in the right direction by creating an Audit Committee dedicated to oversee external and internal audit issues, but it still too new to be assessed.

The CEO was elected to the BOD in March 2003, but participates not as a representative of DAI but rather in his capacity of CEO. DAI has the right under the shareholder’s agreements to appoint a representative, as Tavan Bogd has the right to appoint a second representative, but neither has done so.

### Planning

Khan Bank has a very detailed planning process that includes a one-year business plan and quarterly meetings with all the Management Team and branch managers to evaluate results and set quarterly operational goals. The business plan is based on a deep understanding of the market, the strengths and weaknesses of the bank and includes detailed activities and financial projections. The quarterly meetings go much further in terms of detail and are an opportunity to adjust goals according to achievements. Branches are then free to translate quarterly goals in specific sub-branch goals. This decentralization of planning to branches is consistent with the size of the network and brings higher accountability.

2006 goals are consistent and address the main risks faced by Khan Bank: speed up the process of bringing sub-branches online; implement the new version of the MIS; expand the products range, in particular for urban customers; strengthen cards-based services; continue network expansion based on demand. Financial projections are based on accurate and generally conservative assumptions. Following the trends of the market, the bank is planning a slight reduction of credit interest rates from 31.9% to an average of 28.6% and an increase of the average interest rate on time deposits from 13.8% to 15.0%. This reduction of the financial margin will be largely compensated by volume effects and the development of fee-based services. Portfolio growth is expected to be 22%, something manageable given the growth reported in previous years (55.6% in 2004, 65.7% in 2005). Current accounts and demand savings will grow by 36% both, while time deposits will grow only by 14%. Note that the average growth of deposits in 2004 and 2005 was 65.1% and 40.3% respectively.

As of June 2006 the bank had already exceeded almost all its financial projections. Portfolio growth has been 24%, while deposits growth has been 21.6%. Indeed, despite the strong growth rates reported in previous years, Khan Bank

tends to be cautious due the recent signs of alarm in the banking sector, the demographic limitations of the market and the vulnerability of the Mongolian economy. Additionally, the little reliability of country statistics does not favor the generation of meaningful projections. The quarterly meetings are from this point of view highly useful to adjust goals to reality.

Nonetheless, the bank does not have a strategic plan that would address critical long-term issues such as the building of a local Senior Management Team, the future capital structure, the involvement of DAI in management and capital, and the balance between rural and Ulaanbaatar markets.

### **Management team**

Khan Bank's Management Team is robust and its size is adapted to the dimensions of the institution. After six years managing the bank, the CEO has a long term and personal commitment with the success of the institution. Most key positions are filled (except CIO) and the new organizational chart is adequately structured. Up to 2004, the bank only had three top managers: CEO, COO and CAO. With the growth of the bank and the professional development of local managers, the positions of Deputy CEO, CFO and CIO were also created.

Various communication channels between top managers and middle managers enable a quick decision making. Every week the Executive Committee gathers all top managers. Every two weeks the Management Committee includes members of the Executive Committee plus the heads of departments. The Asset and Liabilities Committee (ALCO) meets every two weeks and the Executive Credit Committee meets as needed. The IT Users Group was created recently to give a special follow up of issues related to the rolling out of online sub-branches and the implementation of the new version of the MIS (see "I"). The quarterly meetings with branch managers are the main coordination tool of the network.

Some top management positions are new (COO, CFO, Ulaanbaatar and Rural business managers) and they are still in the process of fully assuming and defining their strategic responsibilities. They have all the necessary experience to fulfill their duties and are highly respected by their colleagues. They must now develop the strategic dimension of their position.

The foreign top managers have succeeded in creating a skilled local top Management Team. Their international experience and knowledge of best banking practice is complementary with the local knowledge and the dynamism of Mongolian top managers. There is a strong belief that the bank will always require the presence of at

least one foreign top manager as a full time worker or as an advisor, in order to ensure autonomy from political pressure and confidence of foreign shareholders. However, it is also necessary to appoint a local CEO to secure Mongolian leadership of one the largest local banks. Yet there is not a specific plan about who could become local CEO or when. For the time being, it is expected that the DAI management contract will be renewed in 2007 when it will phase out.

### **Human resource management**

Khan Bank has been successful in developing sound human resource policies that favor motivation and good performance:

- The HR policy and procedure manual has been continuously updated since its approval in 2001. Amendments include performance evaluation for branch employees and loan officers, customer confidentiality procedures, recruitment procedures, contracts for branch managers, and new employee orientation program.
- The recruitment process is efficient and focuses more on skills and motivation than on education. The business plan sets a global framework for recruitment during the year, adjusted during the quarterly meetings. Rural branches are then free to conduct their own recruitment and internal promotion processes within this framework. New programs have been implemented to facilitate better recruitment (i.e. Employee Referral Program).
- Bad experiences with the recruitment of staff with banking experience from other institutions have led the bank to prioritize training and internal promotion, even for top management positions, with successful results.
- The initial training process is comprehensive and has been strengthened, with a right mix of practical and theoretical training at headquarters. Starting from March 2006 a series of product and service knowledge tests were conducted among tellers and customer service representative officers of Ulaanbaatar. These tests helped employees improve their knowledge of bank services and products and were also useful to identify training needs.
- The bank offers a very aggressive plan of ongoing training for all staff, including internal and external trainings, as well as the financing of university degrees. In addition to that, the bank has established a Foreign Language Proficiency Program to improve the English level of employees. Top managers and branch managers can also benefit from scholarships for master degrees overseas.
- The bank does not offer the most competitive salary scale of the industry but is working hard to increase salaries as a whole. Employees –both administrative and operational– receive fair performance-based bonuses. In order to encourage team work, the bank grants awards and additional bonuses to branches and sub-branches according to their achievement of quarterly goals. Benefits for employees include low consumer and

mortgage loan interest rates and increased allowances for uniform and telephone usage.

- Evaluation of staff has improved for frontline employees. In 2005 headquarters representatives visited each branch and had performance meetings with each LO from rural areas and Ulaanbaator. Following these meetings training needs were identified and regional training programs were conducted. This evaluation mechanism has not been yet generalized to all staff.

One important issue for the bank is standardization of payroll. All branches are independent for their payroll but do not use a standard tool, which causes inconsistencies. This problem is deeply related to the delays experienced by the bank in the computerization of branches. It should be addressed soon with a new payroll and HR software recently purchased and in the process of being introduced.

Staff turn-over is relatively high (16% in 2005). This issue is linked to the strict policy of firing all staff involved, directly or by negligence, in fraud cases (see “R”). This ratio is comparable to Khan Bank’s peer in the industry, Xac Bank, that reports a staff turn-over of 20% in 2005.

	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
Total number of staff	1,787	1,951	2,226	2,372
% Credit officers	10%	13%	10%	13%
Turnover	NA	NA	16%	15%

## Information

Information and equipment is rated “b”

### Description of the MIS

Equipment	<ul style="list-style-type: none"> <li>▪ 154 online branches and sub-branches fully computerized and with access to the Intranet (87% of outstanding deposits, 66% of outstanding portfolio).</li> <li>▪ 151 standalone sub-branches computerized but not online.</li> <li>▪ 105 sub-branches with a manual information system.</li> <li>▪ Headquarters, UB branches and aimag branches have access to Internet.</li> </ul>
Accounting, portfolio and deposits information	<ul style="list-style-type: none"> <li>▪ Online branches and sub-branches: BANCS, integrated MIS created by the external developer FNS; Cobalt programming language and Oracle database.</li> <li>▪ Standalone sub-branches: BANK4, integrated in-house MIS. The programming language for BANK4 software is Clipper v5.3 with .DBF database</li> <li>▪ Offline sub-branches: manual accounting system; information is communicated by phone or fax to the branches and entered in Excel files.</li> <li>▪ Consolidation of all data on Finance 1 at headquarters; externally developed reporting system.</li> <li>▪ Information available daily for online branches and twice per month for standalone and offline sub-branches.</li> </ul>
Other services	<ul style="list-style-type: none"> <li>▪ 17 applications developed internally or externally for the management of other services and operations: Pension software, Utility Payment System, Web Statement, Email local Intranet, Clearing Standalone PC, CARDS, etc.</li> </ul>

## Management Information System (MIS) and equipment

Despite the MIS challenges inherent in Khan Bank’s massive rural branch network, the bank has managed to establish a good information flow. The Khan Bank management team has a strong commitment to MIS improvements, including aggressively rolling out the online banking system to rural sub-branches. Although Khan Bank still has a large number of offline branches, 66% of the outstanding portfolio and 87% of deposits are managed by online branches and sub-branches. All sub-branches are expected to be online by the end of 2008 despite the cost of the process<sup>1</sup>. This effort will also involve developing innovating solutions for the electrification of some sub-branches (e.g. solar power). A cost/benefit analysis has been carried out, showing that the financial impact of this investment will be compensated by stronger internal controls and a quicker access to information. The bank has successfully completed recently the setting up of its own cards processing centre, which will improve customer service and ease the processing of debit cards transactions. In establishing this centre, Khan Bank became the first bank in Mongolia to connect customer cards directly to their current account. Other IT initiatives include the possible installation of independent servers at the branch level, network monitoring software and remote helpdesk support functionalities.

The professional IT Department is staffed with capable technical staff. A 5-month delay in the setting up of the cards processing system was caused by previous problems in the planning and execution of various IT projects, but these delays have not materially impacted the process of bringing sub-branches online. As a result, Khan Bank management elected to hire a skilled international consultant at the beginning of 2006, who provides oversight for the various MIS and IT infrastructure initiatives. This expert was intentionally hired as an advisor instead of CIO to better focus on project management responsibilities. IT and related departments now report to the COO rather than a specific CIO.

The BANCS MIS software used for online branches is widely used among Mongolian Banks, as well as by BOM. BANCS was initially developed by the Australian firm FNS as part of an ADB and World Bank-financed project and would likely not have been the preferred MIS solution. However, despite some reporting limitations, BANCS adequately fulfils the bank’s information needs. BANK4, an in-house application, is deployed in the standalone (offline but computerized) sub-branches. Both the BANCS and BANK4 systems are user friendly and well understood

<sup>1</sup> According to Khan Bank estimates, turning a branch and all its sub-branches online costs around 450,000 USD. For comparison purposes, this is equal to 10% of Khan Bank net result as of June 2006 and 18.3% of the average loan portfolio of its branches.

by staff at the branch and sub-branch level. However, the remaining standalone and manual sub-branches both increase the workload of branch staff (data must be inputted manually into the computer system at the branch level) and increase the risk of entry error or fraud. This risk is mitigated by frequent control checks at the branch level during consolidation.

The primary area of weakness for the MIS system is the proprietary BANCS source codes. Khan Bank is reliant on FNS for technical support and for any major MIS modifications or upgrades, such as the BANCS update planned for the second quarter of 2007 that will require a separate contract with FNS. Also, because FNS does not offer local technical support in Mongolia and has recently been acquired by an Indian conglomerate, the future level of support is unclear.

Data security is generally good, with individual user passwords, predefined user rights, and audit trail capability. Segregation of duties with regard to customer and financial data entry is adequate. Notably, a special IT security department is planned to administer access rights and develop future information security policies. Data backup procedures are in place at both the headquarters, branch and sub-branch level. In manual sub-branches, storage of documents ensures the protection of information. However, the lack of real time database backup at an external location (currently daily backups at the end of the day) is problematic for a large commercial bank. This weakness should be resolved with infrastructure improvements already underway at the time of this report. The IT department is also working on the development of an automatic antivirus upgrade.

#### **Information on activities**

Although the mixture of online, standalone and offline branches necessarily adds a level of complexity, the consolidation of data from the three systems is well managed. Data from online branches is reliable, detailed and timely. Standalone and offline sub-branches report on a bi-monthly basis but information can be obtained earlier if needed. From Khan Bank experience, 99% of the information received from offline branches is accurate and auditors have never recommended an adjustment on portfolio information. Information available at all branches/sub-branches is sufficient for daily management and follow-up, including delinquency reports, information by product and other reports.

Managers and staff throughout the bank demonstrate a strong understanding of portfolio information and make effective use of available reports in their day-to-day activities. Headquarters managers in particular rely heavily

on comprehensive daily reports giving a global picture of the bank's performance.

#### **Financial and accounting information**

Overall, Khan Bank has a well functioning and reliable accounting system that produces detailed and high quality reports at both the consolidated and branch/sub-branch level. Financial reports for online branches can be produced on a daily basis and all reports are widely disseminated. The CFO and finance team have strong accounting skills and are knowledgeable in financial analysis. Accounting follows proper international practices and the CEO, COO, and other management staff perform detailed financial analysis on the financial data, including calculation of relevant international and BOM prudential ratios. There is also good tracking of budget and variances from plans.

## ■ Risk

**Risk Management** is rated "b"

#### **Procedures and internal controls**

Operational and financial risk awareness and a strong control culture prevail at Khan Bank, from the management team down to the branch/sub-branch staff. Explicit procedures are in place to identify, monitor and mitigate key risks, with recent organizational changes (e.g. reorganization into Ulaanbaatar/Rural business units) intended to further strengthen monitoring and management of specific operational risks. The required information for effective portfolio management is readily available, detailed and widely disseminated, with relevant composite and branch-level indicators such as PAR monitored rigorously.

Staff generally understand and adhere rigorously to stated policies and procedures, which are formalized in detailed manuals widely available. Most policies and procedures are up to date, with necessary changes disseminated rapidly throughout the branch network, including offline branches.

Tight management of the portfolio is facilitated by the reliable and timely information generated by BANCS although the risk of fraud or data entry errors remains for offline manual branches (mitigated by frequent internal audits, see below). BANCS includes various embedded controls that strengthen the internal controls chain.

Segregation of duties with regard to customer and financial data entry at the branch level is good. However, in the smaller sub-branches an occasional shortage of staff (for example, when one of two sub-branch staff is on annual leave) can result in increased operational risks. It must be noted that the bank is working to ensure total segregation of duties through increased staff hiring (minimum two staff per sub-branch at all times) and more careful coordination of leave schedules. Cash management practices are sound,

with good cash security and rigorous cash handling procedures. Cash transportation is well managed despite the challenges of long distances between branches.

### Internal audit

The internal audit function is regular, comprehensive and conducted by a well-qualified team. The control visits are frequent -at least twice per year at each branch and sub-branch- and are unannounced. As an additional control measure, the remote sub-branches get frequent monitoring visits from branch staff. Although fraud discoveries are frequent, this is partly due to the recently strengthened internal audit process that has uncovered old frauds. Setting aside previously undiscovered fraud cases, the incidence of fraud has actually declined sharply<sup>2</sup>. Moreover, all fraud cases are rapidly dealt with using a strict zero tolerance policy. Every year, around 50% of amounts involved in fraud cases are recovered through efficient legal and informal pressure. In any case, given the size of the network and the fact that many sub-branches are still offline, fraud cases are not expected to disappear although they should decrease significantly.

Audit mission findings are readily available to management and to branch and sub-branch staff. The audit teams provide actionable feedback to both headquarters departments and to branches, and also consistently check whether necessary changes are implemented during subsequent visits. An international audit firm performs regular external audits using international accounting standards. Although the firm has no specific experience in microfinance, auditors do visit branches and sub-branches and check all material factors affecting Khan Bank's financial position. The BOD and management team consistently follow up on audit recommendations.

The internal audit team does not report directly to the BOD which does not follow international best practice. This has been considered necessary by the management team since the Chief Internal Auditor does not speak English and therefore cannot communicate directly with many members of the BOD. All his summary reports are translated and provided to the BOD, and an audit committee has recently been created comprising three BOD members (see "G" section).

<sup>2</sup> In 2004 frauds detected amounted to 524 K USD out of which 88.4% stemmed from frauds that occurred that year. In 2005 frauds detected amounted to 359 K USD out of which 67.7% stemmed from frauds that occurred that year.

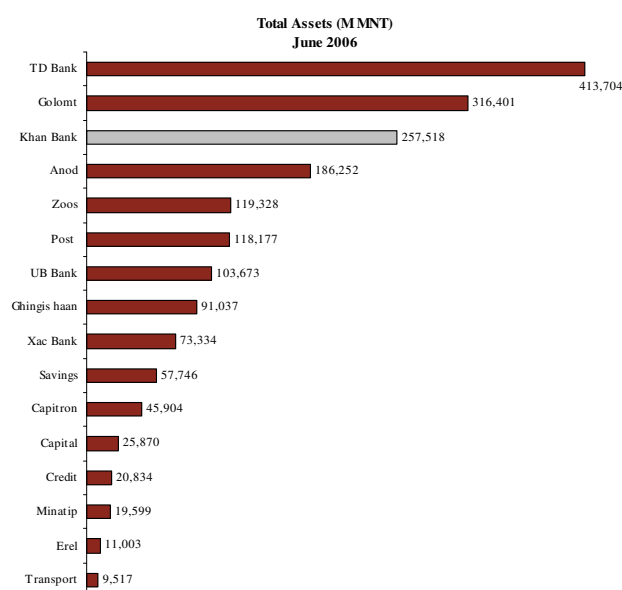
## ■ Activities

Activities: products and services are rated "a"

USD, unless otherwise stated	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
Loan portfolio (K USD)	44,599	67,059	110,037	142,320
Loan portfolio (M MNT)	52,091	81,075	134,356	166,657
Evolution	108.4%	55.6%	65.7%	24.0%
Average outst. portfolio (K USD)	33,129	55,457	84,248	127,867
Active borrowers	108,960	130,695	177,581	207,284
Evolution	28.8%	19.9%	35.9%	16.7%
Average outst. loan/client	409	513	620	687
% of GDP per capita	79.2%	92.3%	112.6%	119.6%
Average amnt disbursed	275	328	385	422
% of GDP per capita	53.2%	59.0%	69.9%	73.6%
Rescheduled loans	na	na	0.9%	1.1%
PAR 31-365	1.0%	3.3%	1.6%	1.2%
PAR > 365	0.1%	0.4%	1.2%	1.3%
Write-off ratio	0.0%	0.0%	0.2%	0.0%

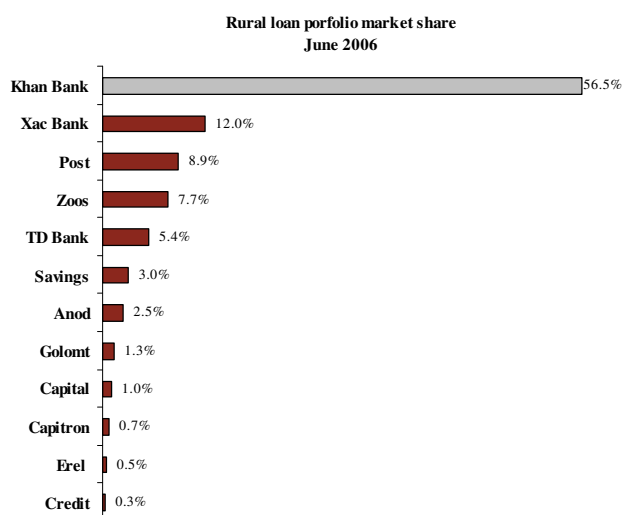
### Marketing and competition

Mongolia's banking sector appears highly competitive at first glance, with 16 banks and 162 NBFIs in operation. However, the vast majority of banking assets are held by the three largest commercial banks: Khan Bank, Golomt Bank and TD Bank. Most commercial banks, including Golomt and TD Bank, have a decidedly urban focus and lend mainly to medium and large corporate clients in Ulaanbaatar. Only Mongol Post Bank and Xac Bank have significant outreach in the rural areas.



Khan Bank is undoubtedly the major rural bank of Mongolia, with 56.5% of rural portfolio market share as of June 2006. However, competition is growing, especially in larger aimag centers. In these markets Xac Bank is Khan Bank's most formidable competitor, given its strong funding position, aggressiveness and capacity to innovate and adapt. Nonetheless, Khan Bank's unmatched "bricks-and-mortar" presence in virtually every aimag center and soum in Mongolia provides a competitive advantage that is

unlikely to erode in medium term. Khan Bank's broad range of well-adapted and flexible loan products, deposit products and fee services (e.g. money transfer) are highly competitive. The decision to adopt flexible pricing within fixed ranges for loan products is also beneficial in terms of competitiveness, particularly in areas where Post Bank and Xac Bank are competing.



Competition is more intense in urban areas, particularly in and around Ulaanbaatar where all major players operate. Although urban areas are not Khan Bank's core market, the Ulaanbaatar area is nonetheless important given that it contains half of the entire Mongolian population. As such, Khan Bank has made strong inroads in the capital city, driven by rapid expansion of its Ulaanbaatar branch network, modified retail products for the urban market and a strong marketing campaign encompassing numerous channels. In addition, Khan Bank has established new business lines, including corporate and institutional banking services, which place the bank in direct competition for business with more established incumbents like TD Bank. Even in these urban markets, Khan Bank's strong service and unmatched brand recognition are potentially significant advantages (as of June 2006 Khan Bank's Ulaanbaatar loan portfolio market share was 5.03%).

Based on its incumbent advantages, Khan Bank will likely remain the rural market leader for the foreseeable future, and continues to position itself as the best bank for rural Mongolians. However, the bank aims to evolve into a comprehensive provider of financial services from rural herders to large corporate clients. Thus far the strategy of entering new market segments (institutional, corporate, international banking services, credit cards, payment services, etc) while leveraging Khan Bank's strong service reputation is proving effective in achieving this goal.

### **Credit methodology**

Khan Bank follows strong credit risk management practices:

- The loan approval process and limits are well balanced to be flexible and efficient while maintaining risk management. Although the previously strict loan policy has been relaxed to allow for greater client outreach, this has not been to the detriment of loan quality. Lending authorities for both branches and sub-branches are clearly defined and reviewed/adapted regularly taking into account branch performance and market demand. Any exceptional loans are subject to a systematic review of risks and appropriate additional scrutiny through specific credit committees and sub-committees.
- LO credit skills are generally good, thanks to a thorough and standardized training curriculum and committed staff. Branch and sub-branch staff, either operational or administrative, benefit from performance-based incentives and awards.
- When it is possible and relevant, branches consult the BOM Credit Bureau through the internet to assess clients' indebtedness.
- Recovery measures are efficient, with immediate follow up of clients after one day of delinquency. Sub-branch LOs receive the support of branch-based Senior LO for recovery. In very specific cases, when the customer has a clear willingness to pay but was not able to repay on time for unexpected reasons, loans can be rescheduled through a new credit committee. By BOM regulation, loans can only be rescheduled once. The bank can bring delinquent clients to court to pursue the collection when necessary.

Each category of product has appropriate credit methodologies and specific advantages:

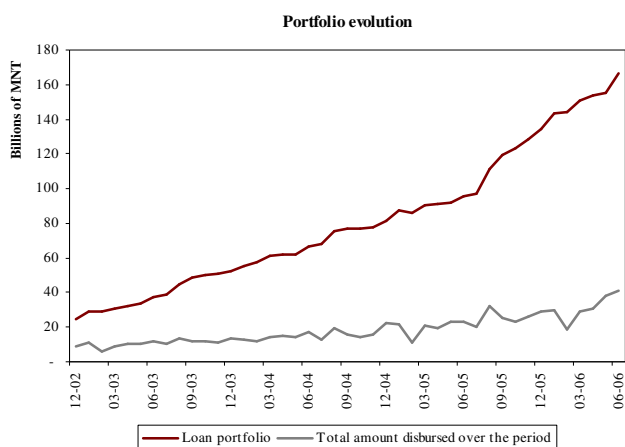
- Consumption loans are highly secured by salaries, pensions or real assets. They involve very little amounts and do not require field visits.
- Agriculture loans are disbursed in rural aimag centers and soums. They are generally directed to customers with high repayment culture and little exposure to competition. Although all clients must go through a specific assessment process involving field visits, authorities provide very reliable and updated statistics about cattle headcount per herder that are highly useful for credit decision making.
- Business loans include a cash flow and repayment capacity analysis, following microfinance best practices. They are however riskier than agriculture and consumer loans since they involve higher amounts and are disbursed either in aimag centers or in Ulaanbaatar, where competition is stronger.

Khan Bank faced some problems in the development of credit services in Ulaanbaatar. Repayment culture in the capital city is much weaker than in rural areas and competition is much stronger. Many LOs did not have the appropriate skills to deal with this environment and seemed to rely heavily on collateral rather than on character

assessment and cash flow analysis. The bank has addressed aggressively this issue through additional training for LOs. A specific Corporate Banking department has been created, where Senior LOs establish personalized relationships with corporations and perform a very detailed analysis of loan applications.

The headquarters bring permanent support in the supervision, improvement and development of banking operations. Both the Ulaanbaatar and the rural business units have specific departments providing continuous follow up and technical support to branches on banking operations. A loan policy department is dedicated to updating loan procedures, developing new loan products and establishing partnerships for project loans. The credit risk departments, both in the rural and Ulaanbaatar business units, permanently monitor the risks that affect credit operations and keep the branches informed (e.g. climate risks, operational risks, political risks). The business development department works on the development of non-credit products<sup>3</sup>.

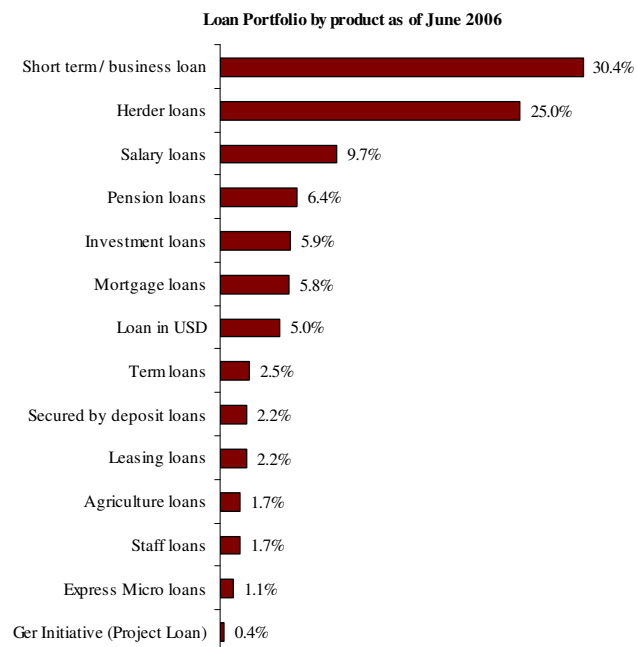
### Evolution of the portfolio



Khan Bank has witnessed remarkable loan portfolio growth over the last three years, with 66% growth registered between 2004 and 2005 alone. This evolution comprises both growth in the number of active borrowers and a continual increase in average loan size per client (64% increase between 2003 and 2006). Short term business loans are still the main product, representing 30.4% of portfolio as of June 2006. However, their portfolio share has diminished from 50.2% of portfolio as of December 2003. The growth in the core rural loan products is the engine of overall portfolio expansion, with Herder Loans alone representing a quarter of total portfolio as of June 2006, from 11.2% of portfolio as of December 2003.

<sup>3</sup> This department spent much of the beginning of 2006 in the creation of the cards processing centre. Upcoming projects include establishing partnerships with banks in Korea, China and Japan to serve Mongolians living abroad, and the development of electronic banking solutions (e-commerce, e-banking, SMS banking).

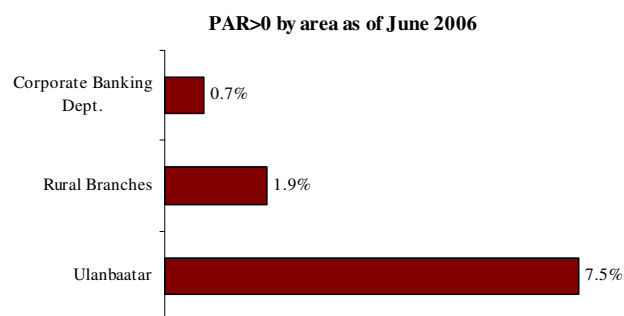
Pension loans are a tremendous penetration instrument: they only represent 6.4% of total portfolio as of June 2006 but involve 42.6% of borrowers. Indeed, Khan Bank is the main channel for distribution of government pensions and nationwide salary disbursements.



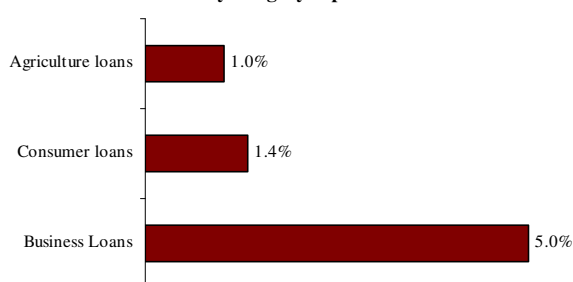
### Portfolio quality

Khan Bank has maintained an excellent portfolio quality for the years of analysis, with PAR>30 always less than 4.0%, and only 2.5% as of June 2006. The ratio jumped to 3.7% in 2004 due to a number of investment and business loans in arrears, mainly in Ulaanbaatar.

As mentioned above, Ulaanbaatar loans are riskier than rural loans. Indeed, as of June 2006 Ulaanbaatar portfolio is significantly less healthy than rural portfolio. Since 68.7% of Ulaanbaatar loans are business loans, this has also led to a higher PAR for business loans. However, tighter monitoring has brought a much better quality of portfolio for recent Ulaanbaatar loans. Also, the new corporate loans, disbursed through the existing loan products but with higher amounts and in-depth analysis, report a very good quality, which is a good sign for the development of this service.



PAR>0 by category of product as of June 2006



The bank writes off loans very exceptionally, on an ad-hoc basis and when all recovery measures have been used. Although this is not in accordance with international microfinance standards, that recommend writing off after one year of delinquency, it follows Mongolian regulatory environment and does not generate a significant portfolio overstatement. Write-off ratio was only 0.2% as of December 2005.

### Portfolio diversification

Khan Bank has not established a formalized diversification policy but undertakes a permanent monitoring of portfolio diversification by sector or area. The credit risk management departments play a key role in this respect. Although some products are necessarily concentrated in rural or urban branches (herder loans for instance), the wide branch network means that concentration risk is still low at the branch level. Concentration is manageable if compared to the overall loan portfolio, with the top 100 borrowers representing 9.6% of total portfolio. The largest borrowers are mainly Ulanbaatar reputable corporations that have provided strong collateral. However, the low equity base means that these same 100 borrowers represent almost 80% of equity.

### Credit risk coverage

	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
Risk coverage ratio	151.1%	90.8%	134.8%	124.0%
Risk coverage ratio incl. rescheduled loans	151.1%	90.8%	101.2%	85.8%
PAR>30 net of loan loss provision / Equity	NA	2.7%	NA	NA

Khan Bank uses a variety of legally enforceable guarantees to secure the loan portfolio, including both movable and fixed assets, salary payments, livestock, and other appropriate collateral. Although the legal process for foreclosure is lengthy Khan Bank has been effective at pursuing the process when necessary. The Special Assets department has contributed significantly to the overall trend of increased collections. The current loan loss provisioning policy used by Khan Bank is a result of regulatory requirements, and is not as conservative now that BOM has lifted the requirement to provision 1% of healthy portfolio. However, Khan Bank's risk coverage is excellent, with a

risk coverage ratio of over 100% for every year except 2004, which was 90.8%.

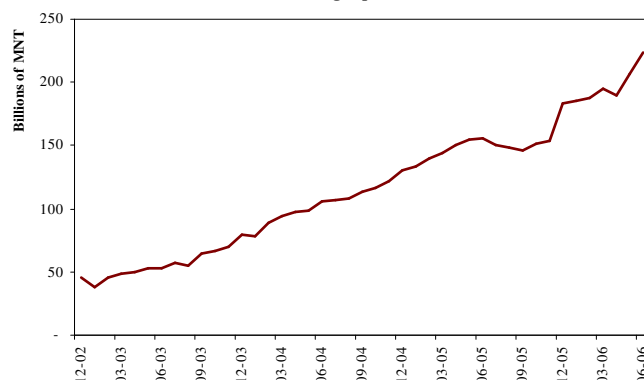
### Savings activities

USD, unless otherwise stated	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
Outstanding deposits	67,821,291	108,150,108	150,254,396	199,040,566
Outstanding deposits (K MNT)	79,215,268	130,753,480	183,460,617	222,999,079
Evolution	73.3%	65.1%	40.3%	21.6%
% of compulsory deposits	0.0%	0.0%	0.0%	0.0%
% of voluntary deposits	100.0%	100.0%	100.0%	100.0%
Number of depositors	371,108	456,064	621,406	767,956
Evolution	NA	22.9%	36.3%	23.6%
Average Balance per Depositor	183	237	242	259
Compulsory	-	-	-	-
Voluntary	183	237	242	259

Note: December 2005 outstanding deposits balance includes 17,532,612 K MNT (14.9 M USD) certificates of deposit with local commercial banks.

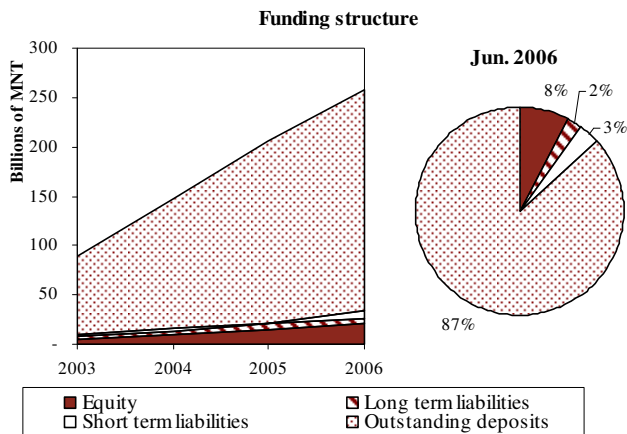
On the deposits side, growth has been relatively steady over the last three years, despite a decrease at the end of 2005 due to a reduction in the rate paid on BOM bills. Although management was forced to discourage further deposits to avoid incurring losses, Khan Bank overcame this challenge successfully through a swap of certificates of deposit with local commercial banks (see "F"). As such, Khan Bank remains the leading deposit collector in local currency, largely due to its nationwide reputation for customer service and prudent management. Additionally, with 40% of its outstanding deposits coming from rural areas, Khan Bank depositors are less sensitive to interest rates than those of other banks collecting their deposits mainly in Ulanbaatar. Loan portfolio has grown commensurate with the deposit base and is always less than 80% of outstanding core deposits, yielding to a good level of liquidity.

Outstanding deposits evolution



## ■ Financing and liquidity

Financing and liquidity is rated “a”



### Capital structure & Leverage

	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
Liabilities / Equity	15.03	13.16	12.66	11.63
Capital adequacy ratio	13.2%	14.1%	11.8%	12.3%

Khan Bank meets the minimum statutory capital requirement for banks of 8 billion MNT (7.1 M USD). Its capital adequacy ratio (risk weighted assets/Tier capital I and II) was 12.3% as of June 2006, while the minimum authorized by the BOM is 10%. But with 11.5 billion MNT statutory capital (10.3 M USD), Khan Bank has one of the lowest capitalization ratios of the industry despite the regular accumulation of retained earnings. There is consensus among shareholders that the bank needs additional capital to accompany growth and meet prudential ratios. All shareholders have shown their willingness to bring new capital before the end of 2006. Other investors have shown their interest in entering the capital structure but shareholders do not want to dilute capital.

Khan Bank capital structure is fully private and includes reputable local and international investors. The current investors have agreed to enter in the capital structure mainly to strengthen the bank in its turnaround. As such, they are committed not to demand dividends and to support the bank in case of need. The main shareholders have not expressed any intent to withdraw from the bank in the medium term. HS Securities particularly has expressed publicly their long term commitment to the bank, including expansion to Japan through branching and into Korea and China, where many Mongolian workers live. Although an initial public offering has been under discussion, the specificities and timeframe of this transaction are not yet clear.

### Financing strategy

Khan Bank financing strategy rests on an active collection of deposits (87% of the balance sheet). Thanks to its very good reputation and its broad network of branches, it has

the largest deposits market share in the 21 aimags. Despite the upward pressure on deposit interest rates brought by competition, the bank has taken advantage of its leading position to keep its average deposit interest rates between December 2005 and June 2006 at the same level while collecting more than 43.5 billion MNT (38.8 M USD).

The financing base is healthy and stable. Khan Bank is one of the most liquid banks of the industry thanks to its conservative management of liquidity and the confidence of customers. Its loans/deposit ratio was 74.7% as of June 2006 while liquidity represented 36.5% of assets. The 100 largest deposits represent 13.4% of total deposits as of June 2006, with the largest deposit representing 1.3%. Less than 1% of deposits are classified as long term, but experience shows that both individual and institutional depositors are loyal to the bank. 52.3% of deposits are time deposits with a determined maturity. Borrowings and other liabilities only represent 5% of the banks' financing structure and are mainly concessional loans from BOM.

### ALM risks

#### *Risk management framework*

ALM risks are followed closely by the ALCO. The bank follows BOM prudential limits as well as internal limits. Reporting on risk positions is done through monthly reports to the BOD. The key ratios followed by Khan Bank are loan/deposit ratio (<80% - internal rule), liquidity ratio (>18% of assets - internal rule), minimum reserve requirement (>14% of liquidity - BOM rule), foreign currency position (total <40%, each currency <15% - BOM rule). The bank has a very dynamic deposit interest rate policy, based on the constant monitoring of competition interest rates

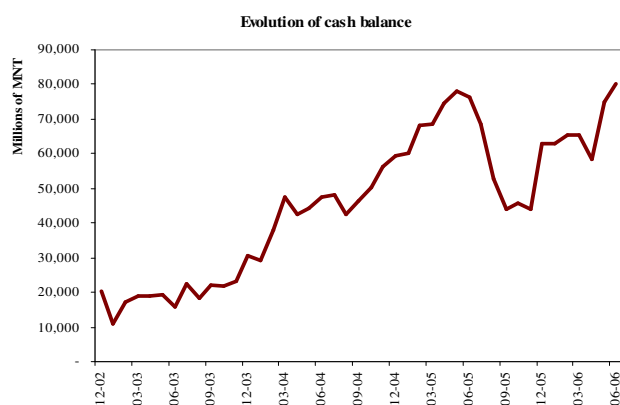
#### *Exposure & Compliance*

The bank is not exposed to any major ALM risk. As of June 2006, Khan Bank reported a total open foreign exchange position as a percentage of Tier I capital (primarily in USD) of 21%, which is inside the BOM's prudential ratio of maximum 40%. Foreign exchange transactions are not very developed yet but are expected to grow as corporate banking operations expand. Similarly, the reported maturity mismatch as of June 2006 stood at 84% which is below the prudential covenant recommended by IFC (<120% of Tier I capital). However, maturity mismatches must be followed very closely given the low capitalization of the bank. There are no variable interest rates on either the assets or liabilities side. Additionally, unlike most banks in the industry, the spread between deposit and loan interest rates has not been threatened by the intensification of competition, and has remained between 21% and 22% throughout the period of analysis.

## Liquidity management

The bank has adequate tools to ensure a sound liquidity management. The treasury department monitors liquidity levels continuously to invest on BOM bills at the most competitive rate. It oversees daily the compliance to internal and external prudential rules. Liquidity projections are established on the long run through the budget and its quarterly adjustments. More detailed projections are performed at the branch level. Liquidity shortage or surplus created by transfer operations are quickly tackled through inter-branch shipments of cash.

The bank has shown a clear capacity to manage liquidity pressures. Given the underdevelopment of the bonds market in Mongolia, Khan Bank invests its liquidity in BOM bills. However, it faced a dramatic and unexpected decrease of BOM bills interest rates in March 2005, from an average of 15% to 5%. This led the bank to decrease its average interest rate on deposits (from an average of 12.7% in December 2004 to 10.0% in December 2005) and to invest more resources in the portfolio. Khan Bank placed unused dollars through a swap of certificates of deposit at rates above BOM deposit rates with other banks and received MNT at below market rates, on a fully secured basis in order to mobilize lower cost MNT funds during a time when loans were growing and deposits stagnating. All were liquidated by April 2006.



## Efficiency and Profitability

Efficiency and Profitability is rated "a"

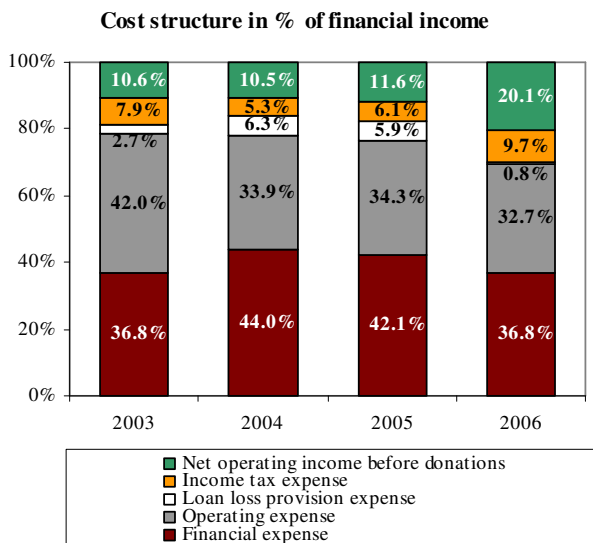
Profitability analysis	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
ROE	38.3%	38.7%	36.6%	60.4%
Liabilities / Equity	15.03	13.16	12.66	11.63
ROA	2.8%	2.6%	2.6%	4.6%
<b>Profit generation</b>				
Operational self-sufficiency	122.8%	118.8%	121.5%	142.3%
Portfolio yield	42.0%	35.6%	33.1%	31.9%
Operating expense ratio	19.8%	14.9%	13.4%	11.6%
Staff productivity (borrowers/staff)	61	67	80	87
Staff productivity (depositors/staff)	208	234	279	324
Loan officer productivity	605	529	834	660
Av. outst. loan per client (USD)	409	513	620	687
Funding expense ratio	17.3%	19.3%	16.5%	13.1%
Cost of savings	11.9%	12.4%	11.2%	9.8%
Cost of liabilities	4.2%	3.9%	2.8%	6.4%
LLP expense ratio	1.3%	2.8%	2.3%	0.3%
PAR 31-365	1.0%	3.3%	1.6%	1.2%
PAR >365	0.1%	0.4%	1.2%	1.3%
Write-off ratio	0.0%	0.0%	0.2%	0.0%
<b>Asset management</b>				
Outstanding Loan Portfolio / Assets	57.8%	53.3%	63.0%	62.7%
Non-portfolio income as a % of financial revenues	10.8%	18.9%	15.3%	10.4%

### Overview of profitability

Khan Bank has the highest levels of profitability of the Mongolian banking industry measured by ROE. This is an exceptional result considering that by the end of 2001 the bank had still negative equity. The management turnaround, the strong commitment of the Mongolian State to recapitalize and privatize the institution and the implementation of sound credit policies were the underlying conditions to this positive evolution. The key to profitability has been strong economies of scale related to volume effects, despite a very competitive environment in which the bank has been able to protect its margins. ROE has been boosted by the exceptional growth of deposits in a relatively undercapitalized structure, leading to a high leverage ratio of more than 11.6 as of June 2006.

### Portfolio yield and effective interest rate

Khan Bank portfolio yield has followed a clear downward trend over the period under review, from 42.0% in 2003 to 33.1% in 2005, and 31.9% as of June 2006. This evolution is emblematic of a general trend in the industry related to the intensification of competition. It is also illustrative of a policy to decrease rates as the institution generates economies of scale and profits. Portfolio yield consistently follows the evolution of the average interest rate, displaying the good quality of portfolio. For instance, the average interest rate was 31.1% in June 2006 while the institution was reporting a portfolio yield of 31.9%.



### Operating expense ratio

The operating expense ratio has experienced a dramatic decrease from 19.8% in 2003 to 11.6% in June 2006. These strong economies of scale have been fostered by portfolio growth, at an average of 62% per year between December 2003 and June 2006. Such results are exceptional considering the challenges created by geography and infrastructure.

The driving factors of Khan Banks economies of scale are:

- A regular increase of the outstanding loan per client, from 409 USD per client in 2003 to 687 USD per client at June 2006. The most demanded products have shown a strong increase of their average loans amount, namely short term business loans, herder loans and salary loans. Note that Khan Bank is favored by its “natural demand” of consumer loans in many areas of the country where it is the only financial institution able to disburse loans to wage-earners or pensioners.
- Staff productivity measured by the number of borrowers has grown slowly. This indicator is not very useful for a retail bank financed by deposits, since an important part of staff must be allocated to the collection of resources. Productivity measured by the number of depositors is much higher, with a clear positive trend, and shows the eminent deposits-collection orientation of the bank. LO productivity has an unstable trend, related to the recruitment of LOs. It is however much higher than the standards of the microfinance sector<sup>4</sup>, thanks to the maturity of the bank and the massive disbursement of consumer loans.
- Operating costs have grown slowly due to a strict follow up of expenditures at branch level. Quarterly reviews of branches profitability motivate them to be very aware of

<sup>4</sup> 174 borrowers per LO, according to MBB benchmarks for banks, 2004 figures.

cost control. The bank as a whole has a light cost structure related to the current salary scale. Staff costs represented 52.0% of total costs as of June 2006. It is expected that salaries will grow as well as bonuses but this process will take time.

The capacity of the bank to continue generating economies of scale will depend on the impact of competition on portfolio growth. Despite clear signs of saturation in Ulaanbaatar, the potential for credit development in rural areas seems to be still high considering historical growth. In the current economic framework, with large investments and remittances coming from China, the outlook for the bank is positive.

### Funding expense ratio

The funding expense ratio follows a downward trend since 2004. This ratio is deeply related to the cost of savings, since these are the main source of financing of the institution. The average interest rate on savings has indeed decreased as competition increases. In March 2005 this trend was encouraged by the unexpected decrease of interest rates on BOM bills. On the long run, the parallel decrease of interest rates on loans and deposits has protected the financial margin of the institution (spread between 21% and 22% since December 2004). This has been the driving factor of increased profitability, as volume effects generated economies of scale.

The cost of liabilities reflects the concessional interest rates charged by BOM in its various loans to Khan Bank (1% to 6%). A recent loan from IDA for the Microfinance Development Fund project has a higher interest rate, between 6% and 8%. As a whole, the cost of liabilities does not affect the cost of financing of the institution, given the small weight of liabilities in the funding structure (5%).

### Asset management

As a bank, Khan Bank obtains a large part of its income from non-portfolio activities. Non-portfolio income as a percentage of financial revenues has evolved between 10% and 18% during the period under review:

- Part of non-portfolio income (40% to 60%) is generated by fee-based services. Indeed, the wide network of the bank means that it has the monopoly for the payment of salaries, pensions and transfer services in various rural areas.
- The rest stems from the revenues of investments, mainly in BOM bills. The bank optimizes its liquidity, with only 9.7% kept in cash in hands and the rest in BOM bills, in placements with other banks and in compulsory reserves at BOM.

## Adjusted performance

Details in annexes.

	Dec. 03	Dec. 04	Dec. 05	Jun. 06
Adjustment expense ratio	0.2%	0.4%	0.5%	0.5%
AROE	36.9%	35.7%	32.4%	56.3%
AROA	2.7%	2.4%	2.3%	4.3%
Financial self-sufficiency	122.2%	117.6%	119.6%	139.6%

Khan Bank remains highly profitable after adjustments, with a reported AROE of 56.3% as of June 2006. The adjustment expense ratio remains below 0.5% all over the period. Overall, adjustments have a very little impact on Khan Bank profitability.

Adjustments on inflation and cost of debt were performed. But given the relatively low inflation rate and the little amount of debt, these are not substantial. There were no adjustments on provisions since Khan Bank's provisioning methodology is more conservative than the GIRAFE standards.

### Profitability outlook

Khan Bank is in a very comfortable financial situation compared to the local banking industry. It is one of the most profitable banks of Mongolia, maintains a large liquidity cushion and has been able to maintain a stable spread despite competition. In the medium term this situation is not expected to change given the strong management and the generalized confidence of customers.

A key challenge in the long run will be the intensification of competition in rural areas, where the bank has had traditionally a dominant position. Xac Bank and other institutions have started investing strongly on microfinance services for rural areas. Khan Bank is responding adequately to this challenge by adopting flexible interest rate policies in the areas where competition is growing and by improving its customer service through its unique network of branches. In Ulaanbaatar, competition is much stronger and Khan Bank positions itself as a challenger.

Other issues that will be fundamental to secure long term profitability include:

- Raising additional capital to accompany growth and minimize financial risks.
- Developing new sources of income through fee-based products, personalized banking services for corporations, international trade banking, etc.

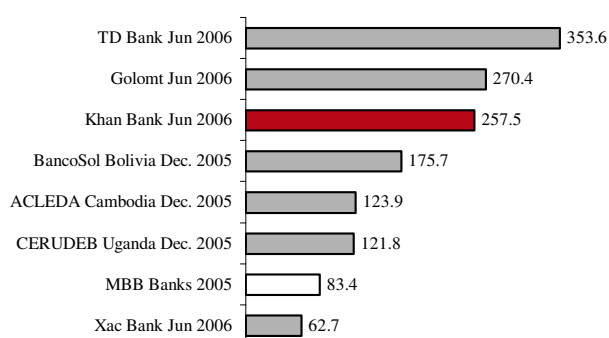
*The opinions expressed within this report are valid for one year after the rating mission. Beyond one year, or in case of a major change during this period affecting the institution's performance, that change due to the institution itself or its operating environment, Planet Rating does not guarantee the validity of the opinions contained herein, and recommends that a new rating evaluation be undertaken. Planet Rating cannot be held responsible for investments/financings that are made based on this report.*

## Benchmarking

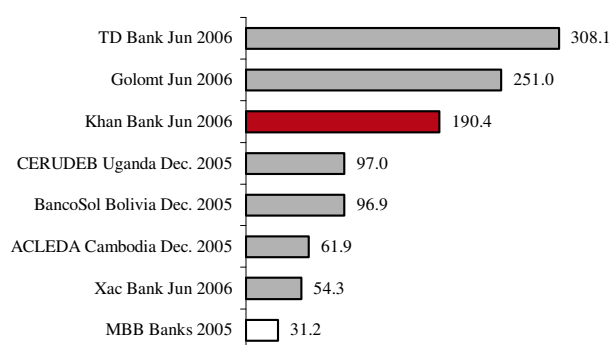
Khan Bank was compared to:

- 3 major banks of the Mongolian banking sector, with data as of June 2006 according to BOM statistics: Xac Bank, Golomt Bank and TD Bank.
- 3 similar microfinance banks (retail banking, national coverage, important rural portfolio), with data as of December 2005 according to The Mix: ACLEDA Cambodia, BancoSol Bolivia and CERUDEB Uganda
- The data of the peer group “Banks” of the December 2005 benchmarks of the MicroBanking Bulletin.

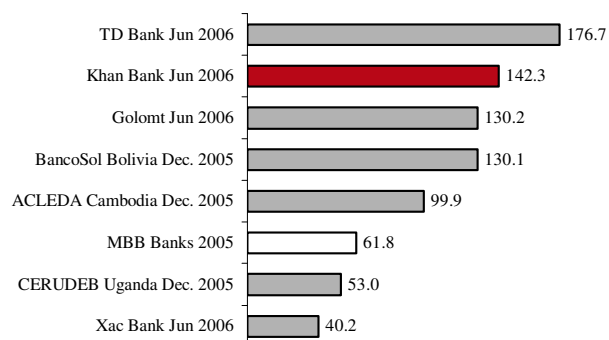
**Assets in M USD**



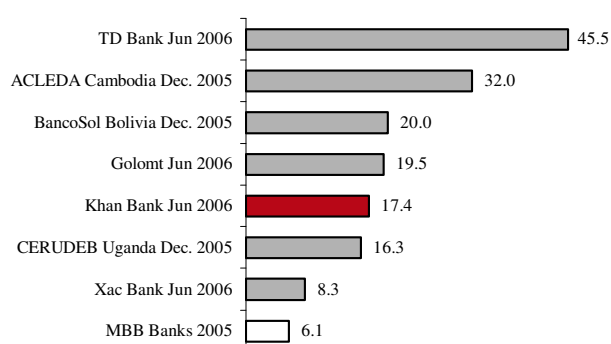
**Deposits in M USD**



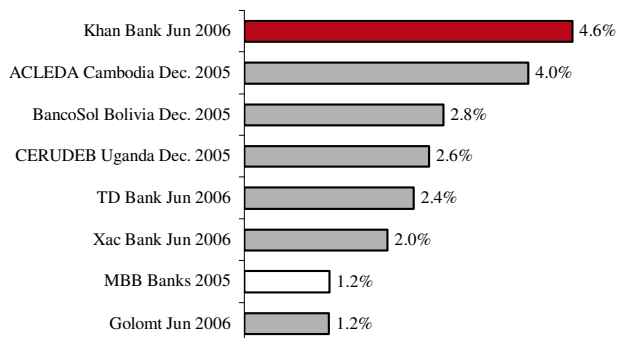
**Gross portfolio outstanding in M USD**



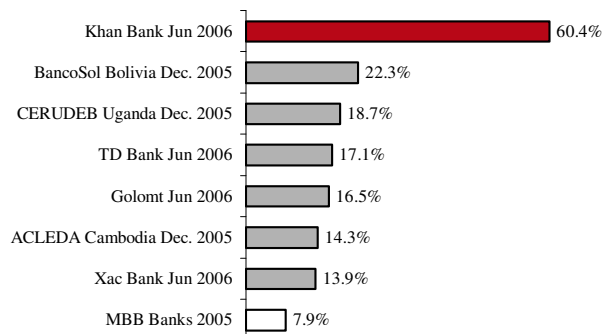
**Equity in M USD**



**ROA**



**ROE**



## ■ Annexes

### Acronyms

ADB	Asian Development Bank
ALM	Asset/Liability Management
APR	Annual Percentage Rate
BoD	Board of Directors
CEO	Chief Executive Officer
EBRD	European Bank for Reconstruction and Development
EU	European Union
EUR	Euro
EURIBOR	Euro Interbank Offered Rate
FI	Financial intermediary
FY	Fiscal Year (October 1st to September 30th)
HO	Head Office
HQ	Headquarters
HR	Human Resources
GNP	Gross National Product
GDP	Gross Domestic Product
GM	General Manager
IAS	International Accounting Standards
IFC	International Finance Corporation
IT	Information technology
LO	Loan officer
LTS	Loan Tracking Specialist
MBB	MicroBanking Bulletin
MIS	Management Information System
MC/SEA	Mercy Corps/Scottish European Aid
MFI	Microfinance institution
NA	Not Applicable
NBFC	Non Banking Financial Company
NGO	Non Governmental Organization
PAR	Portfolio at risk
ROA	Return on assets
ROE	Return on equity
SME	Small and medium sized enterprise
USAID	United States Agency for International Development
UNDP	United Nations Development Program
USD	United States Dollar
USDA	United States Department of Agriculture

### Formulas and ratios

- Personnel productivity: Active borrowers / Total personnel (end of period)
- Loan officer productivity: Active borrowers / Total Loan Officers (end of period)
- Return on assets ROA: Net operating income before donations / Average assets
- Adjusted return on assets: AROA: Adjusted net operating income before donations / Average assets
- Return on equity: ROE: Net operating income before donations / Average equity
- Adjusted return on equity: AROE: Adjusted net operating income before donations / Average equity
- Leverage: Debt (savings + debts) / equity (end of period)
- Portfolio yield: Portfolio revenue / 13-month average gross outstanding portfolio
- Operating expense ratio: Operating expense / 13-month average gross outstanding portfolio
- Funding expense ratio: Interest and fees paid on funding liabilities / 13-month average gross outstanding portfolio
- Cost of funds ratio: Interest and fees paid on funding liabilities / Average funding liabilities (deposits + borrowings)
- Loan loss expense ratio: Net loan loss expense / 13-month average gross outstanding portfolio
- Adjustment expense ratio: Total adjustments / 13-month average gross outstanding portfolio

- Net portfolio as a % of assets: Net outstanding portfolio / total assets (end of period)
- Operational self-sufficiency: Revenue from operations / (Financial expense + Loan loss expense + Operating expense)
- Financial self-sufficiency: Revenue from operations / (Financial expense + Loan loss expense + Operating expense + Adjustments)
- Risk coverage ratio: Loan loss reserves / Portfolio at risk (31-365 days)
- Write-off ratio: Loans written off / 13-month average gross outstanding portfolio

### Notes to the financial statements

General notes to financial statements per CGAP Disclosure Guidelines

**0** The MFI follows International Financial Reporting Standards and the Guidelines and Regulations issued by BOM, which are in line with CGAP reporting standards.

**1** The Financial Statements presented include a balance sheet, income statement, and accompanying notes.

**2** The financial statements provided include 3.5 years of data. 2003, 2004 and 2005 financial statements have been audited. The report as of June 2006 includes unaudited interim condensed financial statements.

**3** Portfolio reporting

**3.1** Loan loss provision expense: expenses related to actual or anticipated loan losses are shown separately from other expenses in the income statement ("loan loss expense").

**3.2** The loan loss reserve is shown as a negative asset in the balance sheet. Provisions are calculated according to the methodology described in the table.

Provisioning methodology	Rate
Healthy portfolio	0.0%
Rescheduled	0.0%
less than 30 days	5.0%
31 – 60	5.0%
61 – 90	5.0%
91 - 180	40.0%
181 - 270	75.0%
over 270 days	100.0%

Note: Healthy portfolio was provisioned 1% until March 23<sup>rd</sup> 2006, when BOM changed provisioning procedures.

**3.3** Loans fully provisioned are written off every December from the loan loss reserve and the loans outstanding in accordance with BOM regulations.

**3.4** The following table reconciles the loan loss reserve movements:

K MNT	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
Loan loss reserve, January 1st	346,835	900,786	2,764,722	5,006,107
+ Loan loss provision expense	555,034	1,869,488	2,432,972	213,390
- Provision reversal	-	-	-	-
- Loans written off	1,083	5,552	191,585	60,410
<b>Loan loss reserve, year end</b>	<b>900,786</b>	<b>2,764,721</b>	<b>5,006,109</b>	<b>5,159,087</b>

**3.5** Accrual vs. Cash accounting: accrued interests on loans are accounted. If the loan is past due more than 90 days, Khan Bank stops accruing interest on loans.

**4** Portfolio quality

**4.1** Indicators: Portfolio quality and the calculations of such are displayed in the tables in Section A and the calculations are based on standard portfolio at risk calculation of: (outstanding loan principal for loans in arrears over X days)/(total portfolio outstanding).

**4.2** Rescheduling of loans: Khan Bank exceptionally reschedules loans for clients with good credit history, bringing evidence of their wish to pay and facing unexpected circumstances. Such loans are tracked separately in the loan software and must be approved through credit committee.

**4.3 Insider loans:** Khan Bank allows employees to borrow funds through its staff loans or employee loans product. Staff loans amount to 2.4 M USD as of June 2006. Loans to employees are formalized in a contract between Khan Bank and the employee that state the amount granted and repayment schedule. They are granted at a flat nominal interest rate of 12%. Amounts can go up to 20 M MNT and terms up to 12 months (consumer) or 120 months (mortgage).

#### 5 Donations

**5.1 Revenue from donations** is shown separately from income generated by operations in the income statement.

**5.2 Current period donations:** Khan bank did not receive any donation during the period under review.

**5.3 Donations accounting methodology:** Grants for operations to be used in the current operating period are recorded in the income statement. Grants for fixed assets are recorded directly in the balance sheet with amortization of such assets passing through the income statement. Grants for loan funds are recorded directly in the balance sheet.

**5.4 In-kind donations:** The bank did not receive any in-kind donations.

**5.5 Cumulative amount of all prior period donations:** The only reported donations are fixed assets transferred from USAID for an amount of 13,990 K MNT (11,947 USD). These assets have already been fully depreciated.

#### 6 Details of liabilities:

**6.1 Loans and conditions** are listed in a table at the end of the report.

**6.2 Deposits:** See "A" section and appendices for details on savings collection.

**6.3 Deposits:** Please refer to the presentation of the institution for more details on the savings products offered by the MFI.

#### 7 Other significant accounting policies.

**7.1 Accrual or deferral income/expense accounting:** none.

**7.2 Depreciation of fixed assets:** 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
Furnitures, fixtures, vehicles	10 years
Computers	5 years

**7.3 Inflation accounting:** none

**7.4 Currency mismatch:** please refer to the "F" area for more information on potential currency mismatch.

## Specific notes to the financial statements

### Balance sheet

1. Includes
  - a. Balances with BOM with interests ranging from 0.0% to 3.5%.
  - b. Placements in local and foreign currency current accounts with foreign and local financial institutions. Deposits with local financial institutions bear interests at annual rates ranging from 0.0% to 7.0%. Placements with foreign financial institutions do not bear interests.
  - c. Investments on securities bought under held-to-maturity or available-for-sale agreement. Khan Bank invests mainly on BOM treasury bills, interest bearing short term bills with maturities of less than six months, issued at a discount. The effective annual interest rates of these bills range from 1.93% to 11.87%
2. Includes deposits and placements of other banks and financial institutions, and obligations on securities sold under repurchased agreement. In June 2006 it also includes the short term loan of the microfinance development fund for 366,880 K MNT.
3. Includes provision for taxation.

4. Includes loans from Bank of Mongolia at concessional rates and a 2.0 M USD subordinated loan of of HS Investment Co. Ltd., the holding company, at 5% per annum.
5. Includes ordinary shares and premium shares. On March 2006, the shareholders approved an amendment to the bank's Charter for the increase of the par value of the authorized ordinary shares from 1,000 MNT per share to 2,000 MNT per share to meet the new capital requirements of BOM. Subsequent to this increase, retained profits amounting to 5,159,130 K MNT were capitalized as paid-in ordinary shares of the bank.
6. Retained earnings are impacted by the realization of revaluation surplus.
7. Revaluation of buildings surplus.

### Income statement

8. Includes application fees, transaction fees and pension fees related to loan products.
9. Includes fees from payment, transfer and transaction services.

## Adjustments

	Dec. 2003	Dec. 2004	Dec. 2005	Jun. 2006
<b>Adjustment for the cost of funds = (a*b)-c</b>	<b>46,120</b>	<b>131,093</b>	<b>241,868</b>	<b>132,416</b>
Average amount of borrowings (a)	1,472,379	3,826,346	5,378,739	5,650,117
Shadow price of borrowings (b)	7.3%	7.3%	7.3%	7.3%
Interest expense on borrowings (c)	61,364	148,230	150,780	73,813
<b>Adjustment for inflation = (d-e)*f</b>	<b>24,765</b>	<b>110,852</b>	<b>284,640</b>	<b>228,251</b>
Avg. Equity (d)	5,051,287	7,956,262	12,708,549	17,707,436
Average fixed assets (e)	4,524,362	5,597,713	7,015,752	8,577,384
Inflation rate (f)	4.7%	4.7%	5.0%	5.0%
<b>Adjustment for in-kind donations</b>	-	-	-	-
Staff and technical assistance				
Other				
<b>Adjustments for provisions</b>	-	-	-	-
Loan losses				
Other risks				
<b>Other adjustments</b>				
<b>Total adjustments</b>	<b>70,885</b>	<b>241,945</b>	<b>526,508</b>	<b>360,668</b>
Net income before donations	1,932,759	3,081,509	4,648,939	5,348,836
Adjusted net income before donations	1,861,874	2,839,564	4,122,431	4,988,168
<b>Adjusted net income before donations (USD)</b>	<b>1,594,070</b>	<b>2,348,688</b>	<b>3,376,275</b>	<b>4,259,751</b>

<b>Khan Bank</b>		<b>K MNT</b>				<b>USD</b>				<b>Evolution</b>		
<b>Balance sheet</b>	<b>Notes</b>	<b>Dec. 2003</b>	<b>Dec. 2004</b>	<b>Dec. 2005</b>	<b>Jun. 2006</b>	<b>Dec. 2003</b>	<b>Dec. 2004</b>	<b>Dec. 2005</b>	<b>Jun. 2006</b>	<b>2004/2003</b>	<b>2005/2004</b>	<b>2006/2005</b>
<b>ASSETS</b>		<b>88,616,818</b>	<b>147,019,148</b>	<b>205,292,474</b>	<b>257,517,542</b>	<b>75,870,563</b>	<b>121,603,927</b>	<b>168,134,704</b>	<b>219,912,504</b>	<b>65.9%</b>	<b>39.6%</b>	<b>25.4%</b>
<b>Short Term Assets</b>		<b>76,265,098</b>	<b>133,414,381</b>	<b>182,221,171</b>	<b>204,787,429</b>	<b>65,295,461</b>	<b>110,351,018</b>	<b>149,239,288</b>	<b>174,882,518</b>	<b>74.9%</b>	<b>36.6%</b>	<b>12.4%</b>
Cash and short term funds		3,936,521	5,103,550	7,338,782	7,823,881	3,370,309	4,221,299	6,010,468	6,681,367	29.6%	43.8%	6.6%
Deposits and short term investments	1	26,559,396	54,208,618	55,758,466	72,441,515	22,739,209	44,837,567	45,666,229	61,862,950	104.1%	2.9%	29.9%
Short Term Net Loan Portfolio		43,725,465	71,013,810	114,001,042	118,200,009	37,436,186	58,737,642	93,366,947	100,939,376	62.4%	60.5%	3.7%
Short Term Gross Loan Portfolio		44,626,251	73,778,532	119,007,149	123,359,096	38,207,407	61,024,426	97,466,952	105,345,086	65.3%	61.3%	3.7%
(Loan Loss Reserve)		900,786	2,764,722	5,006,107	5,159,087	771,221	2,286,784	4,100,006	4,405,711	206.9%	81.1%	3.1%
Interest Receivable		1,147,880	2,011,359	4,139,354	4,837,732	982,774	1,663,655	3,390,134	4,131,283	75.2%	105.8%	16.9%
On loan portfolio		1,147,880	2,011,359	4,139,354	4,837,732	982,774	1,663,655	3,390,134	4,131,283	75.2%	105.8%	16.9%
On investments		-	-	-	-	-	-	-	-	-	-	-
Accounts receivable and other assets		895,836	1,077,044	983,527	1,484,292	766,983	890,855	805,509	1,267,542	20.2%	(8.7%)	50.9%
<b>Long term assets</b>		<b>12,351,720</b>	<b>13,604,767</b>	<b>23,071,303</b>	<b>52,730,113</b>	<b>10,575,103</b>	<b>11,252,909</b>	<b>18,895,416</b>	<b>45,029,986</b>	<b>10.1%</b>	<b>69.6%</b>	<b>128.6%</b>
Long Term Net Investments		-	-	-	-	-	-	-	-	-	-	-
Long Term Gross Loan Portfolio		7,465,029	7,296,033	15,348,534	43,298,114	6,391,292	6,034,767	12,570,462	36,975,332	(2.3%)	110.4%	182.1%
Net Fixed Assets		4,886,691	6,308,734	7,722,769	9,431,999	4,183,811	5,218,142	6,324,954	8,054,653	29.1%	22.4%	22.1%
Other Long Term Assets		-	-	-	-	-	-	-	-	-	-	-
<b>LIABILITIES AND EQUITY</b>		<b>88,616,818</b>	<b>147,019,148</b>	<b>205,292,474</b>	<b>257,517,542</b>	<b>75,870,563</b>	<b>121,603,927</b>	<b>168,134,704</b>	<b>219,912,504</b>	<b>65.9%</b>	<b>39.6%</b>	<b>25.4%</b>
<b>Liabilities</b>		<b>83,088,374</b>	<b>136,635,069</b>	<b>190,259,456</b>	<b>237,135,688</b>	<b>71,137,307</b>	<b>113,014,945</b>	<b>155,822,650</b>	<b>202,506,992</b>	<b>64.4%</b>	<b>39.2%</b>	<b>24.6%</b>
Short term liabilities		80,502,109	133,550,985	185,040,406	231,002,411	68,923,039	110,464,007	151,548,244	197,269,352	65.9%	38.6%	24.8%
Demand Deposits		20,196,104	30,829,382	55,736,568	88,515,005	17,291,185	25,499,902	45,648,295	75,589,244	52.7%	80.8%	58.8%
Compulsory Deposits		-	-	-	-	-	-	-	-	-	-	-
Short Term Time Deposits	2	59,019,164	99,549,452	127,724,048	133,919,981	50,530,106	82,340,324	104,606,100	114,363,775	68.7%	28.3%	4.9%
Short Term Borrowings		40,000	2,317,000	512,000	-	34,247	1,916,460	419,328	-	5,692.5%	(77.9%)	(100.0%)
Interest payable		-	-	-	5,900,062	-	-	-	5,038,482	-	-	-
Accounts Payable and Other Short Term Liabilities	3	1,246,841	855,151	1,067,790	2,667,363	1,067,501	707,321	874,521	2,277,851	(31.4%)	24.9%	149.8%
Long term liabilities		2,586,265	3,084,084	5,219,050	6,133,277	2,214,268	2,550,938	4,274,406	5,237,640	19.2%	69.2%	17.5%
Long Term Time Deposits		-	374,657	-	564,093	-	309,890	-	481,719	-	(100.0%)	-
Long Term Borrowings	4	2,586,265	2,709,427	5,219,050	5,569,184	2,214,268	2,241,048	4,274,406	4,755,921	4.8%	92.6%	6.7%
Other Long Term Liabilities		-	-	-	-	-	-	-	-	-	-	-
<b>Equity</b>		<b>5,528,444</b>	<b>10,384,079</b>	<b>15,033,018</b>	<b>20,381,854</b>	<b>4,733,257</b>	<b>8,588,982</b>	<b>12,312,054</b>	<b>17,405,512</b>	<b>87.8%</b>	<b>44.8%</b>	<b>35.6%</b>
Paid-In Capital	5	4,574,130	6,344,815	6,344,815	11,503,945	3,916,207	5,247,986	5,196,409	9,824,035	38.7%	0.0%	81.3%
Donated equity		13,990	13,990	13,990	13,990	11,978	11,572	11,458	11,947	0.0%	0.0%	0.0%
Retained earnings without donations and reserves	6	145,086	3,303,587	8,035,342	8,258,466	124,217	2,732,495	6,580,952	7,052,490	2,177.0%	143.2%	2.8%
Current year		1,932,759	3,081,509	4,648,939	5,348,836	1,654,759	2,548,808	3,807,485	4,567,750	59.4%	50.9%	15.1%
Other equity accounts	7	795,238	721,687	638,871	605,453	680,854	596,929	523,236	517,039	(9.2%)	(11.5%)	(5.2%)

<b>Khan Bank</b>		<b>K MNT</b>				<b>USD</b>				<b>Evolution</b>		
<b>Income Statement</b>	<b>Notes</b>	<b>Dec. 2003</b>	<b>Dec. 2004</b>	<b>Dec. 2005</b>	<b>Jun. 2006</b>	<b>Dec. 2003</b>	<b>Dec. 2004</b>	<b>Dec. 2005</b>	<b>Jun. 2006</b>	<b>2004/2003</b>	<b>2005/2004</b>	<b>2006/2005</b>
<b>Financial Revenue (a)</b>		<b>18,202,222</b>	<b>29,415,578</b>	<b>40,233,864</b>	<b>26,652,842</b>	<b>15,584,094</b>	<b>24,330,503</b>	<b>32,951,568</b>	<b>22,760,753</b>	<b>61.6%</b>	<b>36.8%</b>	<b>(33.8%)</b>
Financial Revenue from Loan Portfolio		16,239,021	23,866,810	34,058,100	23,855,404	13,903,271	19,740,951	27,893,612	20,371,822	47.0%	42.7%	(30.0%)
Interest on Loan Portfolio		13,159,885	20,892,634	30,752,609	23,138,918	11,267,025	17,280,921	25,186,412	19,759,964	58.8%	47.2%	(24.8%)
Fees and Commissions on Loan Portfolio	8	2,994,750	2,771,929	3,296,019	716,486	2,563,998	2,292,745	2,699,442	611,858	(7.4%)	18.9%	(78.3%)
Penalty Revenue on Loan Portfolio		84,386	202,247	9,472	-	72,248	167,285	7,758	-	139.7%	(95.3%)	(100.0%)
Financial Revenue from Investments		1,106,648	3,483,648	3,262,544	1,227,624	947,473	2,881,429	2,672,026	1,048,355	214.8%	(6.3%)	(62.4%)
Other Operating Revenue	9	856,553	2,065,120	2,913,220	1,569,814	733,350	1,708,122	2,385,930	1,340,576	141.1%	41.1%	(46.1%)
<b>Financial Expense (b)</b>		<b>6,691,178</b>	<b>12,941,676</b>	<b>16,950,823</b>	<b>9,815,684</b>	<b>5,728,748</b>	<b>10,704,447</b>	<b>13,882,738</b>	<b>8,382,309</b>	<b>93.4%</b>	<b>31.0%</b>	<b>(42.1%)</b>
Interest paid on borrowings		61,364	148,230	150,780	73,813	52,538	122,605	123,489	63,034	141.6%	1.7%	(51.0%)
Interest paid on deposits		6,629,814	12,793,446	16,800,043	9,741,871	5,676,211	10,581,841	13,759,249	8,319,275	93.0%	31.3%	(42.0%)
Net Inflation Adjustment Expense		-	-	-	-	-	-	-	-	-	-	-
Other Financial Expenses		-	-	-	-	-	-	-	-	-	-	-
<b>Financial income [c=a-b]</b>		<b>11,511,044</b>	<b>16,473,902</b>	<b>23,283,041</b>	<b>16,837,158</b>	<b>9,855,346</b>	<b>13,626,056</b>	<b>19,068,830</b>	<b>14,378,444</b>	<b>43.1%</b>	<b>41.3%</b>	<b>(27.7%)</b>
<b>Net Loan Loss provision expense (d)</b>		<b>489,373</b>	<b>1,848,187</b>	<b>2,370,958</b>	<b>212,271</b>	<b>418,984</b>	<b>1,528,690</b>	<b>1,941,817</b>	<b>181,274</b>	<b>277.7%</b>	<b>28.3%</b>	<b>(91.0%)</b>
Loan loss provision expense and write-off		555,034	1,869,488	2,432,972	213,390	475,200	1,546,309	1,992,606	182,229	236.8%	30.1%	(91.2%)
Recovery from Loans written off		65,661	21,301	62,014	1,119	56,217	17,619	50,790	956	(67.6%)	191.1%	(98.2%)
<b>Operating expense (e)</b>		<b>7,643,151</b>	<b>9,978,706</b>	<b>13,796,144</b>	<b>8,704,051</b>	<b>6,543,794</b>	<b>8,253,686</b>	<b>11,299,053</b>	<b>7,433,007</b>	<b>30.6%</b>	<b>38.3%</b>	<b>(36.9%)</b>
Personnel Expense (includes fringe)		3,690,378	4,916,546	6,929,369	4,532,490	3,159,570	4,066,622	5,675,159	3,870,615	33.2%	40.9%	(34.6%)
Administrative Expense (non-staff operating expenses)		3,952,773	5,062,160	6,866,775	4,171,561	3,384,223	4,187,064	5,623,894	3,562,392	28.1%	35.6%	(39.3%)
Depreciation and amortization		574,543	755,745	935,373	643,843	491,903	625,099	766,071	549,823	31.5%	23.8%	(31.2%)
Consulting fees		80,990	85,371	118,668	75,353	69,341	70,613	97,189	64,349	5.4%	39.0%	(36.5%)
Other provisions		172,435	100,145	93,159	11,928	147,633	82,833	76,297	10,186	(41.9%)	(7.0%)	(87.2%)
Others		3,124,805	4,120,899	5,719,575	3,440,437	2,675,347	3,408,519	4,684,337	2,938,033	31.9%	38.8%	(39.8%)
<b>Net Operating Income Before Taxes and Donations [f=c-d-e]</b>		<b>3,378,520</b>	<b>4,647,009</b>	<b>7,115,939</b>	<b>7,920,836</b>	<b>2,892,568</b>	<b>3,843,680</b>	<b>5,827,960</b>	<b>6,764,164</b>	<b>37.5%</b>	<b>53.1%</b>	<b>11.3%</b>
Income Taxes (g)		1,445,761	1,565,500	2,467,000	2,572,000	1,237,809	1,294,872	2,020,475	2,196,413	8.3%	57.6%	4.3%
<b>Net Operating Income Before Donations [h=f-g]</b>		<b>1,932,759</b>	<b>3,081,509</b>	<b>4,648,939</b>	<b>5,348,836</b>	<b>1,654,759</b>	<b>2,548,808</b>	<b>3,807,485</b>	<b>4,567,750</b>	<b>59.4%</b>	<b>50.9%</b>	<b>15.1%</b>
Non Operating Revenue (i)		-	-	-	-	-	-	-	-	-	-	-
Non Operating Expense (including related taxes) (j)		-	-	-	-	-	-	-	-	-	-	-
<b>Net Income Before Donations [k=h+i-j]</b>		<b>1,932,759</b>	<b>3,081,509</b>	<b>4,648,939</b>	<b>5,348,836</b>	<b>1,654,759</b>	<b>2,548,808</b>	<b>3,807,485</b>	<b>4,567,750</b>	<b>59.4%</b>	<b>50.9%</b>	<b>15.1%</b>
Donations (l)		-	-	-	-	-	-	-	-	-	-	-
<b>Net Income (after Taxes and Donations) [m=k+l]</b>		<b>1,932,759</b>	<b>3,081,509</b>	<b>4,648,939</b>	<b>5,348,836</b>	<b>1,654,759</b>	<b>2,548,808</b>	<b>3,807,485</b>	<b>4,567,750</b>	<b>59.4%</b>	<b>50.9%</b>	<b>15.1%</b>

## Loan products

### 1/ Business Loans

Name of the product	Short term business Loans	Term Loans	Investment Loans	Express Micro Loans	Loans in USD
Creation Date	November-00	July-03	May-01	June-04	April-03
Client type (rural, urban, etc.)	Rural, urban	Rural, urban	Rural, urban	Rural, urban	Urban
Authorised loan size (minimum and maximum)	100,000 MNT-limitless	1,000,000 MNT-limitless	20,000,000 MNT-2,000,000,000 MNT	100,000 MNT-2,000,000 MNT 100-2,000 USD	Limitless
Average disbursed loans size in K MNT	4,067	17,228	66,887	871	21,629
Authorized loan length	Up to 18 months	Up to 36 months	Up to 60 months	Up to 9 months	Up to 18 months
Average loan length	12 months	32.8 months	38 months	10.2 months	14 months
Grace period	No	Up to 3 months	3 months	No	3 months
Collateral requirements and other conditions	<p>*The Bank shall only accept a combination of collateral, which contain both moveable and immovable property.</p> <p>*To have at least 9 months business experience.</p> <p>*To have established business premises within the branch or sub-branch's operational area.</p> <p>*To reside within the branch or sub-branch's operational area.</p> <p>*The business to be financed must have a regular cash flow.</p> <p>*The applicant shall not have any other outstanding loan facility at another bank or branch.</p>	<p>*The Bank shall only accept a combination of collateral, which contain both moveable and immovable property.</p> <p>*To have at least 9 months business experience</p> <p>*To have at least 24 months experience at that particular business</p> <p>*To be in possession of a current account at Khan Bank</p> <p>*To have established business premises within the branch or sub-branch's operational area;</p> <p>*To reside within the branch or sub-branch's operational area;</p> <p>*The business to be financed must have a regular cash flow; and</p> <p>*The applicant shall not have any other outstanding loan facility at another bank or branch.</p>	<p>*The Bank shall only accept a combination of collateral, which contain both moveable and immovable property.</p> <p>*To have at least 24 months experience at that particular business</p> <p>*To be in possession of a current account at Khan Bank</p> <p>*To have established business premises within the branch or sub-branch's operational area;</p> <p>*To reside within the branch or sub-branch's operational area;</p> <p>*The business to be financed must have a regular cash flow; and</p> <p>*The applicant shall not have any other outstanding loan facility at another bank or b</p>	<p>*The Bank shall accept a combination of collateral, including immovable property.</p> <p>*To have at least 9 months experience at that particular business</p> <p>*To be in possession of a current account at Khan Bank</p> <p>*To have established business premises within the branch or sub-branch's operational area;</p> <p>*To reside within the branch or sub-branch's operational area;</p> <p>*The business to be financed must have a regular cash flow; and</p> <p>*The applicant shall not have any other outstanding loan facility at another bank or branch.</p>	<p>*The Bank shall only accept a combination of collateral, which contain both moveable and immovable property.</p> <p>*To have at least 9 months business experience</p> <p>*To have established business premises within the branch or sub-branch's operational area;</p> <p>*To reside within the branch or sub-branch's operational area;</p> <p>*The business to be financed must have a regular cash flow; and</p> <p>*The applicant shall not have any other outstanding loan facility at another bank or branch.</p>
Repayment Schedule (ex. weekly, monthly)	Depends on borrower's business cash flow.	Monthly	Monthly	Monthly	Monthly
Nominal annualized interest rate	24%-42%	24%-30%	24%-30%	24%-42%	24%-27.6%
Flat or declining ?	Declining	Declining	Declining	Declining	Declining
APR	28.9%	25.0%	23.8%	35.6%	17.3%
Fees and penalties	<p>* Application fee - 5000 MNT</p> <p>* Acceptance fee - 1% of disbursed loan in offline branches,</p> <p>* Penalty - 20% of annual interest rate</p>	<p>* Application fee - 5000 MNT</p> <p>* Acceptance fee - 1% of disbursed loan or up to 150,000 MNT</p> <p>* Penalty - 20% of annual interest rate</p>	<p>* Application fee - 15000 MNT</p> <p>* Acceptance fee - 0.3% of disbursed loan or no more than 1,000,000 MNT</p> <p>* Penalty - 20% of annual interest rate</p>	<p>* Application fee - 5000 MNT or 5 USD</p> <p>* Penalty - 20% of annual interest rate</p> <p>* Restructured fee - 1% of outstanding</p>	<p>* Application fee - 5 USD</p> <p>* Penalty - 20% of annual interest rate</p>
Major changes since creation (rate, size, term)	<p>Interest rate - declining</p> <p>Max size - no limit</p> <p>Term - increased from 12 months to 18 months</p>	<p>Interest rate - declining</p> <p>Max size - no limit</p>	<p>Interest rate - declining</p> <p>Max size - reached 2 billion</p> <p>Term - increased from 12 months to 18 months</p>		<p>Interest rate - declining</p> <p>Max size - no limit</p> <p>Term - increased from 12 months to 18 months</p>

## 2/ Consumer Loans

Name of the product	Pension Loans	Salary Loans	Secured by deposit Loans	Mortgage Loans	Leasing Loans	Staff Loans
Creation Date	May-01	October-01	October-01	April-03	June-04	January-01
Client type (rural, urban, etc.)	Rural, urban	Rural, urban	Rural, urban	Rural, urban	Rural, urban	Rural, urban
Authorized loan size (minimum and maximum)	Min 500,000 Max equal to sum of 6 months pension	No more than sum of 10 months net salary	No more than 85%-90% of the outstanding savings of the client.	No more than 15,000,000 MNT	50,000-30,000,000 MNT	Consumer - 1,000,000 MNT Mortgage - 20,000,000 MNT
Average disbursed loans size in K MNT	103	459	1,276	4,554	306	1,326
Authorized loan length	Up to 6 months	Up to 18 months	Up to 12 months and depends on time deposit term	Up to 60 months	Up to 12 months	Consumer - 12 months Mortgage - 120 months
Average loan length	NA	11.3 months	6 months	53.5 months	11.3 months	NA
Grace period	No	No	No	No	No	No
Collateral requirements and other conditions	Collateral - All pension, allowances and benefits Requirements: - To be registered as a pensioner in Social Insurance office - To receive pension from Khan Bank monthly	Collateral - All salary, allowances and moveable assets and immoveable assets Requirements: - Contract on cooperation should be made between bank and employer organization - An employee should be registered at Social Insurance office - An employee's salary should not be the only income of the family	Collateral - Savings	Collateral - Apartment *The business to be financed must have a regular cash flow. *The applicant shall not have any other outstanding loan facility at another bank or branch. * The applicant must be able to pay at least 30% of apartment price.	Collateral - Purchased goods and additional moveable assets * The applicants must have a regular cash flow	Collateral: Consumer - Salary Mortgage - Apartment * Employee should finance 30% of market price. * Employer should have worked at Khan Bank at least 1 year. * Employer should be able to pay principal and interest 80% of net income.
Repayment Schedule (ex. weekly, monthly)	Monthly	Monthly	Maturity	Monthly	Monthly	Monthly
Nominal annualized interest rate	21.6-24%	30%-36%	MNT- Saving's annual interest rate, plus 0.5% USD - Saving's annual interest rate, plus 0.08%	30.0%	MNT 27.6%-30% USD 18-20.4%	12%
Flat or declining ?	Flat	Declining	Flat	Flat	Flat	Flat
APR	38.0%	35.4%	21.4%	28.0%	30.4%	11.7%
Fees and penalties	No	* Acceptance fee - 1% of disbursed loan * Penalty - 20% of annual interest rate	* Application fee - 1000 MNT or 1 USD * Penalty - 20% of annual interest rate	* Application fee - 15000 MNT * Acceptance fee - 0.5% of disbursed loan * Penalty - 20% of annual interest rate	* Application fee - 1000 MNT or 1 USD * Penalty - 20% of annual interest rate	* Penalty - 20% of annual interest rate
Major changes since creation (rate, size, term)	Fee transferred to interest rate	Interest rate - decreased Max size - increased	Interest rate increased from saving's annual interest rate, plus 0.25% to 0.5%	Interest rate increased from 23.5%-30%	Interest rate - declining	Interest rate - decreased Max size - increased Term - increased from 60 months to 120 months for mortgage 1

### 3/ Agriculture loans

Name of the product	Herder Loans	Ger Initiative (project loan)	Agriculture Loans
Creation Date	August-01	January-04	May-02
Client type (rural, urban, etc.)	Rural, urban	Rural, urban	Rural, urban
Authorized loan size (minimum and maximum)	100,000 MNT-10,000,000 MNT	Limitless	100,000 MNT-5,000,000 MNT
Average disbursed loans size in K MNT	1,032	625	828
Authorized loan length	Up to 12 months	Up to 36 months	Up to 12 months
Average loan length	NA	12 months	9.3 months
Grace period	No	Up to 3 months	No
Collateral requirements and other conditions	<ul style="list-style-type: none"> <li>*The Bank shall only accept a combination of collateral, which contain both moveable and immovable property.</li> <li>*To have at least 5 years experience at that particular business</li> <li>* The herder must have at least 100 head livestock</li> <li>*To be in possession of a current account at Khan Bank</li> <li>*To have established business premises within the branch or sub-branch's operational area;</li> <li>*To reside within the branch or sub-branch's operational area;</li> <li>*The applicant shall not have any other outstanding loan facility at another bank or branch.</li> </ul>	<ul style="list-style-type: none"> <li>*The Bank shall only accept a combination of collateral, which contain both moveable and immovable property.</li> <li>*To have experience at that particular business.</li> <li>*To have established business premises within the branch or sub-branch's operational area.</li> <li>*To reside within the branch or sub-branch's operational area.</li> <li>*The business to be financed must have a regular cash flow.</li> <li>*The applicant shall not have any other outstanding loan facility at another bank or branch.</li> </ul>	<ul style="list-style-type: none"> <li>*The Bank shall only accept a combination of collateral, which contain both moveable and immovable property.</li> <li>*To have experience at that particular business.</li> <li>*To have established business premises within the branch or sub-branch's operational area.</li> <li>*To reside within the branch or sub-branch's operational area.</li> <li>*The business to be financed must have a regular cash flow.</li> <li>*The applicant shall not have any other outstanding loan facility at another bank or branch.</li> </ul>
Repayment Schedule (ex. weekly, monthly)	Maturity, monthly or monthly interest payment and principal at maturity.	Monthly	Depends on borrower's business cash flow
Nominal annualized interest rate	30%-48%	24%-30%	30%-42%
Flat or declining ?	Declining	Declining	Declining
APR	37.5%	31.9%	30.1%
Fees and penalties	<ul style="list-style-type: none"> <li>* Application fee - 1000 MNT</li> <li>* Acceptance fee - 1% of disbursed loan</li> <li>* Penalty - 20% of annual interest rate</li> </ul>	* Penalty - 20% of annual interest rate	<ul style="list-style-type: none"> <li>* Application fee - 5000 MNT</li> <li>* Acceptance fee - 1% of disbursed loan</li> <li>* Penalty - 20% of annual interest rate</li> </ul>
Major changes since creation (rate, size, term)		Interest rate - declining Max size - no limit	Interest rate - declining

### Breakdown of deposits as of June 30<sup>th</sup> 2006

Type of deposit product	Amount in K MNT	% of total deposits	Average interest rates (online branches)
Current account	44,898,516	20.1%	1.50%
Time deposit	116,679,242	52.3%	8.85%
Demand deposit	47,417,406	21.3%	14.41%
Government and others	13,998,109	6.3%	1.20%

### Loans from Bank of Mongolia and foreign financial institutions

Name of loan	Loan Providers	Currency	Initial amount (in loan currency)	Loan outstanding as of June 2006 in K MNT	Interest rate	Maturity date, repayment schedule and conditions.
Term loan I	Bank of Mongolia	USD	100,000	48,880	1%	From 2002 to 2007, repayable in 5 equal annual installments. For the purchase of computer equipment.
Term loan II	Bank of Mongolia	USD	50,000	23,440	1%	From 2002 to 2007, repayable in 5 equal annual installments. For covering cost of additional work performed on the BANCS software.
Term loan III	Bank of Mongolia	USD	137,694	139,861	1%	From 2002 to 2032, repayable in 30 equal annual installments. For Khan Bank's portion of the BANCS software.
Agricultural Development Sector Project loan	Bank of Mongolia	MNT	7,389,724	3,015,003	5.5%	From 17 February 2004, due and payable one year after disbursement. Repayable on a monthly basis. For loan portfolio to small and medium enterprises in the agricultural sector.
Micro Finance Development fund	International Development Association	MNT	958,870	366,880	5%-8%	From 2005 to 2008, repayable on a monthly basis. For improving the living standards of inhabitant of rural areas through credits to be disbursed in 7 aimags: Tuv, Dornod, Uvs, Bayan_Ugllii, Bayankhongor, Uvur Khangai and Zavhan.
Subordinated Loan	H.S. Investment Co. Ltd.	USD	2,000,000	2,368,885	6.25%	Interest payable on a quarterly basis starting 31 October 2003. The loan will be due and payable in full on 31 July 2008. Subordinated loan from the holding company to fund ongoing business operations.

### Members of Board of Directors

Name	Position on Board	Education	Current position	Date elected to Board
Hideo Sawada, Chairman	Director	Economics	President HS Securities	25-Mar-03
Yoshiaki Mishima	Member	Economics	General Manager Capital Market Dpt HS Securities	25-Mar-03
D.Khulan	Member	MBA, International Economics	Executive Director Tavan Bogd Group	25-Mar-03
Hiroshi Arichi	Member	Economics	Director IFC Tokyo Office	2-Aug-05
J.Peter Morrow	Member	Economics, Law	CEO Khan Bank of Mongolia	25-Mar-03

**Organizational chart**

