FINANCIAL ANALYSIS

A. Overview

1. Khan Bank was established in 1991 and was previously known as the Agriculture Bank of Mongolia. Khan Bank is Mongolia's largest bank in terms of loans and deposits—with market shares of 23% (loans) and 26% (deposits) as of the end of 2013. It operates in all 21 provinces and in the capital city of Ulaanbaatar, serving more than 1.8 million customers from its 528 branches (100 in Ulaanbaatar and 428 in rural areas) and through 335 ATMs. The bank seeks to maintain its legacy of serving rural areas as part of its strategy.

B. Capital Adequacy

2. **Capitalization.** Khan Bank had a Tier 1 capital adequacy ratio (CAR) of 11.1% and total CAR of 16.6% at the end of 2013 (2012: 10.8%, 16.6%). The bank's capitalization was above that of its peers, which had an average CAR of 15.5% at the end of 2013, caused by an increase in subordinated debt of $40 million obtained from the International Finance Corporation (IFC). The year-end total CAR was similar to that of 2012, and met the new regulatory requirements for certain larger banks of tier 1 CAR of 9.0% and total CAR of 14.0%, respectively, which came into effect on 30 June 2013.

3. As a result of demand across Mongolia and increased loan growth, Khan Bank continues to invest in capital expenditure. Developments in internet and mobile banking include an upgrade of the bank's production hardware, implementation of a large data center and operations center, and a new information security management system that will enable the bank to achieve ISO 27001. Enhanced customer service is expected as a result of these improved systems. High speed fiber optic cables are being installed at branches, which will result in faster online banking services to the bank's rural customers. The rollout will be done throughout 2014.

C. Assets

4. **Loan portfolio.** Khan Bank's gross loans grew by 41% at the end of 2013 (2012: 25%), which was below the sector average of 55% (2012: 24%). Loan growth was a result of (i) expansion of Khan Bank's branch network in the western, eastern, and southern regions by an additional 14 branches; (ii) an increase in demand for retail and micro, small, and medium-sized enterprise (MSME) loans, and through participation in the Price Stabilization Program, 2012; and (iii) effectively cross-selling products and services within the bank.[1]

5. At the end of 2013, Khan Bank's portfolio was segmented by business line: corporate banking (20%), MSMEs (26%), and retail (54%).[2]

6. Khan Bank has a well-diversified portfolio. At the end of 2013, gross loans were concentrated in the following industry sectors: consumption loans, which include salary, pension, leasing, mortgage, and employee loans (49%); trade and finance (16%); construction (10%); agriculture (3%); industrial (8%); mining (4%); and others (10%).

7. **Asset quality and provisioning.** Khan Bank follows the BOM classification and provisioning policies.[3] The nonperforming loan (NPL) ratio peaked at 8% in 2009 due to the

---

[1] Khan Bank. 2013. *Khan Bank: Mid-term Strategy.* Ulaanbaatar.
[2] Includes salary, pension, leasing, and employee loans.

impact of the 2008/2009 global financial crises. Khan Bank's asset quality began improving significantly in 2010 as a result of improving political and economic conditions, focused recovery efforts, and improved risk management tools (e.g., a risk assessment scoring table). The bank's asset quality, although increased since 2012, is good—accounting for 1.5% of gross loans at the end of 2013 (2012: 0.9%), which is below the sector average of 5.3% (2012: 4.2). Gross NPLs increased to MNT36.2 billion at the end of 2013 (2012: MNT15.1 billion). The increased NPL ratio is due to a few corporate loans in the mining sector that were affected by declining commodity prices in the international market in 2013. The NPL ratio of Khan Bank's MSME portfolio is also low, reported at 1% at the end of 2013 (2012: 0.9%). The largest contributors to gross NPLs by economic sector in 2013 were construction and real estate (30.7%), manufacturing loans (26.9%), mining (14.7%), trade (5.1%), transport and logistics (3%), and others (19.6%).[4] Khan Bank plans to maintain its total gross NPL ratio below 5% at all times.[5]

D. Funding and Liquidity

8. **Funding**. At the end of 2013, Khan Bank's funding structure comprised customer deposits (64.7%), short-term borrowings (16.3%), long-term borrowings (11.4%), equity and retained earnings (7.0%), and others (0.6%). Customer deposits grew by 34% in 2013 (2012: 14.4%), which was slightly above the sector average growth rate of 32% at the end of 2013.[6] However, deposit growth across the industry is expected to decrease in 2014 as a result of slower economic growth. Time deposits accounted for 71.0% of customer deposits (2012: 46.3%) and bank borrowings accounted for 23.7% of total assets (2012: 13.5%) at the end of 2013. As financial sector development is nascent in Mongolia, it is particularly difficult for corporations or banks to issue debt, above all senior, because of the deficit, the falling price of the recent Government Chinggis bonds, and the risk–return profiles associated with issuing longer term debt.[7] Khan Bank has obtained subsidized funding in the amount of MNT592 billion as a loan from the BOM under the government stabilization program and a government deposit placement of MNT109 billion. It has relationships with several international financial institutions through existing credit lines with Netherlands Development Finance Company (FMO), IFC, and the European Bank for Reconstruction and Development; and trade finance facilities with ADB. Khan Bank will continue to maintain and develop relationships with local and international commercial banks.

9. **Liquidity.** At the end of 2013, Khan Bank's cash reserve ratio was 15.8% (2012: 14.7%) and its liquidity ratio (liquid assets as a percentage of total assets) was 46% (2012: 34.6%); this was compliant with the BOM minimum requirement of 12.0% for cash reserve ratio[8] and 25.0% for liquidity ratio.

10. **Currency gap analysis.** The BOM provides swaps for a predetermined period, which enables Mongolian banks to hedge their foreign currency for a tenor of up to 5 years. This enables banks to provide togrog financing to MSME clients. Additionally, US dollars that are

---

[3] Joint Resolution of the Governor of the Bank of Mongolia and the Minister of Finance. 2010. Regulation on Assets Classifying, Provisioning and its Allocations. http://www.mongolbank.mn/documents/regulation/bankactive_eng.pdf. Current, past due 1–30 days, 31–90 days, 91–180 days, 181–360 days, and 361 days and above.

[4] Khan Bank Management.

[5] Due diligence with Khan Management.

[6] ADB's Mongolia Resident Mission; Bank of Mongolia. *Bank Statistics*. http://www.mongolbank.mn/eng/default.aspx (accessed 28 April 2014); Moody's Investor Services. 2014. *Moody's changes ratings outlooks of Mongolia banks to negative and affirms ratings.* New York.

[7] World Bank. 2013. *Mongolia Economic Update April 2013*. Washington, DC.

[8] The reserve requirement (or cash reserve ratio) is a central bank regulation that sets the minimum fraction of customer deposits, and notes that each commercial bank must hold as reserves and not lend out.

onlent to customers will be mitigated by not lending to borrowers that have no foreign-currency-earning sources.[9] Treasury is primarily responsible for maintaining limits on currency exposure and monitoring them at Khan Bank. Khan Bank's credit assessment processes of MSME sub-borrowers take currency mismatch risk into consideration.

11. **Earnings and profitability.** At the end of 2013, net income was MNT96.7 billion (2012: 71.4 billion). Net income grew by 35.0% from the end of 2012 to the end of 2013 (2012: 22.5%). The increase can be attributed to the rise in net interest income (2013: 29.4%; 2012: 19.2%) resulting from the growth in the loan portfolio thanks to effective marketing and sales efforts.

12. Khan Bank's audited financial statements are prepared according to International Financial Reporting Standards and audited by PricewaterhouseCoopers, Mongolia.

[9] The client has customers engaged in processing and trade of construction materials, carpeting, food production, agriculture, milk processing and export, cashmere manufacturing, and meat processing, with US dollar revenue streams that it lends to in US dollars.