Moody's Investors Service

Global Credit Research
Credit Opinion
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Credit Opinion: XacBank LLC

XacBank LLC

Mongolia

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits -Fgn Curr	B2/NP
Bank Deposits -Dom Curr	Ba1/NP
Bank Financial Strength	D
Issuer Rating -Fgn Curr	Ba2
Issuer Rating -Dom Curr	Ba1
ST Issuer Rating	NP

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Opinion

SUMMARY RATING RATIONALE

Moody's assigns a D Bank Financial Strength Rating (BFSR) to XacBank, which translates into a baseline risk assessment of Ba2. The rating reflects bank's well-managed microfinance franchise, strong profitability, solid capital position and superior asset quality. However, the rating is constrained by the bank's small size, rapid growth and the volatility inherent in its operating environment. In addition, as the microfinance business becomes increasingly competitive and the market becomes saturated, the bank's profitability may under pressure. In the medium to long-run, if the bank continues with its rapid growth, it may inevitably move into more small and medium-sized enterprise (SME) business, which is currently limited to 25% of the bank's exposure. This transition could generate some degree of uncertainty in the bank's operations and financials in the long-run.

The adoption of joint-default analysis methodology results in a one-notch upgrade of XacBank's long-term global local currency deposit rating to Ba1 from Ba2. The Ba1 long-term local currency deposit rating is based on the bank's financial strength rating of D, and also on Moody's assessment of moderate probability of systemic support which would be extended by the government to the bank in the event of a systemic crisis. The systemic support results in a one-notch uplift in the local currency deposit rating to Ba1 from a BCA implied Ba2. However, the long-term foreign currency deposit rating is constrained by the B2 sovereign ceiling and the long-term foreign currency issuer rating is constrained by the Ba2 sovereign ceiling.

Credit Strengths

- Mongolia's second largest microfinance player with well-managed niche microfinance-banking franchise

- Strong profitability

- Prudent capital position

- Sound asset quality

- Transparent corporate governance with strong management team

- Socially well-fit mission at helping the poor while achieving profitability

Credit Challenges

- Small size weighs down efficiency and limit business scope

- Lack of business diversification; moving into SMEs may lead to strategy and operational changes

- Increased competition in a crowded banking market environment

- Relatively high loan to deposit ratio could result in reliance on market funding and donor support

- Key man risk and high dependence on a core group of executives

Rating Outlook

The outlook for all ratings is stable.

What Could Change the Rating - Up

- Significant increase in market share and considerable strengthening of franchise

- Successful diversification of business

- Further improvement in market and credit risk management

What Could Change the Rating - Down

- Rapid growth resulting in significant deterioration of asset quality

- Weakening of its capital position

- Increased competition leading to significant deterioration in margin and profitability

Recent Results and Developments

XacBank reported net profit of MNT 1.49 billion in 2005, an increase of 89% YoY from MNT 0.79 billion. The strong performance was attributable to the significant growth in net-interest income of 41.3% YoY to MNT 5.6 billion.

Non-interest income rose 44.2% YoY on the back of strong growth in net fees and commissions income of 70.8% YoY. However, its contribution to total operating income was relatively small, at 13.1% in 2005.

Cost-to-income ratio rose to 71.5% in 2005, from 68.8% in the previous year, while asset quality was good and non-performing loan (NPL) ratio was 0.97% in 2005. The reported risk weighted capital ratio was 21%.

DETAILED RATING CONSIDERATIONS

Detailed rating considerations for XacBank's currently assigned ratings are as follows:

Bank Financial Strength Rating

Moody's assigns a D BFSR to XacBank. The bank's rating is supported by its reputable socially-accepted microfinance franchise, solid risk-adjusted profitability, good liquidity, strong capitalization as well as its superior asset quality. However these strengths are offset by its limited overall franchise in Mongolia, moderate risk profile, lack of diversification and relatively weak market risk management.

As a point of reference, the assigned BFSR is one notch lower than the D+ outcome of Moody's bank financial strength scorecard. This is driven primarily by two factors: 1) Moody's made adjustment in NPLs and risk-weighting for the bank's security holdings, which resulted in weaker profitability, capital adequacy, and asset quality indicators; and 2) volatility inherent in operating environment in Mongolia and uncertainty about the impact of changes in business strategy and operation by gradually moving into the SME businesses.

Qualitative Rating Factors (70%)

Factor 1: Franchise Value

Trend: Neutral

XacBank is Mongolia's second largest microfinance player and ranks eighth in the banking system by assets at end-June 2006. The bank targets the less well-off sections of Mongolia's population. The bank has a unique "double-bottom line" goal of promoting socioeconomic development as well as enhancing shareholder value. XacBank's unique mobile service and franchise models give the bank a broad reach, and have grown its rural services rapidly.

However, the bank's overall franchise is still small. The franchise value score is further weighted down by the uncertainty about earning stability and lack of geographical diversification, given the bank operates only in Mongolian's limited market, which is categorized by Moody's as a "local market". Given the approaching saturation of the microfinance market, XacBank is moving into the SME segment, which could have different business model and risk-return characteristics. The bank has an overall score of E+ in franchise value.

Factor 2: Risk Positioning

Trend: Neutral

The bank has an effective board and exhibits good transparency. It is 55%-owned by a number of foreign investors, including Mercy Corp, a US-based non-profit organization, Micro Vest, ShoreCap International and Triodos. Moody's believes the bank's international shareholders are very supportive of the bank, and they will continue to underpin its strong capitalization, sound governance and access to foreign technical assistance. The bank also follows relatively well-defined comprehensive risk management policies as compared to other Mongolian banks.

However, as the microfinance sector matures and the bank moves into the SME segment, it is set to evolve towards more mainstream commercial banking, potentially raising concentration risk. In addition, liquidity and market risk management are at an early stage at XacBank, given system and technology constraints and the underdevelopment of the domestic capital market.

The bank publishes IAS-based audited financial statements on an annual basis and local GAAP financials statements on a quarterly basis. Although the reports provide relatively more information than the other Mongolian banks, overall disclosure is still limited, for example in the areas of management discussion and analysis, credit concentrations, risk management, market risk exposures and stress testing.

XacBank's risk positioning is scored D+.

Factor 3: Regulatory Environment

Trend: --

All Mongolian banks are subject to the same score on regulatory environment. This factor does not address bank specific issues; instead, it evaluates whether regulatory bodies are independent and credible, demonstrate enforcement powers and adhere to global standards of best practices for risk control.

Moody's assessment of the regulatory environment in Mongolia reflects the improvement in the regulatory regime since the banking crisis in the 1990s. The regulator--Bank of Mongolia, since then, has issued series of regulations in areas such as bank licensing, restructuring, internal control, prudential ratios, on-site examination, as well as more recently corporate governance that are key building blocks for the development of a modern banking system. Moody's also views positively the increasing level of disclosure and transparency sought by the regulator and its efforts to adopt international standards. Nonetheless, the overall banking system is still considered to be weak by global standard and is vulnerable to changes in Monglia's volatile economic and complicated operating environment. More regulation and supervision efforts have to be made, in particular, to help strengthen banks' risk management and corporate governance.

Factor 4: Operating Environment

Trend: Neutral

This factor is also common to all Mongolian banks. Moody's assigns Mongolia a D- for its overall operating environment, incorporating a score of C for the legal system and scores of E for both economic stability and integrity and corruption. The integrity and corruption index is based on data from the World Bank, which ranks approximately 200 countries worldwide.

Quantitative Rating Factors (30%)

Factor 5: Profitability

Trend: Weakening

XacBank has excellent profitability ratios. Net interest margins exceeded 14% in 2005. The three-year average pre-provision profits (PPP) to average risk-weighted assets (RWA) was 6.41%, while net income to average RWA was 3.65%. However, the bank's earnings are highly reliant on loan-interest income. By contrast, its non-interest income accounted for less than 14% of total earnings in 2005. Given the small scale of the bank, operating efficiency has been low.

Furthermore, due to intense competition in the lending business, lending rates in Mongolia have been trending downwards, pressuring XacBank's profit margins. The bank has a score of A with a weakening trend in this factor.

To be more precise on our analysis, we adjusted the bank's risk-weighted assets by assigning a 150% weight to government-related assets, a significant increase from the 0% weighting required by the local regulator. The 150% weighting is consistent with Basel II requirement for assets rated B1, which is Moody's current rating for Mongolian government and central bank-issued local and foreign currency bonds. Because XacBank only has a small investment portfolio in government securities, these adjustments do not have much impact. XacBank's profitability ratios remain comfortably in the A category.

Factor 6: Liquidity

Trend: Neutral

The bank enjoys diversified funding sources from depositors, domestic and foreign financial institutions, and government agencies. At end-2005, loans to deposits measured 120% and loans to funds (loans to deposits + financial institutions funding) exceeded 93%, which is higher than other major Mongolian banks. Short-term assets to total assets were 22%.

However, liquidity management at the bank is still at an early stage, as system and technology constraints limit the bank's capability in liquidity risk management. Furthermore, insufficient development of the domestic capital market and money market, as well as lack of hedging instruments, further constrain the bank's liquidity management. XacBank scores C for liquidity.

Factor 7: Capital Adequacy

Trend: Weakening

XacBank has a solid capital position. Its total capital ratio was 18.7% at end-June 2006, partly helped by an equity raising from shareholders in 2005. Given Mongolia's volatile operating environment, Moody's believes that XacBank needs to keep much higher than the minimum 10% regulatory required total capital ratio to withstand adverse changes. In addition, the growth in the bank's RWAs is much faster than its internal capital formation. Continuous rapid growth of business may therefore need a further capital supplement soon.

Moody's also adjusted RWA as mentioned above. In addition, we assumed a portion of the special mentioned loans (SML) could become NPLs with a certain loss, which need to be written-off from the assets and capital. These adjustments have no impact on XacBank's strong A score in capital adequacy.

Factor 8: Efficiency

Trend: Neutral

Given the small scale of XacBank and its target of the less well-off sections in Mongolia, the operating efficiency of the bank has been low. Its three-year average cost-to-income ratio was 71.4%, which remains high compared to that of similarly-rated peers. The bank scores D in efficiency.

Factor 9: Asset Quality

Trend: Neutral

Asset quality has always been very strong and lending fully secured. Loan concentration is low with XacBank's average loan sized at MNT 760,000 (USD 631). Its NPL ratio was only 0.67% in June 2006. However, as the microfinance sector matures and the bank moves into the SME segment, it is set to evolve towards more mainstream commercial banking, potentially raising concentration risk and may eventually affect its credit quality.

Moody's adjusted the asset quality indicators by including a portion of the SMLs in the NPLs, and also adjusting its capital ratio as mentioned above. Moody's believes there is a reasonable chance for some of the SMLs to become NPLs if the economic cycle turns. However, these adjustments have made little impact on XacBank's strong asset quality score of B+.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a global local currency deposit rating of Ba1 for XacBank. The rating is supported by the bank's baseline risk assessment of Ba2, Moody's assessment of "moderate" systemic support to the bank, and by Mongolia's local currency deposit ceiling (LCDC) of Baa2.

Moody views Mongolia as a "low" support country. The probability of systemic support in the event of a stress situation is judged to be moderate. This is based on XacBank's small-sized national market share of 4% of total assets and loans, and relative importance to the Mongolian banking system.

Foreign Currency Deposit Rating

Moody's assigns a B2 foreign currency deposit rating for XacBank. The rating is constrained by the country's foreign currency deposit ceiling of B2 for Mongolia. Important considerations underlying Mongolia's foreign currency deposit rating are the high degree of dollarization of the Mongolian economy, history of hyper-inflation, narrow economic base, and relative dependence on foreign aid as a source of foreign exchange inflows.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Risk Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

XacBank LLC

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (70%)						**D**	
Factor 1: Franchise Value (7%)						**E+**	**Neutral**
Market Share and Sustainability				**x**			
Geographical Diversification					**x**		
Earnings Stability					**x**		
Earnings Diversification [2]							
Factor 2: Risk Positioning (21%)						**D+**	**Neutral**
Corporate Governance [2]				**x**			
- Ownership and Organizational Complexity							
- Key Man Risk				x			
- Insider and Related-Party Risks							
Controls and Risk Management			**x**				
- Risk Management				x			
- Controls		x					
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information				x			
Credit Risk Concentration	**--**	**--**	**--**	**--**	**--**		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management			**x**				
Market Risk Appetite					**x**		
Factor 3: Regulatory Environment (21%)						**--**	
Factor 4: Operating Environment (21%)						**D-**	**Neutral**
Economic Stability					**x**		
Integrity and Corruption					**x**		
Legal System			**x**				
Financial Factors (30%) [3]						**B-**	
Factor 5: Profitability (4.7%)						**A**	**Weakening**
PPP % Avg RWA	6.41%						

Net Income % Avg RWA	3.65%						
Factor 6: Liquidity (4.7%)						**C**	**Neutral**
(Mkt funds-Liquid Assets) % Total Assets			9.90%				
Liquidity Management			x				
Factor 7: Capital Adequacy (4.7%)						**A**	**Weakening**
Tier 1 ratio (%)	21.20%						
Tangible Common Equity % RWA	21.12%						
Factor 8: Efficiency (2.1%)						**D**	**Neutral**
Cost/income ratio				71.44%			
Factor 9: Asset Quality (4.7%)						**B+**	**Neutral**
Problem Loans % Gross Loans		0.93%					
Problem Loans % (Equity + LLR)	3.28%						
Lowest Combined Score (9%)						**C**	
Economic Insolvency Override						**Neutral**	
Total Scorecard Implied BFSR						**D+**	
Assigned BFSR						**D**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information
[2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral [3] - Financial ratios for three-year average (2003 - 2005)